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The “Market for Corporate Control”

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List of abbreviations

M&A	–	Mergers and Acquisitions
R&D	–	Research and Development
A	–	Assumption

1. Introduction

In a business world characterized by the presence of market imperfections managers very often neglect shareholders' interest and, either due to lack of skills or due to personal interest, fail to manage the firm in a profit maximizing way. Those managers need to be either persuaded by monitoring device or in some cases replaced (Shleifer and Vishny, 1986, p.461). In the latter case, the managers who mismanage their firms and destroy shareholder's wealth driving the stock price down are replaced by more efficient ones, who restructure and reallocate the resources of the undervalued firm. This is facilitated by a managerial labor market (Jensen and Ruback, 1983, p.6), often referred to as the market for corporate control (Manne, 1965, p.112-14), in which other managers outside the target firm compete for the right to take over the corporate resources. This mechanism emerged remarkably during the 1980s, where around 23 percent of all major U.S. companies received a hostile takeover attempt. In addition some firms managed to avoid hostile bids, or in other words bids that are pursued without the agreement of target management, as the incumbent managers restructured the firms making them less attractive targets (Mitchell and Mulherin, 1996, p.198 f.).

The reason for the high hostile takeover rate during the 80s was the so called conglomerate merger wave of the late 1960s, where many companies were engaged in value decreasing diversified acquisitions in order to achieve more growth (Mueller, 1969, p.657 f.). However, after the 1980s the number of hostile takeovers as pointed out by Holmstrom and Kaplan (2001, p.126 f.) declined significantly raising thereby the question regarding the ability of the threat of hostile takeovers to solve the classical principle agent problem. To answer this question a detailed description of the literature regarding the efficiency of the market of corporate control is presented in the first part. In the second part other motives for M&A are presented based on empirical evidence while at the same time the degree to which the market for corporate control is indeed a motive for value increasing takeovers is tested by analyzing the literature regarding the firm's value after a takeover.

2. The disciplinary role of the market for corporate control

As firstly discussed by Berle and Means (1932), a divergence of interest between managers and stockholders is likely to exist in corporations, especially in those that are characterized by diffusely held equity. This implies that firms are encountered with costs, which arise by this deviation of interests, often referred to as "agency

costs". The firms may reduce those agency costs by monitoring and enforcing detailed contracts (Jensen and Meckling, 1976, p.305-60), however, if this internal governance mechanism fails to discipline the management the stock price may decline. More specifically, as argued by Manne (1965, p.112) the stock prices of firms in which managers diverge from profit maximization are lower than they potentially could be. This difference between actual and potential stock prices creates incentives for other managers to take over these firms and operate them in a profit-maximizing way. Thereby an external control mechanism in form of competing management teams is activated and the current management of the firm is threatened to act in the interest of the shareholders. In addition, Jensen (1986, p.328 f.) supports that takeovers alleviate manager principle agent conflicts particularly in firms with significant amount of free cash flow, as in such firms managers often use free cash flow to finance value-reducing acquisitions, rather than pay out it to the stockholders. In his view, takeovers are not only a problem but also a solution, as the threat of hostile takeovers may be designed either to undo preceding unprofitable acquisitions or to prevent future unprofitable acquisitions by target firms.

All in all it can be concluded that the corporate takeover market acts as a "court of last resort" and is an external source of discipline applied when internal control mechanisms are relatively weak or ineffective (Jensen, 1987, p.427). It should be noted that this fits particularly to the Anglo-Saxon countries where the ownership structure is predominantly dispersed in contrast to most of continental European firms which typically have a controlling shareholder, often a family that can block any takeover attempts (La Porta et al., 1999, p.491-513; Holmén and Nivorozhkin, 2007, p.786). For this reason in most of continental Europe there is little or no market for corporate control (Franks and Mayer, 1996, p.165).

3. Efficiency of the Market for Corporate Control

The extent to which the takeover market is an efficient way to solve the principle agent problem has been the research area for a plethora of studies. Many of them advocate the effectiveness of the market for corporate control however a considerable body of the literature questions its efficiency and forms the classical concern of the so-called free-rider problem. The free-rider problem, which is going to be discussed in detail in the following part, is considered to hinder value-increasing takeovers.

