Hostile takeover defenses that maximize shareholder wealth

Article *in* Business Horizons · February 2004

DOI: 10.1016/j.bushor.2004.07.004 · Source: RePEc

John A Pearce
Villanova University

Hostile takeover defenses that maximize shareholder wealth

John A. Pearce II
Endowed Chair in Strategic Management and Entrepreneurship, Villanova University, Villanova, Pennsylvania (john.pearce@villanova.edu)

Richard B. Robinson, Jr.
Professor of Strategy and Entrepreneurship, University of South Carolina, Columbia (robinson@sc.edu)

Companies enact defenses against hostile takeovers to protect their independence and current management initiatives, or to help ensure that hostile bidders are pressured to present their best offers. The critical challenge for executives is to determine—in anticipation of attacks on their firm—which defense strategies will best fortify stockholder investments. To provide a basis for determining recommendations, this article reviews the motivations for hostile takeovers, discusses the effects of popular defenses, and showcases several high-profile takeover bids, all designed to provide executives with well-reasoned and empirically supported evaluations of the major strategies they can use to maximize shareholder wealth.

Executives almost universally accept the goal of maximizing their company's shareholder wealth. However, like many philosophical positions, this intention is easier to embrace than to pursue. Specifically, when a firm faces a hostile takeover attempt, what actions should its executives take in the best interest of their shareholders?

In contrast to friendly takeovers, when the bidder's proposal receives a positive reaction from the target's executives and board of directors, hostile bids are unsolicited offers that challenge the strategic direction and leadership of the company. Facilitating the takeover may result in short-term share appreciation, but the associated loss of the company's strategic agenda or governance team may result in longer-term stock price declines.

Alternatively, by maneuvering to defeat the takeover, the firm's executives may produce modest stock value increases as other investors gain a heightened understanding of the firm's strengths. However, such actions may deprive stockholders of a rare opportunity to bolster their returns as a result of a pursuer's special interest in the company.

Resisting an initial offer may also have value even if the eventual takeover seems likely if it forces the pursuer to sweeten the offer. Of course, such resistance may also discourage a suitor that believes the target has priced itself out-of-reason, thereby depriving the stockholders of an attractive one-time market premium.

Complicating the issue of the appropriateness of defenses in the face of hostile bids is the issue of executive self-interest. Investors and analysts are always suspicious of executives' motives when they oppose a hostile bid. The question that inevitably rises is, "Are the executives trying to save their jobs at the expense of wealth gains for their shareholders?"

Hostile takeover strategies have recently found new devotees. The economic recession that began in the United States in March 2001 spurred a rise in such activity. According to Thornton (2002), the value of hostile takeovers climbed to $94 billion in 2001, more than twice the value in 2000, and almost $15 billion more than in 1988, the previous peak year. The weakened economy renewed interest in these takeovers as a corporate growth strategy because industry leaders can use consolidation during such times to maintain their dominance. Lesser competitors become especially vulnerable to attack because of their declining market performance and falling stock prices. Thus, prevailing conditions make the competitive timing especially propitious for corporations with large cash reserves or attractive borrowing positions to forcibly acquire companies at discounted prices.

A major change in accounting rules is also stimulating the rise in hostile takeover bids. In July 2001, the Financial Accounting Standards Board (FASB) eliminated the need to amortize goodwill, which had been a barrier to hostile takeovers because it diluted earnings of combined firms. Since then, companies are finding it more profitable to target an expanded list of competitors, particularly in industries built on human capital and knowledge assets.

Other motivations explain why particular companies become the targets of unwanted advances. For example, during periods of falling stock prices, corporate strategists search for underused assets in competing companies, and try to seize opportunities to increase their firm's financial leverage through an acquisition, or to accelerate a diversification strategy.

Thus, it is no wonder companies are enacting hostile takeover defenses at unprecedented rates to protect corporate independence and current management initiatives, as well as to help ensure that hostile bidders—if successful—are pressured to present offers that most benefit shareholders. To provide a basis for determining how best to do this, we review the motivations for hostile takeovers, discuss the effects of popular defense strategies on shareholder wealth, and showcase several high-profile takeover bids as examples of outcomes that executives might expect.

The evidence for the conclusions reached here comes from dozens of sophisticated, statistically elegant research studies of hostile takeover attempts—studies conducted by scholars who worked independently to build a unifying theory of competitive dynamics. Because each research project contributes only incrementally to our understanding, each piece must be reconciled with others so that the total dynamic of hostile takeovers can be understood. Toward this end, this article takes an integrative perspective on the huge volume of published research to provide a consensus assessment of the best defenses for maximizing shareholder wealth.

Takeover motivations and mechanics

One company may seek to acquire another to expand product breadth, geographic scope, or customer base. Or it might want to expand horizontally or vertically, diversify into related or unrelated product markets, pursue undervalued resources, or manipulate financial indicators, including risk profiles, performance variability, and financial leverage. Whatever the reason, when the two parties fail to share the belief that a merger would be equally beneficial, the target firm can capitulate, or it can resist the unsolicited advances of the suitor.

A hostile takeover attempt thus represents a battle for corporate control. Most commonly, it involves an outside entity, usually a corporation, making a tender offer to shareholders of a target firm. Directly approaching the company's shareholders—intentionally skirting the executives and the board of directors—the uninvited pursuer usually makes an offer for their stock that includes a premium above the market price. The aggressor's offer may be for any and all outstanding shares, or for some criterion amount that will give it controlling interest in the target.

