Does fairness matter in corporate takeovers?

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Abstract

In interviews with the two head negotiators for a buying and a selling company in a Swedish takeover, a fair price was found to play an important role. A stated reason was that the companies wanted to do business in the future. To further test the importance of fairness, 88 graduate students of business administration playing the role of buyers were asked to evaluate selling prices in fictitious corporate takeovers. The results showed that both satisfaction with the offered selling prices and willingness to buy were affected by information about a fair price. Furthermore, the possibility of doing business in the future appeared to have some importance for this effect. © 2000 Elsevier Science B.V. All rights reserved.

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1. Introduction

As mentioned by Kahneman, Knetsch and Thaler (1986a), the absence of considerations of fairness from standard economic theory is one of the most striking contrasts between this theory and other theories in the social sciences. In the standard microeconomic model of the profit-maximizing firm, an economic agent is assumed to be law-abiding but not “fair” – if fairness implies that some legal opportunities for gain are not exploited.

Why would standards of fairness hinder firms from exploiting excess demand? One radical reason is that there is a significant number of cases in which firms, like individuals, have a preference for acting fairly (Kahneman et al., 1986a). Another reason is that transactors are willing to punish an offending firm by withholding their current and future businesses (Kahneman et al., 1986a,b; Okun, 1981). The second reason implies that firms which are acting fairly are actually maximizing their long-run profits and that a firm’s reputation is an asset which can generate future returns (Wilson, 1985; Weigelt & Camerer, 1988).

A definition of fairness appears to depend on how the question is phrased (Harris & Joyce, 1980). What is perceived as fair may therefore vary as a function of individual, contextual, structural, and cultural factors (Cohen, 1991; Leventhal, 1980; Mannix, Neale & Northcraft, 1995). For instance, Deutsch (1975) has argued that there are at least three criteria that can be applied to determine the fairness of the distribution of benefits and burdens – equity, equality, and need.

It has been shown that equality acts as a simple heuristic in many social decisions (Messick & Schell, 1992), especially when the other individual is a friend or someone with whom future interaction is anticipated (Mannix, 1994; Mannix et al., 1995; Shapiro, 1975). On the other hand, if an organization’s culture is oriented toward economic productivity, Deutsch (1975) suggests that it should embrace an allocation norm that will allocate goods to those who have been able to use them effectively. This is the equity principle.

As pointed out by Tornblum (1988), it is common for more than one distribution norm to operate within a group at any time. When relationship or personal development goals co-exist along with economic goals, conflict is likely to arise (Deutsch, 1975; Mannix et al., 1995). Evidence also supports the hypothesis that individuals are more likely to find justice in distribution rules that favor their own position (Messick & Sentis, 1979, 1985). Such an
“egoistic interpretation” of fairness (Messick & Sentis, 1985; Thompson & Loewenstein, 1992) may cause individuals to fail to reach an agreement although negotiating an otherwise mutually beneficial deal. This is because people are averse to settle for what they consider to be an unfair agreement (Loewenstein, Thompson & Bazerman, 1989).

A central concept in analyzing fairness of actions of a firm is a reference transaction (Kahneman et al., 1986b), that is, a transaction characterized by a reference price and by a reference profit. In general it is assumed in descriptive analysis, as opposed to normative or prescriptive, that the outcomes of participants in a transaction are defined as changes relative to a reference state rather than in absolute and objective terms (Kahneman & Tversky, 1979; Tversky & Kahneman, 1992). However, the relevant reference transaction is not always unique. Disagreements about fairness most likely arise when alternative reference transactions can be invoked, each leading to different assessments of participants’ outcomes.

The importance of fairness for firms has been noted for labor and consumer markets (Kahneman et al., 1986a). However, people seem not to object to allowing the highest bidder to buy a painting at an auction or stock in an exchange market since they are highly competitive situations. Another highly competitive situation is corporate takeovers or acquisitions. Here the relation between buyers and sellers is not as repetitive as for consumer goods, nor does there normally exist a listed market price for a company like it does for stocks. Furthermore, an agreement between a buyer and a seller is most likely to be settled first after negotiations.