3.1 Free-rider problem

Recalling the premise that a firm is owned by many small shareholders, un-negotiated tender offers are usually used to take over a company in a hostile way (Schwert, 2000, p.2612). A tender offer is directly addressed to the shareholders to sell their shares at a specific price, bypassing therefore the target's management. However, in case a firm is primarily owned by many small shareholders the takeover might completely fail. In order to understand the nature of this problem the shareholders' position needs to be further analyzed. The shareholders will not only deny selling their shares below the current market price, but they will also anticipate that the new management or outsider will increase firm value and thus the market price. If they assume that the takeover will be successful, they will demand a premium on the market price. Since the outsider has to pay transaction costs he will not pay a premium that equals the anticipated increased value or post-improvement value. If the premium is equal to the increased value then the outsider would make negative profit because he has to pay transaction costs. But the shareholders on the other hand have an incentive or are not willing to sell their shares at a lower premium than the anticipated increased value. Each shareholder hopes that there will be enough other shareholders overall so that the takeover takes actually place. This means that each shareholder free-rides on the willingness of other shareholders to give up their stakes. This leaves us, as described by Grossman and Hart (1980a, p.42 f.), with the "free-rider problem" that outsiders would never acquire and improve a diffusely held company, because they would generate negative profit. Thus the disciplinary function of the market for corporate control would not be facilitated in such situation.

3.2 Resolution of the free-rider problem

Several solutions have been proposed by the academia in order to mitigate the free-rider problem; however, in order to comprehend those approaches it is crucial to describe the conditions or in other words the assumptions for the existence of the free-rider problem. As proposed by Grossman and Hart (1980a, p. 44 f.) there are five main assumptions for the free-rider problem which encompass the following:

- A1. the bidder maximizes profit and differs from the current management in the ability of running the firm
- A2. the target firm is owned by a large (infinite) number of shareholders and is widely-held i.e. each shareholder is negligibly small and thus will ignore his impact on the outcome of the bid

- A3. the bidder and shareholders are rational and stochastic outcomes of a bid are ignored i.e. a bid only succeeds with certainty if the price to tender equals at least the expected future market value
- A4. unconditional bids, which means that the bidder is willing to buy all shares tendered
- A5. no uncertainty about the firm's future market value i.e. all information is revealed (symmetric information) (see also Grossman and Hart, 1980b)

In order to have a more complete analysis of the resolutions proposed by the literature the above mentioned assumptions will be dropped step by step and for each relaxed underlying assumption the foremost solution or solutions will be presented. By relaxing the assumptions a more extended description of the resolutions will be presented as those will cover also free-rider problem cases in which Grossman and Hart's (1980) assumptions do not occur. It is worth mentioning that the first assumption is considered as mandatory and therefore no attempt will be made to drop it.

Taking the fundamental case that all the assumptions hold, the most suitable resolution to the free-rider problem is the "dilution" of the share value of the non-tendering shareholders as proposed by Grossman and Hart (1980, p.45-47). In this case, for a takeover to take place a profit incentive for the bidder needs to be generated, as without this the bidder will end up with a negative profit due to the shareholders' surplus compensation plus transaction costs for the purchase of their shares. Thus it seems reasonable to conclude that the desired profit incentive will be achieved if the potential free-riders do not gain the total increase in market value induced by the takeover. In practice this approach can be realized by granting the bidder voluntarily the right of benefiting himself on the cost of the shareholders. In other words, after the takeover has taken place the bidder might e.g. issue new shares below the market value, pay a large salary to himself or he could transfer assets below their cost to another firm in his ownership. Therefore, regardless of the outcome of the takeover, this solution makes it relatively unattractive for small shareholders to hold on to their shares. As a result takeovers are facilitated, because the outsider is now able to generate positive profits.