The acceptable level of ownership for an aggressor varies greatly. Some takeovers are accomplished by buying 10 and 20 percent of the outstanding shares, when this block's voting power can sway the target's board of directors. Often, a controlling majority of 51 percent is sought. Occasionally, outright ownership is achieved by buying all of the target's shares outstanding. In any case, once the attacker has acquired a sufficient ownership position to exercise control, it may implement any strategy it prefers, including an integration of the two firms or a divestiture of the target's assets, in whole or in part.

Because takeover bids offer stockholders a premium for their shares, hostile defenses are sometimes viewed as barriers to increased shareholder wealth. In fact, some shareholders whose executives succeed in defeating a takeover attempt have suffered significant losses. Nevertheless, at times the executives of a target company feel compelled to defend it. Among the most common rationales for fending off suitors are the desire to retain autonomy or management control, the preference for an alternative partner, the belief in a traditional mission that would be compromised by new management, and the desire to negotiate a more favorable financial takeover. Almost certainly there will be major restructuring in a company acquired through a hostile offer—usually on a much larger scale than the activities undertaken after friendly takeovers. Divestitures of business units, extensive layoffs, and major changes in strategic direction are common consequences, as are disruptions in the communities in which the firm operates.

Executive motivations are pivotal

There are two opposing views of the reasons for defending against hostile takeovers. The first, according to DeAngelo and Rice (1983), argues that defenses promote the interests of the target firm's shareholders by raising takeover premiums, improving management, or protecting the firm's long-term strategy. In many cases, the pursuers' interests are not aligned with the best long-term interests of the targets' stockholders and a defense is warranted. For example, an acquired firm may be openly pursued with the plan that it be dismantled and offloaded in pieces, often to the detriment of its employees, brand equity, customer welfare, and other non-balance sheet assets.

The other perspective on takeover resistance argues that some executives of target firms advocate defenses simply to maintain their power positions and compensation levels with the company, fearing an ouster by any new controlling interests. As such, their actions do not necessarily reflect the best interests of stockholders. In fact, claim Byrd and Stammerjohan (1997) and others, evidence suggests that executives' efforts at self-preservation—rather than shareholder value maximization—can result in significant negative returns for shareholders.

If the bid is prompted by the target's recent poor performance, then a hostile takeover has again served as the market's most powerful mechanism for disciplining executives.

Investors may worry that the executives' desire to retain control of the company is their fundamental concern. As de facto agents of the stockholders, executives enjoy broad discretion in organizational decision making. Although such decisions are the legal province of owners, they are effectively abdicated to the executive group. Because the dispersed stockholders lack knowledge of and interest in the firm's day-to-day operations, they have no effective mechanism to monitor or discipline executives who do not represent their best interests. Consequently, executives exercise considerable autonomy, even when their decisions compromise the stockholders' interest in maximizing wealth.

The differences in executive motivation for raising a takeover defense have profound implications for stockholders. Because defense types vary in their effect on shareholder wealth, executive motivation is an important predicate of the consequences of an implemented defense.

Suspicions for executives to overcome

Executives strongly influence the board members who make decisions on behalf of shareholders. If their incentives are not perfectly aligned with those of shareholders, say Jensen and Meckling (1976), they may be tempted to add personal criteria when evaluating the attractiveness of a takeover offer and in presenting their recommendations. In a frequent manifestation of this problem, investors worry that self-interested executives garner support for strategic options—including the decision to support or oppose hostile takeover bids—to improve their own well-being or wealth, thereby subordinating the priority of shareholders for value. Incentives for this are great. As a simple example, the executives may fiercely defend the autonomy of their company to retain their compensation packages, which typically far exceed the present value of any separation payment to which they are entitled in the event of a takeover.

Executives in the two firms involved in a takeover have much at stake. Those in the bidding company look forward to opportunities to enhance the target's market performance and financial returns for personal and organizational gains. They enjoy increased job security, as evidenced by their board's confidence in their ability to manage a larger and therefore more prestigious company. Moreover, because executive pay and social status generally rise with the size of the firm, they may be tempted to pursue hostile takeovers that expand the firm, even when the financial rewards for shareholders are debatable. At the same time, executives of an acquired target are likely to lose power and status, even their jobs. If the bid is prompted by the target's recent poor performance—which in turn led to a decrease in stock price and suspicions about the efficiency of the executive team—then a hostile takeover has again served as the market's most powerful mechanism for disciplining executives.

In addition to providing strong evidence that hostile takeovers are often disciplinary in nature, extensive research reports that target firms often exhibit poor pre-bid performance, and that there is a high level of turnover among the target's executives once the takeover has been completed. In a large-scale study of firms in the UK, Franks and Mayer (1996) showed that executive turnover is significantly higher in hostile takeovers than in friendly ones. Approximately 90 percent of executives and board members of target companies resigned after the consummation of a hostile takeover, compared to only 50 percent in the friendly ones. Dahya and Powell (1996) found similar numbers of 59 percent compared to 22 percent.