In economic theory the motives for corporate takeovers are described both at a corporate and an individual level (Donaldson, 1963; Firth, 1991; Larsson, 1990; Steiner, 1975). At a corporate level it is assumed that the motive for a takeover is to create as much value as possible for the shareholders (Rappaport, 1986; Pike & Dobbins, 1986). However, it is easy to imagine that under some conditions individual managers’ interest in maximizing their own utility is negatively correlated with maximizing the shareholders’ wealth (Larsson, 1990). For example, there is a positive correlation between wages (and status) for top managers and the size of a company, whereas the correlation between size and profitability is not always positive (Firth, 1991). The question addressed in this article is if there exist other, more complex, motives in corporate takeovers than profit-maximization? More specifically, it is asked whether fairness matters in corporate takeovers?
2. Study 1

The aim of Study 1 was to investigate the possible role of fairness in a corporate takeover. In order to do so, interviews were conducted with the head negotiator of a Swedish company that recently had acquired another Swedish company approximately worth $10 million. With the buyer’s permission, the head negotiator of the selling firm was also interviewed. Both interviewees had a documented experience with takeover negotiations.

It was explained to the interviewees that the negotiation process in connection with corporate takeovers was the focus of the study. Both parties approved to be interviewed in this matter if anonymity was guaranteed. The interviews with the head negotiator from the buying and selling companies respectively were semi-structured and took approximately 2.5 hours each. They were tape-recorded and transcribed.

2.1. Results and discussion

The interviews revealed that the head negotiators from the buying and selling companies, respectively, were acquainted with each other. In the beginning of the negotiation, both parts had expressed a mutual delight of having a chance of doing business together. However, in retrospect neither of them thought that the fact that they were acquainted had any influence on the final price of the deal, even though both parts explicitly stated that they probably would have negotiated a better deal if they had been tougher.

In the beginning the negotiators had mutually agreed on engaging an accountant for an independent valuation of the company in question. Irrespective of what the accountant would come up with, they had agreed that this valuation should be the point of departure for the continued negotiations. The cost for the accountant was thereafter divided equally between the selling and buying companies. They further explained that they thought that this procedure was fair, as well as the negotiation process and the final price, and that it was very important that both parts perceived it this way. They saw it as generally important, not only for this particular takeover. Their explanation was that they otherwise were afraid that it should be known that they were unfair and, as a result of that, that they would not be able to find as many other potential companies to buy or sell in the future.

The negotiation process was described as open and trustful. The two parties shared all necessary information with the exception of their initial reservation prices. The seller’s reservation price did however increase during
the negotiation process. Similar results have been obtained in experiments, showing that a buyer’s reservation price changes depending on added information, such as changes in beliefs about the market price (Kristensen & Gärling, 1997a,b).

The increase of the seller’s reservation price, from the equivalent of US$8.0 to $9.0 millions, was partly due to the valuation made by the independent accountant. The seller’s reservation price increased further from $9.0 millions to approximately $10.0 millions because their Best Alternative To Negotiated Agreement (BATNA; see Fisher & Ury, 1981) became more explicit. The seller received an offer from another potential buyer, $1.0 million higher than the negotiated offer which, however, at that time was not a formally settled agreement. On the other hand, the new potential buyer was, due to time constraints, not able to finish a deal before the end of that year, making their offer slightly less advantageous because of a planned increase of the corporate taxes. The seller informed the buyer of the situation and chose not to conduct parallel negotiations, even though there was a possibility of making a better deal with the other potential buyer.

These reported findings seem to support Kahneman et al.’s (1986a,b) and Okun’s (1981) suggestions that transactors are willing to punish an offending firm by withholding their future business. That is, a firm acts in a fair way because it is afraid of punishment in the future. This may be especially important in Sweden where the domestic market for corporate acquisitions is so small that a majority of potential actors are explicitly or implicitly acquainted, making fairness more important than elsewhere.