In the case now that *the second assumption* is relaxed and is supposed that the shareholders are not negligible anymore, two different resolutions are described in the

literature. The first widely cited solution is provided by Shleifer and Vishny (1986, p.461-77), who proposed that if the bidder already holds shares of the target firm, he may be able to generate positive profit, despite the fact that he would have to pay the whole anticipated increased share price to all tendering shareholders. The reason for this is that at the same time his personal shares increase in value. At first the bidder has to pay the total surplus and additionally transaction costs which results in a negative profit. Thus depending on the size of his initial stake in the target firm the transaction costs may be offset by the increase of his own shares' value. As a result the bidder generates positive profit and the takeover will actually take place. In case the bidder does not hold any shares large shareholders of the target firm can facilitate takeovers by sharing the abnormal returns on their own shares with the bidder.

Holmström and Nalebuff (1992, p.37-62) also researched the relaxing of the *second assumption* and studied the case of having only few shareholders, who are aware that they can affect the outcome of the takeover. In that case there seems to be no free-rider problem, however, as they argue, when each of the few shareholder owns only one share, the free-rider problem is intensified, since the surplus cannot be split so the tendering is an "all-or-nothing" decision. More specifically, as the number of shares a person holds raises the incentive to tender increases, which mitigates the free-rider problem and thereby leads to an increase of bidder's profit. As Holmström and Nalebuff (1992) further show, even if dilution is impossible and the outsider has no stake in the company, he does not necessarily have to give away more than 50 percent of the surplus. However, this only holds if there is no competition. If there would be more than one bidder this number would significantly decrease.

By relaxing the *third assumption* Bebchuk (1989, p.171-84) studied the case that the bids are under the anticipated increased future market value of the share and he shows that as long as the bid is above the independent targets' share price it may succeed. However, this is only valid for unconditional tender offers. If the tender offer would be conditional the bidder is only obliged to purchase shares if a pre-fixed minimum number is exceeded, that is typically controlling interest (Holmström and Nalebuff, 1992, p.40). By distinguishing between conditional and unconditional bids Bebchuk (1989) relaxes also the *fourth assumption* and he shows that unconditional bids are superior because they offer shareholders the prospect of selling their shares even if the bid fails. On the contrary Holmström and Nalebuff (1992, p.40) conclude that

with an appropriate adjustment in the bid, there is equivalence between unconditional and conditional offers. However, taking failures in bids into account is in contrast to the basic framework of Grossman and Hart (1980) and also to Shleifer and Vishny (1986, p.472) who indirectly assume that all offers made will succeed. Since this is not confirmed by empirical evidence it makes these solutions less consistent (Wong and O'Sullivan, 2001, 169-73).

In the model of Grossman and Hart (1980) it is assumed that the bidder reveals all information to the target shareholders before they make their tendering decision. As a result competitors can enter without having the search costs of identifying such potential targets. With this transparency in information, the takeover is hindered also by the threat of other bidders who will compete with the first bidder, but most importantly by the targets' managers, who have an advantage in retaining the control and restructuring the firm by taking over the bidders' operation plan, because they do not have to pay transaction costs (Fedenia and Thompson, 1994, p.93 f.).

By relaxing the *fifth assumption*, Fedenia and Thompson (1994, p.89-103) show that there is no need for a resolution of the free rider problem when the bidder does not disclose all information regarding the motives of the takeover i.e. under asymmetric information upon the bid announcement. Target shareholders are then left with an expected value of the target firm and the knowledge that the bidder's price is probably less than the true value. The incentive to free-ride is solved by a squeeze-out option (Yarrow, 1985, p.10-12), though it requires to hold a certain threshold of equity e.g. at least 90 percent in the EU (Burkart and Panunzi, 2003, p.17). In other words, if the bid is successful the majority of the shares will be held by the bidder, which means that the minority shareholders will be unable to block a voting that will squeeze them out of the post announcement market value. Instead minority shares expect to be called for less value in a follow-up offer than shareholders would have earned if they would have tendered their shares (Fedenia and Thompson, 1994, p.95). Note that more than 90 percent of all tender offers in the U.S. and the U.K. in 2001 were "any-or-all" offers and included such a follow-up offer to squeeze or freeze out minority shareholders in order to attain full ownership (Gomes, 2001, p.1). This mechanism seems similar compared to Grossman and Hart's (1980a) dilution, except that it is not voluntary. It follows that shareholders have intense pressure to sell their shares at the announcement of the takeover offer and thus the free-riding problem