In combination, these factors explain why executives may be tempted to propose the construction of defenses for personal rather than shareholder motives. In such cases, and even when stockholders' and executives' interests align, it is incumbent on executives to present a persuasive, verifiable, and information-based rationale for their opposition to any tender offer. Shareholders should think twice before approving defenses that reward executives. Such defenses have merit, but only in the rare situations when their deterrent effect is viewed as especially potent and their activation is highly unlikely.

Anti-takeover strategies can be classified into two categories: preventive and reactive. Preventive measures are proactive steps taken by executives to make the firm less attractive as an acquisition target. Reactive measures are activated once a hostile attack has begun because the particular suitor is unwanted. The various forms of each are detailed in the following sections.

Preventive anti-takeover strategies

Preventive defenses against hostile takeovers are constructed when executives sense that the company is vulnerable to attack because of its depressed stock price, competitive weakness, market conditions, or financial exigencies. However, such defenses are put into place prior to an actual attack. The commitment to defend against future takeover attacks is important both because preventive defenses take time to construct and because they signal that the board and the executives are united in pursuit of the goal of company autonomy.

Several forms of preventive defenses are discussed here: poison pills, both with flip-over rights and flip-in options; corporate charter amendments; and golden parachutes. Another well-known option—dual capitalization—is conspicuously missing from the list because the issuance of a second class of stock for the purpose of diminishing the voting power of existing stockholders is no longer permitted under a 1988 SEC ruling. Corporations that have already issued such shares are allowed to maintain them due to a grandfather clause in the rule. However, Partch (1987) suggests that dual capitalization has negligible effects on a company's shareholder wealth.

Poison pills

A poison pill is a defense strategy in which the target company offers its stockholders preferred stock in the merged firm—at a highly attractive rate of exchange—as a mandatory consequence of a successful takeover. The logic in adopting such a provision is to dilute the stock so much that the attacking firm loses money on its investment.

Research at J.P. Morgan offers evidence that poison pills benefit target firm stockholders. Since 1997, billion-dollar corporations that have deployed this defense have received an average 4 percent premium at takeover over companies without such a defense. Hundreds of companies have put poison pills in place, especially those whose depressed stock prices do not reflect internal assessments of company value.

In 2001, notes Harbert (2002), 283 companies enacted poison pill defenses, up from 167 in 2000. As an example, Wall Street analysts speculated that Yahoo! was ripe for a takeover given the existing environment of media and Internet company mergers, such as AOL-Time Warner. Consistent with its desire to remain independent, Yahoo! adopted a shareholder rights plan founded on a poison pill provision. The success of this defense secured Yahoo!'s continued independence and allowed it to strike deals with multiple content and distribution providers, rather than being tied to one partner.

● Poison pill with flip-over rights

A poison pill with *flip-over rights* distributes rights rather than shares of preferred stock, issuing them to existing stockholders who can then buy preferred stock at a deeply discounted price. The rights are distributed after a triggering event has occurred, such as when an unwanted suitor acquires a pre-specified percentage of outstanding stock. Using such rights is advantageous in defending a target firm because of the negative impact preferred shares have on a balance sheet. Financial analysts view preferred stock as a fixed-income security. Therefore, issuing it is tantamount to a bond issue or a loan that raises the amount of debt on the balance sheet. Increasing the amount of preferred stock, as is done with a basic poison pill, boosts the firm's financial leverage and thus raises the risk to an unwanted suitor. Under this extremely adverse condition, an aggressor must think twice before initiating an attack.

The major drawback of using flip-over rights is that they are not exercisable unless the bidder acquires 100 percent of the target firm. Many unwelcome aggressors have used this loophole—they gain control of a company but do not acquire it fully to avoid paying the rights. Therefore, such a poison pill is useful only for corporations looking to prevent a full acquisition.

E*Trade Group Inc, an online securities and banking firm, installed a poison pill in 2001, fearing that it was vulnerable to a takeover attempt because its stock price had fallen 70 percent that year. The poison pill plan has flip-in and flip-over rights that are triggered if a hostile buyer acquires a 10 percent stake in E*Trade. Then, if the buyer succeeds, E*Trade stockholders can buy stock in the merged corporation at attractive prices.

● Flip-in poison pills

To prevent unwelcome corporate suitors from acquiring enough stock to take control of the corporation, *flip-in* *poison pills* can be used. With flip-in options, stockholders are given the right to acquire additional shares in the target company at a substantially lower price than the current offering. For instance, All American Semiconductor announced in 2000 that its board had adopted a flip-in poison pill to be activated when a pursuer announced a tender offer that would result in its owning 15 percent of the common stock. At that point, the flip-in rights entitled the holder to purchase shares of the company's common stock having a market value equal to twice the exercise price of the right.

The staggered board tactic serves more as a nuisance to the acquiring firm than a true roadblock.

Most poison pill plans operate like the All American Semiconductor example. For every one share of common stock investors have in the target company, they are issued one right that allows them to purchase one share of the stock during a period of time known as the exercise period, usually ten years in length. Poison pill plans include a triggering event that begins the issuing of the rights to the stockholders—commonly the purchase of, or a tender offer for, a specified percent of the stock outstanding.

Despite the impressive record of poison pills in rebuffing takeover attempts or forcing up the final price of a takeover, executives should prepare their stockholders for some initial unpleasantness. The announcement of a poison pill defense tends to exert minor, short-term downward pressure on the firm's stock price. In a study of 132 firms that announced a poison pill defense, Malatesta and Walkling (1988) found a small but statistically significant negative return within two days of the announcement.

