

ANTITAKEOVER DEFENSIVE TACTICS:
THEORY, PRACTICE, AND THE EFFECTS
ON STOCKHOLDER WEALTH

by

PHILIP NICHOLAS DUFF
A.B., Harvard University
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Submitted to the Sloan School of Management
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Signature of the Author: _____
Sloan School of Management
May 18, 1984

Certified by: _____
Richard Ruback
Thesis Supervisor

Accepted by: _____
Jeffrey A. Barks
Director of the Master's Program

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ABSTRACT

This thesis evaluates the impact on the wealth of stockholders when the incumbent managers of a corporation subject to a takeover bid resist the offer by employing a variety of antitakeover defensive tactics. Such defensive tactics include antitakeover charter and by-law amendments, various forms of governmental regulation of takeovers, antitrust and other litigation intended to block the offer, issuance of "poison pill" preferred stock, "scorched earth" tactics to make the target less attractive to the bidder, the search for a "white knight," standstill agreements and negotiated premium stock repurchases, and "double pac-man" counter tender offers.

First, the thesis analyzes the various motivations for bidders to attempt a takeover bid and describes the three primary methods used in the market for corporate control. Next, several hypotheses possibly explaining why target managers use antitakeover defensive tactics are presented.

The full array of defensive tactics is catalogued and the previous analytical literature on defensive tactics is reviewed. Using the classic event study methodology, the stock price impacts of five broad classes of defensive tactics are measured over multi-company samples.

The thesis concludes with two chapters drawing on the results of the empirical studies to develop several generalizations about the efficacy and effects of defensive tactics. Two different policy alternatives toward defensive tactics are considered.

Thesis Supervisor: Richard S. Ruback, Assistant Professor
Thesis Reader: Edward B. Dunn, Morgan Stanley & Co.

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Chapter 1. Introduction: Objectives and Outline of Thesis

No aspect of the mergers and acquisitions business elicits more interest and debate in the business, financial and legal communities than the antitakeover defensive tactics potentially available to the target of an unsolicited takeover bid and the prospects of successful assertion of those anti-takeover defenses. These defensive tactics and their related law have undergone significant development in the last few years in response to the takeover "boom" which has witnessed numerous highly-publicized takeover bids involving vigorously contested battles. Not only the Wall Street community, but the general public daily watched with excitement the attacks and counter-attacks unfold in the three-way battle for Conoco, the bitter struggle between Bendix and Martin Marietta which nearly destroyed both companies, and the role T. Boone Pickens played in forcing giant Gulf Oil into a takeover. As would-be acquirors have become increasingly sophisticated in their acquisition techniques, so too have targets developed sophisticated defensive responses, turning the market for corporate control into a tactical game of timing and intrigue.

For those who possess a trading mentality, one can imagine a competitive market for nearly any tangible or intangible good or service, in which supply and demand rule supreme and just about everything has its price. Such a market exists for corporate control - the rights to set the strategic pol-

icies of the corporation, to productively utilize the assets of the corporation, and to hire, fire and set the level of compensation of the managers of the corporation. In their recent survey of the scientific literature on takeovers, Jensen & Ruback (1983) define the market for corporate control as a market "in which alternative managerial teams compete for the rights to manage corporate resources." Thus, the takeover market can be viewed as an arena in which competing management teams battle for the control of corporations with the stockholders functioning as the ultimate judges. The takeover laws provide the rules of the game around which the bidders and targets develop their takeover and defensive strategies. When viewed in this context, one can readily see how and why antitakeover defensive tactics have flourished.

1.1 Purpose and Use of Thesis

The purpose of this thesis is to describe and catalogue the various antitakeover defensive tactics available to target management teams, and to determine the impact on the wealth of target stockholders when incumbent managers use these defensive tactics. Most of these defensive measures provide only a minimum line of defense and have become quite commonplace in publicly-held corporations. Other defensive tactics could be considered almost violent in nature and have been employed in only a handful of instances.

Takeover battles create a great deal of pressure on

target managers and often are fairly compressed in time. Most often the takeover bid is a new experience to the target manager, far from the ordinary day-to-day business operational situation, and presents the most challenging and important decision of his business career. Consequently, there exists a great potential for incumbent managers to lose sight of their primary function - to serve the best interests of the stockholders - during the heat of the takeover battle. Target managers hire investment bankers and takeover lawyers to provide advice on the appropriate level and type of defense. But too often this advice is cloaked in very qualitative terms and focuses only on broad generalities. Hopefully, this thesis will provide some quantitative substantiation for the qualitative reasons for or against the various defensive tactics.

This thesis serves two purposes and attempts to speak to two audiences. First, the thesis takes an academic perspective in that it begins by proposing several hypotheses, then empirically tests these hypotheses, and finally draws some conclusions from the empirical evidence. Second, the thesis intends to function as a useful guide to practitioners in the mergers and acquisition community. When making presentations to target-company clients, the evidence from the thesis will enable the investment banker to say that "such and such a defensive tactic will likely deter the takeover bid, but the tactic will also likely affect your stockholders

by 'x' percent." Thus, the thesis attempts to blend theory and practice as applied to antitakeover defensive tactics.

1.2 Outline of Thesis

The next chapter opens with a theoretical discussion on why potential bidders attempt takeovers and what are the sources of gains in takeovers - thus, justifying the payment of a premium for the target company's stock. Then the chapter describes the various mechanical techniques of takeovers: mergers, tender offers and proxy contests.

In Chapter Three, I propose two competing hypotheses on why target managers use defensive tactics. Other authors in the takeover literature have used these two competing hypotheses - the managerial entrenchment hypothesis and the stockholder interests hypothesis - as the possible motivating forces behind various target management actions.

The description and catalogue of antitakeover defensive tactics available to target managers is detailed in Chapter Four. Conceivably, this chapter could function as a reference manual for target managements, describing the alternative defensive measures at their disposal.

I review the scientific literature that has been written on antitakeover defensive tactics to date in Chapter Five. Generally, these empirical studies have focussed on one particular defensive tactic and have used takeover data preceding the 1980s. I intend to provide a more comprehensive survey

of defensive tactics and to run various empirical tests on takeovers which have occurred more recently (i.e. up through 1983).

Chapter Six presents the event study methodology, describes the sources and selection criteria used in constructing five different samples of target firms which have used defensive tactics, and reports the empirical results of running event studies on these samples. From this empirical evidence, I have determined an average economic impact on the price of the target firm's stock for each defensive tactic.

The findings are then compared with the evidence of other researchers and conclusions are drawn from the evidence in Chapter Seven. The thesis concludes with a final chapter discussing the relative merits of two different policy alternatives toward the use of antitakeover defensive tactics.

Chapter 2. Theory and Practice of Takeovers

2.1 The Theory: Management's Motivations in Takeovers

Takeovers are investment decisions by the bidding firm, and the basic principles of capital investment decisions apply. The expected benefits of the takeover are the incremental cash flows generated by the combination of the two previously independent firms or by the more effective management of the target's assets once control has been achieved. The cost of the takeover investment decision includes, in addition to the actual amount paid for the target firm, the costs associated with the takeover search and with the negotiating of the transaction.¹ The net present value (NPV) of the takeover represents the expected dollar gain to the stockholders of the bidding firm. This takeover NPV - either positive or negative - should be compounded into the market value of the bidder on the day of announcement of the takeover, causing a rise or fall in the bidder's stock.²

Thus, in theory, bidding firms could apply standard NPV capital budgeting techniques to takeover investments,

¹The direct cost of employing takeover specialists (e.g. investment bankers and lawyers) for both parties can in some instances exceed four percent of the value of the transaction. Also, one should consider the internal costs of using management time and resources in the takeover.

²The empirical tests in this thesis use event studies to analyze the stock price effects of the announcement of various antitakeover provisions.

proceeding with those takeovers which make net positive contributions to stockholders' wealth. But in practice many other factors, besides the raw NPV numbers, influence the decision to attempt a takeover (from the bidder's viewpoint) or the decision to defend against a takeover (from the target's viewpoint). For many managers involved in takeover attempts, the takeover is something quite extraordinary relative to his normal day-to-day business operating decisions, and presents the classical agency problem between the manager's welfare and that of the stockholders.³ Takeovers are often awkward and complicated to evaluate, much more difficult than valuing the purchase of a piece of machinery. This section of Chapter Two will explore the motivations of why managers attempt takeovers; the next section will discuss the mechanics and techniques used in the market for corporate control. The intent is to provide some background for the discussion in Chapter Three on why antitakeover provisions exist and for the analytical tests used later in the thesis.

Over the last several decades, economists have put forward a variety of theories to explain why companies acquire other companies, usually viewing corporations as decision-

³Quite often a takeover threatens the target manager's continued employment and his pride in managing a large organization. Although one would like to believe that takeover investments are always valued on NPV, emotions and personalities often play significant roles in takeover transactions. For a discussion of agency problems, see Jensen & Meckling (1976).

making units within the classical market framework.⁴ Most of these theories have some validity in explaining takeovers, and each could likely be applied depending upon the circumstances of the particular takeover. All acquisition theories can be lumped into one of two main categories: (1) non-value maximizing motivations of bidder managements, and (2) value maximization reasons based on maximizing stockholder wealth.⁵

The first category includes many takeovers which are attempted in order to maximize growth in sales or assets, and often involve the ego-gratification of controlling a large empire. One must not forget that growth is not necessarily synonymous with increased profitability (although in some cases, growth is a necessary condition for increased profitability). Takeovers which are motivated solely by a manager's desire to control a larger asset base or show greater sales rarely create any economic gains when the two firms are combined relative to their market values as separate entities. For these types of takeovers, the transaction costs of the takeover and the potential loss of managerial efficiency from coordinating a larger organization will likely cause a substantial economic loss to the bidder's

⁴Manne (1965) was the first to present the theory, which is accepted by most finance people today, that the control of corporations constitutes a valuable asset and that an active market exists for these corporate control assets.

⁵Halpern (1983) provides a useful and concise discussion of merger-takeover theories.

stockholders. On the other hand, the target stockholders will most likely earn the appropriate risk-adjusted return as a result of the merger. The net economic result is negative.

These growth-for-growth's-sake takeovers are often conducted by conglomerates which basically function as holding companies for unrelated business units. At some level of complexity, one management team cannot effectively manage a widely diverse group of businesses.⁶ Second, these non-value maximizing mergers often involve firms whose top manager needs to acquire an increasingly large empire to satisfy his ego. Although at some level the loss of stockholder wealth caused by the manager's ego-gratification is large enough to justify someone bearing the costs of changing control,⁷ the wealth loss due to the manager's ego may be quite large before any individual stockholder or external bidder has enough incentive to battle for control. In the absence of continual pressure from stockholders, some managers can lose sight of stock-price maximization in favor of gratifying their own desires to run a large organization.

Also included in the category of non-value maximizing acquisitions are some takeovers done for reasons of "diversification." Although diversification may be a valid basis for a takeover (as argued below), diversification as an

⁶This is the case when the whole is worth less than the sum of the parts.

⁷For instance, waging a proxy fight (see next section).

end in itself is usually not economically efficient at the level of the corporation. Usually diversification is more easily and more cheaply achieved by individual stockholders than for the corporation.⁸ In addition, the "bootstrap game" of using acquisitions as a means of boosting earnings per share creates no real economic gains.⁹ Many of the aggressive merger programs of the late-1960s were carried out under this theory. The moral is that the market can rarely be fooled, and never for very long!

The second large class of acquisition theories - those which maximize stockholder wealth - include six basic reasons. Any takeover attempted for one of these six reasons should result in some economic gain to be split up between the bidder's and target's stockholder groups. How much of the gain either group receives depends upon their relative negotiating strengths, but in any case, the bidder should earn at least a normal risk-adjusted rate of return (i.e. in that case, the takeover is zero NPV investment).

The largest wealth gains from takeovers result from "synergies" between the two merging entities. The synergies may be the result of increased economies of scale, as in the case of most horizontal mergers and some vertical mergers.

⁸It is generally accepted that investors are not willing to pay premiums for diversified firms, in fact, many conglomerates actually trade at discounts to the values of their individual assets.

⁹See Brealey & Myers (1981), pp. 663-665, for an explanation of this crazy game.

Managers sometimes find these economies of scale rather elusive as it is generally easier to buy another company than it is to integrate it into the buyer's existing operations. Another source of synergies results when the two firms have complementary resources, often creating opportunities for the combined entity which neither firm could pursue on its own. This is the classic case of the whole being worth more than the sum of the parts. Other synergies between the two companies are the result of utilizing excess capacity in either firm - physical plant, managerial talent, or excess financial resources. Related to synergy gains is a second reason for takeovers which is driven by the search for monopoly power. The increase in value comes from the increase in post-acquisition cash flows due to the ability to extract larger monopoly rents. Many horizontal mergers fall into this category (although the antitrust laws prevent many such mergers).

Two further reasons cited in the value-maximizing class are motivated by financial factors. One argument is that an acquisition permits a redeployment of excess cash held by either the acquiror or the target. Large cash balances often make a company a susceptible takeover target. Another argument is that diversification through takeovers can reduce the probability of default and bankruptcy. This reduction in the likelihood of default decreases the expected bankruptcy costs and increases the debt capacity of the

firm. If the direct and indirect costs¹⁰ of bankruptcy are relatively large, a merger may be a less costly (and more civilized) way for the target to go bankrupt. This type of takeover is a voluntary liquidation which transfers assets from falling to rising firms. Both of these financial factors will create increased wealth relative to the values of the two independent firms, but the order of magnitude is likely to be much smaller than in the case of synergistic gains.

A fifth motivation is the attempt of the bidding firm to take advantage of asymmetry in information. The bidder may feel that based on public information the market is under-valuing the target (i.e. the stock market is not perfectly efficient), or the bidder may for some reason possess information not currently available to the public which is not reflected in the target's stock price. In effect, the bidding firm's management can act as security analysts. Although it is generally well accepted that it is difficult to pick under-valued stocks on the basis of broadly distributed public information, it is conceivable that a bidder in the same or related industry as the target may at times hold valuable nonpublic information about the target. The announcement of the takeover attempt should send a signal to the market about the "true" value of the

¹⁰Direct bankruptcy costs include lawyer fees. Indirect costs are the result of disrupted operations, and may be significantly greater than direct bankruptcy costs.

target, and the asymmetry in information should then be ameliorated.

Finally, a takeover for value-maximizing reasons may be attempted simply to obtain control of the target, driven by the belief that the target's management underutilizes the assets under its control. The bidder believes that either the incumbent management is incompetent or seeks to force that management to follow a profit-maximizing strategy. Takeovers based on the former case can be explained by the "managerial competition model."¹¹ Under this model, different management teams compete for the right to manage and control the assets of firms. Each management team has a different propensity to create value from a given set of corporate assets. Stockholders have no loyalties to any one particular team, but rather they simply select the highest market value among those presented by the competing management teams. Jensen and Ruback view the stockholders as passive players fulfilling a judicial role, whereas the competing management teams are the primary activists. Thus, the takeover market complements the traditional managerial labor market in disciplining managers and forcing them to act in the best interests of the stockholders.

The later case, where the bidder forces incumbent managers to follow a profit maximizing strategy, is best

¹¹Jensen & Ruback (1983) in their review of the literature on corporate control provide a concise description of this model and how it disciplines management teams.

explained by the theory of financial contracting. Jensen and Meckling (1976) suggest that the value of a firm reflects the valuation by stockholders which includes the value of the perquisites consumed by managers as the agents of the stockholders. Any time a separation exists between the ownership and the management of a corporation, agency problems arise due to the conflicting interests between the owners of the firm and those having control of the firm's assets. Financial contracting theory says that constraining contracts are made between owners and managers if the costs of writing and monitoring those contracts are less than the potential agency costs. Usually no one individual stockholder is willing to bear these costs alone (given that the benefits would accrue to all stockholders), and consequently, investors will reflect these agency costs in the price of the firm's shares. If this depression on a firm's stock price due to principal-agent problems is quite large, the company is a good candidate for a takeover (or possibly a leveraged buy-out by the top managers¹²).

Under either of the two above takeover-for-control cases, the target firm's stock price is depressed and the bidder expects to gain from purchasing the target through a subsequent capital gain. One would expect that the target

¹²A leveraged buy-out (LBO) is a transaction where a group of investors takes a firm private by putting up a small percentage of the firm's value as equity (usually around 5%) and borrowing the remaining amount to purchase the firm using the firm's assets as collateral.

firm had been earning below normal returns (on a risk-adjusted basis) prior to the takeover.

2.2 The Practice: Mechanics of Mergers and Acquisitions

Having considered the various motivations for attempting a takeover, one needs to understand the rules and mechanics governing the market for corporate control. This section describes the various techniques employed in takeovers and examines the many rules and regulations governing these takeover techniques. Equipped with both the theoretical basis for takeovers and the institutional factors directing those takeover attempts, this thesis will then be ready to examine just why and how defensive tactics are used by target managements to defend against takeovers (Chapters Three and Four).

Takeovers and other battles for corporate control can occur through merger, tender offer or proxy contest. In more complex corporate transactions, potential acquirors may use all three takeover techniques. A **merger** is a transaction in which one corporation (the bidder) secures title to the outstanding shares or assets of another corporation (the target). All state corporate codes require that proposed mergers be approved by the holders of a majority of the

outstanding shares of the target firm.¹³ Mergers are negotiated directly with the target's management and approved by the target's board of directors before being presented for a vote of approval by the target shareholders. Generally then, mergers are "friendly" transactions with the managements of the bidder and the target privately negotiating an equitable price, and together working out the strategic plan for the combined entity and the roles played by each individual in the new management team.¹⁴ Obviously, agreeing on a price for the merger transaction may involve difficult and heated negotiations, but many other issues in addition to price can create hurdles for the successful completion of the merger. For many corporate managers, especially those representing the smaller target firms, a merger transaction is likely to be the largest business decision of his life and something he goes through only once in his career. Consequently, other factors besides rational economics,¹⁵ such as emotions and pride in one's position, can intervene and determine the outcome of a merger.

¹³The percentage of favorable votes required for approval of the merger depends upon state code and the target firm's corporate charter. Supermajority approval (i.e. an approval percentage greater than 50 percent) is often used as an antitakeover defensive tactic (see chapter 4).

¹⁴Merger specialists, such as investment bankers and legal counsel, assist the merging managements by valuing the separate and combined entities, giving a fairness opinion, and suggesting the most appropriate legal and tax structure for the transaction.

¹⁵Rational economics dictates that decisions be based on the theory of net present value, which are in the best interests of the stockholders.

Because any merger must first be approved by the target's board of directors (often containing many members of the target management team), the target board effectively has the power to veto all merger proposals and can refuse to put any proposal to a stockholder vote. A consequence of this veto power by incumbent management is that merger proposals become discretionary decisions delegated to management by stockholders. Stockholders have the final word to approve or reject a merger proposal recommended by the board of directors, but do not get the opportunity to vote on merger proposals which the incumbent management chooses to reject.¹⁶ Very rarely does a merger proposal not receive shareholder approval once the management and board has given the proposal its approval. In theory, stockholders should be willing to accept any offer of a tax-free exchange of new marketable securities worth more than their old shares. Because merger transactions are generally friendly and are worked out in close consultation with the target management team, few defensive measures are directed particularly at mergers. Only supermajority vote approval - a percentage greater than a simple 50% majority - by shareholders creates any impediment to mergers.

¹⁶This presents the classic agency problem created by the separation of ownership and control, leading quite often to antitakeover defensive tactics. Chapter 3 analyzes how defensive tactics deal with these agency problems. For a more detailed explanation of agency problems, see Jensen & Meckling (1976) and Fama & Jensen (1982a and 1982b).

When merger negotiations break down or when a bidder has reason to believe that the target management would oppose any merger proposal, the bidder can go over the heads of the target management and appeal directly to the target company's stockholders. The bidder can achieve control of the target by going directly to the stockholders in two ways: (1) tender offer or (2) proxy fight. Tender offers and proxy fights are generally considered "unfriendly" transactions, and the bidder assumes that the target management is not going to take the offer lying down.¹⁷ In a **tender offer**, the bidder makes an offer directly to the target shareholders to tender their shares for a specified amount of cash or securities. The decision to accept or reject the offer is made by each individual stockholder, and the success or failure of the tender offer depends upon the proportion of stockholders tendering their shares. The incumbent target managers are formally involved only to the extent that they are also stockholders. However, the incumbent management typically announces its approval or disapproval of the offer, and can legally expend corporate resources (e.g. money, management time, etc.) trying to prevent the offer from being successful. Most antitakeover defensive tactics employed by target managements have been created either as preliminary fronts to ward off potential

¹⁷Occasionally friendly tender offers are made with the acquiescence of the selling firm's management.

bidders from ever attempting a takeover or as a line of defense in a hostile tender offer.

Whereas mergers can proceed in many different manners and are generally friendly negotiations, tender offers are made according to specific rules and regulations determined by federal and state statutes and by the Securities and Exchange Commission (SEC). Tender offer rules have evolved in the law over time seeking to maximize the welfare of the target firm's shareholders and to create a "fair" balance of bargaining power between the bidder and the target management. Most of these tender offer rules cause delays in the tender offer process to prevent the bidder from taking advantage of small target stockholders under the theory that smaller stockholders possess less capability to evaluate a proposed tender offer than do larger, more sophisticated investors.

The federal, state and SEC codes change from time to time as bidders develop new techniques to facilitate the tender offer transaction in their favor. Although the purpose of these tender offer rules is to provide equity among all stockholders and to protect the interests of small stockholders, target managements often use these rules as defensive measures to block a tender offer in an effort to remain independent. Takeover specialists, such as investment bankers and legal counsel, are required by both sides to plot the appropriate tender offer strategy around the

complex maze of rules and regulations. If a bidder violates any of the tender offer regulations (however trivial), the target management will file a lawsuit delaying the tender offer and greatly reducing its chances of success. These federal, state and SEC tender offer regulations, how they are manipulated by target managements, and their effects on target firms' stock prices will be examined in depth in Chapters Four, Five and Six.

Alternative to the tender offer, the bidder¹⁸ may attempt a proxy fight to obtain controlling seats (or at least a voice) on the target firm's board of directors. The board of directors has the legal authority for the management and the direction of the corporation, and is required to supervise the general course of the business in the best interests of the stockholders. The board has the authority to delegate responsibility for the day-to-day operations of the company to internal managers, and has the right to remove or replace these officers. A proxy contest is a mechanism by which shareholders can change the firm's board, and thus, effectively change the "control" of the firm. State corporation laws and the company's corporate charter and by-laws establish the rules governing proxy contests.

A proxy contest usually begins in the months prior to the firm's annual meeting, at which time a new board

¹⁸In the case of proxy contests, the bidder is usually a single large stockholder or group of investors, often referred to as "dissidents" or "insurgents."

of directors must be elected by a vote of the firm's stockholders. The incumbent board nominates itself (plus any new directors to replace retiring board members), mails out a proxy statement to the stockholders describing the backgrounds, compensation and stock ownership of the nominated directors, and collects the returned ballots.¹⁹ The outside group - the dissidents - puts together its own slate of directors and initiates a campaign in opposition to the incumbent management. Both the dissident group and the incumbent management seek votes from shareholders using public relations techniques similar to political campaigns. Small stockholders are addressed in large, full-page advertisements taken out in the Wall Street Journal and New York Times, and larger investors are contacted directly over the telephone. Stockholders sign and return their proxy forms having voted for their preferred slate of directors; and the agents for each group collect and cast the votes at the annual meeting.

Generally, the group obtaining the majority of stockholder votes will elect a majority of the directors, and thus, maintains control of the corporation. The exact allocation of votes depends upon the method of voting, which is dictated by the firm's charter and by-laws. Corporations in the United States have one of two ways of voting: (a)

¹⁹A stockholder may vote in person at the annual meeting of the company or cast his ballot in advance by returning the "proxy" through the mail.

non-cumulative or (b) cumulative. In non-cumulative voting, each director is treated as a separate election. Stockholders are entitled to cast votes (equal to the number of shares held) for each director position. Since each group presents an entire slate of directors and since the successful nominee for each position is the one attracting the majority of votes, non-cumulative voting usually precludes minority stockholder groups from electing any directors. On the other hand, cumulative voting does permit minority groups to elect a minority of the directors. Proxy-holders are entitled to cast, in total, votes equal to the number of shares held multiplied by the number of directors. Stockholders may distribute their votes across positions in any way, including casting all votes for a single director. The nominees from both incumbent and dissident groups are ranked in descending order according to the number of votes received, and the required number of directors elected are then taken from this list.

Proxy contests clearly threaten the continued employment of the incumbent board and influence the direction of the corporation. Even if the dissident group fails to win a majority of the board seats (or even any at all), the proxy fight has sent a clear signal to incumbent management that assets are under-utilized and that changes need to be taken to improve the firm's stock value. Furthermore, actual proxy fights constitute only a small percentage of threatened

fight. The parties generally prefer to negotiate a settlement in accordance with their respective strengths than incur the costs of soliciting proxies. Thus, the threat of a proxy contest is often sufficient to discipline management and is a cost-efficient method of reducing the agency problems created by the separation of management and ownership. Many of the antitakeover charter amendments, which limit shareholder rights and make it more difficult to remove directors, are directly targeted at the threat of proxy contests.

But proxy contests do have problems and limitations. First, proxy fights are expensive relative to the expected payout results. Proxy-fight expenses include the direct expenses of mailings, advertising, telephone calls, and visits to large shareholders. These costs - borne entirely by the dissident group - often dwarf the gains received on their small fractional holding of the corporation. On the other hand, the incumbent management can use corporate resources to put forward its position and fend off the dissidents. Second, the dissident group always has difficulty conveying its message, which is often quite complex and subject to interpretation by the media, especially to smaller investors who generally automatically side with incumbent management and who often do not even bother to look at proxy materials. Particularly as equities are increasingly held by institutions, stockholders speak more freely about their

dissatisfaction with management's performance, and incumbent managements can no longer take for granted the outcome of proxy votes at annual meetings.²⁰ Finally, proxy contests face the "free-rider" problem (to be discussed more fully in Chapter Three) whereby most stockholders do not have the incentive to monitor management and to come up with an alternative strategic corporate plan and slate of directors.²¹ The dissident group bears the full cost of the proxy fight for all the firm's stockholders, whereas any increase in value generated as a result of the proxy fight must be shared with all stockholders alike (according to each person's percentage ownership). Thus, a dissident group must hold a sizable position in the company (usually greater than five percent of the outstanding shares) to make a proxy fight worth its while.

²⁰Institutions traditionally followed the "Wall Street Rule" (which was more a habit than a rule) which dictated that professional investment managers either supported corporate management on policy questions or divested the company's stock, but never were they to confront management directly.

²¹Grossman & Hart (1980b) examine this "free-rider" problem and suggest socially optimal corporate charters to minimize this problem.

Chapter 3. Hypotheses of Why Antitakeover Tactics Exist

Chapter Two examined the theoretical and practical motivations and vehicles for takeovers. Generally, the viewpoint was from that of the bidder. With that background, this chapter will explore the possible arguments of why antitakeover provisions exist from the viewpoint of the target's management.

Several authors have each presented two similar competing hypotheses to explain the existence of various antitakeover provisions and to test whether these defensive provisions add to or distract from stockholder's wealth.¹ Briefly summarized, the "managerial entrenchment hypothesis" predicts that stockholders suffer wealth losses when incumbent management uses antitakeover defensive tactics to deter a credible takeover threat, especially when the transfer of control involves receiving a premium over the current market for the stockholders' shares. The competing "stockholder interests hypothesis" suggests that stockholders gain from antitakeover defensive tactics because the reduced threat of competition

¹The literature related to the market for corporate control contains many references to these two hypotheses. For the topic of this thesis, these hypotheses are best discussed in Cary (1969-70), DeAngelo & Rice (1983), and Dann & DeAngelo (1983). Although the terms are not used, several legal writers have also presented these arguments: see Easterbrook & Fischel (1981a,b) and Lipton (1979, 1981). Related arguments to these antitakeover hypotheses have been advanced by Bradley (1980), Grossman & Hart (1980b), and Jarrell & Bradley (1980).

for control allows management to concentrate on running the business and avoids expending real resources in the costly process of competition. Although at odds with one another, each hypothesis likely has some explanatory power over the wealth effects of antitakeover defensive tactics depending upon the situation. But one hypothesis likely dominates the other for most antitakeover defensive actions. The empirical part of the thesis tests the validity of each hypothesis. The next two sections will analyze these two hypotheses, the third section will discuss the free-rider problem, and the final section in this chapter will look at how the courts have interpreted the roles of the board of directors and incumbent management.

3.1 The Managerial Entrenchment Hypothesis

The managerial entrenchment hypothesis suggests that antitakeover defensive tactics primarily act to increase incumbent management's job security and decision-making powers at the expense of stockholders. This hypothesis recognizes that the separation of ownership by stockholders from control by management gives rise to agency costs.² If both parties in the agency relationship maximize their own respective wealth, then there are situations in which

²Jensen & Meckling (1976) define the agency relationship as "a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent" (p. 308).

the agent will not necessarily act in the best interests of the principal. For example, an incumbent manager faced with a hostile tender offer may recommend to stockholders not to tender their shares even though the bidder is offering a substantial premium over the current market value, and he may use corporate resources in an attempt to defeat the tender offer. According to the managerial entrenchment hypothesis, the manager's recommendation and actions are not motivated by the best interests of the stockholders, but rather are taken to save his own job and position of power within the firm. Managers benefit from consuming corporate perquisites, but bear their costs only to the extent to which they are also stockholders of the firm. These perquisites include the right to make strategic business decisions, control sizable amounts of assets, earn large salaries, work in plush offices, and travel to and from work in limousines.

Generally, when negotiating in a takeover situation, managers have no incentive (as managers as opposed to as stockholders) to buy management services for the company at the lowest possible price. Managers possess the obvious self-interest to preserve their own jobs with as high a level of compensation (including perquisites) as the stockholders will bear. To minimize these agency costs inherent in the stockholder-manager relationship, several mechanisms serve to discipline managers: (1) explicit management-stock-

holder contracts,³ (2) managerial labor market forces, and (3) the threat of losing one's job through takeover or stockholder vote. None of these disciplinary mechanisms are costless (in some cases the monitoring costs may be quite high). As a result, these mechanisms are imperfect in disciplining managers, never fully eliminating the agency problem. Stockholders incur wealth losses as they trade off the costs of monitoring and contracting with management against the expected wealth drain due to the agency problem. So long as the cost of management's inefficiency is less than the cost of an outside bidder taking over control, the incumbent managers will remain secure in their positions with their protected high salaries.

To the extent that the wealth loss due to antitakeover provisions is less than the costs to stockholders of monitoring and contracting with management or less than the cost of taking over control, innovative managers will devise ways to minimize the likelihood of being displaced. For example, many antitakeover charter amendments make the transfer of control more difficult and raise the costs of ousting inefficient managers through a proxy contest or tender offer, but each individual stockholder nearly always votes to approve the amendment because the cost of fighting the proposed change is relatively greater. Given the extreme complexities

³A good example of such a contract is the compensation packages of top managers which make compensation contingent on managerial performance (e.g. bonuses and stock options).

of valuing takeover proposals, some actions taking by target managers preceding and during a hostile takeover attempt, such as issuing "blank check" preferred stock or selling off "crown jewel" assets to make the target less desirable to the bidder,⁴ are difficult to evaluate. Were the actions taken for sound business reasons or were the actions motivated by the managers desire to retain his job and position?