seems nonexistent (Fedenia and Thompson 1994, p.96). This is also confirmed by Gomes (2001, p.1-37), who examined additionally the free-rider problem in a dynamic setting. In a static environment the bidder is able to gain the entire surplus from the target shareholders, when using take-it-or-leave-it offer conditioned on a freeze out. However, in reality this is clearly not the case because of competition, as the empirical evidence shows (Bradley, Desai, and Kim, 1988, p.3-40). More specifically, in a dynamic setting trading arbitrageurs are allowed to accumulate block of shares, which enables them to withstand the takeover. If the blockholders eventually do not tender their shares, the bidder will not be able to obtain the necessary number of shares in order to obtain a valuable freeze out option i.e. the bidder has to offer a higher preemptive bid. Noteworthy is that in the model of Gomes (2001) large shareholders are not beneficial as they do not help to solve the free-rider problem, which is in contrast to Shleifer and Vishny' (1986) solution. Moreover, as Bagnoli and Lipman (1988, p.100 f.) argue a conditional offer that can include a supermajority rule to facilitate a freeze out may be superior to an unconditional offer that is preferred by Bebchuk (1989).

As concluded by the analysis above, in the dynamic settings of the real market world the free-rider problem seems not as severe as theory predicts because the collective action problem which leads to free-riding is offset by the pressure to tender. However, many EC rules try to solve or lessen the pressure to tender problem, bringing in that way back the free-rider problem. In this context Enriques (2009, p.1 f.) argues that policymakers tend to enact rules that protect present managers or controlling shareholders from the market for corporate control. More specifically, according to Maug (2006, p.355-79) all freeze out rules cause overbidding, because for some shares the bidder is forced to overpay in order to obtain a freeze out option. Since minority shareholders remain with lower-valued shares this leads to inefficiency. A mechanism to restore efficiency is the so-called mandatory bid rule, which forces the acquirer to offer the same price to all shareholders. However, the bidder faces higher costs and therefore the number of successful value increasing takeovers is reduced, which e.g. would typically apply to German firms with controlling shareholders. Therefore, regulation should neither hinder nor promote takeovers i.e. it should be as neutral as possible (Enriques, 2009, p.3). On the contrary the mandatory bid rule would have no effect if the ownership of a firm remains

dispersed as no shareholder would have the bargaining power to trigger overbidding (Berglöf and Burkart, 2003, p.203).

3.3 Further Concerns

As shown by the analysis above, the free-rider problem is the classical concern and at the same time the main argument of those who criticize the efficiency of takeover market as a solution to the principal agent problem. Besides the free-rider problem the empirical evidence raises other concerns that partly support the questioning of the efficiency of the takeover market.

More specifically, according to the literature if the market for corporate control acts as a disciplinary device then a high rate of replacement of incumbent management should be observed while at the same time the probability of turnover incurred by hostile takeovers should be higher compared to friendly mergers. By looking at the empirical evidence, indeed management turnover is very often implied by a hostile takeover. Franks and Mayer (1996, p.167) using a sample of U.K. firms drawn over the period 1985 to 1986 found that in 90 percent of the cases managers were replaced following a successful hostile takeover compared to only 50 percent for friendly mergers. This result is confirmed by Kini et al. (2004, p.1523) who analyzed the U.S. takeover market over the period 1978 to 1988. On the contrary, Martin and McConnell (1991, p.683 f.) using a sample of U.S. firms drawn over the period 1958 to 1984 found that the probability of turnovers does not differ significantly between hostile and friendly mergers.

Moreover, managerial failure implies inefficient allocation of resources, which means that hostile bids should be in theory primarily targeted at underperforming firms. While Franks and Mayer (1996, p.171-77) hardly find such evidence, this view is supported by Martin and McConnell (1991, p.678-82). These conflicting results might be explained by the different research time periods with distinct governance regimes as well as by country-specific differences in regulation. For this reason, Kini et al. (2004, p.1511-50) distinguish between the period 1979 to 1988 and 1989 to 1998 and find overall no relationship between the rate of hostile takeovers and past underperformance. Instead they assume that hostility occurs due to different expectations of future performance or disagreements over the bid price. However, for the earlier period they found significant negative relation between the probability of managerial turnover and pre-takeover performance, which can be primarily explained

by intense hostile takeover activity and less effective internal control mechanisms. Thus the takeover market seemed to serve as an effective substitute disciplining mechanism. On the contrary the results became insignificant for the period of 1989 and 1998 as the hostile takeover activity declined and alternative control mechanisms such as corporate takeover defenses arose.