Corporate charter amendments

A common defense against a hostile takeover is a *corporate charter amendment*, which staggers the elections of members to the board of directors of the attacked firm so that all are not elected during the same year. The logic is that a well-established board will be able to fend off an attacker's advances. This anti-takeover measure prevents a corporate aggressor from installing a completely new board of sympathetic directors to facilitate the strategic transition in the aftermath of the takeover.

M&F Bancorp, the parent corporation for Mechanics & Farmers Bank, provides a recent example. In 2000, the company added eight charter amendments designed to defend against a hostile takeover. The filing stated that although there were no imminent threats, the bank felt under-protected in the event of such an attempt. The amendments included eliminating shareholders' preemptive rights and cumulative voting in director elections, granting board members the obligation to consider factors other than price when discussing merger offers, and stipulating that board members can be removed only for cause.

The staggered board tactic serves more as a nuisance to the acquiring firm than a true roadblock. Several studies report that the effects on shareholder wealth of such "shark repellants" are negative, resulting in an average loss of 3 percent. Many board members simply follow the wishes of the new owners in fulfilling their fiduciary responsibilities to shareholders, and new owners typically deal with belligerent boards through litigation if the need arises.

Golden parachutes

Golden parachutes are special, lucrative compensation packages, usually arranged as lump-sum payments of cash, that are distributed to a select group of senior executives if a pre-specified threshold of outside stock ownership—an average of 26.6 percent, according to Lambert and Larcker (1985)—is acquired in a takeover bid. Their primary function in hostile takeover situations is to align incentives between shareholders and executives. The concern is that executives faced with a hostile takeover bid that may lead to the loss of their jobs are likely to oppose the offers, even when the bids would increase shareholder wealth. In support of this rationale, Walkling and Long (1984) found that the probability of executives resisting a takeover bid is directly related to the takeover's effect on their personal wealth. Thus, golden parachutes are intended to help executives resist takeover attempts that endanger their jobs by aligning their wealth more closely with shareholders' interest. Their worth is commonly based on the executive's seniority, position, salary, and number of years of service with the firm.

The extraordinarily high cost to an acquirer of paying off such golden parachute obligations also inhibits some takeover attempts, say Wade, O'Reilly, and Chandratat (1990). For example, in a nasty battle in 2002 between Weyerhaeuser and Willamette, two northwest paper and lumber titans, Willamette tried repeatedly to thwart Weyerhaeuser's takeover attempts. Even though the latter sweetened its tender offer, Willamette retaliated with several expensive initiatives, including pumping up its golden parachutes for executives.

Golden parachutes can serve as a minor deterrent by forcing a bidder to expend a significant amount of cash to settle the obligation. Like staggered elections of board members, this option is often used in conjunction with other methods. However, the costs involved can be attention grabbing. When Starwood Hotels & Resorts acquired ITT in 1997, ITT's CEO received $20 million in cash and stock and an option grant of 162,500 shares of Starwood in exchange for help during the transition, plus $22.5 million to help him pay personal income taxes. Despite the size of the settlement costs, the defense failed. On the other hand, the golden parachute of Northrop Grumman's CEO in 1998 helped scuttle the hostile takeover attempt of Lockheed Martin. It would have required the pursuer to give the ousted CEO a cash payment of $7.8 million, plus stock rights and options worth $16.1 million had the merger been approved.

Reactive anti-takeover defenses

Many firms choose not to construct permanent barriers to hostile takeovers. Believing that shareholder wealth is often best served when a firm is acquired at a premium, they refrain from signaling a lack of receptiveness to being acquired. These firms can find themselves hotly pursued by unwelcome suitors and inadequately protected from undesired takeover. Their dilemma is then one of creating an eleventh-hour defense. Fortunately, there are viable options, including litigation, greenmail, standstill agreements, and capital structure changes.[1]

Litigation

Litigation helps a target company to stall hostile attacks, but is usually not effective as a long-term deterrent. It involves pursuing a legal injunction and restraining order against a pursuer to bar that company from acquiring additional stock until such time as the pursuer can prove legally that the justification for the injunction is unfounded. During the time the pursuer is preparing and presenting its legal rebuttal, the target company usually develops other strategies to prevent the takeover. Litigation is often undertaken for a second motive: to stall proceedings so that more attractive offers can be solicited.

There are three charges a target company can make to legally repel an attacker. The first, antitrust, is the argument that if the takeover effort is completed, the resulting combination will de facto violate US antitrust laws. The second, inadequate disclosure, makes the case that the bidder has not fully disclosed all readily available information. Hartmarx Corporation, makers of Hart Shaffner & Marx and Hickey-Freeman clothing, successfully litigated against a hostile takeover bid from The Lincoln Co., suing it for allegedly violating federal securities laws and for failing to provide adequate information about financing in an effort to stall the takeover efforts. The final argument, fraud, involves the claim by the attacked firm that the pursuer deliberately misrepresented facts for the purpose of depriving stockholders of their rights. A fraud charge is seldom used because it is rarely applicable and hard to prove.