Many antitakeover devices must be approved directly by stockholder vote, and for those that are not, stockholders still have the opportunity each year to oust management (and their antitakeover actions) at the annual meeting. Then how does the managerial entrenchment hypothesis explain the existence of antitakeover defensive tactics? Several explanations are possible. First, conceivably stockholders' failure to reject antitakeover devices could simply be irrational or lack of interest in the subject (e.g. not bothering to even look through a proxy statement). This explanation is contrary to all capital asset pricing theory and the idea of efficient markets.⁵ A second explanation is that large block stockholders (primarily institutions) may realize that negative wealth effects of antitakeover provisions, but will still approve them to maintain a working relationship

⁴These "poison pill" and "scorched earth" defensive tactics will be described in detail in the next chapter.

⁵The capital asset pricing model assumes that investors are rational. Countless studies (both theoretical and empirical) over the last 20 years have upheld the notion of at least relatively efficient markets - markets in which investors maximize their own individual wealth (or utility).

with the incumbent management.⁶ These large blockholders, who have substantial voting power, believe that future considerations received from management outweigh the loss in share value due to antitakeover provisions. This explanation is difficult to swallow in light of the substantial premiums (sometimes over 100 percent of current market value) that are often paid in control transfer situations.

Finally, the information and transaction costs required to wage a fight against the antitakeover tactic may be quite high relative to the wealth loss caused by the defensive action. When asked to approve an antitakeover provision, each stockholder considers the net costs and benefits in terms of his own wealth maximization and acts accordingly. The costs of evaluating the antitakeover provision and acting to oppose it may simply be greater than the stockholder's expected loss of just going ahead and accepting it. Anyway, as with other agency costs, investors will take into account management's likelihood of using defensive tactics and the expected costs associated with those tactics in pricing the shares of the company. To the extent that investors anticipate management's antitakeover desires and reflect these costs when pricing the firm's stock, the wealth loss due to antitakeover provisions will fall back onto the managers.

In summary, the takeover mechanism serves as an effect-

⁶DeAngelo & Rice (1983), p. 334.

ive monitor of a corporation's managers. Antitakeover defensive tactics make takeovers more difficult, and reduce the incentives for bidders to seek out takeover candidates and to pay takeover premiums. If takeovers produce real gains for both the bidder and the target, this suggests that defensive tactics cause real losses. Given that the bidder pays a substantial control premium, if defensive tactics preserve incumbent management's "independence," then the target stockholders are unambiguously worse off.

3.2 The Stockholder Interests Hypothesis

The stockholder interests hypothesis predicts that antitakeover defensive tactics increase current stockholder wealth. The stockholder interests hypothesis recognizes the existence of possible agency problems, but believes that stockholder-management contracting and the managerial labor market mechanisms are sufficient in disciplining managers to act in the best interests in shareholders. The threat of a takeover does not necessarily motivate managers to perform more efficiently.

The stockholders interest hypothesis focuses on three main issues. First, the competition for control between incumbent management and potential bidders is assumed to be a costly process. Current stockholders bear the costs

of management's defensive efforts to maintain control.⁷ These costs include the monitoring costs of maintaining a stockholder relations department, publishing a detailed annual report, and direct mailings to stockholders. If a takeover battle develops, managers use the firm's money to hire takeover defense specialists, to take out advertisements in the financial press, and to buy assets incompatible with the bidder.⁸ In addition to these direct costs, management time is consumed in the defensive effort, time which is diverted away from generating profits for the stockholders. The costs of this competitive process include the productive business opportunities foregone when managerial effort is instead used to maintain the incumbent position.⁹

The stockholders interests hypothesis suggests that stockholders benefit from the reduction in competition in the market for corporate control, because the probability of incurring the above defensive costs is reduced. Antitakeover provisions are basically contracts which directly limit takeover competition or which increase the costs to outside bidders attempting to take control. These defensive cost savings outweigh the inefficiencies inherent in the stockholder-

⁷Remember that management can legally use corporate resources in the takeover battle (see section 3.4). These are not simply out-of-pocket expenses.

⁸This is a defensive tactic whereby the target acquires assets in a regulated industry (e.g. a television station) which the bidder does not want to be involved in, or acquires a competitor of the bidder which would create antitrust problems.

⁹Dann & DeAngelo (1983), p. 281.

manager agency relationship.

Second, in the view of the stockholders interests hypothesis, antitakeover defensive tactics function to induce higher takeover premiums from bidders. Defensive tactics can be used to trigger a bidding contest.¹⁰ Confronted by a tender offer, target managements routinely oppose the first bid with the intention of holding out for a higher premium or to buy time allowing competing bidders to make offers as well. Although most federal, state and SEC tender offer regulation was created with the intention of protecting the small stockholder, the tender offer rules have the effect of extracting higher premiums from bidders and increase the power of the target. Target managers often proclaim that the bidder's offer is "grossly inadequate" or that it does not "reflect the true long-run value of the firm," even though the offer often represents a 50 to 100 percent premium over the current market value of the target's stock.

Countering this claim, one could argue that antitakeover defensive tactics do not, in fact, raise takeover premiums, but rather they tend to discourage takeovers. Transactions for which the synergistic gains created by combining the two firms are relatively small (and thus a large takeover premium is not justified by the deal's economics) will

¹⁰One should remember that auctions often lead to higher prices, but auctions can also be quite expensive both in terms of direct costs and in terms of inside information given up.

be discouraged by the antitakeover provisions. Many positive net present value takeover investments will not be undertaken by bidding firms because the costs of overcoming the defensive tactics outweigh the positive NPV of the transaction. Furthermore, given the complexities of evaluating acquisition investments, antitakeover provisions may discourage bidding firms from even searching for worthwhile acquisition targets. The managerial entrenchment hypothesis would argue in this case that the reduction in competition in the takeover market increases the likelihood of managerial inefficiency due to agency problems.

Suppose a bidder makes a tender offer to the stockholders of a target firm for 51% of the outstanding shares of the target at a substantial premium over the target's current stock price. But assume the currently offered price is not as high as the bidder is willing to pay (i.e. the takeover premium does not reflect 100 percent of the potential synergy gains created by combination). Target stockholders are uncertain as to whether the bidder will increase the offering percentage or whether he will conclude a post-tender offer merger for the remaining 49% (and at what price?). No other competing bids have surfaced, but other bids are certainly possible. Should the stockholder tender his shares capturing the premium, or should he hold out in hopes that a competing bidder offers a higher price? If a post-tender offer merger takes place, will the remaining shares get

paid the same tender-offer premium?

The third issue argued by the the stockholder interests hypothesis revolves around how the target stockholders make tendering decisions as in the above predicament, and how the synergy gains - the incremental cash flows created by combining the two firms - are split up between the bidder and target. The above hypothetical case places each stockholder in a prisoner's dilemma¹¹ in deciding whether to tender his shares. As an individual, each stockholder has the private-level incentive to tender his shares at the first offer - in effect, take the money and run. But if the target stockholders all held out as one unified cohesive group, the bidder would be forced to up his offering price towards his maximum level. Obviously, target stockholders are unable to enforce a perfectly cohesive cartel to hold out against the bidder for a higher price. If any one stockholder participates in the group holdout, he runs the risk of losing the currently offered takeover premium should other stockholders opportunistically tender. The stockholder interests hypothesis suggests that antitakeover defensive tactics encourage a cartelized stockholder response to a takeover offer, and thus, push up the premiums paid.

Target stockholders obviously will not accept a

¹¹The prisoner's dilemma is a classic case in gaming theory, and comes up in many different situations throughout life. For a good description of the prisoner's dilemma and how it explains making economic choices, see Nicholson (1978), pp. 164-166.

value for their shares less than the current market; and the acquiror will not bid more than the sum of the target as an independent entity plus the value of the synergistic gains created. Thus, a range is established in which both parties will benefit from the transaction, but how the range is split up depends upon the relative negotiating strengths of the two parties. The stockholder interests hypothesis claims that antitakeover defensive tactics enable the target stockholder group to extract a larger percentage of those synergy gains. Antitakeover provisions reduce each stockholder's private incentive to tender shares at a relatively low offer price in order to appropriate a larger takeover premium. The antitakeover provision enables the target stockholders as a group to holdout for a larger premium.

3.3 The Free-Rider Problem

Suppose that incumbent management is taking advantage of potential agency problems by not acting exclusively in the best interests of the stockholders, or that another management team could create more value from the target's assets. The bidder tenders for the shares of the target, buying the shares at a low price (relative to the value achieved under his management) and hopes for price appreciation under his more efficient control. If the target stockholder thinks that the takeover will succeed and that the bidder will increase the value of the firm beyond what he pays

to the tendering stockholders, he will retain his shares and "free ride" on the price appreciation created by the bidder's better management.¹²

The bidder bears the entire cost of paying the premium to gain control of the target, but he must share the benefits of his superior management with the free-riding stockholders not tendering their shares. As discussed in Chapter Two in the case of proxy fights, the expected gain to the bidder must at least compensate him for taking on the battle for control and for carrying all the takeover costs for the entire stockholder group. Thus, when considering a potential takeover, the bidder must not only consider the cost of waging the takeover battle, but he must also calculate the costs created by free-riding stockholders.

Grossman & Hart (1980b) argue that antitakeover provisions in corporate charters can help reduce the "externality" of the free-rider problem. Grossman & Hart support the idea of two-tier takeovers in which different groups of stockholders are treated unequally.¹³ They view the management of a diversely-held corporation as a public good which should be run for the good of all, and that free-riders should

¹²The free-riding stockholder runs the risk that his decision to hold out could cause the tender offer to fail, or that the bidder does not buy the remaining shares at a later date (in which case the target's stock price will fall to reflect the loss of gains due to synergies).

¹³The merits of two-tier takeovers will be discussed in length in Chapter Eight when considering the socially optimal level of antitakeover provisions and tactics.

not receive the same benefits as the bidder (bearing the costs) or the tendering stockholders (who give the bidder the right of control):

The only way to create proper incentives for the production of a public good is to exclude nonpayers from enjoying the benefits of the public good. . . This can be accomplished by permitting the raider [bidder] to treat the shares of those who have not tendered differently from the shares he owns.¹⁴

These arguments concerning the problems associated with free-riding stockholders lead to the same conclusions about antitakeover defensive tactics as does the stockholder interests hypothesis - defensive tactics increase stockholder wealth.

3.4 How the Courts View Defensive Tactics

Before discussing how the courts rule on defensive tactics, it is helpful to briefly review the role of directors in the corporate governance system. Ultimate power rests with the stockholders who cannot act directly but only through elected representatives - the directors. Directors owe a fiduciary duty to the stockholders meaning that they are supposed to act as prudent businessmen, in good faith and on a reasonable basis in the best interests of the stockholders. In the past the board of directors focussed solely on the interests of its stockholders. In last several decades public opinion, legislation and the courts have forced boards

¹⁴Grossman & Hart (1980b), p. 59.

of directors to consider a broader constituency including employees, consumers, the community, the environment and the national welfare.

In stockholder suits against management, the courts generally give management a great deal of leeway (rarely do stockholders ever win) by applying the "business judgement rule." Under the business judgement rule, a board of directors "enjoys a presumption of sound business judgement, and its decisions will not be disturbed if they can be attributed to any rational business purpose. A court under such circumstances will not substitute its own notions of what is or is not sound business judgement."¹⁵ Generally, the application of the business judgement rule contributes to the efficient management of the corporation. There is no reason to believe that the courts could improve on the performance of managers. Courts lack the experience, the speed, and, most importantly, the necessary information necessary to make business decisions. Furthermore, the courts recognize that market forces (e.g. the labor market, compensation packages, and the takeover market) operate more efficiently than judicial scrutiny in disciplining managers and providing incentives for managers to act in the best interests of stockholders.

The court's rulings on the legality of antitakeover defensive tactics is somewhat mixed, but generally the courts

¹⁵Gimbel v. Signal Companies, 316 A.2d 599, 609 (Del.Ch) aff'd per curiam, 316 A.2d 619 (Del.Supr. 1974).

side with the target management deferring to their better business judgement. In Panter v. Marshall Field & Co., a stockholder action attacking the rejection of a takeover proposal and the defensive measures taken by the board of Marshall Field against Carter Hawley Hale, the court held that the business judgement rule governs the actions and consideration of a takeover bid by the board of directors of a target.¹⁶ The court said:

Directors of a publicly owned corporation do not act outside of the law when they, in good faith, decide that it is in the best interest of the company and its shareholders that it remain an independent business entity. Having so determined, they can authorize management to oppose offers which, in their best judgement are detrimental to the company and its shareholders.¹⁷

On the other hand, the courts have sometimes questioned the motives of management, overriding the business judgement rule and ruling against management. The courts recognize that severe conflicts of interests between management and stockholders can arise in corporate control situations. In these cases, the burden of proof in court is on the board

¹⁶This is the leading case in defense of antitakeover defensive tactics. Critics would argue that the Marshall Field case was a special, isolated case. Marshall Field's growth had lagged that of other firms in its industry and had been approached repeatedly as a takeover candidate, each time rejecting the approach. Marshall Field has (quite vigorously) used the full array of defensive tactics against these merger proposals. Critics question how stockholders benefit by a legal rule that allows target managers to spend huge sums of stockholder's money for the purpose of preventing them from more than doubling their investment.

¹⁷Panter v. Marshall Field & Co., 486 F. Supp. 1168 (N.D. Ill. 1980), appeal docketed, No. 375 (7th Cir. March 21, 1980).

of directors to demonstrate a "compelling business purpose" to render their defensive actions fair rather than in their own self-serving interest. In Kennecott Corp. v. Smith, for example, the Third Circuit explained that "[w]hile being subjected to these [defensive] actions, which are designed to influence their decision, the shareholders cannot enjoy their federally protected right . . . to make a choice about the governance of their corporation or the disposition of their shares."¹⁸ The Seventh Circuit¹⁹ expressed its opinion against defensive tactics even more strongly in MITE Corp. v. Dixon:

[I]f the weapons in management's arsenal are dramatically augmented [by state antitakeover statutes], the vigor of the tender offer device will at some point be impaired, denying protection to shareholders in an obvious dimension: the right to tender their shares at a premium.²⁰

Thus, the courts do recognize the rights of target stockholders to receive a control premium, but at the same time do not want to take away the business judgement flexibility of management.

The Williams Act²¹ permits management to remain neutral when presented with a takeover bid. However, under some circumstances, management is legally obligated to take a

¹⁸Kennecott Corp. v. Smith, 637 F.2d 181 (3d Cir. 1980), at 189.

¹⁹The same court which gave the Marshall Field opinion.

²⁰MITE Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980), at 496.

²¹See Chapter Four for a description of federal, state and SEC regulation of the market for corporate control (including the Williams Act).

position (for or against) regarding a takeover bid. The court ruled in Insuranshares Corp. v. Northern Fiscal Corp. that "those who control a corporation . . . owe some duty to the corporation in respect to the transfer of control to outsiders."²² Insuranshares has been interpreted to require that management oppose transfers of control "if the circumstances surrounding the proposed transfer would alert suspicion in a prudent man that the purchasers are an irresponsible group who will mismanage and loot the corporate assets."²³ Once again, the business judgement rule is the governing doctrine most often followed by the courts.

²²Insuranshares Corp. v. Norther Fiscal Corp., 35 F.Supp. 22 (ED Pa. 1940), at 25.

²³McDaniel v. Painter, 418 F.2d 545, 547 (10th Cir. 1969). See also Swinney v. Keebler Co., 329 F.Supp. 216 (DSC 1971); Gerdes v. Reynolds, 28 N.Y.S. 2d 622, 651 (Sup. Ct. 1941).

Chapter 4. How Antitakeover Defensive Tactics Are Used

So far this thesis has explored the possible motivations behind a bidder's takeover attempt of a target firm, and has discussed the mechanics and techniques of control battles. Next the thesis presented two competing hypotheses as to why target managements often resist takeover attempts, and considered how the courts deal with these defensive actions. This chapter will describe (a catalog, so to speak) the full range of defensive tactics available to target-company managements. With this background, the thesis will be ready to test the wealth effects of these tactics and compare these findings to the results of others. The following is a description of currently legal defensive tactics. Some of these tactics are used prior to a control situation (e.g. antitakeover charter provisions), but most are undertaken by management when faced with a takeover bid or proxy fight.

4.1 Antitakeover Charter and By-Law Amendments

Antitakeover amendments made to a company's charter or by-laws tend to fall into one of three groups: (1) voting methods and approval percentages, (2) terms, nominations and powers of the board of directors, and (3) rights of the stockholders. These antitakeover charter provisions have been aptly named "shark repellents," serving as a first

line of defense to ward off potential raiders. Generally, these charter amendments serve to either make the approval of a takeover more difficult or to delay any transfer of control (particularly within the board of directors). Each of the following antitakeover amendments will be described in detail:

1. Supermajority voting approval
 - a) Merger
 - b) Remove/change number of directors
 - c) Amend charter/by-laws
2. Changes in business or capital structure
3. Board of directors
 - a) Removal for cause only
 - b) Staggered board (classified)
 - c) Advance nomination required
4. Fair price provisions
5. Changes in by-laws or amendments by board only
6. Creating class of voting preferred (see section 4.6)
7. Elimination of cumulative voting
8. Reduce stockholders' rights
 - a) No written consent
 - b) Increase percentage to call special meeting
 - c) Only board can fill vacancies
 - d) Elimination of preemptive rights
 - e) Special meeting called by board only
 - f) Limit voting power of substantial stockholders
9. Board must consider social factors in merger review

The incumbent management and board must present the arguments (pro and con) for these new amendments in the firm's proxy statement, and the amendments must be approved by the stockholders at the annual meeting. Typically, combinations of the above amendments (e.g. staggered board and elimination of cumulative voting) will be put together for approval all at one time, rather than presenting single amendment

changes at separate meetings.¹

4.1.1 Defenses Against Changing the Board at Annual Meeting

Staggered board provisions divide the board of directors into three equal classes of directors, each serving a three-year term with each such term ending in a successive year (this is a classified board). In contrast, with a non-classified board, every member stands for election at each annual meeting. The business justification for a classified board is that, at any given time, two-thirds of the directors will have had prior experience as directors of the company. However, the practical effect (whether intended or not) is that even a substantial majority-stockholder would have to wait for at least two successive annual meetings in order to elect a majority of the board and, thus, gain control. Furthermore, under Delaware law,² classified board members may not be removed before their terms expire without establishing cause, whereas non-classified board members may be removed at any time by a majority stockholder vote without specifying cause (unless stipulated by the firm's charter, see below). A classified board's incumbency is secured by this "lock-up" provision and by supermajority voting requirements to change the total number of directors.

¹But stockholders have the right to vote separately on each proposed amendment, choosing only those that he feels enhance his equity holding in the company.

²Approximately 45% of the corporations listed on the New York Stock Exchange are incorporated in Delaware.

Cumulative voting to elect members of the board³ has long been considered primarily a device to facilitate minority stockholder representation on the board and, therefore, has usually been looked upon with disfavor by management. In the absence of a staggered board, the incumbent management would likely propose an amendment to eliminate cumulative voting. However, when coupled with a classified board, cumulative voting can have the effect of extending the time it might otherwise take for a majority of dissident stockholders to obtain control of the board. For example, with a board of nine consisting of three classes of three directors, it would take a majority of the votes cast to elect two of the three directors standing for election in any one year. Voting under a cumulative system, even a dissident stockholder controlling 70 percent of the votes might, after two successive annual meetings, find that he had been able to elect only four of the nine directors.⁴ Nonetheless, few companies have combined cumulative voting with a staggered board, fearing that a dissident stockholder could gain representation on the board.

By requiring **advance nomination for director positions**, the incumbent board can ward off surprise nominations made from the floor at the annual meeting. Usually, management will have no fear of surprise nominations if dissidents

³See section 2.2 (the practice of takeovers) on the effects of cumulative voting in proxy contests.

⁴Example taken from Hochman & Folger (1979), p. 539.

did not solicit proxies or if the dissidents' intentions were not disclosed early enough by Schedule 13D filings. But if the company has a large block stockholder (e.g. 30 percent), the substantial stockholder could potentially propose his own slate of directors and get them elected from the floor of the annual meeting. By requiring advance nomination, the incumbent management has the time to establish a defense using the standard proxy fight techniques (including delaying the annual meeting). Although the right to make nominations from the floor seems like an inherent right of stockholders, one could argue that this provision gives stockholders time to consider the qualifications of all nominees before voting.⁵

Some companies have proposed (and even passed!) amendments **limiting voting power** of substantial sized stockholders.⁶ The statutes of most states allow firms to establish almost any voting practice they please. In almost every corporation, each common share has one vote, and only those shares possess votes. In a few instances, target firms have passed an amendment which dilutes the one share, one

⁵A further by-law limitation on the right to nominate directors has been held legal in several cases: director nominees must meet certain qualifications, including residency in the county in which the corporation has its principal place of business. See *McKee & Co. v. First Nat'l Bank*, 265 F.Supp. 1 (S.D. Cal. 1967).

⁶Easterbrook & Fischel (1983) provide an excellent discussion on the practices and values of voting in corporate law. They describe how managers can effectively use the proxy machinery to their own advantage.

vote status for those shares held in single blocks. For example, the charter amendment may dictate that the shares held in any single block greater than 20% of the outstanding stock will carry only 1/10th of a vote per share, rather than a full one vote.

4.1.2 Defenses Against Changing Board Prior to Annual Meeting

Several antitakeover amendments limit the rights of stockholders to influence management outside the setting of the annual meeting. Limitation of right to call special meetings depend upon each particular state's statute, but in many cases the by-laws can be changed to permit only the board - and not the stockholders - to call a special meeting.

Some states' corporate codes (including Delaware) allow stockholders to take action by written consent, if the requisite proportion of stockholders sign the written consent and prompt notice thereof is sent to all other stockholders, rather than through a formal meeting. Thus, a bidder could request written consent from the target's stockholders approving changes in the corporate charter, including approval of changes in the way in which the board is elected or how a proposed merger is approved. An amendment to eliminate written consent would force a bidder to wait at least until the next stockholder's meeting to implement changes in the firm's activities (even if the bidder owned a majority

of the outstanding shares).

Other amendments have been adopted to increase the difficulty of removing incumbent directors. In some states, charter changes allow directors to be removed from office for **specific causes only**. Typically, with a non-classified board, stockholders can remove any or all directors for virtually any reason. The exact conditions constituting "cause" are spelled out in the charter amendment, sometimes limiting cause to criminal or quasi-criminal types of conduct. Furthermore, even in the "cause" conditions are satisfied, the amendment may require a **supermajority vote for removal** of the directors - often 80 percent of the shares outstanding. This amendment limits a bidder's ability to quickly replace an incumbent board with its own slate of directors even if the bidder controls a majority of the outstanding shares (but not a supermajority).

In order to prevent a majority stockholder from circumventing the effect of a classified board, management may propose an amendment to provide that the power to determine the **number of directors** and the power to **fill vacancies** be vested solely in the board and not with the stockholders. Otherwise, a majority stockholder could obtain control by enlarging the size of the board and filling the new vacancies with his own directors. This amendment is obviously complementary to staggered board and supermajority voting amendments.

4.1.3 Defenses Against Attempts to Impede Incumbent Board

The statutes which govern the vote required to amend the charter and by-laws differ considerably from state to state. In Delaware, the charter can be amended only if the proposed amendment is first approved by the board of directors and then by the stockholders. Thus, as long as incumbent management controls the board of directors, anti-takeover charter provisions remain secure. In New York, on the other hand, stockholders can act directly to amend the charter without action by the board. In such states, a large stockholder could use various charter amendments to frustrate the board getting around the above described amendments. For example, this stockholder could through charter and by-law amendments:

- a) elect and determine the duties of corporate officers;
- b) pack the board by filling vacancies, whether arising by resignations or from an increase in the number of directors;
- c) permit the calling of special meetings, the removal of directors, the abolition of other defensive charter amendments;
- d) abolish provisions indemnifying officers and directors;
- e) require unanimous votes for all board actions (just one board seat has veto power); or
- f) slow down the board by requiring board action only at actual meetings or (more frustrating) only at

meetings in the state of incorporation.⁷

To prevent stockholders from using by-law changes as such a weapon against incumbent management, an amendment could be considered which required **supermajority approval** of any charter and by-law amendments. This effectively "locks up" the other antitakeover amendments. Or even more stringent, an amendment could remove the stockholders' right to make amendments directly, requiring that charter and by-law amendments be made **only by the board**.⁸

4.1.4 Antisqueezeout Charter Provisions

Supermajority merger approval provisions require that more than a simple majority (e.g. 80 percent) of the outstanding shares must approve a merger or similar transaction such as liquidation, consolidation or sale of major assets. Supermajority approval usually applies only when the transaction involves a "substantial stockholder," most often defined as a holding of more than 10 percent. Most supermajority provisions stipulate approval percentages from 67 to 80 percent, although some have required as much

⁷These examples are taken from Hochman & Folger (1979). See Hochman & Folger for cited statutes and common law cases. They cite an interesting case whereby DPF Incorporated, through the use of by-law changes, completely handcuffed the ability of the board of Interstate Brands Corporation from making normal business decisions.

⁸The corporate codes of some states may not allow this (e.g. New York). In this case, management might consider amending the charter to require board action as a precondition to all future charter amendments.

as 95 percent (under certain conditions). Other supermajority amendments require a majority or supermajority of shares not held by the substantial stockholder. This supermajority approval requirement may delay or block a bidder from implementing a merger strategy even though he controls the target's board of directors.

Because supermajority merger approval may in some cases be too constraining to the decision-making of the company, supermajority provisions often include escape clauses. Transactions covered by the escape clauses usually include (1) internal corporate reorganizations where the transaction is between the target company and its own subsidiary or (2) friendly external transactions where the target's board approves the merger.

Fair price provisions inhibit a bidder from squeezing out minority shareholders even after the bidder has gained control of the target's board of directors. Such provisions are strong forms of supermajority approval whereby stockholders who do not tender their shares in a takeover bid will receive a price for their shares in any follow-on merger at least as high as the original tender offer price. The determination of the "fair" price to the remaining minority stockholders is usually stated in terms of market values or as some P/E multiple of earnings per share. Some fair price redemption clauses stipulate that any remaining stockholder may demand payment (at any time) at the specified "fair" price for

the shares he still owns once the bidder acquires more than 50 percent of the currently outstanding stock. As with supermajority merger approval, escape clauses exist for fair price provisions: (1) when a very large percentage of the stockholders waive them or (2) when the same board of directors continues on with the new entity.

Fair price provisions discourage takeovers in several ways. First, they reduce the pressure on stockholders to tender their shares at the initial offer by assuring them that they will receive a price at least as high as the tender offer price if they do not tender (assuming the bid is successful). Second, they prevent the bidder from buying the target at a bargain price and then squeezing out the remaining stockholders at a lower price. With fair price provisions, the buyer loses some control over what price he will ultimately have to pay. Although many more companies have adopted supermajority merger approval than fair price provisions, some stockholders may find the fair price amendment easier to accept. Fair price provisions focus directly on the fair treatment and interests of public stockholders, rather than "entrenching" management's position by increasing the approval percentage needed for a transfer of control.

4.1.5 Other Antitakeover Charter Defenses

Change of state of incorporation to a state where the corporate codes contain more antitakeover provisions

or where state officials impose more regulation on tender offers was once a viable defensive tactic, but today a large majority of states have adopted antitakeover statutes. Relatively few states remain with no tender offer regulation. Hochman & Folger (1979) suggest changing incorporation to states having milder, more neutral statutes which are not likely to be inconsistent with the Williams Act.⁹

Another charter amendment authorizes the board of directors to consider the **social effects of a merger** in addition to the exclusive interests of the stockholders. Control Data Corporation first made this sort of proposal to its stockholders in 1978 whereby the directors are expressly asked to review the social and economic effects on employees and local communities of any transaction proposed by another corporation. Presumably, the purpose is to legitimize for directors another area as grounds for rejection of proposed offers. Many companies that agree with Control Data on the morality of hostile takeovers, however, find it difficult to use this kind of defense. It puts on the record commitments that a company may find undesirable to keep in the future, such as laying off a large number of employees or selling an unprofitable plant.

⁹The Williams Act (see section 4.2) is a federal statute regulating tender offers. Bidders have at times attacked a particular state's antitakeover statutes and subsequently, have successfully completed the takeover of the target.

4.1.6 How Shark Repellents Have Been Accepted

Antitakeover charter and by-law amendments have generally been approved by stockholders. During the 1983 proxy season, 95 percent of the 180 companies that proposed the two most common shark repellents (staggered boards and super-majority merger approval) got them approved.¹⁰ Some companies whose proposals were turned down actually received majority votes, but fell short of the two-thirds margin often required for approval. Roughly 20 to 30 percent of all New York Stock Exchange companies currently have some antitakeover provisions in effect, and an additional 10-20 percent intend to add shark repellents in 1984.

Thus, stockholders nearly always approve antitakeover charter amendments. But resistance to these shark repellents, particularly among institutional investors, has been rising rapidly in the past several years. In the past, institutional investors followed the "Wall Street Rule" whereby professional money managers either supported incumbent management or sold their position in the firm's stock. Given the 1983 proxy season and the number of battles shaping up currently in 1984, institutional investors seem to have speeded up the gradual movement away from the Wall Street Rule towards

¹⁰There were some notable exceptions in 1983: Data General, International Paper and Black & Decker. Each of these companies has been rumored from time to time to be a takeover candidate. In these cases, stockholders had a clearer view of the takeover premium they could potentially receive.

greater independence. Those institutional investors acting as fiduciaries, most notably pension fund managers subject to the strict fiduciary standards of the Employee Retirement Income Security Act (ERISA), often have had no choice but to oppose antitakeover proposals that could diminish the value of portfolio securities:¹¹ "As fiduciaries, we cannot justify voting for provisions which would make it easier for incumbent management to fend off buyers who would like to pay a premium for our stock."¹²

By deferring to the business judgement rule (discussed in section 3.4), the courts have generally allowed incumbent management to make antitakeover proposals which the board views as prudent. But some securities regulators have taken a somewhat dim view of antitakeover amendments, such as the Wisconsin Securities Commissioner:

We believe that certain of the common defensive charter amendments [are] an anathema to shareholder democracy and entirely inconsistent with the concept of public ownership of corporate issuers. For that reason, for the last two years or so, Wisconsin has been reviewing the articles and by-laws of issuers seeking to register their securities in this state.¹³

Furthermore, the New York Stock Exchange (NYSE) screens any proposed charter or by-law changes involving defensive measures to ascertain that they do not conflict with NYSE

¹¹The empirical results in Chapter Six will show the actual stock price effects of antitakeover provisions.

¹²Alan Strassman, Batterymarch Financial Management, quoted in the Wall Street Journal (March 30, 1984).

¹³Jeffrey B. Bartell, Securities Commissioner of Wisconsin, quoted in Hochman & Folger (1979), p. 546.

policies. The Exchange is likely to object to provisions impinging upon the voting rights of stockholders or that differentiate between the rights of several holders of the same security. The Exchange has, on occasion, refused to authorize the listing of additional shares or threatened to delist the company's securities unless the offending policy violations were removed.

4.2 Federal, State and SEC Regulation

Until the late 1960s, no federal laws specifically regulated takeovers. The Securities Act of 1933 concerned itself largely with disclosure matters pertaining to the sale of securities to the general public.¹⁴ The three anti-trust statutes - the Sherman Act (1890), the Clayton Act (1914), and the Cellar-Kefauver Act (1950) - blocked some vertical and horizontal mergers but not the conglomerate or multi-industry types that were the rave of the late 1960s. In addition, other federal laws and their related administrative agencies (e.g. the Federal Communications Act, the Atomic Energy Act) influenced takeovers in certain regulated industries by: (1) requiring advance clearance for changes in control of firms under their regulation, and (2) imposing limits on the extent of foreign ownership in those firms.