Among those takeover defenses are the so called “poison pills”, which became increasingly common in the U.S. during the 1990s. In the case of a poison pill, the target company attempts to make its stock less attractive to the acquirer by basically raising its takeover cost. Under certain conditions such as a hostile tender offer, existing shareholders are allowed to purchase shares at a discount diluting in that way the value of the shares already bought by the bidder. As a result, the takeover attempt becomes riskier and more costly, which gives time to the incumbent managers to determine the best course of action (Bruner, 1991, p.1-5). Another powerful anti-takeover practice which was commonly adopted was that of the “staggered boards”. These boards force any hostile bidder to complete the deal and gain control formally far apart in time that is usually at least 3 years. Particularly together with a poison pill, a staggered board is one of the most powerful takeover defenses (Bebchuk, Coates and Subramanian, 2002). However, it is worth mentioning that shareholder activists have been recently successful in eliminating poison pills and likewise staggered boards (Akyol and Carroll, 2006, p.1; Favole, 2007). Another more indirect defensive mechanism which reduces the likelihood of becoming a takeover target is size, which implies that larger firms are unlikely to feel the disciplinary impact of the market for corporate control (Dickerson et al., 2003, p.337-57).

In other words, the given examples of defensive mechanisms may act as a protection shield for the incumbent managers to continue mismanaging the firm thereby undermining the efficiency of the market for corporate control. On the contrary, Offenberg (2009, p.66-79) for the period 1980-1999 shows that larger firms are more likely to be the target of a disciplinary takeover which may be explained by the fact that many large firms became too large and complicated to be efficient during the conglomerate merger wave of the 1960s (Jensen, 1987, p.429). A potential bidder could also initiate a “proxy fight” to bypass defensive barriers, which is normally a suboptimal alternative to a hostile takeover. In a proxy contest, the acquirer would try to persuade the shareholders to vote out the firm’s board of directors in favor of a

team that will approve the bidder's takeover attempt (Manne, 1965, p.114 f.; Shleifer and Vishny, p.472). However, a further analysis would go beyond this report.

Moreover, it is notable that even if those defensive mechanisms fail and the management faces the threat of takeover, managers might not act in a maximizing manner. As Stein (1988, p.61-78) shows takeover pressure might force managers to boost short-term profit, neglecting thereby long-term share value maximizing projects. The empirical evidence for such myopic behavior is mixed, as Hall (1994, p.110-143) fails to support that takeovers caused reduction in R&D, whereas Hitt et al. (1991, p.1084-119) did find R&D falling post merger.

As a conclusion it is worth mentioning that not only the above mentioned defensive mechanisms have evolved, but also the internal control devices have become relatively more effective. As a result the market for corporate control's role as a source of managerial discipline has dramatically mitigated from the 1980s to 1990s (Kini et al, 2004, p.1511-50).

4. Other causes of takeovers

From the analysis above it can be concluded that the market for corporate control, despite its inefficiencies, represents a fundamental reason why takeovers take place. However, a takeover is not always hostile and thus the motives are not restricted only to the above one.

4.1 Synergy

A motive which is very often intuitively associated with mergers is the potential benefits that firms enjoy after the merger. Those benefits may refer to a number of factors such as market power (e.g. purchasing power) or efficiency (e.g. economies of scales). In contrast to the market for corporate control those synergistic mergers are more likely to be friendly transactions among managers who want to cooperate (Mueller and Sirower, 2003, p.375).