3. Study 2

In order to further investigate whether or not fairness matters in corporate takeovers, a simulation experiment was conducted with graduate students of business administration (MBA students) playing the roles of buyers of a company. The subjects rated their satisfaction with offered selling prices and indicated whether or not they would buy. Before being offered the prices, they were given valuation intervals, assumed to have been estimated by an expert, together with fixed reservation prices and aspiration prices, assumed to have been decided by the board of directors. Half of the subjects also received information about either a high or low fair price determined by the valuation expert, whereas the other half received no such information. All subjects also obtained information about the seller. Half of them were told
that they expected to do business with him or her in the future, whereas the other half were told that they did not. The offered selling prices varied within the valuation interval from lower than the aspiration price to higher than the reservation price. As a consequence, the difference between the offered selling prices and the fair prices also varied.

By letting subjects rate their degree of satisfaction with the offered selling prices, it was possible to establish a "social utility function" which specifies the level of satisfaction with outcomes to oneself and others (Loewenstein et al., 1989). Such a social utility function permits comparison with other theories, for instance, prospect theory (Kahneman & Tversky, 1979; Tversky & Kahneman, 1992) which posits a utility function defined on outcomes to oneself only. This theory also makes specific behavioral predictions in similar situations. In accordance with prospect theory, in previous research (Kristensen & Gärling, 1997a,b; White, Valley, Bazerman, Neale & Peck, 1994) it has been shown that a buyer’s reservation price often operates as a reference point in price negotiations so that paying a price higher than the reservation price is perceived as a loss whereas paying a price lower than the reservation price is perceived as a gain. If fairness is important in corporate takeovers, information about a fair price may also have an influence on buyers’ ratings of satisfaction with an offered selling price as well as their rated willingness to buy at that price. In the experiment it was expected that a high fair price would cause buyers to perceive offers to be more satisfactory whereas information of a low fair price was expected to cause them to perceive offers to be less satisfactory. An anticipated future interaction between buyers and sellers was furthermore hypothesized to increase the effect of a fair price.

3.1. Method

3.1.1. Subjects

Eighty-eight MBA students participated in return for payment. On an average they were 24.6 years old (S.D. = 3.7) with 2.3 years of working experience (S.D. = 3.0). An equal number of subjects were randomly assigned to each of four groups.

3.1.2. Procedure

Subjects answered a brief questionnaire in class. In the questionnaire they were asked to imagine that the board of directors in the company where they were employed had asked them to evaluate the possibility to buy other companies. They were then presented information about 22 fictitious com-
panies on separate pages in the questionnaire. All subjects were told that their company had engaged a valuation expert who had provided them with estimated values for each company.

The estimated value of each company was indicated as an interval with the explanation that it varied depending on which valuation method was used. This valuation interval corresponded to an value index between 100 and 170 for each of 11 intervals. The lowest valuation interval was $3.0–$5.1 millions, which was increased in 10 steps by $0.6 millions to the highest valuation interval $9.0–$15.3 millions. Each subject was presented with two different companies for each valuation interval.

For each of the 22 companies presented in the questionnaire, subjects were also given a reservation price (the highest price they could pay) and an aspiration price (the lowest price they thought the seller would settle for). These prices were held constant for each of the 11 valuation intervals, corresponding to an index of 160 (reservation price) and 115 (aspiration price), respectively.

All subjects were then presented with an offered selling price from the hypothetical seller. These prices were varied in 11 steps, equivalent to an index between 110 and 170, for each of the 11 valuation intervals. The offered selling prices were counterbalanced so that subjects received different prices for each valuation interval. The presentation order of the companies was individually randomized.

For each company, half of the subjects received information about which price the valuation expert thought were a fair price, whereas the other half received no such information. This fair price was high (equivalent to index 140) for half of the companies, low (equivalent to index 125) for the other half of the companies with the same valuation intervals. The subjects who were given information about a fair price were told that the surplus of the takeover was, at that price, divided equally between the buying and the selling firms. For the buying firm this meant that the takeover would result in larger profits in the future, and the selling firm would invest the purchase-sum in its core business to generate larger profits in the future. Half of the subjects in each subgroup were asked to imagine that they anticipated to do business with the seller in the future, whereas the other half of the subjects were asked to imagine that they should not expect to do any business with the seller in the future.