The rash of conglomerate mergers in the late 1960s

¹⁴Obviously, this act covered any new securities issued for exchange in a merger or tender offer transaction, but did not apply to any cash transactions.

prompted Congress to take some action to regulate takeovers, primarily targeted at cash tender offers.¹⁵ In July of 1968, Congress enacted into law the Williams Bill. A good deal of regulatory legislation has followed right up to the present day - federal and state laws, and SEC regulations. The primary intent of all this regulation was to establish disclosure and timing requirements that will protect the rights of stockholders and balance the relative positions of bidders and targets. The remaining parts of section 4.2 describe the principal federal, state, and SEC statutes regulating takeovers, primarily cash tender offers. The section concludes with a discussion of how target managements can use these regulations to deflect takeover bids.

4.2.1 Securities Act (1933) & Securities Exchange Act (1934)

The Securities Act of 1933 provides for "truth in securities." The 1933 Act had two basic objectives: (1) to provide investors with material financial and other information concerning securities offered for public sale, and (2) to prohibit misrepresentation, deceit and other fraudulent acts and practices in the sale of securities. The Securities Exchange Act of 1934 filled in some of gaps in the 1933

¹⁵Cash takeover bids were very rare in the United States prior to the mid-1960s. It has been argued that changes in proxy rules in 1964 raised bidders' costs of obtaining control via a proxy contest which, in turn, lead to the increased usage of the cash tender offer to achieve a change in control.

Act and extended securities regulation by creating the Securities Exchange Commission (SEC). The 1934 Act requires that companies¹⁶ register any new securities with and provide periodic financial information to the SEC. Furthermore, the 1934 Act regulates the solicitation of proxies by registered companies and prevents the manipulation of security prices in the exchange markets. These two landmark acts provide the primary regulation governing control transactions which involve the exchange of securities, and set the basic rules governing proxy contests. But these acts in no way influence transactions which do not involve the exchange of securities (i.e. cash transactions).

4.2.2 The Williams Act

The Williams Act extended the jurisdiction of the 1934 Act's provisions for disclosure and antifraud to include tender offers, open market purchases of a target's securities, and repurchases by the target of its own securities. The major provisions of the Williams Act are its disclosure requirements, its regulated minimum tender period, and its antifraud provisions that give the target management standing to sue for injunctive relief. The intent of this act when passed in 1968 was to prevent the sudden takeovers of the 1960s by providing target stockholders with more information

¹⁶This covered companies which either have securities listed on national exchanges or meet certain asset and public ownership tests.

about the bidder and to give them more time to decide whether or not to tender. The proponents of the act reasoned that disclosure provisions coupled with greater time for evaluation would enable target stockholders to make better decisions and would lessen the chance of the bidder taking advantage of target stockholders - especially small investors.

After acquiring beneficial ownership of at least five percent of a target's common stock, the bidder is required to file a **Schedule 13D** with the SEC and the target within ten days of the purchase.¹⁷ This requirement holds for all equity purchases whether made privately,¹⁸ on the open market, or by tender offer. The Schedule 13D statement must disclose: (1) the purchasers identity including any associates, (2) the source and amount of funds used in the purchase (including details about borrowings), (3) the purpose for which the purchase is being made, (4) the number of shares the purchaser now owns, and (5) any details about arrangements the purchaser has made with other parties with respect to the acquired stock. If the purpose of the purchase is to acquire control of the target, the bidder must also disclose a description of any plans to liquidate the target,

¹⁷The percentage ownership was initially set at ten percent, but was made more stringent to five percent in the 1970 Amendments to the Williams Act.

¹⁸The Securities Act of 1933 had exempted private transactions from disclosure. The Williams Act extends the SEC's jurisdiction over these private transactions as well; thus, requiring disclosure on all acquisitions of stock over five percent.

sell its assets, merge it, or make any changes in its basic corporate structure.

If after disclosing on Schedule 13D that the bidder intends to proceed with acquiring control of the target, the bidder must file a **Schedule 14D** with the SEC at the time he makes a tender offer to the stockholders of the target.¹⁹ This disclosure under Section 14(d) of the Williams Act pertains to anyone - including the incumbent target management - making recommendations to the target stockholders with regard to the acceptance of a tender offer. The Schedule 14D discloses the reasons for the recommendation and any arrangements made between the purchaser and the target's management. As a defensive measure, the target management usually has a Schedule 14D fully prepared with an agent in Washington ready to be filed with the SEC in the event of a hostile tender offer, allowing a swift public recommendation to their stockholders.

In addition to the disclosure requirements, Section 14(d) imposes several requirements on the tender offeror to protect the target stockholders. First, persons tendering their shares to the bidder have the right to withdraw their shares during the first seven days in which the offer is

¹⁹As originally introduced, the Williams Bill required the bidder to disclose his plans in a Schedule 14D for a tender offer before actually making the tender offer. This obviously gave incumbent management an unfair advantage; and thus, the bill was changed to require filing simultaneously with the transmittal of the tender offer.

outstanding or after sixty days from the making of the offer. This permits target stockholders to change their minds if a more attractive competing offer is made soon after the first tender offer. Second, if the offer is for less than all of the outstanding shares of the target and if a greater number of shares are tendered than will be accepted by the bidder under the terms of his tender offer, the bidder must accept the shares tendered in the first ten days pro rata. This prevents the bidder from, as was frequently done prior to this act, giving preferential treatment to some stockholders by making the offer on a first-come, first-served basis. In addition, this requires the bidder to hold the offer open for a minimum of ten days.

Section 14(e) of the Act makes the disclosures contained in Schedules 13D and 14D effective by providing a general antifraud provision which prohibits material misstatements or omissions or other deceptive acts related to the tender offer. Target managements have used this provision to sue the bidder in an attempt to ward off the tender offer (or at least to delay the offer) or to tarnish the reputation of the bidder influencing the stockholders' tendering decision. Prior to the Williams Act, the courts had held that only the target stockholders - and not the management - had standing to challenge fraudulent actions by the bidder.

The 1970 Amendments to the Williams Act expanded

the scope of the Act to cover exchange offers.²⁰ Furthermore, the 1970 Amendments through Section 14(e) granted the SEC the power to make rules to "define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative."²¹ While this increased power of the SEC sounds quite noncontroversial, the SEC has interpreted section 14(e) quite broadly establishing sweeping regulation over most takeovers. Several of the more significant rules resulting from this new power are worth mentioning. First, target management is required to inform other stockholders how whether or not they intend to tender their own shares in the target. Second, the SEC made "short-tendering" illegal. Brokers and arbitrageurs previously could short-tender by tendering more shares than they actually owned, promising to make delivery within a short period of time. The SEC felt that this practice was abused by arbitrageurs who, by betting on oversubscription to a pro rata tender offer, would tender more shares than they planned to purchase in order to have proportionately more shares accepted by the bidder than other tenderers. This rule has the effect of causing tender offers to remain open longer.²²

²⁰Exchange offers are tender offers in which payment is made (at least partially) with the bidder's stock or bonds rather than entirely with cash.

²¹Brown (1971), p. 1647.

²²This happens because the bidder making the tender offer must wait for stock certificates to be delivered.

In summary, the Williams Act and Amendments were designed to protect target stockholders by enabling them to make "better" decisions through increased disclosure (particularly by the bidder) and more time before the tender offer expires. In practice the Williams Act does much more: it gives the SEC broad rule-making power, and through its broad proscription of fraud, provides much new ground for litigation. Faced with a hostile tender offer, incumbent managements have learned to use these new sources of litigation most effectively, often scaring away the bidder or dramatically slowing the tender offer process. And in takeover battles, the success of a tender offer depends a great deal on its speed of execution.

4.2.3 State Takeover Legislation

Prior to the Williams Act in 1968, only Virginia had a state law directly regulating tender offers. Today, 38 states have enacted takeover legislation, some of which are much more stringent on bidders than the Williams Act. The provisions of most state takeover statutes are similar to the Williams Act in that they require increased disclosure and delay periods, but often the hurdles for bidders are more onerous and are the result of different motivations than the Williams Act. Although most state takeover statutes have similar themes, almost every state structures its specific

provisions differently.²³ Most states claim that their duplication and extension of federal regulation increases investor protection, but in reality some of the state provisions significantly increase the ability of incumbent management to successfully fend off a hostile takeover bid.

State tender offer laws base their jurisdiction over tender offers upon the relationship between the target corporation and the state. A combination of factors usually is used to determine this relationship, such as state of incorporation, principle place of business, or location of substantial assets. Like the Williams Act, the state laws apply once the bidder has acquired a specific number of shares of the target. All state tender offer statutes require the bidder to disclose information about itself and its intentions, but generally these disclosure requirements are much more extensive than the federal Schedule 13D filing. Under the Williams Act, tender offer disclosure is made on the day of the actual tender offer, whereas all state laws are more stringent requiring disclosure of tender offer plans well in advance of making the actual offer.²⁴ The state laws also require tender offers to remain open

²³For a detailed discussion on the differences between the various states having takeover legislation, see Aranow, Einhorn & Berlstein (1977). Also, Jarrell & Bradley (1980) provide a comprehensive chart summarizing the critical issues, pp. 406-407.

²⁴Most states require disclosure between ten and thirty days before the offer is announced, giving incumbent management more time to prepare a defense.

longer than the period required under federal law or by the SEC.²⁵ Furthermore, state laws provide rather liberal withdrawal rights to tendering stockholders which also tends to lengthen the time the tender offer must remain open.

The most important provisions of state takeover regulation establish administrative procedures by which a tender offer can be significantly delayed or directly outlawed if it goes against the state law. The state securities commissioner can request and, in many states, the target management can demand a hearing to determine whether full and effective disclosure has been made and if the offer is in compliance with statutory requirements for tender offers. In several states, the commissioner also has the power to prohibit any offer that he finds to be unfair or inequitable to the target stockholders.²⁶ The state statutes back up the commissioner's authority by giving him the power to seek an injunction in state court to delay or prevent the tender offer.²⁷ In addition, many of the state statutes provide that an offeror who violates the state law shall be liable for damages to an offeree (and, in a few instances, to non-tendering stockholders). Most of the state laws also make violations a criminal offense and subject violators

²⁵Massachusetts and Michigan require that tender offers under their jurisdiction remain open 60 days!

²⁶Neither the federal courts nor the SEC has comparable power under the Williams Act.

²⁷In Virginia the commissioner actually has the authority to issue the injunction directly with the same force and effect as if it was issued by a court.

to fines and/or imprisonment.

In general, the intent of federal takeover legislation has been to benefit the aggregate economy and to protect target stockholders, whereas state legislators have often acted to benefit more local interests. Quite often these local interests include efforts to maintain the independence of the target firm to ensure the future of local employment and local corporate taxes. Conceivably, such efforts to maintain the independence of the target through state takeover statutes could prevent target stockholders from receiving a significant takeover premium and rob the larger economy of the beneficial synergies created by the combination of the two firms.

This conflict in legislators' intents provides the basis for a continuing struggle to determine the constitutionality of many state tender offer laws and of states jurisdiction to regulate takeover bids. Often the constitutionality of these state laws is not tested until a bidder brings a counter-suit against its target, following the target's filing of a suit claiming violations of state takeover laws by the bidder. Unfortunately, by this time the bidder's tender offer has become so deeply embroiled in litigation that it has very little chance of success.

4.2.4 Hart-Scott-Rodino Act

The Hart-Scott-Rodino Antitrust Improvements Act,

which became effective in 1977, amends the Clayton Act requiring the bidder to make direct notification of tender offer plans to the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice. The law effects companies of \$100 million or more in sales or assets that expect to acquire companies of \$10 million or more in sales or assets. The Hart-Scott-Rodino Act provides for a waiting period during which the antitrust regulators have the opportunity to examine the proposed takeover for violations of the antitrust before the transaction may proceed. Furthermore, the FTC or the Justice Department can extend the waiting period by making further requests for information on the proposed combination. This provides yet another delay in the tender offer process, a delay which reduces the bidder's chances of success. Also, this pre-notification to antitrust officials releases valuable information to the market, particularly to other potential competitors, which was costly for the initial bidder to collect. Thus, Hart-Scott-Rodino disclosures tend to discourage bidders from attempting takeover bids because (1) it causes delays in the takeover process, and (2) it forces the bidder to give up (costly) information. Both effects tend to shift the balance of power towards the target management.

4.2.5 Accounting Principles Board Opinions 16 and 17

The Accounting Principles Board (APB) Opinions 16

and 17 restricted the use of the pooling-of-interests accounting method to only those business combinations meeting twelve different criteria. APB Opinions 16 and 17 also required amortization of the excess in the purchase price over the book value of net assets acquired (i.e. goodwill) for business combinations using the purchase method of accounting. Pooling accounting was the dominant accounting treatment used for mergers in the wave of conglomerate mergers in the late 1960s, but some people criticized the method as misleading and unfair in that pooling tended to overstate current earnings. The Accounting Principles Board issued these two opinions in 1970 in response to these criticisms.

But many merger specialists argued against the new accounting restrictions convinced that many worthwhile combinations would be barred. The adverse effects predicted by the opponents of the APB Opinions were based on the expected effects of purchase accounting on the accounting numbers of the combined entity. Purchase accounting invariably leads to lower reported earnings per share than does a pooling-of-interests. The choice of accounting method for the merger has no effect on the actual future cash flows of the merged firms. According to finance theory, which believes that investors can "see through" the higher EPS generated by pooling accounting, the choice between pooling or purchase accounting will have no effect on the real economic value of the merger.

Consequently, one could argue that these APB Opinions have no effect on takeover activity nor do they influence bidders' decisions to proceed with a takeover transactions. But to the extent that bidder managers believe that reported accounting earnings do in fact impact stock prices (as opposed to expected cash flows), these APB Opinions restricting the use of pooling accounting and requiring the amortization of goodwill will tend to discourage takeover attempts. Schipper and Thompson (1983) also argue that APB Opinions 16 and 17 may have other indirect effects for individual firms whose lending agreements depend on the firm's accounting numbers. To the extent that some bidding firms are constrained by these loan agreements, their stockholders are made worse off by the accounting rules.

4.2.6 The Impact of Takeover Regulation

The most significant impact of takeover regulation by federal and state statutes and SEC rule-making has been to provide the management of target companies with substantial warning of pending offers. These takeover regulations make it more difficult for the bidder to prepare its offer in the total secrecy often required for successful execution, and they give the target's management ample time to respond to the offer. After receiving notice of a proposed tender offer, the target management has a variety of opportunities to delay the effective date of the offer or to tarnish the

reputation of the bidder in an attempt to influence target stockholders: (1) file suit against bidder for improper or fraudulent disclosure on Schedules 13D and 14D; (2) file suit on the basis of not adhering to minimum tender offer waiting periods as dictated by the Williams Act, the SEC, or the Hart-Scott-Rodino Act; (3) demand a hearing before the state securities commissioner if a state tender offer law applies; (4) prepare an effective public relations campaign against the bidder. From the standpoint of the bidder, any form of regulation or any action by the target which serves to delay the tender offer process functions to reduce the probability of successfully completing the takeover and to increase the probability that a competing offer will be made, forcing the offeror into a bidding war.

Whereas the Williams Act probably creates a more equitable balance between the bidder and the target, the state takeover statutes tend to push the balance too far in favor of the target. The increased disclosure required by state takeover statutes over and above that dictated by the Williams Act provides little marginal value to stockholders. However, the statutory disclosures do provide vastly increased opportunities for target managements to find fault with the disclosures made by the bidders and to obtain injunctions halting the takeover bids. Regardless of the ultimate success of the target's suit against the bidder over the accuracy and sufficiency of disclosure,

the statutes provide numerous opportunities for the target to challenge, and thereby delaying the offer and its probability of success. In addition, disclosure requirements impose direct administrative costs on the bidder. But there is also the possibility that the disclosure and the delays place less knowledgeable stockholders on an equal footing. In this respect, the benefits obtained from the disclosure may far outweigh the costs to the bidder.

The regulatory provisions lengthening the time in which a tender offer must remain open likely have a beneficial effect on takeover transactions. To the extent that the takeover statutes facilitate better, more rational decisions on the part of target stockholders, the social welfare of the aggregate economy is improved. Furthermore, these takeover regulations may benefit target stockholders by causing the bidder to raise its tender offer price in order to obtain the approval of the target's management. In addition, during the waiting period the stockholders may be offered a better price from a competing buyer. On the other hand, if takeover regulation disrupts the control transfer process so much that prospective bidders refrain from making takeover bids or withdraw from contested situations, then stockholders lose the opportunity to obtain a control premium for their

shares.²⁸

4.3 Litigation and Other Legal Recourse

If the target management plans to present any sort of defense in response to a takeover bid, the most likely initial action will be to hire antitakeover defense lawyers. Legal defenses which utilize the judicial system to the hilt require the masterful minds of Wall Street defense lawyers and investment bankers. The amount of litigation involving corporate control transactions continues to mount each year. Not only have target managements learned how to use litigation as an effective defensive tactic, target stockholders are beginning to stretch their legal muscle in the courts by filing lawsuits against "entrenched" managements whose defensive tactics prevent them from obtaining premiums for their stock.

Direct attacks on the legality of a takeover bid can be made in both judicial and regulatory forums at both the federal and state level. In addition to bringing its own proceeding in one of these forums, the target can approach federal and state regulatory agencies urging the government to commence its own action against the bidder. An aggressive target may even purchase shares of the bidder and thereby

²⁸These various hypotheses concerning the effects of takeover regulation on the welfare of bidder and target stockholder groups have been examined by several authors and will be discussed in section 5.2 of Chapter Five.

qualify to bring a stockholder suit to block the acquisition. Quite often the target is relatively unconcerned about the ultimate disposition of these legal proceedings, but rather the lawsuits are used as a tactical advantage to buy time and "chill" the arbitrage activity in the target's stock.²⁹ Some of these lawsuits, particularly those involving antitrust issues, are real "show-stoppers" in the sense that the litigation halts the takeover bid dead in its tracks; others are considered merely "roadblocks" delaying the takeover process.

Using litigation as a defensive tactic, the target will seek to assert as many challenges in as many forums as possible. The target need only win one motion for a preliminary injunction in one court or obtain one hearing before one regulatory agency to significantly delay the takeover process and to force the bidder from the offensive to the defensive. On the other hand, the bidder has to fend off every challenge in every forum to ensure that its takeover attempt proceeds with the requisite speed. To the bidder, defending against these defensive legal affronts consumes both management time and money.

These lawsuits hope to accomplish several possible results as defensive measures. First and foremost, the lawsuits are intended to have offers which fail to meet

²⁹Many of the legal proceedings brought during a takeover battle never actually reach the stage of a final decision.

legal requirements (e.g. in disclosure or in tender offer mechanics) either quashed or withdrawn. Second, the intention is to gain time - time for the target to mount a campaign against the bidder through letters, advertisements, telephone calls and through the press denigrating the bidder and his offer.

As a defensive tactic, a lawsuit in **federal court** seeking equitable relief to prevent a takeover bid from going forward will generally set forth one or more of the following causes of action: (1) disclosure violations; (2) margin violations;³⁰ (3) breach of fiduciary duty by a party to the proposed transaction or a conflict of interest involving such a party; and (4) antitrust violations.³¹ Regardless of whether the takeover attempt is through merger, tender offer or proxy fight, there exist many variations on these four basic themes by which the target could mount a credible legal defense. Some of the more significant will be mentioned.

The tender offer disclosure requirements of the Williams Act and the SEC's rules (as discussed above in section 4.2) provide a fertile source of challenge for the target. Schedule

³⁰The Federal Reserve, through its rules Regulations U and T, imposes limits on the amount of credit that can be used to acquire publicly-traded securities. The amount of borrowing must be disclosed by the bidder on Schedule 14D. The target may use this information to file a suit claiming that the bidder has over-extended its margin limits.

³¹Lipton & Lesser (1982) present this basic outline for various types of litigation as a defensive tactic.

14D presents the most vulnerable point of attack due to the numerous specific topics which must be disclosed by the bidder. In addition, the Williams Act imposes a general obligation on the bidder for full disclosure of material information under which the creative target can allege some error or omission within this "catch-all" requirement. These disclosure violations are not show-stoppers because the target can correct its disclosure, but they often buy valuable time and serve to embarrass the bidder.

Banks which finance tender offers play a "critical role in determining whether tender offers will go forward" and as a result exert a "significant influence in determining whether [target] management survives."³² The banks provide bridge financing to the bidder in order to complete a tender offer during a relatively short period of time, and the number of financial institutions able to extend credit in sufficient quantities is limited, particularly given today's multibillion dollar mergers. Consequently, a relatively small number of commercial banks have the resources to finance a bidder's takeover attempt, but those same banks often have client relationships with the target firm. This places the banker in a difficult dilemma: customers on both sides

³²Humana, Inc. v. American Medicorp, Inc., CCH Fed. Sec. L. Rep. 96,286 at 92,829 (S.D.N.Y. 1978).

of a hostile takeover.³³

These conflict-of-interests situations furnish the target with the opportunity for making embarrassing and reputation-damaging charges of breach of fiduciary duty, conflict of interest, and misuse of confidential information.³⁴ This breach of fiduciary duty defense is not a show-stopper, because a court may rule that a particular bank cannot finance the tender offer, but it will not grant an injunction against the tender offer on this basis. However, this defense does create a credible roadblock.

An antitrust challenge is potentially the most significant defense to a takeover because, if successful, it is frequently a show-stopper in that the bidder is forced to withdraw his hostile takeover. To obtain an injunction against the bidder, the target can file suit directly or it can request the Justice Department or the FTC to examine the proposed takeover. Claims are usually made under the Sherman Act Section 1 or the Clayton Act Section 7 alleging that the merger will lessen competition in the relevant

³³The same delimma often arises for the limited number of investment banking and law firms that have mergers and acquisition expertise. These conflicts are not new to these firms, for potential conflicts of interest arise virtually every day in their respective businesses. See Shapiro (June 1979), "Bankers in a Bind," for an interesting discussion of this problem.

³⁴Commercial and investment bankings have developed internal systems, known as a "Chinese Wall," to control the flow of confidential information between departments within the bank. The courts have recognized and approved these "Chinese Wall" systems.

geographic and/or product markets. The Antitrust Division of the Department of Justice has issued "Merger Guidelines" setting forth the standards it applies in determining whether it will challenge the proposed takeover. The bidder may possibly be able to persuade the court that it will abide by any divestiture rulings following the completion of the merger, but generally the courts are leery of these promises and will likely put an end to the takeover attempt.

There exist many other types of legal defenses, most notably claims of violations of state takeover statutes (as discussed in section 4.2.3). An interesting legal angle was attempted by Marshall Field & Co. in its defensive fight against investor Carl Icahn.³⁵ Marshall Field charged Icahn and his group with "racketeering," based on the federal Racketeering Influenced & Corrupt Organizations Act of 1970 (RICO). RICO was originally passed to provide a basis to prosecute companies associated with organized crime. Marshall Field used the law with a different twist, never claiming that Icahn was connected to organized crime. But the adverse publicity surrounding the racketeering charge fulfilled its intended purpose: an injunction was issued against Icahn giving Marshall Field time to arrange a merger with a "white knight."

³⁵See Business Week, May 24, 1982, p. 91.

4.4 Scorched Earth

The term "scorched earth," derived from the traditional war technique of starving an invading army by razing the home countryside, denotes a defensive tactic where the target makes itself significantly less attractive in an effort to discourage the bidder. It is difficult to categorize the various scorched earth defensive tactics because they usually depend upon the unique characteristics of the target company. Generally, a scorched earth defense includes any action taken by the target to make its company less appealing than it currently is to the bidder, i.e. action which will likely reduce the target's market value when combined with the bidder. The McGraw-Hill/American Express battle in 1979 serves as an illustrating example.

In response to an unsolicited tender offer by American Express, McGraw-Hill Chairman Harold McGraw did everything in his power to convince American Express that the company would be decimated by critical employee defections if the takeover bid went through. For example, when Business Week editor Lewis Young wrote a memo to his staff expressing his concern that American Express might not respect the editorial independence of the magazine, McGraw-Hill's defense team made sure that copies of the memo were made available to the press. McGraw Hill sent a letter to the board of American Express, reprinted in a two-page newspaper ad, in response to "concerns voiced by many of the constituents

served by McGraw-Hill - authors, journalists, business people around the world, employees and shareholders of McGraw-Hill, Inc."³⁶ It is significant that shareholders were listed last. These actions led American Express to fear that McGraw-Hill might really become a "shell" after a long and acrimonious takeover fight. Consequently, American Express withdrew its tender offer and McGraw-Hill's stock dropped precipitously to its pre-offer level.

Many variations on this basic scorched earth theme are possible and many involve strong personal attacks. The specific scorched earth tactic employed depends to a great extent on the specific characteristics of the target and bidder, and on whether the target board has the stomach for such tactics. Often the scorched earth action involves (1) sale of attractive or under-valued assets, (2) partial liquidation or spin-off, (3) total liquidation, or (4) self-tender which places the company severely into debt. Scorched earth tactics can function as a double-edged sword: an angered bidder may attack that much more aggressively and stockholders often file a spate of lawsuits against the management.

Some courts have expressed outrage at various scorched earth tactics. In a takeover battle with Joseph E. Seagram & Sons, the target management of St. Joe Minerals proposed selling a significant division (Can Del) and threatened

³⁶Institutional Investor, June 1979, p. 35.

to liquidate the company if Seagram proceeded with its offer. Judge Pollack of the Southern District of New York expressed his view of such tactics:

It is inconceivable that an alleged flourishing enterprise has authorized its board to subject the assets and charter of the company to a scorched earth policy to be accomplished in the name of an exercise of business judgement . . . [The intent of the actions] is to keep control of the company entrenched within the present board of directors regardless of the company's real best interests . . . regardless of the proclaimed profitability and in the absence of all evidence whatsoever that the actual owners of the enterprise want its demise.³⁷

The courts have indicated that they may not consider such scorched earth tactics to be acceptable under the business judgement rule, and might intervene to stop defensive tactics which seem to go too far.

4.5 Third-Party Acquisitions or Mergers

If the above defensive tactics have failed, the most common strategy for a target of an unsolicited takeover attempt is to search for an alternative buyer of its own choice, a "white knight." With the help of investment bankers, the target searches for a buyer that can meet two criteria: (1) able and willing to bid equal to or greater than the price asked by the hostile bidder, and (2) a buyer with which the incumbent management is likely to have a more corrigible relationship or who will be willing to let

³⁷Joseph E. Seagram & Sons v. Abrams, 510 F. Supp. 860, 861, 862 (S.D.N.Y. 1981).

the company retain some of its operating independence. Companies do exist which are eager for an acquisition, but would never make an unfriendly offer. Finding white knights can be difficult,³⁸ and getting the new suitor to top the hostile party's bid can be nearly impossible. Another problem with the white knight strategy is that once the white knight search has begun, it is difficult to control. A white knight search often attracts "gray knights" or even "black knights," i.e. companies watch out for their own interests first and often cannot pass up a good deal.

Should the target opt for the white knight strategy, various devices, known collectively as "lock-ups," may be employed to make the consummation of the transaction more certain. A lock-up has the advantages to the target of encouraging bidders who might otherwise be unwilling to participate in an auction of the company, and discouraging potential or actual hostile bidders from disrupting the transaction. Lock-up agreements often consist of one or more of the following types of arrangements:

- 1) **Stock purchase agreements.** The target may sell the friendly buyer preferred stock with special voting rights;³⁹ or arrange for the third party to buy the

³⁸Investment bankers use both personal contacts and sophisticated computer packages to identify potential white knights.

³⁹This tactic will be considered more fully in section 4.6 below. Other bidders may attack this tactic on the grounds that it "manipulates" the market for the target stock.

target's common stock from treasury or on the open market.

- 2) **Stock options.** Options contracts can be written with great flexibility.
- 3) **"Crown jewel" options.** Sometimes the target has a particular asset - the crown jewel - which is the primary reason the bidder is going after the target. The target could agree to sell this crown jewel to the white knight, or to give an option on the asset.⁴⁰

Like most other defensive tactics, there are many variants to these basic lock-up agreements. The target must be aware that a court may ask it to show the "business judgement" in its lock-up agreement and to show that it was not intended to choke off a potential auction for the company.

Alternatively, the target can pursue its own acquisition program in an attempt to ward off the hostile bidder. While most acquisitions attempted under takeover conditions share the common purpose of frustrating control bids, the means of achieving the desired end fall into two quite different categories. In the first are acquisitions made to complement existing lines of business, usually transacted through negotiated security exchanges. These acquisitions serve to get more shares into friendly hands, or if transacted with cash, to deplete the cash reserves of the target making it less

⁴⁰These crown jewel options are particularly vulnerable to claims of manipulation.

attractive to bidder. These sort of acquisitions used as a defensive tactic need to be thought out and preliminary arrangements made well before receiving the hostile takeover bid.

The other group of third-party acquisitions is intended to make the merger impossible for the bidder. Because these defensive acquisitions usually require some time to complete, the target has to purchase the business prior to being subjected to an unfriendly takeover bid. Three possible types of acquisitions exist fitting this requirement. First, the target could purchase a business which would create antitrust problems when combined with the bidder. For example, the purchase of a coal producer by a target that is the subject of a tender offer from a company with interests in the energy field may be sufficient to halt the offer on antitrust grounds. The effectiveness of this strategy has weakened given the Justice Department's increased willingness to allow horizontal mergers.

Second, the target could acquire a Canadian subsidiary which will at least delay or deter a bidder. Under the Foreign Investment Review Act of Canada, any change of control of a Canadian business must be approved by an agency of the Canadian government as being likely to be "of sufficient benefit to Canada." However, the target must bear in mind that the Canadian statute applies to friendly as well as unfriendly changes in control.

Finally, another possible defensive purchase for the

target is to acquire a business in a regulated industry or which requires a license from a governmental regulatory authority, such as a small air carrier, or a radio or television station. A change in the control of the target company may then be subject to the approval of the regulatory authority. This will produce obvious delays. The risk that a successful takeover may result in the loss or forced sale of a valuable license or regulated business may discourage potential bidders, especially foreign buyers.

4.6 Stock Issuance

Section 4.5 pointed out the possibility of entering a lock-up agreement with a friendly third party by selling him a block of the target's common either out of treasury or arranging for the third party to buy the stock on the open market. By putting this stock in "friendly" hands, the target is more likely to retain its independence and ward off the hostile bidder. The courts have upheld these treasury share sales and options to white knights if the target claims that it was done in connection with obtaining a higher bid. This stock issuance has become common practice in takeover battles.

A defensive strategy involving the distribution to stockholders of a special-characteristic preferred stock

has been attempted in four recent takeover battles,⁴¹ and the courts have not yet resolved the legality of the stock issue. Essential to this strategy is the availability of "blank check" preferred stock authorized under provisions in the target's charter giving the board of directors power to specify the terms of the issue and to issue without further stockholder vote.⁴² The target's objective is to impose special, onerous charter requirements on the bidder. The special characteristics of the preferred issue depend upon the unique takeover situation. Takeover specialists have named these defensive preferred issues "poison pills" because the terms of the stock are constructed so as to be difficult for the bidder to swallow. The Lenox/Brown-Forman transaction illustrates the use of this novel technique.

In mid-1983, Brown-Forman tendered for all of the outstanding shares of Lenox common stock.⁴³ The Lenox board rejected the offer (quite aggressively) and declared special preferred stock dividend on its common stock. Each preferred share, created by the board out of pre-existing "blank check"

⁴¹"Poison pill" preferred stock has been used in the following takeover battles: El Paso/Burlington Northern, Lenox/Brown-Forman, Bell & Howell/National Education Corp., and at Superior Oil in response to actions taken by major stockholders to find a buyer for the company.

⁴²One of the event studies in the empirical section of the thesis analyzes the stock price effects of a target's creation of a special class of voting preferred stock. This "blank check" preferred must first be approved by the stockholders.