The consequences of litigation defenses are more conclusive than those of other strategies because, according to Jarrell (1985), approximately one-third of all tender offers are challenged by the litigation defense. Sixty-two percent of all such challenged offers precipitate competing bids. Initially, litigious targets lose an average of 0.45 percent on the date of the public announcement of the lawsuit. However, the average final result is a 17 percent premium over the original bid. In contrast, only 11 percent of firms that do not legally challenge receive competing bids. Careful inspection of these cases shows that the value of a lawsuit is its ability to extend the negotiation period before the target firm's board is required to respond. Ensuing negotiations often lead to sweetening of the initial bid and a higher probability of a successful takeover.

Greenmail

An effective and simple method for fending off corporate takeover attacks when the aggressor's goal is short-term profit rather than long-term corporate control is also extremely expensive. Greenmail involves repurchasing the shares of stock that have been acquired by the aggressor at a premium in exchange for an agreement that the aggressor will no longer target the company for takeover. Sometimes referred to as a "targeted repurchase," this type of defense is equivalent to a payoff. Companies should proceed with caution when considering it. The Tax Reform Act of 1986 inflicts a 25 percent tax penalty on the corporation making a greenmail payment. Consequently, greenmail payments have declined dramatically in recent years as a method of anti-takeover defense.

The value of a lawsuit is its ability to extend the negotiation period before the target firm's board is required to respond.

Though not common, greenmail payments do take place. In 2001, Mid-Atlantic held 1.4 million shares of Provident Bancshares Corp. Since acquiring them in 1998, Mid-Atlantic had been a source of constant aggravation to Provident. Finally, Provident announced that it would buy back Mid-Atlantic's 5 percent stake at a premium. Mid-

Atlantic accepted the payment because it lacked broad shareholder support for the takeover and because of Provident's improved performance fundamentals.

The effect of greenmail payments on shareholder wealth is generally, but not necessarily, negative. Bradley and Wakeman (1983) found initial drops in target stock prices, whereas Mikkelson (1991) reported a 7 percent rise in stock price when the attack was repelled. A more recent investigation by Giammarino, Heinkel, and Hollifield (1997) concludes that greenmail results in a loss to stockholders significantly larger than the amount of the payoff unless greenmail is combined with a poison pill. The best conclusion may be that greenmail is an effective barrier and that, in special situations, it helps publicize the previously unrecognized value in the corporation.

Standstill agreements

A *standstill agreement* is a contract between the parties in which the pursuer agrees not to acquire any more stock of the target firm for a specified period of time in exchange for the firm paying the pursuer a fee. Such agreements usually include a clause that allows the target firm the right of first refusal in the event that the attacker decides to sell its portion of stock. This provision gives the target firm the right to keep the shares from being sold to another pursuer that would not honor the agreement.

Comcast's 2001 attempt to buy rival AT&T Broadband produced a demand by AT&T that Comcast sign a confidentiality agreement due to the sensitivity of financial and competitive information. Comcast lawyers contended that hidden inside the confidentiality agreement were clauses that amounted to a standstill agreement because they essentially prevented Comcast both from initiating another takeover offer if AT&T Broadband selected another suitor, and from joining with another company to jointly bid for the AT&T unit.

Research by Gaughan (1996) found that as a result of entering into a standstill agreement, which often signals the cessation of the takeover attempt, stockholders in the target company suffer a decline in value that negates the price boost that follows the announcement of the takeover bid.

Capital structure changes

A firm can *restructure its capital* to defend against a hostile takeover. Four principal options are available: recapitalizing, assuming additional debt, approving the sale of additional stock, or buying back outstanding shares.

Recapitalizing entails paying shareholders a superdividend, primarily financed through the assumption of additional debt. This action causes the firm to look dramatically less attractive from a financial perspective because much of the equity on its balance sheet is replaced with debt. Moreover, it no longer needs the help of a white knight to fend off the unsolicited attack; in essence, it becomes its own white knight. The superdividend paid to incumbent stockholders is usually superior to any bid by the attacking firm, making the takeover offer unattractive.

Recapitalizing also offers the opportunity for executives to gain more control over the firm by increasing "their" voting power. During the recapitalization, the firm can issue shares to be directed to an employee stock ownership plan (ESOP), thereby increasing the number of shares controlled by inside interests. It is important to note, however, that recapitalization requires the approval of all stockholders, not just the board of directors. Defensive ESOPs are strong deterrents to takeovers, and research suggests they do not have a significant negative effect on shareholder wealth.

The executives of some firms might believe it is disadvantageous to pay out a large dividend just to assume a large amount of debt, and that it is more effective to simply *add debt* to the balance sheet. (Typically, these are executives who manage firms with low debt-to-asset ratios, since the attacker can use the target firm's own borrowing capacity to finance the acquisition.) The easiest way for a company to assume such debt is to issue bonds or borrow funds from a lender that can then be used in a variety of ways to keep the debt on the balance sheet. Implementing this defense is time-sensitive because firms contemplating a bond issue must first gain SEC approval, a process that might not happen quickly enough to be effective against a hostile bid. Thus, a firm that anticipates the use of this strategy as a defense can obtain prior approval under Rule 415 of the SEC. Known as the shelf registration rule, this allows a company to issue offerings for up to two years from date of filing.