All subjects were requested to first rate how satisfied or dissatisfied they would be with the offered selling price on a scale ranging from 10 (very unsatisfactory) to 90 (very satisfactory) with a midpoint of 50 (neither
satisfactory nor unsatisfactory). Thereafter, they were asked to indicate how likely they were to buy the company at the offered selling price on a 6-point scale with verbally defined steps (almost certainly, very likely, rather likely, rather unlikely, very unlikely, and almost certainly not).

3.2. Results and discussion

The ratings of satisfaction with the offered selling price were transformed by subtracting 50. The ratings of likelihood to buy were converted to a scale ranging from −3 (almost certainly not) to 3 (almost certainly). A positive value therefore represents a positive evaluation (gain) and that subjects are likely to buy, while a negative value represents a negative evaluation (loss) and that subjects are not likely to buy. All statistical analyses were performed on averages across the different levels of the offered selling price.

Fig. 1 shows that there were differences depending on whether subjects knew the fair price, and whether the fair price was high or low. As may be seen, both the ratings of satisfaction and indicated willingness to buy decreased with increasing price level. However, both when subjects were informed about the high and low fair price, the slope of the decrease was steeper above and flatter below the fair price. This observation was substantiated by a 2 (expectation of future business or not) by 2 (information about a fair price or not) by 2 (high or low fair price) by 11 (price level) analysis of variance (ANOVA) with repeated measures on the last two factors followed by trend analyses. For both the dependent variables, the linear and quadratic trends associated with price level were highly significant, $F(1, 84) = 914.52, p < 0.001$, and $F(1, 84) = 48.89, p < 0.001$, for the ratings of satisfaction, and $F(1, 84) = 773.47, p < 0.001$, and $F(1, 84) = 69.66, p < 0.001$, for the ratings of willingness to buy, respectively. Furthermore, statistically confirming the effect of fair price, the quadratic trends associated with the interaction between price level and high or low fair price were significant, $F(1, 84) = 35.76, p < 0.001$, for the ratings of satisfaction, and $F(1, 84) = 16.49, p < 0.001$, for the ratings of likelihood to buy, respectively. Similarly, the quadratic trends associated with the interaction between price level, high or low fair price, and whether subjects were informed about a fair price were significant, $F(1, 84) = 41.65, p < 0.001$, for the ratings of satisfaction, and $F(1, 84) = 22.18, p < 0.001$, for the rated likelihood to buy, respectively. Not fully supporting an effect of future business, only for the ratings of willingness to buy, the quadratic trend associated with the interaction between price level and whether subjects
expected to do business with the seller in the future was significant, $F(1, 84) = 4.23$, $p < 0.05$.

In conclusion, the results clearly showed that buyers’ utility function was affected by information of a fair price. However, it seems likely that they were
more interested in that they themselves were not being treated unfair (steeper decreasing social utility for buying at a price higher than a fair price) than treating others unfairly (flatter increasing social utility for buying at a price lower than a fair price). Thus, for buyers the induced social utility function implicates that any given monetary change in price higher than a fair price causes a larger change in social utility than an equally monetary change in price lower than a fair price. A behavioral prediction from these results is that a negotiator in the role of buyer is expected to show a more risk seeking behavior for offers higher than a fair price, and a more risk averse behavior for offers lower than a fair price. A risk seeking behavior would be equivalent to continue the bidding process in hope for greater successions in the future, and a risk averse behavior would be equivalent to accepting the opponent’s offer (Neale & Bazerman, 1991).

4. General discussion

The results of Study 1 are inconsistent with the standard microeconomic model of the profit-maximizing firm which assumes that an economic agent is law-abiding but not fair. Furthermore, in the standard microeconomic model it is assumed that prices paid in markets are “fair” per definition (Zeithaml, 1984; Kaufman, Ortmeyer & Smith, 1991). That is, if a buyer and a seller reach an agreement, then the price is fair, as long as none of them breaks the law. Contrary to these assumptions, the two head negotiators who were interviewed in Study 1 emphasized the importance of fairness in corporate takeovers. In line with Kahneman et al. (1986a,b) and Okun (1981), their stated reason was that they were afraid it would be known that they were unfair in business, and that they as a consequence would run the risk of being excluded from buying and selling companies in the future. In a small market such as Sweden this may be even more pronounced.