⁴³Fogg & Foye (1983) provide a legal discussion and the specific tactics used in the four attempts to use "poison pill" preferred in a takeover defense.

preferred, was convertible into 40 common shares in the event of a takeover. This new preferred, on a fully converted basis, represented 50 percent of the equity of Lenox.

The preferred contained a unique "forced equity" provision that, absent the vote of 95 percent of the holders of the preferred, in any business combination the preferred automatically became convertible into the voting stock of the acquiror. This "forced equity" provision of Lenox's preferred created two problems for Brown-Forman. First, Brown-Forman had hoped to complete the transaction entirely for cash; the "forced equity" provision required issuing new Brown-Forman stock. Second, the Brown family had historically retained control of Brown-Forman through a system of two classes of common stock, one voting and the other non-voting. Forced conversion of the Lenox preferred into voting Brown-Forman common would have diluted the Brown family's voting position so that the family would no longer retain voting control. In a letter to Lenox stockholders, the Lenox chairman stated that "the preferred stock is intended to cause Brown-Forman to rethink its ill-advised attempt to acquire Lenox."

Brown-Forman obviously filed a lawsuit declaring that the Lenox's "poison pill" preferred stock was illegal. Unfortunately, this case did not determine the legality of the use of "blank check" preferred as a defensive tactic. After Brown-Forman raised its tender offer price, the Lenox board

gave in, accepted the takeover bid, rescinded the preferred stock dividend, and all lawsuits were dropped.

To be an effective deterrent against unsolicited takeover bids, the preferred should not be callable for a prolonged period (e.g. 10-15 years). This in turn may have an adverse effect on the target's prospects of being acquired in a friendly transaction of by a "white knight." Furthermore, if the target does in fact ward off the bidder, then it is left with this big chunk of preferred in its capital structure which has a fixed dividend senior to the common dividend. Conceivably, by putting half or more of its market value into preferred stock, the issuance of the "poison pill" preferred may have an adverse impact on the liquidity of its common stock. Finally, the "poison pill" preferred may have little deterrent effect against a bidder willing and financially able to tender for any-and-all of the shares of the target. The preferred is likely to have its greatest value as a last-resort tactic in combatting a two-tier offer where significant doubt exists that the second tier would be fair and where alternative transactions for the target are not likely.

4.7 Standstill Agreements and Negotiated Stock Repurchases

Negotiated stock repurchases and standstill agreements are not actually defensive tactics, but rather are methods of resolving the conflicts between two parties created in

a contest for control. The typical chain of events is as follows: The bidder accumulates a position in the stock of the target, either through open market purchases or a tender offer, in an attempt to gain control. The target management presents a stiff defense usually resulting in lawsuits and counter-lawsuits. Given the aggressiveness of the incumbent management's defense, the bidder chooses to give up his contest for control of the target, but now he is left with a sizable block of the target's stock (e.g. 10-40 percent). To settle their differences, the target agrees to repurchase the block held by the bidder and to drop all legal action, but the bidder demands a purchase price for his block at a substantial premium to the currently traded price. In exchange for the purchase premium, the bidder enters into a "standstill agreement" whereby he agrees to not to purchase any common stock of the target for a specified period of years.

These standstill agreements and negotiated stock repurchases at a premium above the market price are transactions which (1) reduce competition in the market for control and (2) provide for differential treatment of large block stockholders. The stock repurchase often causes the target's stock price to fall, i.e. those stockholders not involved

in the repurchase suffer a wealth loss.⁴⁴ Whether target stockholders benefit or not from these transactions depends upon whether one accepts the managerial entrenchment hypothesis or the competing stockholder interests hypothesis (see Chapter Three).

The business rationale for these defensive agreements is simply to allow incumbent management to better manage the company. The incumbent management argues that to the extent that the holder of the block is truly dissident and at odds on significant policy matters with at least a majority of the board, the block imposes costs on the management of the firm and should be eliminated. Unfortunately for the incumbent management, stockholders who have just suffered a loss due to the negotiated repurchase often do not agree with this line of reasoning and file lawsuits against the management. Particularly if the purchase is at a significant premium over the market, the target's purchase of a large block of its own stock raises concerns of fiduciary duty and fairness to the remaining stockholders. To minimize the risk of litigation on this basis, the target management often tries to avoid disclosure of the transaction, or if that is not possible, to maintain as low a disclosure profile

⁴⁴The existence and magnitude of this wealth loss due to stock repurchases and standstill agreements will be tested in the empirical part of the thesis, Chapter Six. Conclusions as to whether target stockholders benefit or lose from these transactions will be discussed in Chapters Seven and Eight.

as possible.⁴⁵

The courts have held that these standstill agreements and stock repurchases are legally valid, and that differential payments can be made to large block stockholders as long as the firm demonstrates a valid business purpose for the transaction. Nathan & Sobel (1980) maintain that these business purposes include (1) "differences in business philosophies between the corporation's management and the selling shareholders," or (2) "eliminating what appeared to be a threat to the future of the business and preserving an established management's business policy."⁴⁶

Several individual investors and companies (e.g. Carl Icahn, Victor Posner, Mesa Petroleum) have made significant profits through the process of accumulating stock in a target, threatening a takeover or proxy fight, and then eventually settling the dispute by selling the shares back to the target at a substantial premium. Critics of this process have named the technique "greenmail" - legal corporate blackmail by villainous raiders.

4.8 Investor and Public Relations Efforts

Target managements often underestimate the defensive effectiveness of attacking the bidder through shareholder

⁴⁵If the stock repurchase is large enough to be material to the firm, SEC rule 10b-5 and the stock exchange disclosure policies require the issuance of a press release describing the transaction.

⁴⁶Nathan & Sobel (1980), pp. 1547-1548.

and public relations. A vigorous public attack, in the form of press statements, shareholder letters, and so forth, can often make the difference between winning and losing a battle for control. As illustrated earlier in section 4.4, Harold McGraw stopped American Express' tender offer by virtually screaming bloody murder and by undermining the reputation of American Express management. Compared with the alternative tactics, publicity is both relatively inexpensive and relatively effective.

Management-shareholder relationships are critical in building a long range takeover defense. Developing a supportive relationship takes time and concerted effort on the part of management. Investor relations programs have become virtually standard at every major corporation, and there has been a marked increase in the number and professionalism of investor communications. To effectively use investor and public relations as a takeover defense, target management needs to know exactly who its stockholders are and what their attitudes are towards the company. Armed with this basic, yet critical information, target managers can contact major stockholders quickly in the event of a takeover attempt, sometimes even before these owners are aware of the takeover bid.

Typically, when confronted by the uncertainty of a control battle, stockholders are inclined to side with incumbent management and to somewhat distrust the hostile bidder.

Any investor or public relations effort that feeds on this normal inclination can only benefit incumbent management. If the stockholders, both individual and institutional, have confidence in management's judgement, they are more likely to accept its word that an unfriendly offer is underpriced or not in the best interests of the stockholders. Just as important, stockholders must approve advance antitakeover planning such as antitakeover charter amendments. The slightest mistrust of management's motives can quickly turn the tide against the incumbents during the volatile dynamics of a takeover battle. As in adverse selection, those managements which lose the trust of their stockholders are the most likely targets of hostile bidders.

4.9 Other Defensive Responses

The first eight sections of this chapter have provided a discussion of the principal antitakeover defensive tactics employed by target-company managements. Many more defensive tactics exist and takeover specialists have refined all of these methods. Many new defensive tactics will likely be developed by the creative minds on Wall Street as the statutory and regulatory framework of takeover battles evolves. The following is a list and brief explanation of other anti-takeover defensive tactics which are less frequently used or which apply only in limited situations:

- 1) **Dividend and stock split declarations.** This tactic

primarily functions to "signal" stockholders that management firmly believes that its strategic plan for the company will maximize the investors' wealth.

- 2) **Establish an employee stock ownership plan (ESOP).** Issuing shares to employees as compensation places shares in friendly hands. Employees have an obvious interest in preserving their jobs, which is most likely (at least in the short run) as an independent entity.
- 3) **Disaggregation defenses.** Included in this group are liquidations and self-tenders. These defensive maneuvers usually come under consideration where the target believes its stock price does not adequately reflect underlying asset values.
- 4) **Double pac-man defenses.** A double pac-man is a counter tender offer where both the target and the bidder attempt to swallow each other. The final result of such a strategy depends upon skillful manipulation of the tender offer rules. Bendix/Martin Marietta is the most celebrated example.
- 5) **Various threats.** Key members of the incumbent management team may threaten to resign if the target loses its independence - usually effective in a "people" business. Target managements may also ask politicians or unions to intervene on their behalf to put heavy pressure on the bidder.

Chapter 5. Review of the Analytical Literature on Anti-takeover Defensive Tactics

Economists have qualitatively discussed corporate mergers and the existence of "merger waves" for many decades, but only in the last ten to twelve years have researchers taken a scientific approach to mergers in an attempt to quantify the wealth effects on acquiror and acquiree stockholder groups. The first quantitative research focussed on the stock price impacts of a takeover announcement on the two stockholder groups, and tested for the amount of economic value created in corporate mergers. These studies measured the effect of mergers on stock prices by employing "event studies"¹ which estimate the abnormal stock price changes around the date of announcement. Although Mandelker (1974) was the first to use these methods to quantify the stock price effects of mergers, Dodd and Ruback (1977) were the first to focus the event study on the date of the first public announcement of a takeover, on which date the market should capitalize the news of the takeover.

The bulk of the scientific studies done during the 1970s concentrated on the stockholder returns to targets and bidders, the source of the merger gains, and the aggregate

¹Fama, Fischer, Jensen & Roll (1969) first used this methodology in their study of the price effects of stock splits. The empirical part of this thesis uses similar event study techniques. The event study methodology will be explained in detail in Chapter Six.

benefits of mergers to the economy. Only in the last several years have any researchers turned their efforts toward the examination of antitakeover defensive tactics. Except for several studies dating back to 1980, the first thorough tests on the stock price effects of defensive tactics were published in the Journal of Financial Economics, Volume 11 (1983). Roughly half the journal articles published in this volume were devoted to examining the effects of defensive tactics, usually focussing on a single antitakeover provision and using event study techniques to analyze the impact on the target's stock on the day of announcement. The authors of these studies have examined the following defensive tactics: (1) antitakeover charter and by-law amendments, (2) government takeover regulation, (3) antitrust litigation, and (4) standstill agreements and negotiated stock repurchases. This chapter will summarize the results of these antitakeover studies so that they can be contrasted with the empirical findings of this thesis in Chapter Seven.

Virtually all scientific studies of defensive tactics employ the "event study" methodology. Event studies measure the abnormal returns in stock prices in the days just preceding and following the announcement of the defensive measure—the "event." Abnormal returns are measured by the difference between actual and expected stock returns, the announcement event having caused the deviation. The expected stock return is measured conditional on the realized return on a market

index to take account of the effects of general marketwide events on the returns of the individual securities. This basic methodology was used in each of the following studies discussed in this chapter.

5.1 Charter and By-Law Amendments

DeAngelo & Rice (1983) and Linn & McConnell (1983) offer the two most complete studies examining the effect of the adoption of antitakeover amendments on stock prices of the target firms. Both studies introduce the managerial entrenchment and stockholder interests hypotheses as competing explanations of why target managements propose and why stockholders approve these antitakeover provisions. Although both sets of authors recognize that the event studies on the announcement of antitakeover amendments contain various biases against the managerial entrenchment hypothesis,² their test between the two competing hypothesis is as follows:

- a) The managerial entrenchment hypothesis predicts a negative abnormal return on the announcement date reflecting the erosion of stockholders' voting rights.
- b) The stockholder interests hypothesis predicts a positive

²Their test samples contain unavoidable biases. It is presumed that managers (with inside information) who assess an increased probability of merger or tender offer are more likely to propose defensive charter amendments. Since stockholders in acquired firms typically earn large abnormal returns, any such signal that a takeover may be imminent should impart an upward bias to the announcement return.

abnormal return on the amendment announcement date as stockholders now believe that the probability of incurring the costs of a control battle have been decreased.

The authors concede that many other possible explanations exist, including that the changes in voting rights associated with antitakeover amendments have no effect on stockholder wealth, but that the above two hypotheses appear to provide the most plausible explanations and that they can be readily tested using event study techniques.

DeAngelo & Rice examined 100 firms that adopted super-majority voting, staggered board, fair price, and lock-up provisions over the period 1974-1978. For the day of and the day after the mailing of the proxy statement containing the proposals, they found negative abnormal returns averaging -0.16% for the sample. But these findings were not statistically significant in that the t-statistic was -0.41. The cumulative abnormal returns covering the period of 10 days preceding the announcement through 11 days following the proxy mailing was a statistically insignificant -0.90% ($t=-0.70$). Given the low t-statistics in their findings, DeAngelo & Rice could not unequivocally support one hypothesis; but they do state that if forced to choose, the preponderance of observed negative returns would support the managerial entrenchment hypothesis, particularly given the natural upward bias of the returns in their sample.

Linn & McConnell performed a similar study for a sample of 388 firms that adopted antitakeover amendments over the period 1960-1980. They reasoned that it is difficult to identify the precise date on which information about the antitakeover provisions is actually released and capitalized into the market.³ Consequently, they ran several event studies which examined the stock returns around: (1) dates on which boards of directors ratified the proposals containing antitakeover amendments; (2) dates on which proxy statements describing the amendments were mailed to stockholders; and (3) dates of the stockholder meetings at which the proposals were ratified.

Linn & McConnell's results are somewhat ambiguous, but tend to lean towards the stockholders interest hypothesis. Using daily data, they found no statistically significant abnormal returns for any of the three event days examined. On the other hand, using monthly data, Linn & McConnell found a positive cumulative abnormal return of 1.43% ($t=3.41$) from the day before mailing the proxy through the day before the stockholders meeting. The aggregate cross-sectional

³Conceivably, the information could first be released when the board approves the antitakeover provision to be put on the proxy, but generally this information is not reported in the press until much later (if at all). Quite often the results of the voting by stockholders on these proposals at the annual meeting do not even get reported in the Wall Street Journal. It seems likely that the information about the adoption of these proposals gets released at different times by different companies. The proxy mailing date probably serves as the "best" event date.

cumulative abnormal for the other periods were slightly positive, but all had insignificant t-statistics. Linn & McConnell also performed some other tests on firms which had repealed antitakeover amendments and on firms which were incorporated in Delaware when Delaware changed its takeover statute requiring only a simple majority vote to approve a merger rather than two-thirds. These tests showed negative abnormal returns in the month of the events, but the results are tarnished by sample selection bias and the use of less-precise monthly data. Linn & McConnell conclude that generally their results are consistent with the stockholder interests hypothesis.

In addition to these two studies, Dodd & Leftwich (1980) examined a topic somewhat related to antitakeover charter amendments. Dodd & Leftwich examine stock price returns for 140 companies that changed their state of incorporation during the period 1927-1977. The vast majority of these reincorporations were into the state of Delaware. The authors present two hypotheses motivating these reincorporations which are tested by their event study:

- a) The stockholder-exploitation hypothesis maintains that managers change the state of incorporation of their firms to enrich themselves at the expense of stockholders. This hypothesis uses basically the same reasoning as the managerial entrenchment hypothesis.

b) The cost-avoidance hypothesis argues that managers select the state in which to incorporate where the corporate code minimizes the expected costs of the firm's production-investment and financing activities. As in the previous studies, the former hypothesis predicts negative abnormal returns and the later predicts positive abnormal returns on the day of announcing the reincorporation.

Unfortunately, Dodd & Leftwich had difficulty determining the actual date of the first public announcement of the change in incorporation for many of the companies.⁴ This problem reduces somewhat the power of their tests. Nonetheless, using monthly return data, their results show that stockholders earn positive abnormal returns of 30.25% ($t=7.90$) over the 25-month period preceding and including the month of the change. Recognizing that these returns seem to be too large to result only from the change in incorporation, Dodd & Leftwich use a variety of tests to separate out the gains associated with reincorporation from gains driven by other factors - a very difficult task. They end up concluding that firms usually change their state of incorporation after a period of exceptionally good performance, and rule out the possibility of explaining managers' motiva-

⁴For 50 of the 140 firms, Dodd & Leftwich found announcements in the Wall Street Journal. For the other firms, they had to use the proxy mailing date, the stockholder approval date, or the date of formal registration of the new charter. Obviously, this left open the possibility of many inconsistencies, and did not ensure that the date of first public announcement was used as the event day.

tions by the stockholder-exploitation hypothesis.

5.2 Federal, State and SEC Regulation of Takeover Battles

As discussed in Chapter Four, the government regulates takeover situations in order to protect target stockholders by providing them with more information about the bidder and by giving them more time to decide whether or not to tender their shares. These regulatory disclosures and delays impose costs on the takeover process: who bears these costs and how great are they? Does takeover regulation discourage bidding firms from attempting takeovers, and does it impact the split up of synergy gains between the two firms? Several groups of researchers have performed studies in an attempt to answer these questions concerning the effects of takeover regulation.

Jarrell & Bradley (1980) take a sample of 161 targets acquired during the period 1962-1977 and divide them into three subgroups covering two periods:

- 1) Unregulated (pre-July 1968): the period prior to the passage of the Williams Act.
- 2) Federal regulated (post-July 1968): acquisitions occurring after the passage of the Williams Act, but in states not governed by state-level takeover statutes.
- 3) Federal and state regulated (post-July 1968): takeovers completing following enactment of the Williams

Act and in states with their own takeover statutes. To test their theory that federal and state laws increase tender offer premiums, Jarrell & Bradley compared the average tender premium across the three subsamples of actual tender offers. They found that the mean tender premium and the average cumulative abnormal returns were for each group, respectively:

<u>Subsample</u>	<u>Premium</u>	<u>CAR(5)⁵</u>	<u>t-statistic</u>
Unregulated	32.4%	22.0%	12.9
Federal Regulated	52.8%	40.0%	19.2
Fed. & State Reg.	73.1%	35.0%	5.1

Jarrell & Bradley perform a variety of other tests on these three subgroups to get at the actual effects of takeover regulation, which are likely quite complicated.

Attributing the above differences entirely to regulation would lead one to conclude that the Williams Act increased tender premiums by 20 percentage points and the state laws increased tender premiums by yet another 20 percentage points. This implies that the regulation serves to increase the returns of the target stockholders at the expense of the stockholders of the bidding firm. On the basis of Jarrell & Bradley's tests, one can reasonably safely draw that conclu-

⁵CAR(5) represents the cumulative abnormal return for the period of 40 days before the takeover announcement through five days following the announcement.

sion, but there are other possible effects as well. Jarrell & Bradley argue that the takeover regulation deters bidders from attempting many takeover bids, so that the regulation effectively functions as a tax on takeovers. Some acquisitions that would be profitable absent the takeover laws will be deterred by the higher tender premiums caused by regulation. Furthermore, they argue that the information leaked by the disclosure regulations before the actual takeover bid reduces the amount of resources (skill and knowledge) committed to takeover attempts. Therefore, takeover regulation - essentially a tax - tends to decrease the aggregate gains to the economy created through takeovers, and functions primarily to redistribute the gains from bidders to targets.

Asquith, Bruner & Mullins (1983) provide similar evidence in a study of the gains to bidding firms from takeovers. For mergers prior to October 1, 1969,⁶ they found average abnormal returns to bidders of 4.40% over the period 20 days before through the first public announcement and average abnormal returns of 1.7% to bidders after October 1, 1969. They conclude that the market for control changed due to the new government regulation of takeovers.

Schipper & Thompson (1983b) examine the economic impact of four merger-related regulatory changes during 1966-1970: the Williams Act, the 1969 Tax Reform Act, Account-

⁶This is the date on which the SEC adopted permanent, binding rules implementing the Williams Act.

ing Principles Board (APB) Opinions 16 and 17, and the SEC's segment disclosure rules. Recognizing that event studies present the problem of high cross-sectional correlation in security returns when the announcement event occurs on the same calendar day, Schipper & Thompson employ an alternative technique to estimate the effects of the regulatory changes. Rather than focus on the the stock price impacts of individual acquisitions, their approach conditions the return-generating process on the presence of regulatory change and employs generalized least squares (GLS) estimation.⁷ Studying the effects of the four regulations on 39 firms during the regulatory change period of 1969-1970, they find that the Williams Act reduced the equity values of the acquiring firms by -6.0 percent. Compared to this evidence, the findings for the other three regulatory changes measured by Schipper & Thompson are comparatively weak and suggest an overall insignificant impact for these regulations.

5.3 Antitrust Litigation

Ellert (1976) sets the stage for latter studies on the effects on target stockholder wealth caused by antitrust opposition to takeovers. Ellert examined the risk and return characteristics of 205 companies whose acquisition activities

⁷Schipper & Thompson's type of test should give more accurate results than standard abnormal return event studies when the problems of multiple announcement events, cross-sectional correlation, and small sample sizes exist.

were challenged by the Justice Department or the Federal Trade Commission (FTC) over the period 1950-1972. As usual, Ellert proposes two competing hypotheses on manager's motives for takeovers with respect to antitrust problems:

- a) Monopolist hypothesis: Mergers involving large companies are likely to be motivated by considerations of monopoly power or other anticompetitive advantages associated with increases in business size.
- b) Benign merger hypothesis: The mergers actually challenged under the Clayton Act Section 7 are relatively benign in their anticompetitive effects, and they perform a useful function in promoting competition in the market for corporate control.

Ellert found that companies indicted under antimerger law earned average abnormal returns of 23.3% over the eight years preceding the antitrust complaints, but the market adjusts their stocks downward only 1.83% when the Justice Department or FTC files its antitrust case. On the basis of this evidence, Ellert sides with the "benign merger" hypothesis and concludes that merger gains do not come from the acquisition of monopoly power. He argues that mergers serve a useful economic function in reallocating resources from less efficient to more efficient users. Antimerger litigation, including its use as a defensive tactic, imposes costs on stockholders and can be interpreted as a regulatory tax on wealth accumulation.

Wier (1983) extends Ellert's analysis to show that when acquisitions are canceled following antitrust complaints (usually motivated as a defensive tactic), the losses to the target firms are substantial and completely offset the positive gains generated by the takeover bid. For a sample of 17 target firms whose takeovers were canceled after antitrust complaints, Wier found that the group had an average cumulative abnormal return of 9.25% for the 30 days prior to and including the announcement of the takeover proposal. But for the period following the announcement of the takeover proposal up through the day of the the antitrust complaint, the firms recorded average cumulative abnormal returns of -10.85%. The firms then lost an additional -0.51% up through the actual cancellation period, netting the target firms an average cumulative abnormal return for the antitrust-defeated takeover attempt of -2.11%. Thus, the antitrust defensive tactic employed by incumbent managements not only prevented the stockholders from realizing a substantial abnormal gain, but in the end it actually hurt the stockholders by a significant -2.11%.

Eckbo's (1983) findings are similar: for the days surrounding the announcement of an antitrust complaint, the targets suffered an average abnormal return loss of -9.27% ($t=-7.61$). He concludes that antitrust enforcement, whether initiated by suits from the target or from the government, is effectively a regulatory tax, and that this cost

is imposed most heavily on the most profitable mergers. On the basis of his empirical tests, Eckbo also concludes that takeovers are not motivated by the search for monopoly power or collusion. Therefore, antitrust defensive tactics not only harm target stockholders, but they also impose a social cost by distorting the allocation of corporate resources by making some efficient mergers unprofitable.

5.4 Standstill Agreements and Negotiated Stock Repurchases

Two recent studies, Bradley & Wakeman (1983) and Dann & DeAngelo (1983), examined the wealth impacts of share repurchases that restrict participation to a particular subset of a firm's stockholders.⁸ Bradley & Wakeman break their sample of targeted share repurchases, taken from the period 1974-1980, into two sub-groups on the basis of whether or not the repurchase settled a takeover dispute:

- 1) No merger termination (15 firms). Typically, share repurchases in this category were made to all stockholders owning less than 100 shares, for which the average premium offered was 10%.
- 2) Merger termination (61 firms). These single block repurchases settled the disputes between the two parties locked in a takeover battle. The average

⁸Other studies have also looked at the issue of stock repurchases more generally. See Masulis (1980), Dann (1981), and Vermaelen (1981).

premium paid was 18.9% with a range from -23.3%⁹ to 98.2%.

In the former case, Bradley & Wakeman found that the announcement of these stock repurchases generated a positive abnormal return of 1.25% in the case of small shareholdings, and 1.9% for repurchases from insiders. In the case of small shareholdings, this represents the reduction of the relatively high costs involved in maintaining small shareholdings, such as the costs of mailing dividend checks, annual reports and proxy statements. In addition, these repurchases likely provide a signal of positive information to the market.

The latter case, single block repurchases ending hostile takeover battles, is of more interest to the thesis topic. Their results show that the stockholders of the repurchasing firms in the merger-termination group sustain a significant wealth-loss as a result of the repurchase. For the target repurchasing firms, they found that the average abnormal return associated with the announcement of the block repurchase was -5.50% ($t=-7.14$). This evidence, along with their other tests measuring the "information effect" of an announcement, suggests that block repurchases that signal the termination of a pending takeover significantly reduce the value of the purchasing firm beyond the wealth-

⁹Bradley & Wakeman calculated these premiums relative to the closing stock price two days before the repurchase. For all but one of the single block repurchases, the offer price was greater than the lowest daily market price during the previous month.

transfer associated with the repurchase premium. Bradley & Wakeman's results support the managerial entrenchment hypothesis: the intent of the managers of repurchasing firms in buying back the block is to thwart a profitable takeover, presumably to enhance their own welfare. The repurchase premiums can be interpreted as direct payments to potential bidders to cease takeover activity.

On the other hand, Bradley & Wakeman's evidence shows that the firm selling the stock back to the target (i.e. the bidder in the takeover attempt) realized an abnormal return of 1.82% ($t=1.74$). Apparently, any negative effect of the cancellation of the takeover on the value of the bidder is more than offset by the premium received in the stock repurchase.

The findings of Dann & DeAngelo on negotiated block repurchases concurs with that of Bradley & Wakeman. For their sample of 41 repurchases involving a premium, Dann & DeAngelo found an average abnormal return on the repurchaser's stock of -1.76% ($t=-3.59$) on the day before and the day of the announcement. They also performed similar tests on 30 target firms which entered into standstill agreements with their hostile bidders. This group realized an abnormal return of -4.52% ($t=-5.72$) on the day before and the day of the announcement.

The evidence from these two studies demonstrates the significant transfer of wealth between two sub-groups

of the target's stockholders: from the non-participating stockholders to the blockholder receiving the premium. Standstill agreements and premium buybacks reduce competition in the market for corporate control and provide differential treatment for large block stockholders. Their findings are inconsistent with the hypothesis that these target management actions are in the best interests of the stockholders, at least the non-participating stockholders.

5.5 Management Resistance in General

Few researchers have specifically focussed on the wealth effects of general management resistance against takeover attempts. Those authors interested in defensive tactics have chosen to isolate one particular tactic and analyze its effect on the stock of the target (note that all the papers discussed so far in this chapter fall into this category). Nonetheless, several authors have touched on the wealth effects of management resistance in their broader studies of takeovers and stockholder returns. The results of these findings will be discussed in this section.

Krummer & Hoffmeister (1978) begin their work on the valuation consequences of cash tender offers with four hypotheses:

- 1) Target firms are expected to have abnormally low returns prior to takeover because of managerial inefficiency as well as other possible reasons;

- 2) Those firms involved in target takeovers faced with management resistance will display poorer performance (prior to takeover) relative to friendly takeovers;
- 3) The bid premium required for unfriendly takeovers will be greater than for friendly takeovers; and
- 4) Bidding firms will increase their shareholder wealth in the event of a takeover.

Their evidence, based on takeovers occurring during the period 1958-1974, supports these hypotheses. When they broke their sample of successful takeovers into two groups - opposed and unopposed by target management - they found stockholders earned abnormal returns in the announcement month of 16.45% ($t=15.16$) when management did not oppose the offer, and 19.80% ($t=13.62$) when management fought the takeover.

Thus, target management resistance forced bidders to pay higher premiums, at least for those mergers which were successful. This appears to support the stockholder interests hypothesis that defensive tactics tend to enhance the wealth of target stockholders. But Krummer & Hoffmeister's evidence is far from conclusive. First of all, these results are based only on successful takeovers. If the loss of takeover premium in unsuccessful attempts were included, it could be that the net impact of defensive tactics is negative, or that the choice of defensive tactic and the intensity in which they are pursued by the target management

makes a material difference. Second, to the extent that investors anticipate management's use of defensive tactics, investors could discount the price of the target's stock by that amount when buying it. Then the higher premiums received by stockholders when management opposes in successful takeovers represents both a control premium and an elimination of this negative effect on the stock due to expected management opposition to takeovers. Finally, it could also be that target management opposition reduces the frequency of takeovers. The higher returns to targets with managerial resistance could arise because only the more profitable takeovers will be attempted when the bidder anticipates the target's resistance and its relatively higher execution costs.

A study by Dodd (1980) appears to lend evidence that generally defensive tactics harm target stockholders, but if the defensive tactics lead to higher takeover bids at sometime in the future, they might be beneficial. Dodd collected a sample of terminated merger proposals and divided it into two groups: (1) mergers terminated by actions of the target, and (2) mergers terminated by either the bidder or some other party. The average abnormal return on the day before and the day of the termination announcement was -5.57% for the former group and -9.75% for the later group.

This evidence - as well as that of Dodd & Ruback (1977), Bradley (1982), and Bradley, Desai & Kim (1983) - shows that when incumbent management vetoes the takeover

proposal there is a significant drop in the price of target shares. But this drop may or may not wipe out the significant gain obtained when the takeover attempt is first proposed. Typically in this case, the target's stock does not fall to its pre-proposal level, but rather the stockholders retain some of the initial gain as the market anticipates that a significant probability exists that another bidder may make another possibly successful takeover attempt. If another attempt is made, the defensive actions of the incumbent management benefited stockholders. If another attempt is not made within several years, the target loses the entire initial positive abnormal return, and the defensive tactics were detrimental (also remember that defensive tactics consume real resources of the target). In the bidder-terminated merger cases, Dodd found that the price of the target shares returns (on average) to its pre-proposal level.

Chapter 6. Empirical Analysis

The thesis discussion to this point has provided the groundwork and background for the empirical analysis in this chapter and the discussion of those findings in the following two chapters. To assess the impact of the various antitakeover defensive tactics employed by target managers on stockholder wealth, samples of such actions for New York Stock Exchange (NYSE) and American Stock Exchange (ASE) listed firms were collected for each category of defensive tactics outlined in Chapter Four. This chapter presents the empirical findings resulting from using the "event study" method of analysis on the stock prices of firms using defensive tactics. From these empirical results, conclusions can be drawn concerning the wealth effects on target stockholders caused by target managers' use of defensive tactics.

The chapter opens with a section describing the basic "event study" methodology. The following five sections present the results of applying this methodology on five categories of defensive tactics: (1) antitakeover charter and by-law amendments, (2) standstill agreements and negotiated stock repurchases, (3) antitrust litigation as a "show-stopper," (4) "poison pill" preferred stock issuance, and (5) "double pac-man" counter tender offers. Each of these five sections describes its data sample and reports the empirical results.

6.1 Event-Study Methodology

In order to test the two competing hypotheses - managerial entrenchment versus stockholder interests - presented in Chapter Three and to determine whether or not stockholders benefit from defensive tactics, the thesis measures price impacts relative to a benchmark estimated from the simple market model:¹

$$\tilde{R}_{jt} = \alpha_j + \beta_j \tilde{R}_{mt} + \tilde{\epsilon}_{jt}, \quad (1)$$

where

\tilde{R}_{jt} = rate of return of security j over period t (period t is one day in this empirical analysis),

\tilde{R}_{mt} = rate of return on an equal-weighted market index² on day t ,

α_j = $E(\tilde{R}_j) - \beta_j E(\tilde{R}_m)$,

$\tilde{\epsilon}_{jt}$ = disturbance term of security j at day t , and $E(\tilde{\epsilon}_{jt})=0$,

β_j = $\text{cov}(\tilde{R}_{jt}, \tilde{R}_{mt}) / \text{var}(\tilde{R}_{mt})$.