The third method of capital restructuring is to *issue additional shares*. Although this dilutes shareholder equity, it is effective for preventing corporate raiders from gaining control. The advantage is that it changes the firm's capital structure by raising equity while maintaining the current debt level, forcing the bidder into a costlier battle to buy shares to gain control. A firm needs to be cautious when implementing this method, however. A general issue might allow the pursuer to acquire the shares on the open market. Thus, many firms find it advantageous to issue new shares to allied investors. The management-friendly investor might be a white squire, which, rather than purchasing a majority interest as a white knight would, purchases a lesser interest to block a hostile takeover. More likely, it will be the firm's own ESOP, which may borrow the funds from the corporation itself to finance the purchase. In 1990, when Pennzoil made a hostile takeover bid for Chevron Corporation, Chevron responded by initiating an ESOP in which $1 billion was borrowed from Chevron itself so that 14 million new shares of its stock could be purchased. The creation of additional shares effectively diluted the number available to Pennzoil, guaranteed that insiders controlled the new shares, and ultimately kept Pennzoil from succeeding in its forced merger attempt.

It is important to note that the effect of creating an ESOP on stockholder wealth is not clear when the sole purpose is fending off corporate raiders. Chang (1990) and other studies have found a negative impact. In one assessment, firms that announced the creation of an ESOP for the purpose of defending against an attacker averaged a loss of 5.1 percent ("Use of ESOPs…" 1989). On the other hand, a more recent study by Chaplinsky and Niehaus (1994) concluded that ESOPs effectively deter takeovers and that initial stock price declines that occur when the defensive action is publicly announced are more than offset by higher stock prices for successfully acquired firms.

A target firm may also *buy back existing shares* on the open market in an effort to ward off an attack. This has important advantages. Fewer shares are available to the attacker. And arbitragers who attempt to capitalize on differences between takeover prices and current prices are prevented from controlling shares. (Arbitragers aid corporate raiders in their efforts to generate high returns by selling their shares to the highest bidder.) Buying back shares also has a capital restructuring effect in that the firm uses its own resources to purchase the shares. For example, a firm that is cash rich with very low debt might be considered vulnerable to a hostile takeover. However, if the executives use its cash resources to buy back shares, the firm's attractiveness is diminished and fewer shares are available on the open market.

Caution must be exercised in deploying this strategy because the repurchasing of stock may have the exact opposite effect of what is intended. When a firm decides that it wants to buy back shares, the attacker then has fewer shares to acquire to gain a controlling percentage. Because of this double-edged sword, many companies target stockholders from whom they buy shares.

There are three ways for a firm to repurchase its shares:

1. a general repurchase in which it buys back shares with little regard to who owns them
2. targeted repurchases from shareholders who are more likely to sell their shares to a raider
3. a tender offer for its own shares that would rival any bid made by the raider

In a variation on this final category, the target firm can issue an *exclusionary self-tender*, in which it makes a tender offer for a specified number of its own shares to stockholders other than the instigator of the hostile bid. This approach has the effect of transferring wealth from the attacker to the target firm's shareholders.

The most drastic defense against an unsolicited bid is for a firm to buy back all of its shares and become a private company. Similarly, it can engage in a reverse leverage buyout (RLB) to become private. If executives feel the firm is undervalued in the market, they will use its own resources to buy back its outstanding shares. Often, such RLBs are later presented to the market as IPOs. When former executives of Republic HealthCorp attempted a hostile takeover of Hospital Corporation of America (HCA) in 1987, prompted by the low stock price, HCA executives led the company to escape by selling off 104 smaller hospitals and buying back stock. They then engineered a $5.1 billion LBO that took the health care conglomerate private in 1989. In 1992, HCA completed the hostile takeover defense cycle by publicly selling one-quarter of the company to investors through an IPO. This HCA example is not atypical. In a study of 72 companies that used this strategy, Muscarella and Vetsuypens (1990) found that firms performed better on a post-buyout basis because of efficiency gains, cost cutting measures, and higher revenues.

Overall, the effects of capital structure defenses on shareholder wealth are inconclusive. Each approach—recapitalizing, assuming additional debt, selling additional

Table 1
Hostile takeover defense strategies

Defense strategy	*Category*	*Popularity among firms*	*Effectiveness as a defense*	*Stockholder wealth effects*
Poison pills—plus flip-over rights and flip-in options	Preventive	High	High	Positive
Corporate charter amendment	Preventive	Medium	Very low	Negative
Golden parachutes	Preventive	Medium	Low	Negligible
Litigation—antitrust, fraud, inadequate disclosure	Reactive	Medium	Low	Positive
Greenmail	Reactive	Very low	Medium	Negative
Standstill agreements	Reactive	Low	Low	Negative
Capital structure changes—recapitalization, new debt, stock selling, share buybacks	Reactive	Medium	Medium	Inconclusive

stock, and buying back outstanding shares—logically decreases the attractiveness of the firm as a takeover candidate. Yet because none of these defenses permanently alters the prospects for the firm's competitiveness, the deterrent poses more nuisance than barrier.

A pattern emerges from research on the effects of hostile takeover defense strategies on shareholder wealth. At the time of a target firm's initial announcement of defensive activity, its stock value declines. This is typically a short-run deviation from fundamentals, caused by speculation, confusion, and high levels of information uncertainty. However, the negotiation and auction processes that result from raising a defense typically produce increased bids and higher stock prices, ultimately resulting in a positive revaluation and wealth gains for its stockholders.