4.2 Managerial Discretion

Both the market for corporate control and the synergy are neoclassical hypotheses as they assume that mergers increase efficiency and maximize shareholders wealth. On the contrary the managerial discretion hypothesis posits that managers pursue their own objectives that are usually not in the interest of the shareholders (Gugler et al., 2005, p.18). The utility function of a manager depends generally on his salary, status

and the level of security, which can be best maximized through a policy of growth and the fastest way to achieve this is M&A (Marris, 1964; Mueller, 1969, p.644-48). Managerial discretion is particularly severe in boom phases when the discipline of the stock market is reduced due to a higher likelihood of over-optimism in the market. However, investors need to be convinced that share prices will increase after the takeover. This can be achieved by giving them “excuses to believe” e.g. synergies (Galbraith, 1961, p.8). Under normal conditions announcing an unprofitable merger would result in a large decline of the market price preventing managers from undertaking such deals. But during a market boom investors are overoptimistic so that the costs from announcing unprofitable mergers are lowered increasing in that way the incentive to engage in value-decreasing mergers (Gugler et al., 2006, p.15-17).

4.3 Hubris

Hubris can be defined as “overoptimism or irrationality on the part of the managers of the acquiring firm” and is not directly a motive for takeovers, but “rather a potential factor affecting the size of the bid in a merger” (Mueller and Sirower, 2003, p. 376). That means that hubris is additive to the above mentioned motives. The hubris theory is based on the winners’ curse in a common value auction. There is a potential gain, when winning the auction (acquiring a firm), but bidders do not know exactly the size of this gain. Though, the target firm has the same value to every bidder, the expectations of future profits may differ. The winner thus has the most optimistic expectations of future profits and might bid more than the actual gain destroying thus its shareholders’ wealth. Although rational managers are well aware of the winners’ curse, they may suffer from hubris and bid incautiously as they believe that they are better than other managers in spotting value-generating merger opportunities (Roll, 1986, p.197-216, Mueller and Sirower, 2003, p.376).

5. Empirical evidence on the outcome of the takeover market

After comprehending the other motives for M&A and especially the hubris, it is important at this point to test whether indeed after a hostile takeover the shareholder’s wealth increases. In other words it is crucial to test if the shareholders have positive gains when the market for corporate control works properly as a motive of M&A.

Mueller and Sirower (2003, p.373-91) examined the above mentioned motives of takeovers by measuring the average returns to the acquiring firms’ shareholders drawn on a sample of 168 U.S. mergers from 1978 to 1990. The strongest support

was found for managerial discretion and hubris, while only some support was found for the market for corporate control. The synergy hypothesis, however, was primarily rejected. The implication of those results is that the bidder may be able to increase efficiency, but at the same time may suffer from hubris which results in an overpayment for the target firm and offsetting of the positive gains. This is further supported by Malmendier and Tate (2008, p.20-43), who found a significantly more negative market reaction for overconfident managers than for non-overconfident managers. However, as a conclusion it is important to note that overall the literature supports the market for corporate control as a mechanism to generate value. In other words, there is indeed an increase in the shareholders' wealth after the takeover. Indicative is Loughran and Vijh's (1997, p.1784 f.) study, which found that abnormal returns around the announcement date of 24,5 percent rose to 126,9 percent 5 years after the hostile takeover, though their results are rather high in comparison to other studies (see e.g. also Higson and Elliot, 1998).

6. Conclusion

The above report has provided some important insights into the concept of market for corporate control, and after giving a brief description of the term it focused on the efficiency of the concept as well as on its importance as a motive for M&A. The market for corporate control can be seen as a "court of last resort" (Jensen, 1987, p.427) when internal governance mechanisms fail to solve the principle-agent problem. However, although the market for corporate control has great potential as an alternative mechanism, it may work inefficiently mainly due to the free rider problem and the takeover defenses. The possible solutions to this problem, as proposed by the literature are of great importance, however, the lack of consensus in the empirical evidence as another concern highlights the need for further empirical investigation.

Finally it is worth noting that after the 1980s internal governance became more efficient and takeover defenses evolved. As a result the activity in hostile takeovers declined significantly and the takeover market played a reduced role as a source of managerial discipline. However, defensive mechanisms have been recently lowered due to shareholders' activism and in the aftermath of the recession, low share prices may attract potential bidders. Therefore, it cannot be excluded that a new hostile merger wave will reemerge and in that way the necessity of the market for corporate control as a wealth enhancing mechanism to restore efficiency within a firm.

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