Another determining factor may be that the culturally transmitted values in a society also influence business. It is likely that learned rules and norms in a particular culture or society also influence negotiations in connection with corporate takeovers as it influences many other activities. Fairness, usually defined as equality, is a very prominent norm in the Swedish society (Biel, Eek & Gärling, 1996). A question that therefore needs to be raised is whether or not fairness in corporate takeovers matters on other markets than the Swedish?
The findings in the case study interviews were corroborated in Study 2 featuring a simulation experiment with students playing the roles of buyers of a company. Not surprisingly, the results showed that their ratings of satisfaction and willingness to buy decreased with an increasing price level. However, when they were informed about a fair price, the slope of the decrease was steeper above and flatter below the fair price. These differences were found in both groups receiving information about the fair price, although the differences were slightly more pronounced when subjects were asked to imagine that they would do business with the sellers in the future.

It may however be noted that in Study 2 the fair price was clearly not the only consideration. If it had been, one should expect that the “social utility function” (Loewenstein et al., 1989) would have had a maximum rather than being monotonically decreasing with the price level, as expressed in both the ratings of satisfaction and willingness to buy. Yet, a strong effect of fairness is indicated in Fig. 1 for the ratings of satisfaction when comparisons are made with the aspiration and reservation prices. The latter are hypothesized to play important roles in negotiations, both as witnessed by previous empirical research (Carnevale & Pruitt, 1992; Kristensen & Gärling, 1997c) as well as assumed in normative or prescriptive theories (Raiffa, 1982). One should expect that an offered selling price equivalent to the reservation price would be the point where the ratings of satisfaction intercept the zero-point on the satisfaction scale. Consistent with this, earlier studies (Kristensen & Gärling, 1997a,b; White et al., 1994) have shown that a reservation price is a dominant reference point. However, in all groups in Study 2 the intercepts for the ratings of satisfaction with the offered selling prices are approximately midway between the aspiration price and the reservation price, that is, in the middle of what the subjects believe to be the negotiation zone (Raiffa, 1982). It therefore seems as if buyers were more interested in comparing their own outcome with the hypothetical sellers’ outcome than increasing their own utility, that is, accepting offered selling prices below their reservation price (Neale & Bazerman, 1991). It has been found that equality is a prominent heuristic for allocating resources (Messick & Schell, 1992). The present results suggest that it may be practiced even in highly competitive situations as corporate takeovers.

A limitation of the present findings is that they are based on a single case study. However, the results were corroborated in an experiment with simulated corporate takeovers. It is true that even though the students participating in the experiment were academically trained in an equivalent way to the corporate negotiators in the case study, there are important remaining
differences between them and the professional negotiators who in the case study closed a $10 million deal. While the subjects were motivated to participate in the experiment, the stakes for the professional negotiators were clearly much higher. Furthermore, there is of course a difference in complexity between real and simulated corporate takeovers, which also limits the possibility to generalize the findings. Yet, the present approach featuring concurrent laboratory and field studies has been advocated as the most fruitful one in research on strategic management (Duhaime & Schwenk, 1984).

To summarize, the results clearly suggested that fairness matters in corporate takeovers, although it is not the only consideration. Yet, further research is needed. Such research both needs to confirm the present finding that buyer’s social utility function is affected by information of a fair price as well as to test the behavioral predictions that follow, such as, for instance, different degrees of risk seeking below and above the fair price. It cannot strictly be concluded that information of a fair price will have an effect on the outcome of a single price negotiation. An additional question that therefore remains to be answered is what impacts a fair price have on the outcome of a dyadic price negotiation if it does not matter to all parties. For instance, are negotiators concerned with a fair price better or worse off than profit-maximizing negotiators?

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