The disturbance term, $\tilde{\epsilon}_{jt}$, is interpreted as a measure of the abnormal return to stockholders of firm j on day t . It is an abnormal return in the sense that it represents

¹This is the standard capital market residual technique first developed by Fama, Fischer, Jensen & Roll (1969) and further explained by Fama (1976, pp. 63-132). Brown & Warner (1980) compare the explanatory power of this market-model event study methodology against that of various other methodologies. Also, Langetieg (1978) uses merger data to compare the market model with a more complex three-factor performance index methodology. This simple market model performs well under a wide variety of conditions.

²Brown & Warner (1980) find that using an equal-weighted market index, as opposed to a value-weighted market index, offers no systematic disadvantages and perhaps slight advantages in detecting price impacts.

the deviation of the return on the security from its expected return (based on all available information capitalized into the price), given the return earned by the market index on that day. That part of the return to security j represented by $\beta_j \bar{R}_{mt}$ is presumed to be caused by market-wide changes on day t , and the disturbance term captures the effects of changes on day t due to firm-specific variables. When a large group of firms experiences the same event (e.g. the proposal of an antitakeover charter amendment), the disturbance terms averaged over all the firms in the sample is interpreted as capturing the economic impact of that event.

In each of the five samples of various defensive tactics, the "event" (day $t=0$) is the first public announcement of that defensive tactic. The abnormal return on the stock of the target using the tactic for that "event" day and for each day surrounding the "event," is estimated by

$$AR_{jt} = \bar{R}_{jt} - (\hat{\alpha}_j + \hat{\beta}_j \bar{R}_{mt}), \quad (2)$$

where AR_{jt} is the abnormal return to security j on day t . The coefficients $\hat{\alpha}_j$ and $\hat{\beta}_j$ are estimated using stock price data from a period outside of (i.e. not including) the period of interest around the announcement of the defensive tactic. Day t is equal to zero on the announcement date, is negative for days before the announcement, and is positive for days after the announcement. Generally, the coefficients in the market model were estimated by regressing over the fol-

lowing periods:³

- a) For days up to and including the event, coefficients were used that were estimated over a minimum of 100 and a maximum of 200 trading before the analysis period (i.e. before day $t=-60$).
- b) For days following the event, coefficients were used that were estimated over a minimum of 100 and a maximum of 200 trading after the analysis period (i.e. after day $t=+60$).

The market model (1) and the calculation of abnormal returns (2) are applied to all firms in each sample. An average abnormal return (\overline{AR}_t) for each day t is calculated for the N firms in each sample. These average abnormal returns of each day are summed over different defined periods (depends upon the tactic) to obtain cumulative average abnormal returns (CAR). For example, the cumulative abnormal return for the eleven days before and including the announcement date (i.e. from $t=-10$ through $t=0$) is the sum of the abnormal returns for each of those eleven days and is denoted $CAR_{-10,0}$. In a perfectly efficient market where all information is

³Generally, this period was used for each event study, if not, differences will be mentioned in the relevant results section. Sometimes there was not enough data following the event to estimate the "after" coefficients because the event dates were close to the end of 1983. In each case different estimation periods were tried, but all produced essentially the same final results. Rick Ruback kindly let me use his computer program to process multi-company event studies; Robyn McGlaughlin and Bob Clyatt provided a great deal of computer assistance.

immediately reflected in stock prices, the average abnormal return for the sample on the event date, \overline{AB}_0 , should represent the wealth effect of the defensive tactic. Generally, one wants to consider the cumulative abnormal return leading up to and including the actual event day, because quite often information leaks to some people in the market before the event is actually announced to the public - either directly by the company or in the Wall Street Journal. Assuming that there are no other "events" during this period, this CAR should capture the stock price effect associated with the action of the defensive tactic.

The primary statistical procedure employed to test the statistical significance of \overline{AR}_t and CAR is a t-test. The t-statistic provides a confidence factor as to the likelihood that the actual abnormal return is some percentage other than zero. This t-statistic is given by

$$t = \overline{AR}_t / \hat{\sigma}$$

where $\hat{\sigma}$ is the estimated standard deviation of the abnormal returns over the analysis period for each sample.

In all of the event studies, the daily stock price data was taken from the Center for Research in Securities Prices (CRSP). The market index used was the CRSP equal-weighted return index of NYSE and ASE firms. Although many over-the-counter (OTC) firms have used defensive tactics in fighting off bidders, none of the samples in any of the

event studies contain OTC firms because CRSP does not record data for OTC companies. Announcement dates were generally taken from the Wall Street Journal and the Wall Street Journal Index. Events that had other announcements made by the company (e.g. declaring dividends or obtaining a significant new contract), which could possibly confound the results, were eliminated from the sample.

6.2 Antitakeover Charter and By-Law Amendments

6.2.1 Data Sources and Sample Construction

During the proxy seasons covering the period 1979-1983, 253 firms presented antitakeover charter and by-law amendments to stockholders for their approval.⁴ The OTC firms and the firms with nearby confounding events were eliminated bringing the sample size down to 159 firms. Table 1 shows the frequency distribution of the antitakeover proposals according to the proxy season in which they were proposed. The table shows that 84% of the firms proposing antitakeover amendments did so in the 1983 proxy season. A possible explanation for this sharp increase in the number of proposals may be a reaction to the well-publicized and very hostile takeover battles the previous summer of 1982: Cities Services/

⁴I must thank Chuck Cory (Morgan Stanley) for providing this listing of firms that proposed antitakeover charter and by-law amendments during 1979-1980.

Mesa Petroleum/Occidental and Bendix/Martin Marietta/Allied.

Table 1

Frequency distribution, by year, of the number of proxy statements that contained antitakeover amendments, 1979-1983.

Year	Number of proxy statements
1983	134
1982	5
1981	5
1980	8
1979	7
Total	159

Although generally not included in the final sample because their stocks are traded on the OTC market, many commercial banks have recently proposed antitakeover amendments in response to the many bank mergers motivated by creeping interstate bank (e.g. in New England). Early indications this spring show that the pace of antitakeover amendment proposals in the 1984 proxy season should be at least as great as that of the 1983 season.

Table 2 contains some descriptive data on the final sample. Panel A of Table 2 is a frequency distribution of the different types of antitakeover provisions proposed

Table 2

Description of antitakeover amendments and by-law changes proposed in the sample of 159 proxy statements, 1979-1980.

A. Frequency distribution by type of amendment	
Type of amendment	Number of proxy statements
1. Supermajority approval required for mergers, consolidations, and sale of major assets	104
2. Supermajority approval required to amend charter/by-laws	86
3. By-laws amended by board only	3
4. Supermajority approval required to remove or change number of directors	32
5. Fair price provisions	77
6. Classified board of directors and staggered elections	73
7. Removal of directors for cause only	45
8. Advance nomination of directors required	3
9. Only board can fill vacancies	5
10. No right to written consent	42
11. Special meeting to be called by board only	7
12. Increase percentage required to call a special meeting	2
13. Elimination of cumulative voting	10
14. Non-tendering stockholders can demand redemption in unfriendly takeover	2
15. Elimination of preemptive rights	6
16. Limit voting power of substantial stockholders	1
17. Offer review - board must consider social factors	4
18. No ESOP shares tendered without directions	2
19. Bar foreign ownership	1
20. Change in business or capital structure (e.g. state of incorporation)	2
21. Create class of voting preferred	19
Total	526

Table 2
(continued)

B. Frequency distribution of multiple amendments per proxy	
Multiple amendments proposed	Number of proxy statements
1. Single amendment only	43
2. Two amendments only	40
3. Three amendments only	24
4. Four or more amendments	52
Total	159
C. Frequency distribution of amendments with "lock-in" provision	
Type of proposed amendment	Number of proxy statements
1. Supermajority merger approval <u>and</u> supermajority approval required to amend charter	67
2. Supermajority approval required to remove/change number of directors <u>and</u> supermajority approval required to amend charter	25
3. Limitations on right to act by written consent, <u>and</u> supermajority approval required to amend charter	33
Total	125

by the 159 firms in the sample. The most popular provisions were supermajority merger approval, fair price provisions, and classified boards with staggered terms; and these were often "locked-in" by an amendment requiring supermajority stockholder approval to change the firm's charter and/or by-laws. Of the 526 antitakeover amendment proposals, 224 required supermajority stockholder approval for some action

to be taken by the firm. Curiously, Linn & McConnell (1983) had found relatively few proposals for fair price provisions (only 24 of 998 proposals) in their sample taken from the period 1960-1980. The relative increase in popularity of fair price provisions may be a reaction to some of the recent two-tier tender offers in which the remaining non-tendering target stockholders were bought out at a price significantly below the initial tender offer price. An alarming number of companies (19) created a class of special-voting preferred stock to hold in reserve for use as a "poison pill."⁵

Because many of the proxy statements contained multiple amendment proposals, the total number of proposed antitakeover provisions shown in panel A is greater than the total number of firms proposing antitakeover amendments. Panel B shows the distribution of the number of proposals per proxy statement. Nearly 73% of the firms in the sample presented multiple amendments to their stockholders.

Panel C of Table 2 gives the frequency with which various types of antitakeover amendments were "locked-in," so that if a bidder did happen to obtain a minority board seat or purchase a minority block in the target, it would be difficult for him to circumvent other antitakeover provisions by amending the charter and/or by-laws. Typically, this was done by simply requiring that a supermajority vote

⁵A separate event study involving those firms creating "blank check" preferred will be studied in section 6.5 along with other companies who have actually used this poison pill.

of the stockholders is needed to amend the charter/by-laws. This can provide an effective "lock-in" for a wide variety of other antitakeover provisions. Three of the more popular combinations are given in Panel C. In other cases, this sort of "lock-in" provision was not needed, because the state law covering the particular firm provided enough coverage.⁶

The vast majority of these antitakeover proposals were approved by the firms' stockholders at the annual meeting. Of the 159 firms in the sample, stockholders failed to approve the proposals at only 11 companies.⁷ Many of these rejected proposals actually received majority votes, but did not top the supermajority required by the particular corporation laws governing that firm. In addition, several of the companies failing to pass the proposals were considered likely takeover targets or had been in recent takeover battles where stockholders had been denied substantial premiums because of target management's defensive actions.

6.2.2 Specifics of the event study

In the case of amendments proposed to stockholders

⁶The corporation laws of many states already require more than a simple majority of the firm's stockholders is needed to amend the firm's charter and by-laws.

⁷Those firms rejecting the proposed antitakeover amendments were Black & Decker, Canal Randolph, Castle & Cook, Data General, Enstar, Fox-Stanley Photo Products, International Paper, Northwestern Steel & Wire, Pogo Producing, Sherwin-Williams, and Tech-Sym.

through proxy statements, it is difficult to determine when the event - the realization that management is trying to impose antitakeover provisions on the firm - is made public to the market, and when the news is capitalized into the firm's stock price. Obviously, the board of directors does not consider proposing such amendments on one particular day, but rather it considers the action over a period of time and usually with the outside assistance of legal and investment banking counsel.⁸ Then the proxy statements are printed and mailed to stockholders. Generally, these board considerations and the mailing of proxy statements are not reported in the financial press. The stockholders' meeting usually follows the proxy mailing by about 30-45 days, at which time the results are announced. Quite often these results do not get reported in the press until several days after the annual meeting, and sometimes they do not appear at all.

Thus, on which date in this process does the market learn of the antitakeover amendment proposals and reflect their value in the firm's stock price? Although the "event day" likely occurs at different points for different companies depending upon their size, visibility, etc., I have chosen the proxy mailing date as the "event date" (day $t=0$) for each firm. In some cases, the information may be leaked

⁸The board has to pass a resolution to get an antitakeover amendment placed on its proxy, but the firm very rarely ever issues a press release of these resolutions.

to the market over time prior to proxy mailing, but on average the proxy mailing date is likely to be the best "event date." Many "insiders" likely knew of the event before this date, but the mailing of proxy statements confirms that the board plans to go ahead with its proposals, and announces them to the stockholders. Furthermore, because very few proposals have failed to meet stockholder approval in the past, the announcement of the provisions in the proxy is as good as having the proposals actually passed (i.e. there is little uncertainty as to their outcome).

6.2.3 Results and Comments

Table 3 presents the sample average abnormal returns (columns 2 and 5) and cumulative average abnormal returns (columns 3 and 6) for the days surrounding the mailing of the firms' proxy statements containing the antitakeover amendments. Table 4 shows the cumulative abnormal returns (CAR) for the sample of 159 firms over various periods along with the t-statistics testing the significance of those CAR's. Over the 60 days just prior to the proxy mailing date the firms earn a CAR of 0.929%. This CAR is both small and statistically not different than zero ($t=0.53$). Thus, we cannot conclude that firms attempting to add antitakeover provisions to their charters were firms that sought protection from raiders after performing particularly well, but rather these firms appear to have done about as well as the market,

Table 3

Daily abnormal returns (in percent) surrounding the mailing date of the proxies containing the antitakeover charter and by-law amendments.

(N = 159)

(1) Event day	(2) Abnormal return ^a	(3) Cumulative abnormal return	(4) Event day	(5) Abnormal return ^a	(6) Cumulative abnormal return
-60	0.087	0.087	+1	0.081	0.935
-30	0.353	2.304	+2	-0.316	0.619
-20	0.097	1.878	+3	0.031	0.650
-19	-0.284	1.594	+4	0.422**	1.072
-18	-0.090	1.504	+5	0.044	1.116
-17	0.249	1.753	+6	0.236	1.352
-16	0.243	1.996	+7	0.328*	1.680
-15	-0.220	1.776	+8	0.177	1.857
-14	-0.357*	1.419	+9	0.217	2.074
-13	0.059	1.478	+10	-0.094	1.980
-12	-0.326*	1.152	+11	0.305	2.285
-11	-0.031	1.121	+12	0.155	2.440
-10	0.088	1.209	+13	0.244	2.684
-9	0.235	1.444	+14	0.186	2.870
-8	-0.179	1.265	+15	0.385**	3.255
-7	-0.160	1.105	+16	-0.056	3.199
-6	-0.282	0.823	+17	0.139	3.338
-5	-0.070	0.753	+18	0.317	3.655
-4	-0.007	0.746	+19	0.010	3.665
-3	0.020	0.766	+20	-0.055	3.610
-2	0.269	1.035	+30	0.122	4.453
-1	-0.106	0.929	+60	-0.065	6.298
0	-0.075	0.854			

^a**(*) indicates that the average of the standardized residuals is significantly different from zero at the 5% (10%) level of significance using a two-tailed test.

Table 4

Cumulative abnormal returns over various periods around the proxy mailing date for the sample of 159 firms proposing antitakeover charter and by-law amendments during the period 1979-1983.

Period ^a				
Start date	End date	Number of days in period	Cumulative abnormal return (CAR)	T-statistic of CAR

-60	-21	40	1.62%	1.25
-20	-1	20	-0.83%	-0.91
-1	-1	1	-0.11%	-0.53
0	0	1	-0.07%	-0.37
-1	0	2	-0.18%	-0.63
1	10	10	1.13%	1.75
11	20	10	1.63%	2.53
1	20	20	2.76%	3.02

^aThe cumulative abnormal returns are the abnormal returns beginning on the "start date" up through and including the "end date." Periods with the same start and end dates are the abnormal returns (AR) on that date.

or just as anticipated.

On the days right around the proxy mailing - days -1, 0 and 1 - the average abnormal returns are -0.106%, -0.075% and 0.081% with t-statistics of -0.53, -0.37 and 0.42, respectively. None of these appear to be statistically different from zero. Over the 21 days surrounding the proxy mailing (from -10 through 10), 12 of the abnormal returns are positive and 9 are negative. These results do not show that firms are affected - either positive or negative - by the mailing of proxies containing antitakeover charter

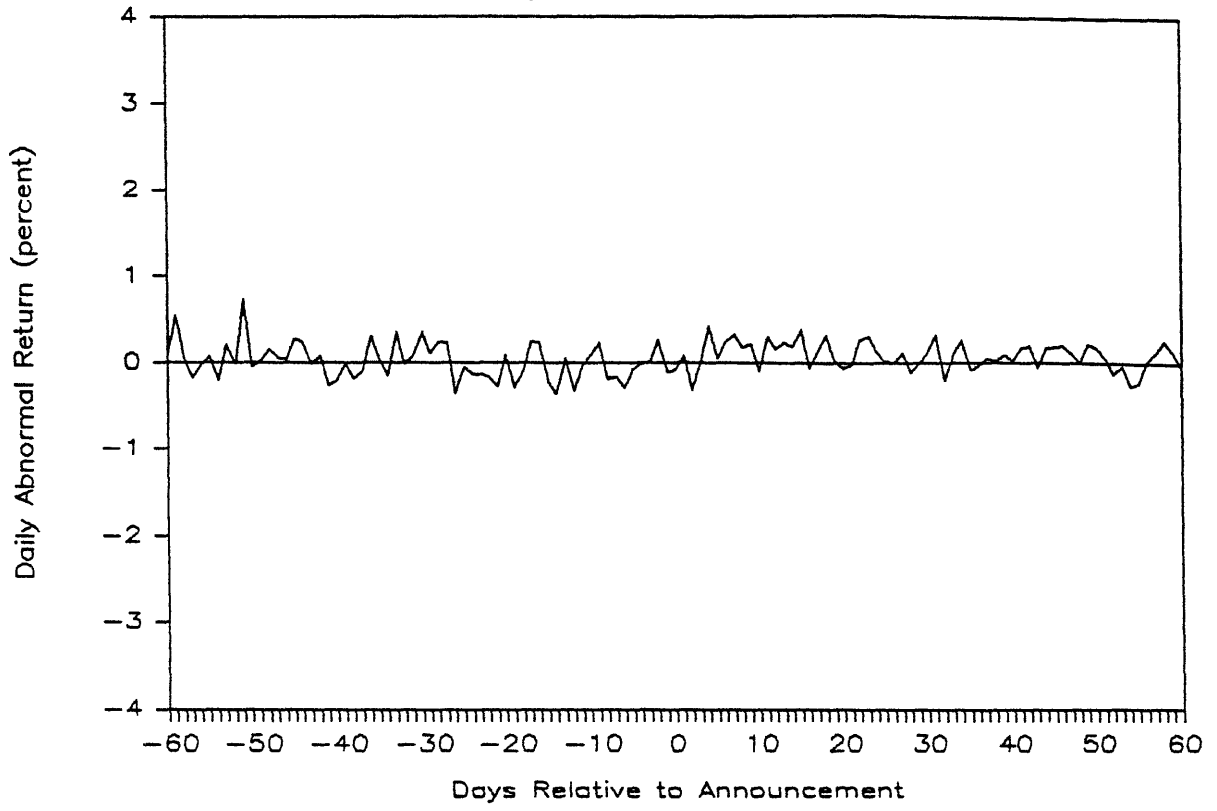
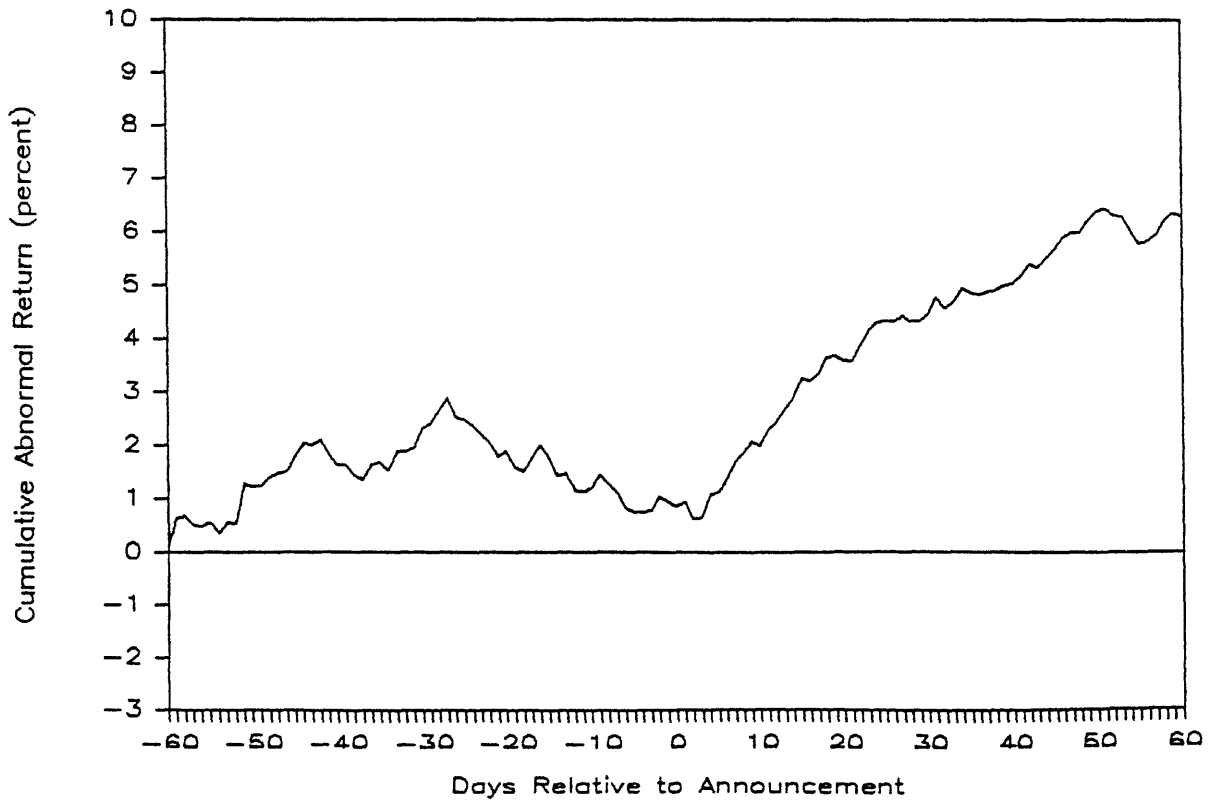


Figure 1



and by-law amendments. Thus, the data presented to this point accepts neither the managerial entrenchment nor the stockholders interest hypotheses. It could be that these provisions have no effect on stock prices, or it could be (on average) that the proxy mailing date is not the date on which the proposal for antitakeover provisions is capitalized into the firm's stock price.

But for the 20 days following the proxy mailing, the group of firms earn a CAR of 2.76% ($t=3.02$) which does indicate that on average something has caused these firms to perform somewhat better than anticipated (see graphs in figure 1). By day $t=60$, this CAR following the proxy mailing has increased to 5.363%. This positive abnormal performance following the proxy mailing is significant and is consistent with the hypothesis that antitakeover amendments have a positive impact on stock price (i.e. the stockholder interests hypothesis explains why target managers adopt these antitakeover provisions).

If one concludes that the proposal of antitakeover amendments produced this abnormal return, then one must also conclude that either the market is inefficient (unlikely) or that the news of the firm proposing antitakeover provisions was not released to the market on the proxy mailing date, but rather on average sometime just following that date. Because no one day from the sample shows a particularly strong positive or negative abnormal return, it could be

that the news of the antitakeover provisions is released to the market at different times by different firms.⁹ Sometimes the news is released by the board before the proxies are mailed, sometimes the proxy is the news-breaker, and sometimes the market does not learn of the new amendments until several days after the mailing. During the 60 days following the proxy mailing, each firm holds its annual meeting and actually votes on the new amendments. Thus, during this 60-day period, all uncertainty as to whether or not the antitakeover provisions are going to be adopted is eliminated.

Based on this set of results, if one were forced to choose between concluding that antitakeover charter amendments have a positive or negative impact on stock price, one would have to conclude that the impact is positive, primarily based on the significantly positive CAR following the proxy mailing date. Contrarily, there is no evidence that the impact is negative. Nonetheless, these results are not definitively conclusive. The sample contained a wide variety of antitakeover proposals, some of which could have negative impacts, some neutral, and some positive.

⁹In an event study, if the actual release date of news of the "event" cannot be exactly determined within a day or two, the confidence intervals (represented by the t-statistics) blow-up rather quickly. Thus, one loses the power to pinpoint the AR caused by the event on any one day, but the CAR over the period still provides some information about the effect of the event (assuming no other significant events are occurring at the same time).

One cannot differentiate between the effects caused by different types of proposals because so many firms proposed multiple amendments all at once. But on average, antitakeover charter provisions tend to benefit stockholders, and the evidence lends credence to the stockholder interests hypothesis.¹⁰

6.3 Standstill Agreements and Negotiated Stock Repurchases

6.3.1 Data Sources and Sample Construction

An initial sample of negotiated stock repurchases for the period 1980-1983 was collected from the Wall Street Journal Index using the "Reacquired Shares" entry in the "General News" section of the index. Other repurchases were added to this sample from a list compiled by the mergers & acquisitions department at Morgan Stanley. The dates and the relevant statistics about the repurchase were then checked with the original stories in the Wall Street Journal. The final sample had to meet the following criteria:

- 1) No other significant "events" for the company occurred around the repurchase date.

¹⁰One should keep in mind the bias in such antitakeover amendment samples suggested in DeAngelo & Rice (1983) and discussed earlier: the tests are biased against the managerial entrenchment hypothesis because the proposal of antiatkeover provisions signals to the market that the firm is likely to be a takeover candidate.

- 2) The date of announcement of the repurchase could be explicitly pinpointed, and was not part of a previous plan or the exercising of a previously purchased option.
- 3) The repurchase transaction was settled entirely for cash (no notes or other consideration).
- 4) The stock repurchase was successful.
- 5) The repurchasing company was listed on the New York or American Stock Exchanges (so that data would be available from CRSP).

This resulted in a final sample of 77 negotiated stock repurchases covering the period 1980-1983. This sample was then broken down into two subsamples: (1) 44 firms repurchasing their own stock to terminate a control dispute between the target firm and the external bidder, and (2) 27 firms who concluded standstill agreements in addition to the block repurchase.

Table 5 shows some summary statistics for the final sample of repurchases and the two subgroups. The average size block of stock repurchased by the target firm is roughly the same for all three groups - 12% of the firm's outstanding common stock. But the average premiums paid for the blocks over the current market price varies among the three groups. The premiums paid were calculated two ways: (1) the repurchase price relative to the closing price of the firm's stock 30 days prior to the date of repurchase (no information

Table 4

Privately negotiated repurchases of single blocks of stock with strictly cash payments during 1980-1983: Percentage of outstanding shares repurchased and percentage premium paid (77 repurchases).

Type of Transaction	Number of events	Percentage of outstanding common stock repurchased (mean)	Repurchase Premium (mean) ^a	
			30 days	2 days
All negotiated repurchases (entire sample)	77	11.9%	25.1%	19.6%
Negotiated repurchases terminating a takeover battle	44	12.6%	29.8%	25.1%
Negotiated repurchases done with a standstill agreement	27	12.4%	37.0%	31.5%
For the entire repurchase sample:				
Minimum		1.3%	152.0%	144.3%
Maximum		40.5%	-31.5%	-45.1%

^aPremiums measured as the block repurchase price relative to the dividend-adjusted closing prices 30 days and 2 days prior to the Wall Street Journal report of the transaction (which in all cases is the trading day following the event).

of or about the repurchase likely had leaked to the market at this time), and (2) the repurchase price relative to the firm's closing stock price two days prior to the Wall Street Journal announcement. The average two-day repurchase premiums are 19.6%, 25.1% and 31.5% for the total sample, the merger-termination group, and the standstill-agreement group, respectively. These repurchase premiums are of the same order of magnitude as the premiums offered to stockholders by bidders in tender offers. The repurchase premiums ranged from -45.1% to 144.3%.

Notice that both the 30-day and two-day repurchase premiums increase over the three groups. Firms repurchasing their own stock had to pay significantly higher premiums when the repurchase also involved a merger termination or standstill agreement than when the repurchase was simple and straightforward (the highest premiums were associated with standstills). Thus, to obtain concessions from the block seller, the firm had to pay higher prices (nothing is free!). Quite often the repurchases settling takeover battles also contained agreements in which each party dropped its lawsuits against the other. Getting the seller to agree not to purchase any stock in the target company for a significant period of years is the most costly to firms. These standstill agreements are relatively long-term contracts averaging slightly longer than eight years (range from three to ten years). Although standstills exist which limit the

ownership of the blockholder to a non-zero percentage, all the standstill agreements in this sample prevented the seller from purchasing any shares of the target, and the block repurchased represented the seller's entire holding in the target.

6.3.2 Specifics of the Event Study

The "event" date (day $t=0$) in the event study was the day the announcement of the repurchase appeared in the Wall Street Journal. In nearly every case, the Wall Street Journal story followed the actual repurchase by one trading day. So generally the "news" of the repurchase was known by traders on day -1 and the greatest impact on the firm's stock should occur on that day. Unlike the previous study on antitakeover amendments, the event date of repurchase can cleanly be identified, and there is likely to be little leakage of information prior to the announcement of the repurchase.

6.3.3 Results and Comments

Tables 5 and 7 show the abnormal returns (AR) and the cumulative abnormal returns (CAR) to stockholders of firms repurchasing blocks of their own stock from a substantial minority stockholder for the entire sample of 77 firms and the two subsamples, respectively. Tables 6 and 8 present the cumulative abnormal returns over various periods with

Table 5

Daily abnormal returns (in percent) to the common stock of 77 firms repurchasing single blocks of their own stock during the period 1980-1983. The event date (day $t=0$) is the announcement of the negotiated stock repurchase.

(1) Event day	(2) Abnormal return ^a	(3) Cumulative abnormal return	(4) Event day	(5) Abnormal return ^a	(6) Cumulative abnormal return
-60	-0.074	-0.074	+1	-0.166	-2.055
-30	-0.131	1.563	+2	0.516*	-1.539
-20	-0.476	1.516	+3	-0.255	-1.794
-19	-0.422	1.094	+4	-0.593**	-2.387
-18	0.455	1.549	+5	0.063	-2.324
-17	0.329	1.878	+6	-0.212	-2.536
-16	-0.137	1.741	+7	0.236	-2.300
-15	-0.258	1.483	+8	0.019	-2.281
-14	0.474	1.957	+9	0.028	-2.253
-13	0.202	2.159	+10	-0.688**	-2.921
-12	0.069	2.228	+11	-0.126	-3.047
-11	-0.260	1.968	+12	-0.501*	-3.548
-10	-0.035	1.933	+13	-0.036	-3.584
-9	0.476	2.409	+14	-0.183	-3.767
-8	-0.192	2.217	+15	0.035	-3.732
-7	-0.622**	1.595	+16	-0.317	-4.049
-6	0.103	1.698	+17	-0.134	-4.049
-5	0.366	2.064	+18	-0.584**	-4.767
-4	-0.420	1.644	+19	-0.135	-4.902
-3	0.099	1.743	+20	-0.386	-5.288
-2	0.110	1.853	+30	0.335	-4.713
-1	-2.114**	-0.261	+60	-0.414	-5.581
0	-1.628**	-1.889			

^a**(*) indicates that the average of the standardized residuals is significantly different from zero at the 5% (10%) level of significance using a two-tailed test.

Table 6

Cumulative abnormal returns over various periods around the date of announcement of repurchase for the sample of 77 firms repurchasing blocks of their own stock during the period 1979-1983.