Regardless of the success of the attack, the target's stockholders typically benefit when executives actively pursue a defense strategy. In fact, defensive actions produce double benefits: positive wealth effects for stockholders ranging from 9 to 14 percent, and significantly lowered probabilities of bid success with the benefit of job security for the incumbent executives who raise the defense.

However, hostile takeover defenses differ in their effects. As shown in **Table 1**, among the principal preventive strategies, only poison pills have been shown to consistently raise stockholder wealth. The effect of golden parachutes is negligible, whereas the effect of corporate charter amendments is usually negative. Of the four reactive strategies, litigation is likely to increase stockholder wealth, while greenmail and standstill agreements have negative effects. Capital structure changes have mixed effects, but they are almost always so short-term in their duration that they have limited defensive value.

Although situations vary and exceptions occur, research on companies that raised defenses to forestall hostile takeovers provides convincing evidence that their wealth increased as a result. When an unwanted suitor is successfully repulsed, the target firm retains its independence and the profits that its corporate strategy produces. When an unwanted suitor succeeds—as happens in approximately 20 percent of all attempts, according to Raj and Forsyth (2002)—the target firm's defense has nevertheless led to a more thorough assessment of the bid and bidder, an opportunity to negotiate the price with the bidder and possibly others, a chance for other investors to reassess the performance and potential of the target and bid up its stock price or become alternative suitors, and an opportunity for the executive teams vying for corporate control to plead the case for their strategic visions.

The summary conclusion from decades of sophisticated research and analysis is that executives produce wealth for their stockholders when they activate a corporate defense against a hostile takeover. Especially when executives support a poison pill provision to repeal a hostile attack or encourage litigation to extend the negotiation period between the two companies, the defense is likely to boost shareholder wealth. Moreover, because these defenses are largely free of the specter of self-serving executive motivation, they enhance the alignment between the embattled company's stockholders and their corporate leaders, thereby adding to the prospects of success for the firm. ❍

Notes

[1] Three often mentioned reactive defenses are omitted from this discussion because they are so seldom used. A *white knight* is a company that the targeted firm asks to intervene in a takeover attempt and offer to buy the target on more favorable, amicable terms than the hostile bidder. White knights are hard to find. Their willingness to serve can lower returns to their shareholders since, according to Niden (1993), they "are bidders in a contested auction environment where prices tend to be higher than non-auction environments." In a *white squire* defense, the target firms asks another investor to buy a large block and to block the pursuer's acquisition of a controlling interest in the firm while agreeing not to sell its shares to the takeover strategist. The problem is that when the target repurchases its stock from the white squire, it pays a premium, thereby exposing itself to the 25% tax penalty for making a greenmail payment. A rarely used *Pac-Man defense* involves counterattack. The one, albeit classic, example of this defense occurred in 1982, when Mesa Petroleum made an offer for Cities Service, an oil company roughly 20 times larger than itself. Mesa management thought Cities had greatly underutilized assets, so it initiated a hostile bid. In response, Cities made a bid for Mesa stock. Even this use of the Pac-Man defense proved ineffective due to the low premium Cities offered to pay for Mesa. However, Cities was forced to make a greenmail payment of $30 to Mesa to buy back its stock.

References and selected bibliography

Agrawal, Anup, and Ralph A. Walkling. 1994. Executive careers and compensation surrounding takeover bids. *Journal of Finance* 49/3 (July): 985–1,014.

Banerjee, Ajeyo, and James E. Owers. 1992. Wealth reduction in white knight bids. *Financial Management* 21/3 (Fall): 48-57.

Berkovitch, Elazar, and Naveen Khanna. 1990. How target shareholders benefit from value-reducing defensive strategies in takeovers. *Journal of Finance* 45/1 (March): 137-156.

Bradley, Michael, and L. MacDonald Wakeman. 1983. The wealth effects of targeted share repurchases. *Journal of Financial Economics* 11/1-4 (April): 301-328.

Byrd, John W., and William W. Stammerjohan. 1997. Success and failure in the market for corporate control: Evidence from the petroleum industry. *Financial Review* 32/4 (November): 635-659.

Chang, Saeyoung. 1990. Employee stock ownership plans and shareholder wealth: An empirical investigation. *Financial Management* 19/1 (Spring): 48-59.

Chaplinsky, Susan, and Greg Niehaus. 1994. The role of ESOPs in takeover contests. *Journal of Finance* 49/4 (September): 1,451–1,471.

Dahya, J., and R. Powell. 1996. Top management changes following hostile and friendly takeovers. *ACCA Research Report No. 61*.

DeAngelo, Harry and Eugene Rice. 1983. Anti-takeover charter amendments and stockholder wealth. *Journal of Financial Economics* 11/1-4 (April): 329-360.

DeLong, J. Bradford, Andrei Shleifer, Lawrence Summers, and Robert Waldmann. 1990. Noise trader risk in financial markets. *Journal of Political Economy* 98/4 (August): 703-738.

Denis, David, and Diane Denis. 1995. Performance changes following top management dismissals. *Journal of Finance* 50/4 (September): 1,029–1,057.

Dunn, Craig P. 1989. ESOPs: The "Trojan Horse" of the anti-takeover realm. *Business Horizons* 32/4 (July-August): 28-35.

Easterbrook, Frank H., and Gregg A. Jarrell. 1984. Do targets gain from defeating tender offers? *New York University Law Review* 59: 277-299.