Period ^a		Number of days in period	Cumulative abnormal return (CAR)	T-statistic of CAR
Start date	End date			
-60	-21	40	1.99%	1.22
-20	-11	10	-0.02%	-0.03
-10	0	11	-3.89%	-4.53
-1	-1	1	-2.11%	-8.33
0	0	1	-1.63%	-6.41
-1	0	2	-3.74%	-10.32
1	10	10	-1.03%	-1.26
11	20	10	-2.37%	-2.90
1	20	20	-3.40%	-2.94

^aThe cumulative abnormal returns are the abnormal returns beginning on the "start date" up through and including the "end date." Periods with the same start and end dates are the abnormal returns (AR) on that date.

the relevant t-statistics. Time-series graphs of these data are presented in figure 2.

The two-day CAR over days -1 and 0 should provide an assessment of the average market price impact of negotiated stock repurchases and standstill agreements. For the entire 77-firm sample, this two-day CAR is -3.74% and is highly statistically significant ($t=-10.32$). Thus, while the selling minority blockholder is (on average) being paid a premium of 19.6%, the remaining non-participating stockholders earn (on average) a negative abnormal return of -3.74% due to

Table 7

Daily abnormal returns (in percent) to the common stock of 44 companies repurchasing single blocks of their own stock accompanied by the settlement of a takeover battle, and 27 companies repurchasing single blocks of their own stock accompanied by a standstill agreement with the seller in the period 1980-1983.

Event day	Merger Termination		Standstill Agreement	
	Abnormal return ^a	Cumulative abnormal return	Abnormal return ^a	Cumulative abnormal return
-60	-0.066	-0.066	0.386	0.386
-50	0.809*	1.309	0.044	1.518
-40	0.058	0.880	-0.307	0.880
-30	-0.169	1.164	0.359	1.002
-20	-0.416	1.433	-0.549	0.496
-10	0.314	2.132	-0.036	2.166
-9	0.314	2.446	0.421	2.587
-8	-0.275	2.171	0.346	2.933
-7	-0.799*	1.372	-1.066**	1.867
-6	0.278	1.650	0.169	2.036
-5	0.357	2.007	0.176	2.212
-4	-0.634	1.373	-0.481	1.731
-3	-0.188	1.185	-0.396	1.335
-2	-0.184	1.001	-0.169	1.166
-1	-3.735**	-2.734	-4.899**	-3.733
0	-2.056**	-4.790	-3.033**	-6.766
+1	0.194	-4.596	-0.071	-6.837
+2	1.148**	-3.448	0.889*	-5.948
+3	0.016	-3.432	0.233	-5.715
+4	-0.878**	-4.310	-0.847*	-6.562
+5	-0.371	-4.681	-0.641	-7.203
+6	-0.376	-5.057	-0.635	-7.838
+7	0.732*	-4.325	0.965*	-6.873
+8	0.086	-4.239	0.090	-6.783
+9	-0.060	-4.299	-0.366	-7.149
+10	-1.024**	-5.323	0.017	-7.132
+20	-0.366	-6.991	-0.214	-7.697
+30	0.235	-6.025	0.505	-7.092
+40	-0.179	-6.430	-0.017	-7.439
+50	0.034	-8.190	-0.002	-8.573
+60	-0.545	-7.834	-0.570	-8.724

^aSignificant AR: ** at 5% level, * at 10% level.

Table 8

Cumulative abnormal returns over various periods around the date of announcement of repurchase for the samples: (1) 44 firms repurchasing blocks of their own stock in termination of a takeover battle, and (2) 27 firms repurchasing blocks of their own stock with a standstill agreement.

Period ^a		Number of days in period	Cumulative abnormal return (CAR)	T-statistic of CAR
Start date	End date			
(1) Merger-terminating repurchases				
-60	-21	40	1.85%	0.73
-20	-11	10	-0.03%	-0.03
-10	0	11	-6.61%	-5.01
-1	-1	1	-3.74%	-10.32
0	0	1	-2.06%	-5.68
-1	0	2	-5.79%	-10.72
1	10	10	-0.53%	-0.42
11	20	10	-1.67%	-1.33
1	20	20	-2.20%	-1.23
(1) Repurchases with standstill agreement				
-60	-21	40	1.92%	0.65
-20	-11	10	1.15%	0.78
-10	0	11	-8.97%	-5.77
-1	-1	1	-4.90%	-9.99
0	0	1	-3.03%	-6.18
-1	0	2	-7.93%	-11.72
1	10	10	-0.37%	-0.25
11	20	10	-0.56%	-0.38
1	20	20	-0.93%	-0.44

^aThe cumulative abnormal returns are the abnormal returns beginning on the "start date" up through and including the "end date." Periods with the same start and end dates are the abnormal returns (AR) on that date.

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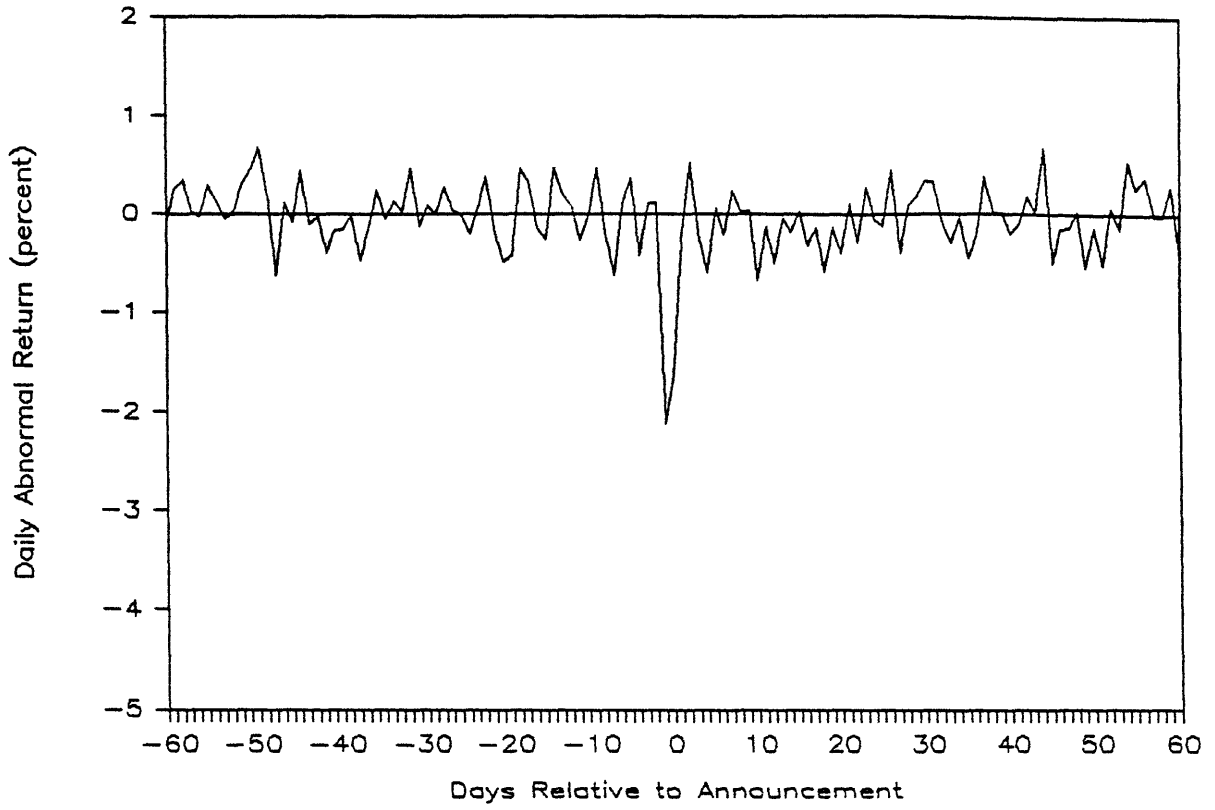


Figure 2



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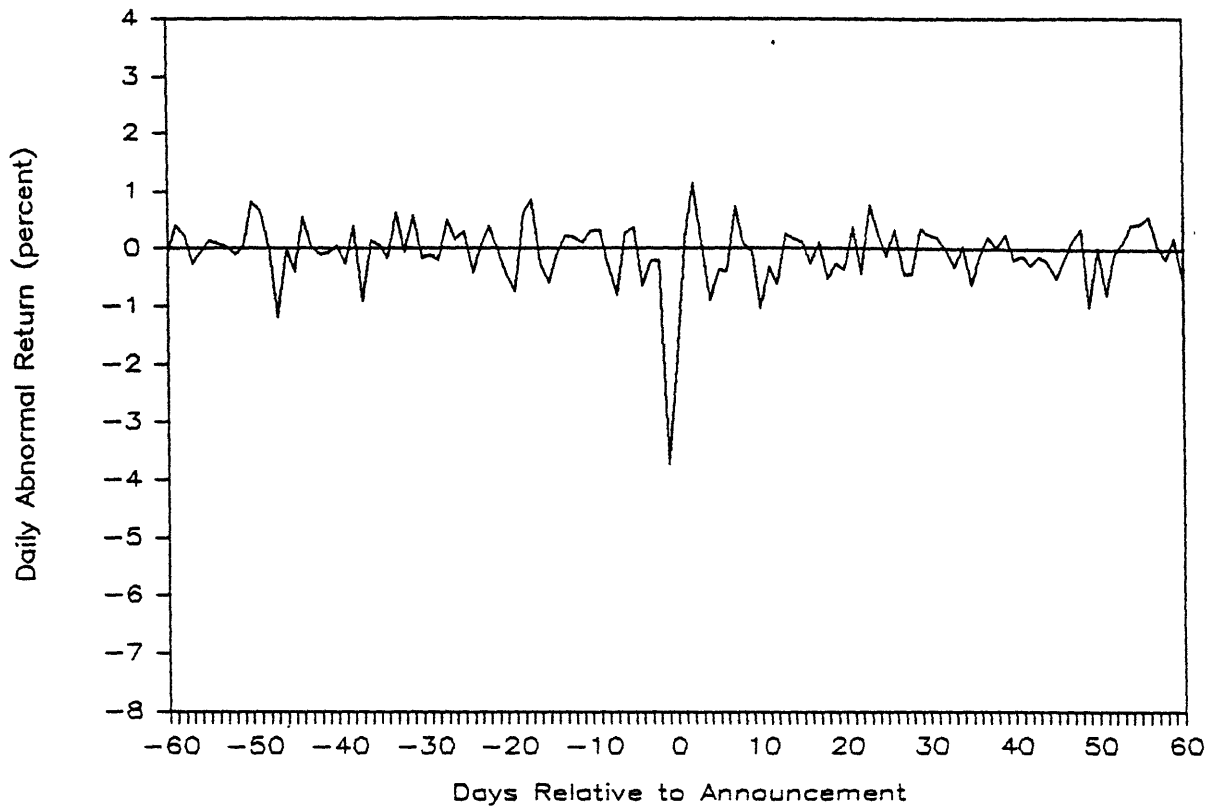
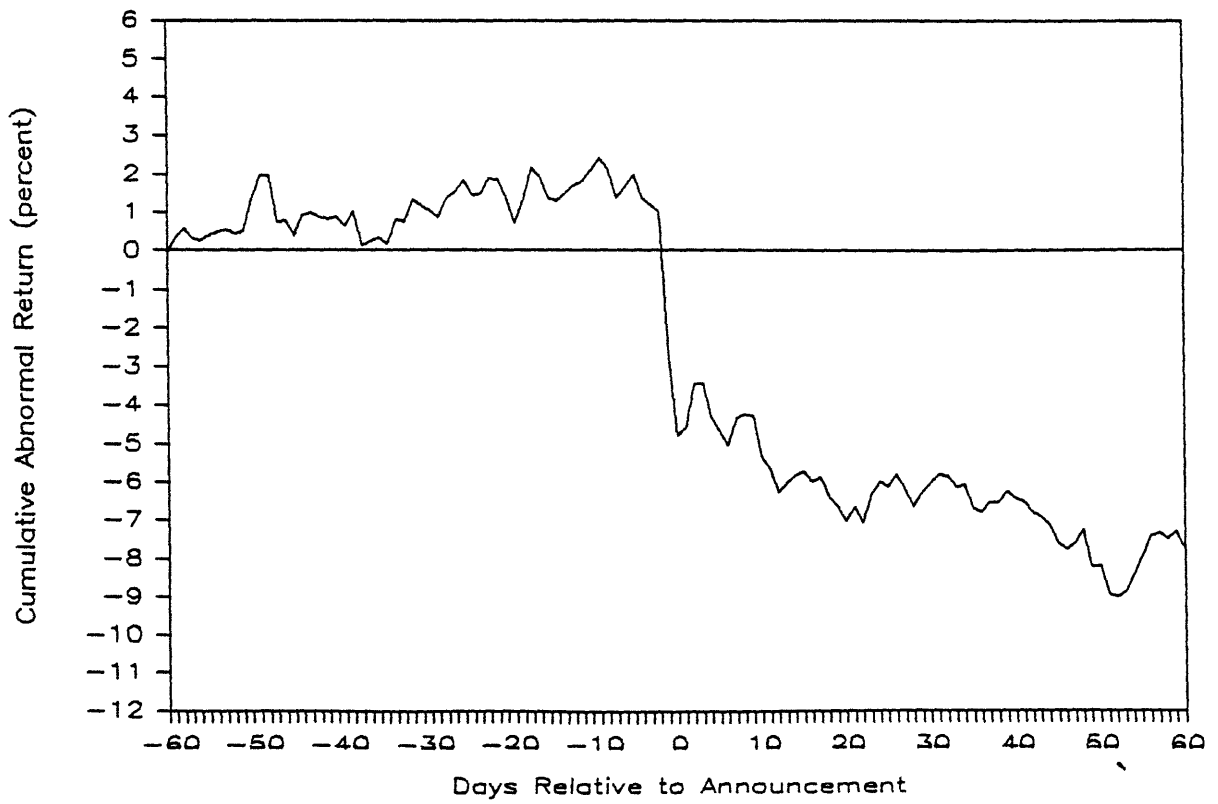


Figure 3



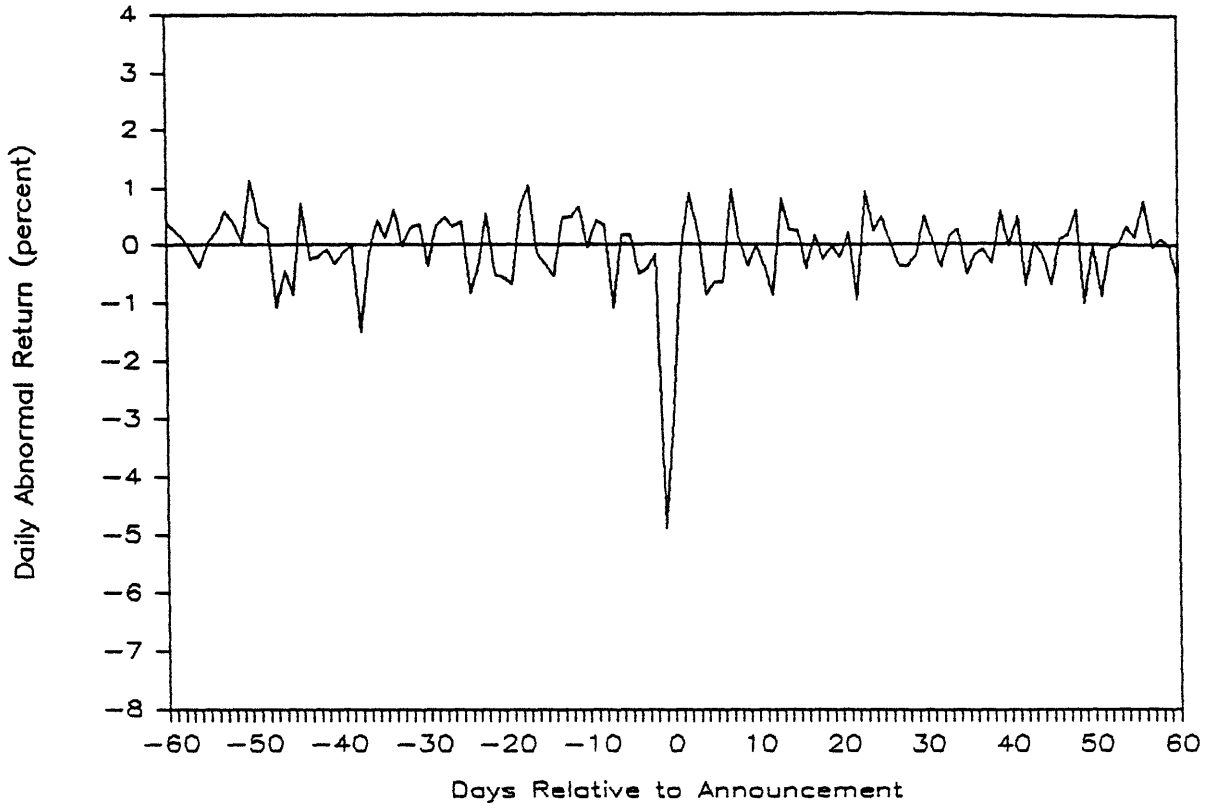
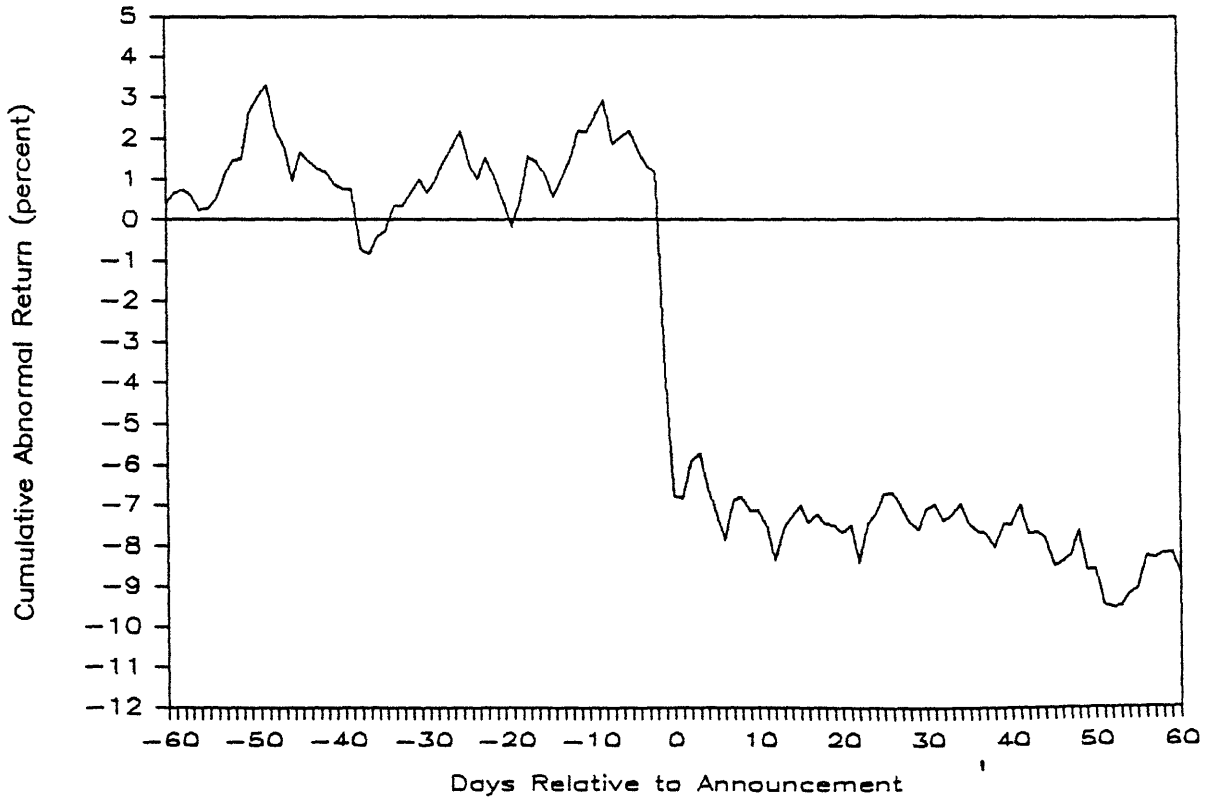


Figure 4



the stock repurchase. There is a direct transfer of wealth from the non-participating stockholders to the seller receiving the premium over the current market. For some reason, stockholders continue to earn statistically significant abnormal returns during the period immediately following the repurchase, particularly over days 1 through 20 where the CAR is -3.40% ($t=-2.94$). This is somewhat puzzling. It could be that the market does not efficiently capitalize the "news" of the stock repurchase on announcement. Conceivably, the market may anticipate that another bidder could enter making a bid for the target now that the substantial minority block has been eliminated (this rarely happens). Realizing that another bidder is not around the corner to offer another premium, the target's stock drops off.

Similar results are found for block repurchases which involve merger terminations and/or standstill agreements. From tables 7 and 8, the two-day CAR's associated with the announcement of the stock repurchase are -5.79% ($t=-10.72$) and -7.93% ($t=11.72$) for the merger-termination and standstill agreement subsamples, respectively. Again, these negative abnormal returns are highly statistically significant lending credence to the hypothesis that non-participating stockholders are hurt by these actions. As further support of this theory, the vast majority of these two-day CAR's associated with the repurchase in both groups are negative (see table 9). In both groups of repurchases, the firms appear to earn

Table 9

Distribution of the abnormal returns earned by the stockholders of the target firm buying back its own stock to settle a control dispute. These are two-day abnormal returns for the day before and the day of the repurchase announcement ($t=-1$ and $t=0$).

Magnitude of two-day abnormal return ($AR_{-1,0}$)	Number of observed abnormal returns	
	Block repurchases terminating a takeover battle (44 repurchases)	Block repurchases with standstill (27 repurchases)
$AR < -21\%$	1	1
$-21\% < AR < -18\%$	2	2
$-18\% < AR < -15\%$	3	2
$-15\% < AR < -12\%$	0	0
$-12\% < AR < -9\%$	2	2
$-9\% < AR < -6\%$	6	5
$-6\% < AR < -3\%$	9	5
$-3\% < AR < 0\%$	12	8
$0\% < AR < 3\%$	7	2
$3\% < AR$	2	0
Total	44	27
Minimum	-43.05%	-43.05%
Mean	-5.79%	-7.93%
Maximum	6.72%	1.93%

average expected returns (i.e. no abnormal returns) over the period preceding and following the repurchase announcement. This implies that the market efficiently capitalizes the "news" associated with the announcement of the block repurchase and standstill agreement into the stock price of the target firm.

The merger-termination group shows a greater wealth loss than does the entire sample of stock repurchases, and the group with standstill agreements reports losses greater than that of either the two other groups. The distribution of two-day abnormal returns in table 9 is skewed more towards the negative end for the standstill-agreement group than for the merger-termination group. This finding is consistent with the earlier discussion reporting that the repurchase premiums increase over the three groups and that the repurchase premiums are commensurate with what the target management is obtaining from the selling blockholder. In all three cases, the seller gives up his leverage from which he could launch another takeover battle. In the merger-termination and standstill-agreement groups, the target management also gets rid of a potential bidder and eliminates the lawsuits (and their related costs) against the company. Finally, in the case of the standstill-agreement group, the target management receives even more - an assurance that the bidder will not return for at least the period of the standstill agreement. Thus, the more the target asks for in addition to the repurchase, the more cash they have to give up to the seller and the greater the wealth loss to the remaining stockholders.

To summarize, these statistical tests and results presented in tables 5-9 are inconsistent with the hypothesis that incumbent managers are acting in the best interests

of their stockholders when repurchasing blocks of stock from minority stockholders at a premium over the current market. This is particularly true when the repurchase terminates a takeover battle and/or when the seller agrees not to make another attempt in the future. The data suggests that the intent of incumbent managers in repurchasing the block is to thwart a profitable takeover, and to secure their own positions of power and compensation within the firm. As an additional note, it should be pointed out that quite often non-participating stockholders file lawsuits against the management in an attempt to block the repurchase at a premium.¹¹ This is strong evidence against the stockholder interests hypothesis, at least for this defensive tactic.

On the other hand, the results do not automatically imply that the managerial entrenchment hypothesis holds. Even though management's intent may be to "entrench" their positions, the wealth loss observed in these repurchases may simply represent the decline in the probability that the minority blockholder will attempt a control battle in which the other stockholders would receive a control premium. Countering this argument is the fact that the elimination of the substantial block reduces the impediments to other

¹¹The courts, applying the "business judgement" rule, often rule in favor of the incumbent management in these cases. Based on the evidence presented here, judges should reconsider before siding with management in these cases.

potential bidders; thus, the probability of the target stockholders receiving a takeover premium may in some cases actually increase.

6.4 Antitrust "Show-Stopper" Litigation

6.4.1 Data Sources and Sample Construction

A large list of several hundred mergers involving antitrust violations over the period 1975-1983 was collected from the Trade Regulation Reporter, which contains brief summaries of all antitrust cases undertaken by the Federal Trade Commission (FTC) and the Department of Justice (DOJ). To be included in the final sample of target firms using antitrust litigation as a defensive tactic, each case from the Trade Regulation Reporter had to meet the following criteria:

- 1) The filing of the antitrust suit against the bidder had to be at least three days after the announcement of the tender offer bid.
- 2) No other defensive tactics could be used concurrently with the antitrust litigation tactic (i.e. during days -2 through 0).
- 3) The target firm's stock had to trade on the day before and the day of the antitrust announcement.
- 4) The antitrust case had to come under the supervision

of the FTC or the DOJ rather than some other regulatory agency (this eliminated bank and insurance mergers).

5) Announcements about the cases had to be found in the Wall Street Journal.

6) The target had to be listed on the New York or American Stock Exchanges.

The first three criteria were intended to select only antitrust cases which were somewhat isolated so that the effect of the defensive tactic could be measured less ambiguously.¹²

Many of the firms in the preliminary sample filed the antitrust suit, or at least stated their intention to do so, as their first reaction to the hostile takeover bid. This announcement usually was made on the day following the takeover bid, and occasionally the stock exchange had suspended trading in the target company's stock during this period. Furthermore, in the vast majority of cases in the preliminary sample, the antitrust tactic was only one of many defensive tactics announced on that day, quite often concurrent with incumbent management's explicit rejection of the takeover offer. In these situations, any measurable abnormal return associated with the use of antitrust litigation as a defensive tactic would be confounded by the other "events" occurring and being reflected in the firm's stock price

¹²The actual Wall Street Journal articles covering the days of the takeover bid through the filing of the antitrust suit were studied to filter out all those cases which had other confounding events.

at the same time. The first two criteria eliminated all such cases from the final sample. The six filters reduced the initial sample down to a group of 19 target firms from the period 1975-1983.

6.4.2 Specifics of the Event Study

The announcement of the filing of the antitrust suit in the Wall Street Journal was assigned to day 0, so that typically the actual filing of the suit and the resulting stock price impact occurred on day -1. Because the sample criteria eliminated all cases in which other defensive tactics were employed on the day before, day of, and day following the actual filing of the antitrust suit, one would expect that days -2 and 0 would not show statistically significant abnormal returns (unless information leaked or unless the market was not efficient in this case).

For each of the 19 firms in the sample, the takeover bid was made sometime during the 10 days preceding the filing of the antitrust suit. Typically, the bidder offered for the target on days -5 or -4. One should expect to see large positive abnormal returns for these firms during the period prior to the use of the antitrust defensive tactic. The big returns should come during the period -10 through -2, but positive abnormal returns are also likely before day -10 as the market anticipates the bid or as information is leaked out before the actual offer. Unless the market

gives the antitrust suit a probability of one of successfully warding off the bidder and that a replacement bidder does not appear, the abnormal return associated with the antitrust defensive tactic should not completely eliminate the positive return associated with the takeover bid. The empirical results should test these hypotheses.

6.4.3 Results and Comments

Tables 10 and 11 report the results of the abnormal returns (AR) and the cumulative abnormal returns (CAR) for the 19-firm sample of target companies using the antitrust litigation defensive tactic. The time-series data of the abnormal returns are shown graphically in figure 5. The abnormal return generated by the announcement of the filing of the antitrust suit on day -1 is -3.142% ($t=-4.29$). In all but one of the 19 cases, the CAR covering days -1 and 0 is negative (range from -11.99% to 0.33%). Thus, it does appear that the use of an antitrust block against a takeover offer is costly to target stockholders. As hypothesized, because of the sample selection filters, the firms (on average) do not earn statistically significant abnormal returns on the days on either side of the actual filing - day -2 has an average AR of 1.009% ($t=1.31$) and day 0's AR is -0.937% ($t=-1.22$).

The announcement of the takeover bid results in significant abnormal returns to the target stockholders preceding

Table 10

Daily abnormal returns (in percent) to the common stock of 19 firms filing antitrust suits against bidders attempting to take control of the target via a tender offer during the period 1975-1983. The antitrust suits were filed on event date (day $t=-1$).

(1) Event day	(2) Abnormal return ^a	(3) Cumulative abnormal return	(4) Event day	(5) Abnormal return ^a	(6) Cumulative abnormal return
-60	0.312	0.312	+1	-0.503	21.910
-30	-0.454	-6.357	+2	0.915	22.825
-20	-0.019	-3.115	+3	0.439	23.264
-19	0.316	-2.799	+4	-1.416*	21.848
-18	0.491	-2.308	+5	-1.956**	19.892
-17	2.268**	-0.040	+6	1.285*	21.177
-16	-0.396	-0.436	+7	1.530**	22.707
-15	1.416	0.980	+8	0.324	23.031
-14	0.833	1.813	+9	-1.324*	21.707
-13	1.872**	3.685	+10	-0.389	21.318
-12	-0.350	3.335	+11	0.826	22.144
-11	1.052	4.387	+12	-0.931	21.213
-10	4.898**	9.285	+13	-0.440	20.773
-9	2.228**	11.513	+14	-0.739	20.034
-8	0.612	12.125	+15	-0.509	19.525
-7	1.574**	13.699	+16	-0.182	19.343
-6	1.054	14.753	+17	0.312	19.655
-5	4.072**	18.825	+18	0.930	20.585
-4	6.710**	25.535	+19	-0.620	19.965
-3	-0.052	25.483	+20	-0.084	19.881
-2	1.009	26.492	+30	0.268	13.342
-1	-3.142**	23.350	+60	0.226	16.078
0	-0.937	22.413			

^a***(*) indicates that the average of the standardized residuals is significantly different from zero at the 5% (10%) level of significance using a two-tailed test.

Table 11

Cumulative abnormal returns over various periods around the date of the target filing an antitrust suit ($t=-1$) against its hostile bidder as a defensive tactic for a sample of 19 firms from the period 1975-1983.

Period ^a				
Start date	End date	Number of days in period	Cumulative abnormal return (CAR)	T-statistic of CAR

-60	-21	40	-3.10%	-0.74
-20	-11	10	7.48%	3.55
-10	-2	9	22.11%	9.90
-1	-1	1	-3.14%	-4.29
0	0	1	-0.94%	-1.28
-1	0	2	-4.08%	-4.14
1	10	10	-1.09%	-0.52
11	20	10	-1.44%	-0.68
1	20	20	-2.53%	-0.85

^aThe cumulative abnormal returns are the abnormal returns beginning on the "start date" up through and including the "end date." Periods with the same start and end dates are the abnormal returns (AR) on that date.

the use of the antitrust defensive tactic. During the nine days preceding the actual filing of the lawsuit (days -10 through -2) which includes the announcement of the takeover bid, the target stockholders earned a CAR of 22.11% ($t=9.90$). The ten-day period preceding this offer period (days -20 through -11) also have a statistically significant AR of 7.48% ($t=3.55$), indicating that "news" of the imminent takeover attempt leaked to the market. But during the period preceding this takeover offer period (days -60 through -21)

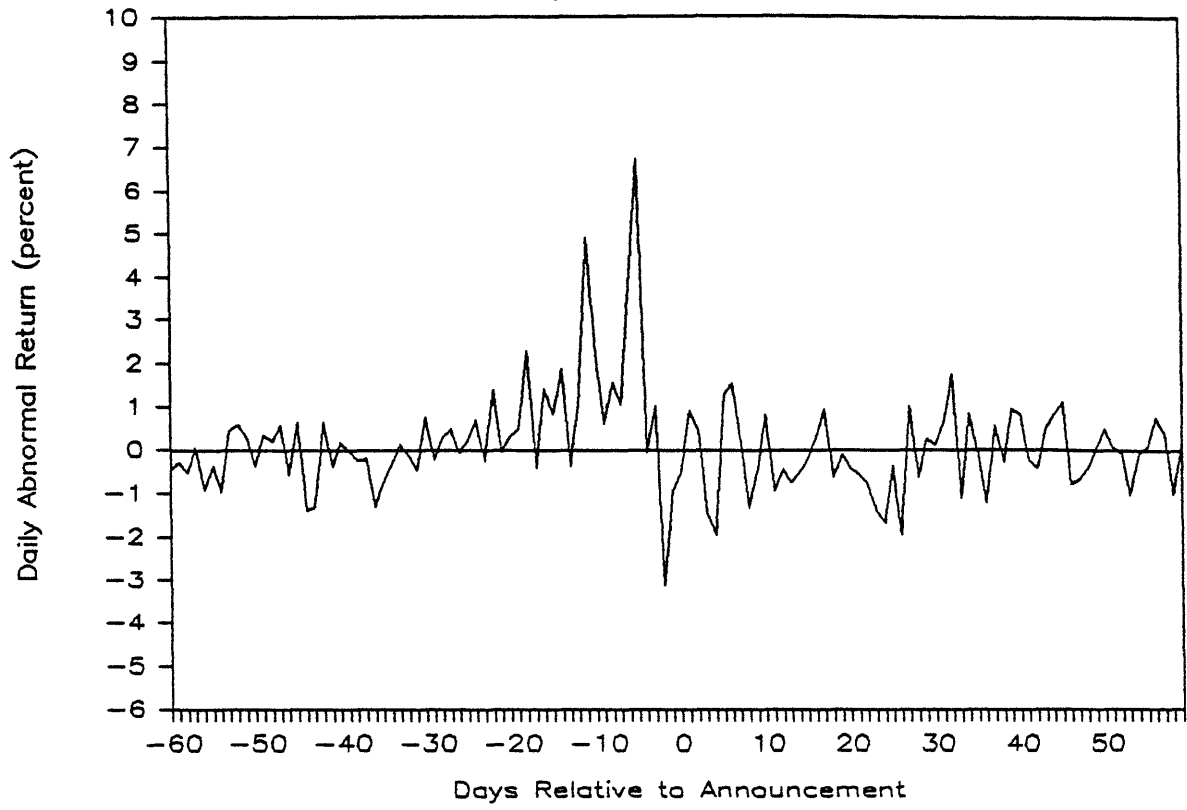
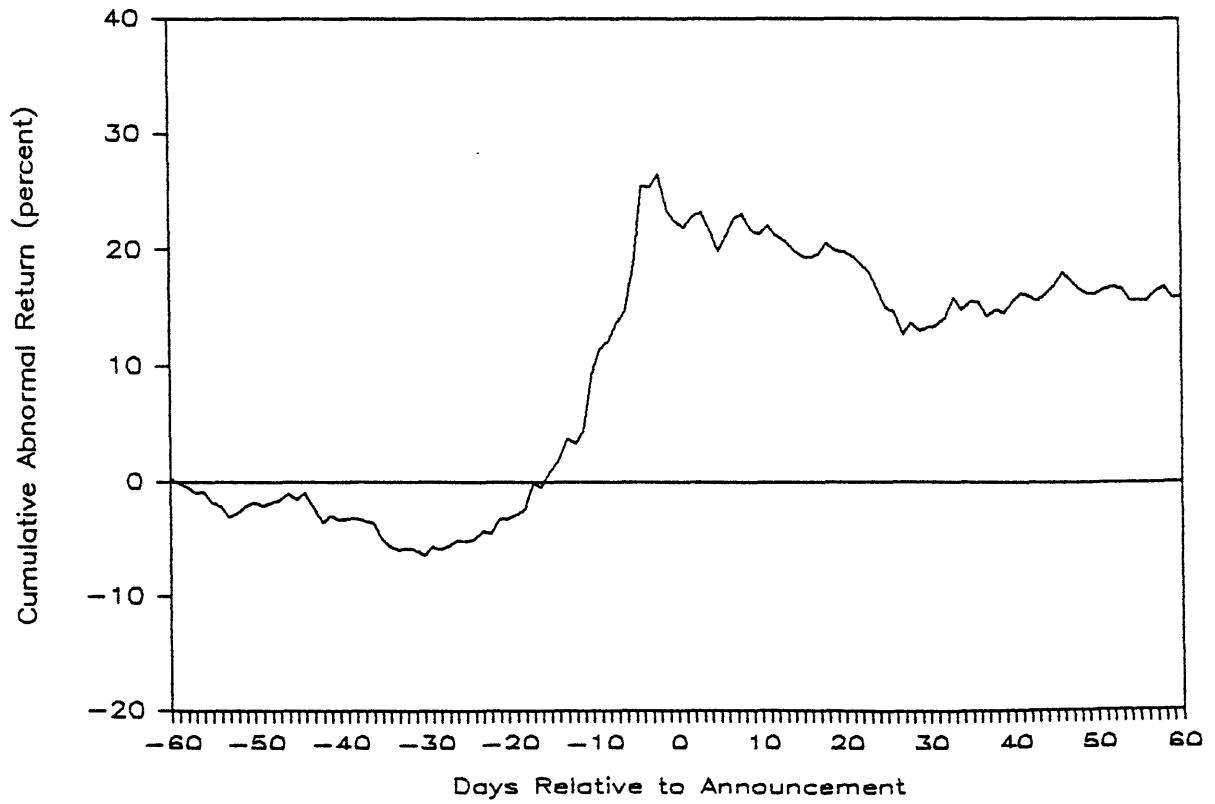


Figure 5



and the period immediately following the filing of the antitrust (days 1 through 20), the target firms appear to have (on average) earned normal, expected returns (i.e. the CAR's over these periods are not statistically significant). From a high of 26.492% on the day just preceding the use of the antitrust tactic (day -2), the CAR of the sample of 19 firms falls to a low of 12.708% (day 27) during the 60 days following the announcement of the antitrust suit.¹³ Thus, the antitrust defensive tactic does incur significant wealth losses for target stockholders, but it does not eliminate the entire abnormal return earned by the stockholders due to the takeover attempt.

6.5 "Poison Pill" Preferred Stock Issuance

The remaining two categories of defensive tactics to be examined empirically in this thesis - "poison pill" preferred stock issuance and "double pac-man" counter tender offers - will employ an event-study type of methodology. But because only a few firms have attempted either of these two types of defensive tactics (no more than five in either case), the sample sizes are not large enough to perform the types of statistical tests used in the previous three

¹³In many of the cases in the sample, the uncertainty about the outcome of the antitrust suit and the takeover attempt was not resolved during the 60 days following the filing of the antitrust suit.

event studies. Furthermore, in the case of all of the target firms using these two defensive measures, there are too many confounding events occurring on the same day or on the days just before the action to determine the specific impact from the one particular tactic. When confounding events occur concurrent with the "event" under study, the event study methodology quickly loses its explanatory power. Therefore, similar to the difference between a civil trial and a criminal trial, any verdict as to the impact of these defensive tactics drawn from the presented evidence will depend upon a "preponderance of evidence" rather than "beyond a shadow of doubt."

6.5.1 Data Sources and Sample Construction

"Poison pill" preferred stock has only been used as an antitakeover defensive tactic three times by target companies:

- 1) El Paso Company against Burlington Northern (December 1982). Takeover was successful; both preferred and related litigation was dropped.
- 2) Lenox, Inc. against Brown-Forman Distillers (June 1983). Takeover was successful; both preferred and related litigation was dropped.
- 3) Bell & Howell against National Education Corporation (July 1983). Litigation on Bell & Howell's preferred distribution is still pending.

In each of the three cases, the new preferred issue was challenged in court, but the legality of this defensive tactic has yet to be determined.

During the last four proxy seasons, 37 companies¹⁴ have proposed the establishment of a special class of "blank check" preferred stock, presumably to be held in reserve for use as a defensive "poison pill." One particular attempt to create such a class of "blank check" preferred carried heavy coverage in the press and had a significant impact on the firm's stock. In November 1983, Superior Oil declared a special dividend on its common stock that would issue 0.9 of a share of new convertible preferred for each common share. If a third party were to acquire more than 35% of Superior's voting stock, holders of the preferred could demand redemption at the highest price paid by such third party during the year in which it acquired its 35% interest. With institutions holding about 35% of Superior's stock, many stockholders thought that this new preferred dividend would make the company much less attractive as a takeover candidate,¹⁵ and they spoke out quite vocally against the new issue. As one bank portfolio manager with more than a million Superior shares said: "The whole idea of the

¹⁴These 37 companies include OTC-listed firms in addition to the 19 firms establishing such preferred stock included in the antitakeover charter amendment sample (see section 6.2.1).

¹⁵Superior Oil had been considered a takeover candidate for some time. Previous charter amendments impeding such a takeover were changed in the spring of 1983.

preferred is ludicrous and totally in management's self interest." Bowing to this pressure and the pressure of several lawsuits, Superior's management rescinded the new issue. The evidence below examines the impact on Superior's stock price.

Thus, this limited sample makes it more difficult to determine an "average" stock price impact of using "poison pill" preferred as a defensive tactic. The small number of companies in this sample prevents the "law of large numbers" from filtering out the "noise" in this event study. Consequently, the empirical analysis will look at two samples individually:

- 1) An event study on the 15 firms that proposed the creation of a special class of "blank check" preferred to stockholders in the firm's proxy statement during the period 1979-1983. Of the 19 firm's proposing such an amendment form the antitakeover charter amendment sample, these 15 firms had no other antitakeover amendments (i.e. this proposal was the only antitakeover provision on the ballot).
- 2) The abnormal returns earned by the stockholders of El Paso, Lenox and Superior Oil when the "poison pill" defensive tactic was attempted will be measured individually. Bell & Howell was left out of this sample because there were too many confounding events on the same day.

Although these tests are not as powerful as an event study when the sample size is large, hopefully these two tests will provide a "preponderance of evidence" showing the impact of the preferred stock defensive tactic.

6.5.2 Specifics of the Event Study

The 15-firm event study on the "blank check" preferred charter amendments used the proxy mailing date as the event day 0. Because the sample size in this event study is relatively small, one would expect that more variance will exist in the average abnormal returns for each day and that the t-statistics would be (everything else being equal) less significant. This in turn would lead to more variation in the average cumulative abnormal returns over various periods.

The abnormal returns calculated individually for the three-company sample employed the same market model type of methodology as used in the event studies. The beta coefficient in the market model for each firm was regressed over 200 days of returns during a period preceding the use of the "poison pill" preferred.

6.5.3 Results and Comments

Tables 12 and 13 report the abnormal returns and the cumulative abnormal returns for the 15 firms proposing the creation of "blank check" preferred to stockholders

Table 12

Daily abnormal returns (in percent) to the common stock of 15 firms proposing the creation of a special class of "blank check" preferred stock in the firms' proxy statement sent out to target stockholders during the period 1979-1980. Although the proxy statement does not explicitly claim that the new preferred will be used as a defensive weapon, the creation of such a class of stock implies that the management intends to use this "poison pill." The proxy mailing date is day $t=0$.

(1) Event day	(2) Abnormal return ^a	(3) Cumulative abnormal return	(4) Event day	(5) Abnormal return ^a	(6) Cumulative abnormal return
-60	0.488	0.488	+1	0.054	-5.133
-30	0.964	0.610	+2	0.739	-4.394
-20	-0.032	-0.351	+3	0.738	-3.656
-19	-1.140	-1.491	+4	0.451	-3.205
-18	0.334	-1.157	+5	-0.074	-3.279
-17	0.449	-0.748	+6	-0.137	-3.416
-16	0.887	0.139	+7	1.490**	-1.926
-15	-0.779	-0.640	+8	0.345	-1.581
-14	-0.645	-1.285	+9	0.281	-1.300
-13	0.367	-0.918	+10	0.505	-0.795
-12	0.860	-0.058	+11	-0.138	-0.933
-11	0.170	0.112	+12	-0.104	-1.037
-10	0.239	0.351	+13	0.677	-0.360
-9	0.627	0.978	+14	1.197*	0.837
-8	-0.010	0.968	+15	-0.330	0.507
-7	-2.287**	-1.319	+16	-0.372	0.135
-6	-1.617**	-2.936	+17	-0.161	-0.026
-5	0.073	-2.863	+18	0.149	0.123
-4	0.155	-2.708	+19	0.389	0.512
-3	-0.387	-3.095	+20	0.480	0.992
-2	-0.575	-3.670	+30	-0.335	3.271
-1	-0.213	-3.883	+60	1.101	10.056
0	-1.304*	-5.187			

^{a**}(*) indicates that the average of the standardized residuals is significantly different from zero at the 5% (10%) level of significance using a two-tailed test.

Table 13

Cumulative abnormal returns over various periods around the mailing date of proxy statements of 15 firms proposing to establish "blank check" preferred stock to be held in reserve for defensive purposes during the period 1979-1980.

Period ^a		Number of days in period	Cumulative abnormal return (CAR)	T-statistic of CAR
Start date	End date			
-60	-21	40	-0.32%	-0.06
-20	-11	10	0.43%	0.16
-10	-1	10	-3.99%	-1.47
-1	-1	1	-0.22%	-0.29
0	0	1	-1.30%	-1.93
-1	0	2	-1.52%	-1.39
1	10	10	4.39%	1.61
11	20	10	1.79%	0.66
1	20	20	6.18%	1.59

^aThe cumulative abnormal returns are the abnormal returns beginning on the "start date" up through and including the "end date." Periods with the same start and end dates are the abnormal returns (AR) on that date.

on the firm's proxy statement for vote at the annual meeting. The time-series representation of these results are shown graphically in figure 6. The abnormal return for the day the proxy statements are mailed (day 0) is -1.304%. The t-statistic for this AR is -1.93 which just misses the cut-off for statistical significance at the 5% level, but is significant at the 10% level. None of the days immediately surrounding the event day appear to have statistically significant abnormal returns. But notice that the AR's are generally larger in magnitude (in absolute value) than the AR's from

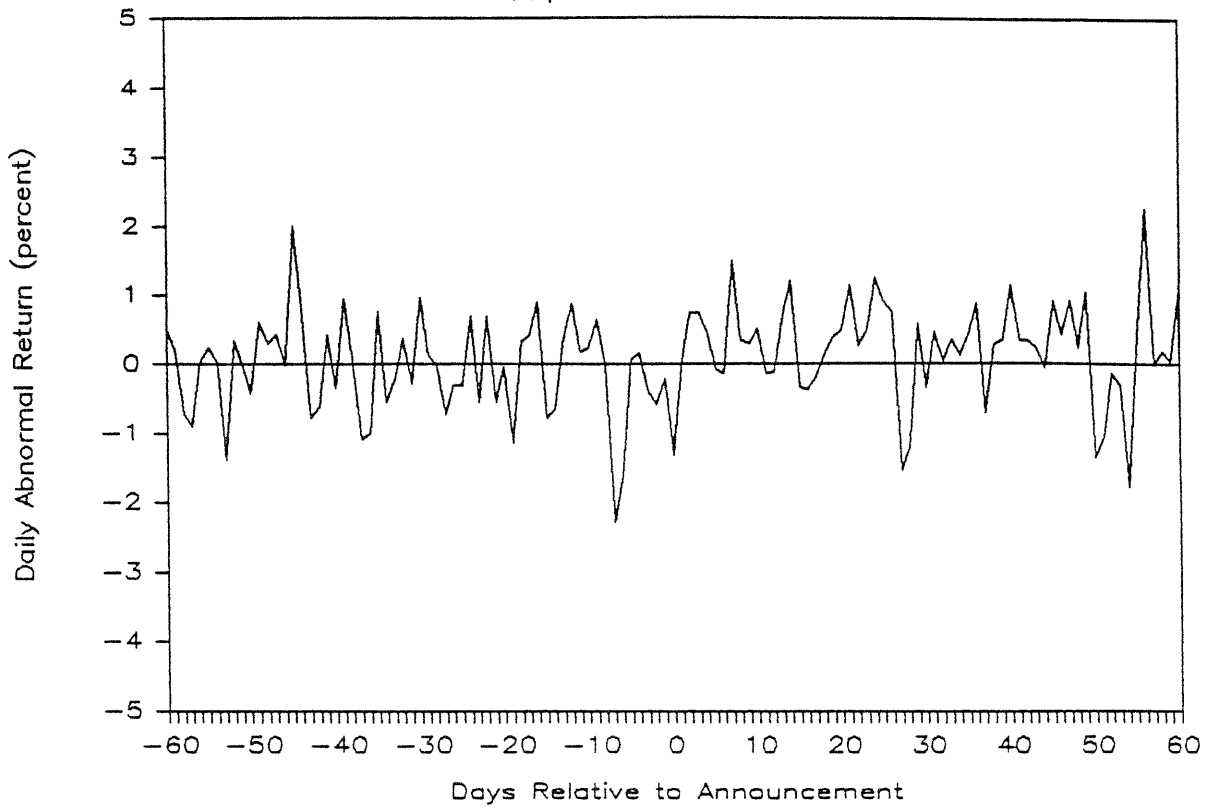
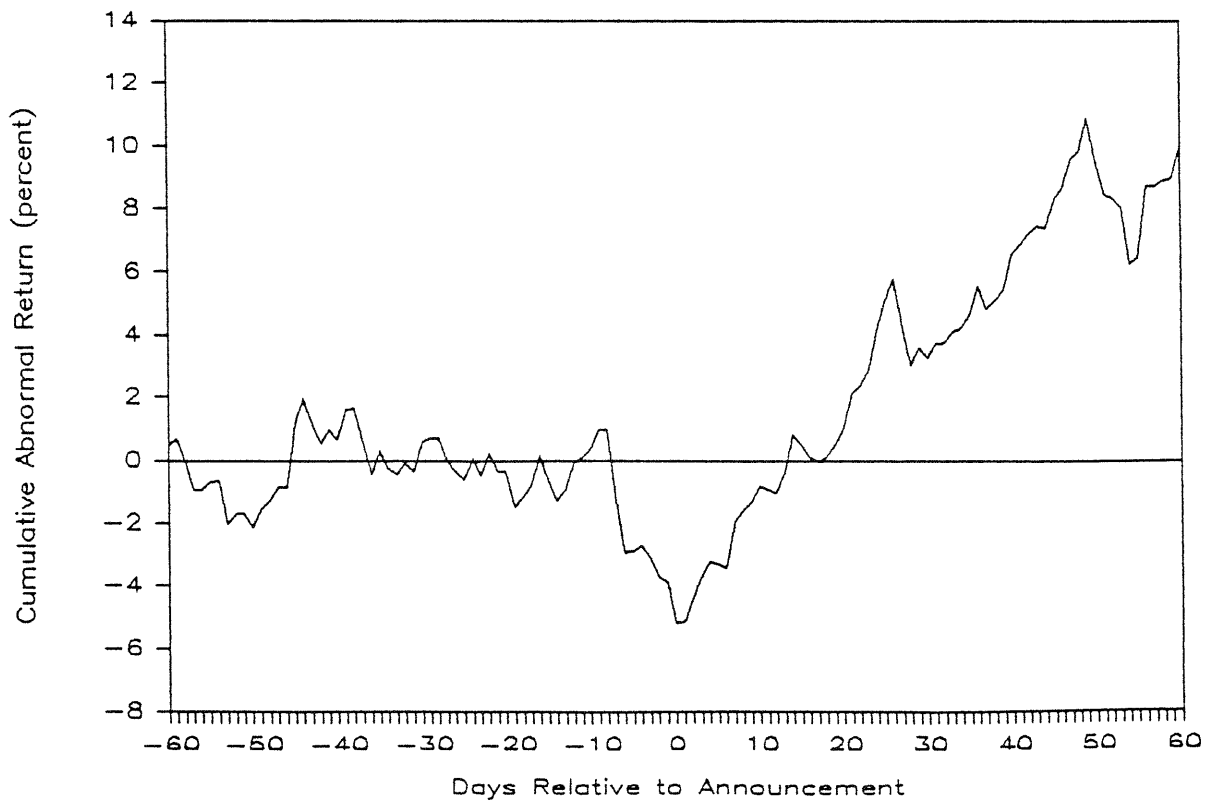


Figure 6



the previous event studies. Furthermore, only one of the 15 firms in the sample had a positive two-day CAR for days -1 and 0 (range of -4.178% to 1.978%). Two statistically-significant AR's appear on days -7 and -6 which could be due to a number of different factors: leak of information about the "blank check" preferred proxy statement, another significant unexpected event for one of the companies, or just random noise. These two negative abnormal returns account for the negative (but not statistically significant) CAR during the ten-day period just preceding day 0: CAR for day -10 through -1 is -3.99% ($t=-1.47$).

None of the other periods before or after the event day 0 show statistically significant CAR's. Although not conclusive because of the small sample size and because of the marginal statistical significance, this evidence does lend credence to the hypothesis that the creation of "blank check" preferred held in reserve to be used as a "poison pill" defensive weapon is contrary to the best interests of the target stockholders. The preferred stock makes takeover attempts more difficult and costly, and simply reduces the likelihood that target stockholders will receive a control premium.

Notice that this "blank check" preferred subsample of the larger antitakeover charter amendment sample leads one to contrary conclusions about the wealth impacts of antitakeover amendments. From section 6.2.3, the evidence

supported the hypothesis that, in general, antitakeover charter and by-law amendments do benefit target stockholders. In that event study, the abnormal returns associated with the mailing of the proxy statements were positive. In this case, a small subsample of the antitakeover amendment sample, the abnormal returns associated with the mailing of the proxies are negative, leading one to conclude that "blank check" preferred stock and the "poison pill" defensive tactic are motivated by the managerial entrenchment hypothesis.

Turning to the second test of the "poison pill" defensive tactic, table 14 shows how the stock prices of El Paso, Lenox, and Superior Oil were affected when such a strategy was attempted. The stockholders of both El Paso and Lenox earned substantial abnormal returns when their bidders first announced their intentions to commence with tender offers, 30.84% and 45.58%, respectively. But both groups of stockholders were hurt by the incumbent managements' proposal to block the takeover with "poison pill" preferred stock. El Paso stockholders earned a negative AR of -6.16% on the day the "poison pill" was announced. Brown-Forman filed a lawsuit challenging the legality of Lenox's preferred on the same day Lenox declared the preferred dividend. Lenox stockholders were hurt by -1.77% on that day. Five days later, the federal judge considering the case allowed Lenox's management to proceed with the "poison pill" defensive

Table 14

Four firms tried to use "poison pill" preferred stock in 1983. None of the four were carried out to completion, but each had a significant impact on the stock price of the target. Three of the four are listed in this table (the fourth, Bell & Howell had too many other events occurring on the same day to successfully isolate an abnormal return.

Target: Issuer of preferred stock	Abnormal return on tender offer announcement	Abnormal return on "poison pill" preferred stock announcement
El Paso Company/ Burlington Northern	30.84%	-6.16%
Lenox, Inc./ Brown-Forman Dist.	45.58%	-1.77% ^a -3.96% ^b

Target: Issuer of preferred stock	Abnormal return on announcement of plan to issue preferred	Abnormal return on announcement rescinding plan to issue pref'd
Superior Oil Company	-4.89%	5.23%

^aLenox announced its intention to issue the "poison pill" preferred stock on this day (June 15, 1983). Brown-Forman responded immediately by challenging the new preferred in federal court.

^bThe federal judge allows Lenox to proceed with its "poison pill" defense against Brown-Forman on this day (June 20, 1983).

tactic against Brown-Forman. Lenox stockholders suffered again by -3.96% when the judge made his ruling.

The case of Superior Oil's attempt to create its own "poison pill" preferred is particularly illuminating

because the company was not under the attack of a control bid at the time. On the day Superior Oil's management announced its plan to issue the preferred, Superior's stock had a negative abnormal return of -4.89%. Two weeks later, under pressure from its stockholders, the management rescinded its plan to issue the preferred stock. Superior stockholders benefited from this announcement by earning an AR of 5.23%. None of the days during that intervening two-week period showed any statistically significant abnormal returns. It is interesting to note that the two abnormal returns associated with first the proposal and then its cancellation nearly exactly cancel each other out, leaving the stockholders no better nor no worse off than they were before the "poison pill" preferred was ever presented.

Although the evidence from the event study and the three-company sample is not overwhelmingly conclusive, the results do lead one to believe that "blank check" and "poison pill" preferred stock used as a defensive tactic against takeover attempts is detrimental to target stockholder wealth. Further data is needed to draw more persuasive conclusions. It could be that the courts will make this defensive tactic illegal before we get anymore "poison pill" data.

6.6 "Double Pac-Man" Counter Tender Offers

6.5.1 Data Sources and Sample Construction

As in the previous event study, only a very limited number of target companies have attempted the "double pac-man" defensive strategy of repelling a tender offer by responding with a counter tender offer for the bidder. This "biting back" sometimes presents some awkward situations in that the counter tender offer involves a company attempting to purchase another company five times larger in market value. The "double pac-man" defensive strategy has been used in the following five takeover battles (the initial target using the tactic is listed first):

- 1) **Kennecott Copper/Curtiss-Wright.** Curtiss-Wright, although significantly smaller, held a 14.3% block in Kennecott after waging a bitter proxy fight against the Kennecott management. The two firms entered into a three-year agreement preventing Curtiss-Wright from gaining further control. Anticipating the end of this agreement, Kennecott responded with a counter tender offer for Curtiss-Wright. Two months after the announcement of the counter tender offer, the two firms settled their differences, exchanged their positions in each other, and entered a new ten-year standstill agreement.

- 2) **Heublin, Inc./General Cinema Corporation.** General

Cinema first bought a 9.7% position in Heublin and announced its intention of increasing its ownership to 15%. Heublin first responded by filing a lawsuit against General Cinema's stock purchase. After that failed, Heublin purchased a position in General Cinema and filed its intention with the SEC to purchase up to 25% of General Cinema. As a "white knight," R.J. Reynolds came to Heublin's rescue by buying the firm and preventing General Cinema from obtaining control (although General Cinema did reap a hefty capital gain on the transaction).

- 3) **NLT Corp./American General Corp.** American General opened the bidding with a \$1.1 billion stock-swap offer for NLT Corp. After studying the offer, the NLT board rejected the offer and counter tendered for its unwelcome suitor. After a prolonged battle, NLT agreed to merge into American General for \$1.6 billion.
- 4) **Mesa Petroleum/Cities Service.** This takeover struggle was one of the more contested and complicated in takeover history. Cities Service opened by tendering for 51% of Mesa; to which Mesa responded seven days later with its own tender offer for 15% of Cities Service. Mesa could only go for a relatively small chunk of Cities Service because it was several orders of magnitude smaller than Cities. After many rounds

of bidding and counter-bidding and after several other players entered the battle, Occidental Petroleum acquired Cities Service, and (once again) Mesa Petroleum remained independent.

- 5) **Martin Marietta/Bendix.** This is the classic and most violent case of the "double pac-man" strategy. The two firms locked horns for several months by tendering for each other and by filing suits and counter-suits against each other. In the end, Allied Corporation bought Bendix and Martin Marietta remained independent, but not until after great costs to Martin Marietta stockholders. For a period of time it looked as if the incumbent management of each company would totally destroy their company rather than be acquired by the other - the "scorched earth" defense. The complex, high-stakes battle kept not only the financial community, but the whole country captivated for several months.

Each of these hostile takeover battles took place during 1982, except for Kennecott/Curtiss-Wright which occurred over the Christmas holidays of 1980.

6.6.2 Specifics of the Event Study

The abnormal return on the day of announcement of the "double pac-man" counter tender offer for each of the five targets will be measured. Unfortunately, I do not

anticipate that this will lead to profound conclusions as to the impact on the wealth of target stockholders. First, the sample is quite small. Second, there are so many concurrent events taking place at the same time - some positive, some negative - that any price impact due to the counter tender offer will be clouded by other events. Finally, the complexity and speed of events in several of these transactions led to highly erratic stock price behavior, and likely impeded the market's ability to efficiently capitalize the value of each event into the firms' stock price.

6.6.3 Results and Comments

Table 15 reports the abnormal returns earned by the five target companies for the two days: (1) the day of announcement of the bidder's takeover offer for the target, and (2) the day of announcement of the target's "double pac-man" counter tender offer for the bidder. Each of the targets earned substantial positive abnormal returns on the day the bidder made its offer (Curtiss-Wright had not made a tender offer for Kennecott, but rather had previously attempted a proxy fight). This AR averaged 18.849% for the four firms receiving a direct takeover offer (this AR is just the single-day AR for the day of announcement). On the other hand, four of the five targets earned negative abnormal returns when they announced their "double pac-man" counter tender offer. For the five firms on this day, the

Table 15

The abnormal returns (in percent) earned by the stockholders of the five target firms attempting to thwart a hostile takeover bid by countering with its own "double pac-man" tender offer for the initial bidder. The abnormal returns are calculated for two days: (1) the day of the initial tender offer and (2) the day of the "double pac-man" counter tender offer.

Target (User of pac-man tactic)/ Initial bidder	Abnormal return on the day of bidder's tender offer	Abnormal return on the day of target's pac-man counter tender offer
Kennecott Copper/ Curtiss-Wright		-2.404%
Heublin, Inc./ General Cinema	21.101% ^a	-2.363%
NLT Corp./ American General	21.255%	-2.345% ^b
Mesa Petroleum/ Cities Service	16.704%	0.628%
Martin Marietta/ Bendix	16.335% ^c	-4.184%

^aGeneral Cinema had purchased a 9.7% stake in Heublin in the open market. This is the CAR over the 13 days prior to making an announcement about its purchase of Heublin stock.

^bThe day following the announcement of NLT's counter tender offer NLT earned another negative AR of -4.675%. The two-day CAR associated with the announcement was -7.020%.

^cMartin Marietta earned AR's of 8.899% and 6.728% on the day just prior to and the day just following this date. The three-day CAR associated with Bendix's tender offer was 31.962%.

abnormal return averaged -2.134% . Mesa Petroleum was the only firm which earned a positive AR on the day of announcement of its "double pac-man" counter tender offer (0.628%).¹⁶

The Martin Marietta negative AR on the day of announcement of its counter tender offer for Bendix may be somewhat underestimated as well. The NYSE had suspended trading in Martin Marietta stock the morning of the announcement (before the news was released). The AR calculation was based on the closing price of the next day when the stock resumed trading. On that day (the resumption of trading in Martin Marietta), the stock opened \$6 lower than the closing the day before the NYSE had halted trading; but by the close, Marietta's price had rebounded significantly so that the AR was -4.184% . If the AR had been measured from the stock's opening price (rather than its closing price) on the day it resumed trading, the AR associated with the announcement of Marietta's "double pac-man" defense would have been -16.379% .

One could imagine several different explanations as to why the "double pac-man" defensive tactic generates

¹⁶These abnormal returns for Mesa Petroleum are very close to what Ruback (1983) found in his careful study of the Cities Service takeover. Although Ruback uses this hypothesis to explain Cities Service's negative AR on this day, it is equally applicable to Mesa (but in reverse). Ruback suggests that the market had anticipated a Mesa counter tender offer, but that the price and percent Mesa tendered for was less than expected. This could explain the market's positive reaction to Mesa's otherwise negative "double pac-man" counter tender offer.

a negative abnormal return for the target. Is the abnormal return negative because the counter tender offer may prevent the target stockholders from receiving a control premium? Or is the negative abnormal return simply indicating that the investment in the bidding firm at the tender price is a negative net present value investment? For the target stockholders, the correct answer is academic. Regardless of what the actual explanation is, either one suggests that the incumbent target management is acting out of their own self interest and not in the best interests of the target stockholders. It could be that in their haste to do anything to remain independent, the target management does not thoroughly evaluate the economics of making a bid for the other company.