Franks, Julian, and Colin Mayer. 1996. Hostile takeovers and the correction of managerial failure. *Journal of Financial Economics* 40/1 (January): 163-181.

Froot, Kenneth A., David S. Scharfstein, and Jeremy C. Stein. 1992. Herd on the street: Informational inefficiencies in a market with short-term speculation. *Journal of Finance* 47/4 (September): 1,461–1,484.

Gaughan, Patrick. 1996. *Mergers, acquisitions, and corporate restructurings*. New York: John Wiley & Sons.

Giammarino, Ronald, Robert Heinkel, and Burton Hollifield. 1997. Defensive mechanisms and managerial discretion. *Journal of Finance* 52/4 (September): 1,467–1,493.

Harbert, Tam. 2002. Popping poison pills. *Electronic Business* 28/4 (April): 21.

Hirsch, Paul M. 1987. *Pack your own parachute: How to survive mergers, takeovers, and other corporate disasters*. Reading, MA: Addison-Wesley.

Holl, Peter, and Dimitris Kyriazis. 1997a. Agency, bid resistance and the market for corporate control. *Journal of Business Finance & Accounting* 24/7-8 (September): 1,037–1,066.

———. 1997b. Wealth creation and bid resistance in UK takeover bids. *Strategic Management Journal* 18/6 (June): 483-498.

Huang, Yen-Sheng, and Ralph A. Walkling. 1987. Target abnormal returns associated with acquisition announcements. *Journal of Financial Economics* 19/2 (December): 329-349.

Jarrell, Gregg A. 1985. The wealth effects of litigation by targets: Do interests diverge in a merge? *Journal of Law and Economics* 28/1 (April): 151-179.

———, and Annette B. Poulsen. 1987. Shark repellents and stock prices: The effects of antitakeover amendments since 1980. *Journal of Financial Economics* 19/1 (September): 127-169.

Jensen, Michael C., and William H. Meckling. 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of Financial Economics* 3/4 (October): 305-360.

Kennedy, V.A., and R.J. Limmack. 1996. Take-over activity, CEO turnover, and the market for corporate control. *Journal of Business Finance and Accounting* 23/2 (March): 267-285.

Lambert, Richard A., and David F. Larcker. 1985. Golden parachutes, executive decision making, and shareholder wealth. *Journal of Accounting & Economics* 7/1-3 (April): 179-204.

Mahoney, James M., and Joseph T. Mahoney. 1993. An empirical investigation of the effect of corporate charter antitakeover amendments on stockholder wealth. *Strategic Management Journal* 14/1 (January): 17-32.

Malatesta, Paul, and Ralph A. Walkling. 1988. Poison pill securities: Stockholder wealth, profitability and ownership structure. *Journal of Financial Economics*: 347-376.

Martin, Kenneth J., and John J. McConnell. 1991. Corporate performance, corporate takeovers and management turnover. *Journal of Finance* 46/2 (June): 671-88.

Mikkelson, Wayne H. 1991. Targeted repurchases and common stock returns. *Rand Journal of Economics* 22/4 (Winter): 544-562.

Muscarella, Chris J., and Michael R. Vetsuypens. 1990. Efficiency and organizational structure: A study of reverse LBOs. *Journal of Finance* 45/5 (December): 1,389–1,414.

Niden, Cathy M. 1993. An empirical examination of white knight corporate takeovers: Synergy and overbidding. *Financial Management* 22/4 (Winter): 28-45.

Partch, M. Megan. 1987. The creation of a class of limited voting common stock and shareholder wealth. *Journal of Financial Economics* 18/2 (June): 313-351.

Pound, John. 1987. The effects of antitakeover amendments on takeover activity: Some direct evidence. *Journal of Law and Economics* 30/2: 353-367.

Raj, Mahendra, and Michael Forsyth. 2002. Hostile bidders, long-term performance, and restructuring methods: Evidence from the UK. *American Business Review* 20/1 (January): 71-81.

Thornton, Emily. 2002. The bids sure are getting hostile. *Business Week Online* @ www.businessweek.com (14 January).

Thosar, Satish. 1996. Tender offers and target management responses: Managerial entrenchment versus stockholder interest revisited. *Financial Review* 31/1 (February): 87-105.

Use of ESOPs against bids lowers stock. 1989. *Wall Street Journal* (6 June): C1.

Varaiya, Nikhil, and Kenneth Ferris. 1987. Overpaying in corporate takeovers: The winner's curse. *Financial Analysts Journal* 43/3 (May-June): 64-70.

Wade, James, Charles A. O'Reilly III, and Ike Chandratat. 1990. Golden parachutes: CEOs and the exercise of social influence. *Administrative Science Quarterly* 35/4 (December): 587-603.

Walkling, Ralph A., and Michael S. Long. 1984. Agency theory, managerial welfare, and takeover bid resistance. *Rand Journal of Economics* 15/1 (Spring): 54-69.

Walsh, J., and J. Ellwood. 1991. Mergers, acquisitions and the pruning of managerial deadwood. *Strategic Management Journal* 12/3 (March): 201-217.

Wright, Mike. 1997. Discussion of agency, bid resistance and the market for corporate control. *Journal of Business Finance & Accounting* 24/7-8 (September): 1,067–1,075.