Chapter 7. Summary of Empirical Results and Conclusions

Except for the case of antitakeover charter amendments, target managers are often compelled to employ antitakeover defensive tactics under the severe pressure - in terms of both time and emotions - of a hostile takeover battle. Many incumbent managements have, in advance, considered what actions they will take in the event of a hostile takeover bid. These companies often keep an investment banking firm on retainer to provide advice from time to time and to assist in the defense against any "raiders." Other firms spend little time worrying about takeover defense, because they are too busy running their businesses, certain that no one will make a stab at them, or intend not to take any actions to block the takeover attempt. But when faced with a takeover situation, these managers are then forced to make hasty, often emotional decisions which present sharp conflicts between their own employment interests and the interests of their stockholders.

Whether the target managers explicitly plan their defensive maneuvers prior to any takeover bid or work out their tactics in the heat of the takeover battle, the incumbent managers usually consider the ramifications of their defensive measures in very qualitative terms. When making presentations to their clients, investment bankers also discuss the relative merits of the various defensive strategies in broad, qualita-

tive terms. The target manager's or investment banker's usual point-of-view is focussed on what effect the defensive action will have on the bidder and not on the impact the tactics will have on the target stockholders' wealth.

The goal of this thesis has been to not only discuss target managers' motivations for using defensive tactics and the various defensive measures open to targets, but more importantly to determine the quantitative effects of defensive tactics on the wealth of target stockholders. Although the economics are different in every takeover situation, target managers and investment bankers can use this quantitative information, in addition to the qualitative reasons, in making a decision on how to handle an unsolicited takeover bid. Hopefully, this will shift the focus from how to defeat the bidder and remain independent to how to maximize the wealth of the firm's stockholders. These two points of view do not have to be mutually exclusive, but rather, the quantitative information about the wealth impacts of defensive tactics can help managers make more rational decisions.

Table 16 summarizes the quantitative empirical results of this thesis from the event studies performed on samples of target companies using various antitakeover defensive tactics. This chapter compares these results with those of other studies (presented in Chapter Five), and based on this evidence, draws some generalizations about the effects

Table 16

Summary of the empirical results derived from the event studies on the following defensive tactics: (1) antitakeover charter amendments (1979-1983), (2) negotiated stock repurchases and standstill agreements (1980-1983), (3) antitrust blocking litigation (1975-1983), (4) "poison pill" preferred stock issuance (1979-1983), and (5) "double pac-man" counter tender offers (1980-1983). Cumulative abnormal returns surrounding the event (day 0). T-statistics are given in parentheses.

Antitakeover defensive tactic	Cumulative abnormal return for days -10,0	Cumulative abnormal return for days -1,0	Cumulative abnormal return for days 1,20
Charter and by-law amendments	-0.27% (-0.40)	-0.18% (-0.63)	2.76% (3.02)
Stock repurchases:			
a) Entire sample	-3.89% (-4.53)	-3.74% (-10.32)	-3.40% (-2.94)
b) Merger-termina- tion sample	-6.61% (-5.01)	-5.79% (-10.72)	-2.20% (-1.23)
c) Standstill agreement sample	-8.97% (-5.97)	-7.93% (-11.72)	-0.93% (-0.44)
Antitrust litigation	22.11% ^a (9.90)	-4.08% (-4.14)	-2.53% (-0.85)
Preferred stock:			
a) "Blank check" pfd. charter amendments	-5.30% (-1.91)	-1.30% ^b (-1.93)	6.18% (1.59)
b) Use as a "poison pill"		-4.64%	
"Double pac-man" counter tender offers		-2.13%	

^aThis CAR covers days -10 through -2.

^bThis is the AR for day 0 only.

of defensive tactics. Chapter Eight will conclude the thesis with a discussion of the alternative policies which target managers could follow with respect to defensive tactics and takeover bids in general.

7.1 Antitakeover Charter Amendments

Antitakeover charter and by-law amendments may be the one defensive measure available to target managers which actually enhances the wealth of the target stockholders, or at least does not make stockholders worse off. Table 17 compares the empirical results of Linn & McConnell (1983) and DeAngelo & Rice (1983) with those derived from the event study on antitakeover charter and by-law amendments in this thesis. As discussed in section 6.2.3, the event studies do not appear to pick up any statistically significant single-day abnormal returns associated with the announcement of the antitakeover charter proposals. Whether one uses the proxy mailing date (as all three studies tried) or the day on which the board passed the resolution placing the proposals on the proxy statement (Linn & McConnell also tried this) as the "event" day, the event studies report a normal expected return for the target firm's stock on the day of announcement. This could be because target companies release the information about the antitakeover amendment proposals to the market at different points in time. If that is the case, the event study is not powerful enough to pick up any statistically

Table 17

Comparison of the empirical results of the event study on antitakeover charter and by-law amendments done in this thesis with those results found in the studies done by Linn & McConnell (1983) and DeAngelo & Rice (1983).

Author (date of publication)	Number of proxies in sample	Period covered	Abnormal return generated by antitakeover amendments
Duff (1984)			
a) Proxy mailing	159	1979-1983	-0.18% (-0.63)
b) 20 days after proxy mailing	159	1979-1983	2.76% (3.02)
Linn & McConnell (1983)			
a) Board meeting	172	1960-1980	
- on that day			0.22% (1.43)
- for 90 days following			2.58% (3.11)
b) Proxy mailing	388	1960-1980	
- on that day			-0.02% (-0.01)
- for 90 days following			0.90% (2.19)
DeAngelo & Rice (1983)			
a) Proxy mailing	100	1974-1979	-0.13% (-0.24)
b) 40 days after proxy mailing	100	1974-1979	2.04% (1.08)

significant average abnormal returns for individual days. The absence of statistically significant abnormal returns on the day of "announcement" of the antitakeover proposals could also be explained by the null hypothesis - antitakeover charter amendments have no impact on the wealth of target stockholders.

On the other hand, my event study and both studies done by Linn & McConnell find that target stockholders earn statistically significant positive abnormal returns over the period just following the "event" day. If one accepts the hypothesis that the news about antitakeover amendments is released to the market at different times for different companies, then one would expect to detect the abnormal return (if any) associated with the antitakeover amendment not on the "event" day, but rather in the cumulative abnormal return over a period of time. Based on this evidence and reasoning, one could conclude that target stockholders do, in fact, benefit from antitakeover "shark repellent" provisions, and that the stockholder interests hypothesis explains the motivations behind target managers' use of these provisions.¹ This may also explain why target stockholders so readily approve antitakeover charter and by-law amendments.

This evidence could lead one to the conclusion that antitakeover provisions in a target's charter discourage

¹The analysis of Grossman & Hart (1980b) and Jarrell & Bradley (1980) also supports this conclusion.

frivolous bidders from attempting takeover bids, and thus, ensure that if a takeover bid is to be made for the target, it will be made by the bidder which can most fully maximize the value of the combined entity. If antitakeover charter provisions function in this manner, then target stockholders are less likely to bear the (real) costs of the incumbent managers' defensive fight against the bidder when the takeover bid does not serve the best interests of the stockholders. Frivolous bidders will find that the costs of the takeover fight are also too high.

The defensive charter provisions cause a different slicing between bidder and target of the future "synergy" gains created by combining the two entities. Although bidders are unlikely to bid more for the target than the combined value of the target and the synergy gains, the antitakeover provisions may force the bidder to give up a larger percentage of those synergy gains to the target than it would otherwise have had to do. According to Grossman & Hart (1980b), anti-takeover charter amendments accomplish this by minimizing the "free-rider" problem giving target stockholders more incentive to communally hold out for a higher price.

In summary, antitakeover charter and by-law amendments can (on average) enhance target stockholder wealth by several percent. These defensive provisions help to raise takeover premiums and reduce the likelihood that stockholders will have to bear the costs created when incumbent managers find

it in their own interests to use corporate resources to oppose takeover bids. Particularly in the last several proxy seasons, astute institutional investors have begun to make more selective votes for and against different anti-takeover amendments. This helps to separate the beneficial amendments from those, such as "blank check" preferred stock, which reduce stockholder wealth.

7.2 Standstill Agreements and Negotiated Stock Repurchases

Standstill agreements and negotiated stock repurchases are transactions which (1) reduce competition for control over the firm's resources and which (2) provide preferential treatment for large block stockholders. Target managers use the premium block repurchases and standstill agreements to reduce the threat to their control over the firm. In a sense, they use the repurchase premium to "bribe" the selling blockholder into giving up his interest in the firm and preventing him from proceeding with a profitable takeover of the firm. As a result, the target managers are able to pursue an operating strategy that is more in line with their own interests and less in line with those of their stockholders. In this case, the managerial entrenchment hypothesis best explains the motivations of the target managers' use of these defensive tactics.

Table 18 reports the evidence found in the event study in this thesis and those done by Dann & DeAngelo (1983)

Table 18

Comparison of the empirical results of the event study of negotiated stock repurchases and standstill agreements in this thesis against the results found in the studies done by Dann & DeAngelo (1983) and Bradley & Wakeman (1983).

Author (date of publication)	Number of firms in sample	Period covered	Abnormal return generated by the stock repurchase
Duff (1984)			
a) Total sample	77	1980-1983	-3.74% (-10.32)
b) Merger-termination sample	44	1980-1983	-5.79% (-10.72)
c) Standstill agreement sample	27	1980-1983	-7.93% (-11.72)
Dann & DeAngelo (1983)			
a) Repurchase without standstill	34	1977-1980	-1.16% (-2.15)
b) Repurchase with standstill	30	1977-1980	-4.52% (-5.72)
c) Standstill agreement with no stock repurchase	19	1977-1980	-4.04% (-4.49)
Bradley & Wakeman (1983)			
a) Total sample of repurchases	61	1974-1980	-2.85% (-5.82)
b) Repurchases without merger term.	40	1974-1980	-1.40% (-1.97)
c) Repurchases with merger termination	21	1974-1980	-5.50% (-7.14)

and Bradley & Wakeman (1983) which demonstrate the magnitude of the target stockholders wealth loss. All three studies report statistically significant drops in the target's stock price on the announcement of the block repurchase and/or standstill agreement. The greater the premium paid or the more restrictive the agreement, the greater the wealth loss to the remaining stockholders. Targeted repurchases are more costly to non-participating stockholders when they are used to thwart takeover attempts. Standstill agreements which prevent the potential bidder from making another takeover run at the firm appear to be particularly costly to stockholders.

Whether measuring the price impact of those repurchases terminating a merger, those which include a standstill agreement, or stock repurchases in general, my event study reports larger wealth losses than the studies by Dann & DeAngelo and Bradley & Wakeman. The repurchases and standstills in my sample were taken from 1980-1983, whereas those in the other two studies were from the mid-1970s. Conceivably, target managers are having to pay larger premiums to get rid of dissident blockholders than in the past; and therefore, target stockholders are suffering more from these defensive actions than in the past.

As formulated by Jensen & Meckling (1976), the theory of agency implies that managers repurchase a single block of common stock to reduce the probability of losing control

of the firm's resources. The target stockholders approve such repurchases and standstill agreements because it is more costly for them to monitor and contract with management to prevent the inherent owner-manager conflicts of interest than it is to bear the wealth losses from such defensive actions. But when the drop in the target's stock price approaches the 5-8% level (or greater), many stockholders find it in their interests to file lawsuits against the incumbent management. Traditionally, the courts have dismissed these stockholder suits by falling back onto the "business judgement" rule, which keeps the judicial system out of corporate management except in the most extreme situations. Based on the evidence of these event studies, the judges ruling in these cases may want to reconsider their decisions.

7.3 The Costs of Antitrust Defensive Actions

It seems clear from the evidence reported in table 19 that using antitrust litigation to block an unsolicited takeover bid is detrimental to the welfare of the target stockholders. The antitrust defensive tactic is often a "show-stopper" halting the takeover attempt dead in its tracks. In this respect, the litigation prevents target stockholders from earning the substantial abnormal returns generated by the takeover bid. Regardless as to whether or not the proposed combination actually does violate the antitrust laws, target managers should not initiate the

Table 19

Comparison of the empirical results of the event study on antitrust blocking litigation in thesis with those studies done on antimerger lawsuits by Wier (1983) and Eckbo (1983).

Author (date of publication)	Number of firms in sample	Period covered	Abnormal return generated by the target's antitrust suit
Duff (1984)	19	1975-1983	-4.08% (-4.14)
Wier (1983):			
a) Convicted firms	24	1962-1979	-2.62% (-3.97)
b) Dismissed firms	24	1962-1979	-1.53% (-1.77)
c) Firms that settle suits	63	1962-1979	-2.96% (-6.56)
Eckbo (1983)	17	1963-1978	-4.63% (-7.20)

antitrust suit nor should they encourage the FTC or the Department of Justice to do so. If the government antitrust regulators file an antimerger suit during the takeover process or after the combination has been completed, the bidder bears the costs of defending against the antitrust claims. If the suit is filed after the takeover transaction has taken place, the target stockholders will have already received their large takeover premium and the legal costs of the

antitrust litigation will fall disproportionately onto the bidder's stockholders.

If the incumbent management earnestly believes (because of inside information) that the target firm is truly worth more than what the bidder is offering, other defensive tactics exist which are less costly to stockholders that will allow the management to repel the bidder or to buy time to search for a "white knight." If the managers intend to seek out a "white knight" willing to outbid the hostile suitor, filing an antitrust suit against the initial bidder will likely raise the same antitrust questions about the friendly "white knight." Thus, the antitrust defensive tactic may not only block a marginally profitable combination, but it may also prevent a friendly, more profitable merger later. The antitrust litigation tactic prevents stockholders from receiving an immediate takeover premium, incurs direct legal expenses, and imposes the indirect cost of possibly giving up a future profitable merger. Except for some of the scorched earth defensive tactics which explicitly decrease the attractiveness of the target firm, no other defensive tactic has a greater long-term cost to the target stockholders than the antitrust blocking lawsuit.

Other types of litigation used as a target defensive tactic may not be quite so harmful to stockholders, particularly if the litigation is merely a time delay and not a "show-stopper." Defensive litigation which falls into this

category includes lawsuits claiming improper or incomplete disclosure by the bidder, or charges that the bidder has violated the federal and/or state takeover laws by not following the proper, timed sequence of events. After all, these takeover regulations were designed to even the balance of negotiating power between the two parties. Blocking or delaying a takeover bid by these means may give target stockholders more time to evaluate the offer, or it may provide the opportunity for management and its investment bankers to seek out another bidder willing to pay a greater control premium. If the lawsuit does not drive the bidder away or does not impede other bidders from attempting takeover bids, then the defensive litigation has the effect of raising takeover premiums and grants target stockholders a larger slice of the synergy gains.

Whether or not the market interprets these blocking litigation tactics favorably or unfavorably depends upon whether investors trust the intentions of the managers. Managers build up the trust and confidence of stockholders over time. In this respect, an effective investor relations program can be a powerful defensive tactic (note the McGraw-Hill/American Express battle mentioned earlier). If managers have performed reasonably well in the past and have not consumed an unusually large amount of perquisites, chances are that target stockholders will go along with the managers' defensive program. But everything has its price. When

the takeover premium gets high enough, stockholder loyalty will not keep the company independent.

7.4 The Impact of Other Defensive Tactics

The studies done by other researchers discussed in Chapter Five and the five events studies carried out by this thesis reported in Chapter Six have analyzed the stock price effects of the major types of antitakeover defensive tactics. I chose to analyze these particular groups of target defensive tactics in Chapter Six for several reasons: (1) the tactics were either prevalently used in takeover contests or were rather new, but controversial; (2) the way in which the tactic was used had to be relatively similar across all companies; (3) the "event" dates on which the tactic was applied had to be identifiable; and (4) any new study had to add some new value rather than just replicating the results of previous studies. These criteria eliminated several of the defensive tactics outlined in Chapter Four from my analytic scrutiny. Nonetheless, each of these defensive tactics will be considered briefly in this section.

I did not study the stock price effects of federal, state and SEC takeover regulation because relatively little substantive regulation has been legislated since the Hart-Scott-Rodino Act in 1977, except for some SEC tender offer rules. In particular, the two studies by Jarrell & Bradley (1980) and Schipper & Thompson (1983b) provide concrete

evidence as to the effects of takeover regulation on the wealth of target stockholders. Their results show that takeover regulation has raised the level of takeover premiums increasing the returns to the target stockholders at the expense of the bidders. Two conclusions could be drawn from this evidence: (1) takeover regulations actually increase the bargaining power of targets in takeover contests, or (2) takeover regulation increases the transactions costs in control transfers effectively eliminating many less-profitable takeovers. Based on their evidence and basic common sense, one would more readily accept the later conclusion than the former. Regulation over the market for corporate control tends to discourage only the most highly profitable mergers, effectively functioning as a tax on the transfer of control. Because of the takeover regulation, target stockholders no longer have the opportunity to receive the relatively modest takeover premiums from low-value takeovers which would likely exist absent the regulation.²

On the whole, it does appear that much of the federal regulation does serve its intended purpose in protecting small stockholders and evening the relative bargaining positions between bidder and target. The Williams Act likely

²This reasoning assumes that in control transfers the target derives the majority of the the synergy gains from combination rather than the bidder. If the market for corporate control is competitive, this will in fact happen. The evidence from tender offers shows that targets earn substantial abnormal returns and bidders earn just average, expected returns.

falls into this category of beneficial regulation. On the other hand, most of the state takeover statutes go too far in regulating takeovers and ultimately hurt stockholders because of the elimination of some potentially profitable mergers. The state takeover regulations extend the waiting periods and disclosure requirements too far putting the bidder at a severe disadvantage. Many bidders, unwilling to be scared off by lawsuits claiming violations of state takeover regulations, have challenged the constitutionality of these state statutes claiming that they violate the Williams Act. A free and unrestricted takeover market best functions to allocate resources in our economy, and ensures that managers minimize the inherent conflicts of interest in the owner-manager relationship.

A second category of defensive tactics not empirically analyzed in this thesis is the collection of various "scorched earth" practices. One finds it difficult to determine a simple average price impact for these defensive actions because scorched earth defensive tactics vary a great deal depending upon the particular characteristics of the bidder and target. Any study of these tactics will have to be done on a case-by-case basis. True scorched earth tactics, which devastate the value of the target, have only been used in a couple of takeover battles, such as McGraw-Hill/American Express and Bendix/Martin Marietta. Usually the tactic never actually reaches the point of laying waste to the

target; both sides back down from the takeover battle realizing that neither party will benefit. If these scorched earth tactics were to be fully carried out, the target stockholders would not only forgo the takeover premium, but they would be left with a severely crippled company worth much less than before the takeover situation began. Fortunately, as in the Seagram-St. Joe court case cited in section 4.4, the courts are taking a dim view of these scorched earth tactics and are less willing to stay out of corporate affairs by applying the business judgement rule.

Many of the third-party acquisition defensive tactics are mild forms of scorched earth. For example, it has been claimed that Marshall Field purchased or constructed retail stores in particular markets to build an antitrust block against the its possible takeover by some of its rival retail competitors. On a stand alone basis, such acquisitions may or may not be sound investment decisions, but when incumbent managers undertake these projects solely for the purpose of remaining independent, the projects likely have negative net present values. Although it is difficult to evaluate the takeover ramifications of a target's acquisition when made outside of the the actual control-transfer period, one can measure the effects of such defensive purchases when the acquisition is made in haste during the takeover process.

On the other hand, the search for a "white knight"

willing to pay an even greater premium for the target is obviously a defensive tactic that does enhance target stockholder wealth. Not only do stockholders receive a greater premium for their shares, but the transfer of control is made on a friendly basis decreasing the costs of integrating the target into the business of the buyer. One may question the relative value of target managers using management time and resources to search for buyers when a takeover bid is not imminent. But once a takeover bid has been made, target management's search for a "white knight" is surely in the best interests of the target stockholders.

Another category of defensive tactics somewhat related to scorched earth is the disaggregation defense - liquidations and self-tenders. Again, decisions to proceed with either of these strategies must be based on standard capital-budgeting investment rules, including the effects the investment may have on the outcome of the the takeover bid. Self-tenders may be motivated by either (1) management's belief that its stock truly is undervalued and therefore a good investment, or (2) because the costs of acquiring its own shares at a premium will so financially cripple the company that the bidder will back down from its offer. Which of these intentions actually motivates the target managers' defensive self-tender greatly affects the welfare of the stockholders. The self-tender and liquidation defensive tactics could be an area that one could further study with the event study

methodology.

One of the more effective defensive tactics, but least harmful to stockholders, is an effective investor and public relations campaign. Some critics have labelled Gulf Oil Chairman James Lee a "loser" for having lost control of the company to Standard Oil of California. Contrarily, Lee effectively utilized the press and the goodwill he had developed with investors over the years to maximize the takeover premium received by the Gulf stockholders due to the control contest first initiated by T. Boone Pickens' Gulf Investor Group. The economic fundamentals of the situation dictated that Gulf was going to be acquired by someone. Rather than employ the "survive at all costs" type of defensive tactics, Lee primarily used an effective public relations campaign to resist Pickens until the optimal bid price was presented by Standard Oil. This strategy maximized the wealth of the Gulf stockholders by forcing the premium up at the same time keeping defense costs low. Lee effectively squashed the desires of his management associates to present a more vigorous, but more costly (to stockholders) defense in order to maintain their high-salaried positions. From my viewpoint, the fact that Gulf stockholders got a high price for their shares and avoided a prolonged and expensive defense demonstrates the effectiveness of investor and public relations tactics. James Lee provided a genuine service to Gulf stockholders and employees.

Chapter 8. Defensive Tactics Policy Alternatives

This final chapter considers the merits of several possible policy alternatives which target managers could follow when presented with a takeover bid. Obviously, the specific actions of incumbent managers will depend upon the characteristics of the particular takeover situation. Nonetheless, with the knowledge gained from the empirical studies on antitakeover defensive tactics, one can better choose the defensive strategy which optimizes the welfare of the target stockholders. But stockholders are not the only party impacted by the transfer of control process. The target firm's employees, customers, suppliers, and communities in which it conducts business are all greatly affected by the change in control. Because of the broad public interest in these takeover situations, state and federal legislatures enact various laws establishing the public policy towards the market for corporate control. Two such policy alternatives, which are currently being debated within the financial community and have been introduced in state legislatures will be discussed in this chapter:

- 1) A passivity rule whereby target managers are forbidden from resisting takeover bids, but rather the managers function to facilitate the auctioneering process in order to obtain the highest premium at the lowest defensive cost.

- 2) A requirement that any stockholder controlling some sizable percentage (e.g. 10, 20 or 30 percent) of a corporation without the approval of its board must make a tender offer for the remaining outstanding shares.

8.1 The Managerial Passivity Rule

Over the last four years, a three-cornered debate has been waged in various law and economic journals over the relative merits of antitakeover defensive tactics.¹ Law professors Frank Easterbrook and Daniel Fischel have proposed a managerial passivity rule whereby target managers are forbidden from using corporate resources to oppose any takeover bid. At the opposite extreme, specialist mergers and acquisitions lawyer, Martin Lipton, has rebutted this passivity rule arguing that corporations have a right to remain independent and that corporate officers should pursue this objective by resisting takeover offers with almost any available device. Then somewhere between these two viewpoints, two other law professors, Lucian Bebchuk and Ronald Gilson, have suggested that target managers should not sit back idly in the face of a takeover bid, but rather

¹This exchange has been particularly vigorous and has uncovered many of the primary issues concerning the proper role of target management in responding to takeover bids. See Easterbrook & Fischel (1981a, 1981b, 1982a, 1982b), Lipton (1979, 1981), Bebchuk (1982a, 1982b), and Gilson (1981, 1982b).

should help facilitate the process of "auctioneering" in an effort to generate competing bids. The hypotheses put forward and tested by the empirical studies in this thesis should shed additional light on this debate over the proper role of target managers in responding to takeover bids.

The proposed managerial passivity rule mandates that managers should not actively resist takeover bids and definitely should not expend real corporate resources defending against the bid. This rule does not prevent target managers from expressing their opinion about the possible combination through a press release to stockholders. Nor does the rule bar managers from providing information about the combination to the market or from searching for other bidders, possibly a white knight, willing to pay an even greater premium. But almost any other defensive action would be banned, particularly those that expend the target's resources and produce no gains to investors. Thus, management should not propose antitakeover charter or by-law amendments, file suits against the bidder, acquire a competitor of the bidder in order to create an antitrust obstacle, buy or sell shares to make the offer more costly, give away potentially valuable options or corporate information to "white knights," or initiate any other defensive tactic to defeat the takeover offer.

The rationale for such a passivity rule lies in the theory of agency costs inherent in the owner-manager relation-

ship and is based upon the managerial entrenchment hypothesis.² Anyone who hires an agent - the target managers are the agents of the stockholders - must find some way to control the agent's conduct. Because the stockholders of a diversely held public corporation have little incentive on their own to monitor the actions of their agents and, thus, the stockholders tend to "free-ride" on the monitoring efforts of others, takeover bids provide the primary means whereby the market disciplines corporate managers who do not perform well in their role as agents for the stockholders. A prospective bidder can study potential targets, ascertain which have excessive agency costs, and then make a bid for one or more of these firms. Both parties in the transaction gain: the target stockholders obtain a profit because of the premium bid, and the bidder earns a fair rate of return on its investment in the search for targets, its acquisition, and in making improvements in the management of the target.

This argument maintains that takeovers are beneficial to both sets of stockholders and to society at large. If takeover offers produce real gains for both the bidder and the target, it follows (possibly) that any defensive tactics designed to block such a takeover causes real losses and reduces total welfare. If the defensive tactics work to

²See Chapter Three for a discussion of the agency problems which arise particularly in the transfer of control process. These agency problems are the foundation of the managerial entrenchment hypothesis.

block the takeover preserving the independence of the target, the stockholders are unambiguously worse off for having not received the takeover premium. Easterbrook and Fischel carry the rule to its extreme claiming that even resistance that ultimately elicits a higher bid is socially wasteful, because the increase in takeover premium is simply a transfer of wealth between bidder and target stockholders and the defensive tactics employed to force that higher premium consumed significant amounts of real resources. Indeed, the empirical studies in this thesis have demonstrated just how significant those defensive costs can be to target stockholders.

Defensive tactics and their related costs can readily be justified if they do, in fact, trigger a bidding contest for the target firm. Target stockholders are quite pleased when the defensive tactics produce a higher takeover premium. Unfortunately, evaluating the intentions and final outcome of the use of defensive tactics *ex ante* - that is, before the takeover process is completed or even before any bid has been made - is very difficult. Target stockholders may be willing to accept the first premium offer made for their shares even though the offer may not be the bidder's highest price or that defensive tactics may produce higher offers. The trade-off between accepting this initial offer (at a relatively low premium) or allowing target managers to expend substantial resources fighting the takeover and

running the risk of not receiving any premium at all is a difficult choice for stockholders to make ex ante. Obviously, when asked this question ex post, stockholders would prefer that their managers apply enough resistance to force the premium up, but not enough to kill the offer. But ex ante, stockholders may simply want to "take the money and run."

The real problem with defensive tactics and the primary justification for the passivity rule is the effect those tactics have on the incentives for bidders to attempt takeover offers. If target managers' defensive tactics are completely effective in forcing all the gains from a takeover transaction to accrue to the target stockholders, no bidder would have an incentive to make a takeover offer, and thus no one will offer a premium for the target's shares. Prospective bidders incur substantial costs to identify underpriced targets and to determine how their managements could be improved. The transactions costs of carrying out the bidder's takeover are also quite high, and defensive tactics simply add to these costs. The higher the takeover transactions costs, the less incentive there is to incur the costs of seeking out and drawing up plans for takeover targets.

Furthermore, when the bidder announces his takeover bid and makes the appropriate disclosures required by federal and state law, other potential bidders have the opportunity to receive this information without incurring the costs

of obtaining it, free-riding on the efforts of the initial bidder. As a result, no firm wants to be the first bidder unless it has some advantage, such as speed, over subsequent bidders to compensate for the fact that only the initial bidder had to bear the search and monitoring costs.³ Of course, if there is no first bidder there will be no takeover premiums.

Although difficult to determine by empirical tests, it could be that the stock prices of target firms, which the market anticipates will vigorously use defensive tactics, are depressed by the higher expected transactions costs relative to those prices of firms which intend not to defend against takeover attempts. If defensive tactics in general raise takeover premiums, then fewer and only the most profitable takeovers will be attempted, reducing the total number of takeover bids. This reduces the effectiveness of the takeover's role of disciplining managers, and consequently, the stock prices of target firms will fall to reflect the reduction in monitoring and the increase in agency costs. An explicit managerial passivity rule forbidding managers from using defensive tactics to block takeovers would eliminate this negative burden on target firms' stock prices. The rule of acquiescence would encourage more takeover bids, even if at lower premiums, by reducing the transactions

³Studies have shown that in the vast majority of takeover cases in which there were multiple bidders, the initial bidder did not end up as the buyer of the target.

costs of takeover attempts, and would function to provide the most efficient cost-benefit reduction in agency costs.

Martin Lipton has criticized this passivity rule on the basis that takeover offers are detrimental to social welfare because they adversely affect the ability of managers to engage in long-term planning and jeopardize the economy in order to benefit short-term speculators.⁴ Conceivably this could be true, but generally bidders attempt takeovers because they believe that they can create more value from the target's assets than can the incumbent management. To do so obviously requires some sort of long-term plan. These bidders are willing to put their own wealth and reputations on the line to prove so. The uncertainty in tenure of incumbent management functions to spur the incumbent managers to their best performances and to reduce the inherent agency problems.

A second objection to the passivity rule and (more generally) to takeovers has been put forward by former SEC Chairman Harold Williams, and more recently, by several Congressmen objecting to the recent multi-billion dollar oil mergers. These critics argue that takeovers divert resources that would otherwise could be used for capital investments, but instead are used only to rearrange the

⁴Lipton (1979) aggressively attacks the passivity rule and looks at the stock prices of target firms using defensive tactics to remain independent in an attempt to justify defensive strategies at any cost.

ownership of existing corporate assets. Defensive tactics are beneficial because they prevent such a waste of limited capital. These critics simply misunderstand the nature of financial markets. The funds paid to the target's stockholders do not disappear; investors receiving the takeover premium reinvest the money. There is no reason to think that the stockholders receiving these payments will burn the money or go out and increase their consumption. The funds are recycled through the economy and reallocated to more efficient investments. One cannot conclude a priori that an active takeover market diverts funds from capital investment.

8.2 The "10% Solution" to Takeover Offers

In response to public concern over violent defensive tactics, especially those used in the Bendix/Martin Marietta/Allied Corp. battle in 1982, the Securities and Exchange Commission last year formed an Advisory Committee on Tender Offers made up of prominent corporate officers and Wall Street takeover specialists. From the committee's final report has sprung the idea of the "10% solution" to the problem of partial bids, which their critics maintain should be abolished because the partial bids "stampede" stockholders to tender lest they miss out on the premium. The "10% solution" would require that any stockholder purchasing more than 10% of the outstanding shares of a company without

the approval of its board of directors would be required to make a tender offer for all of the remaining shares.

This idea has been proposed by merger lawyer Martin Lipton (who served on the advisory committee) and appears to have support among some lawmakers. Congressman Timothy Wirth (D-Colorado), chairman of the House securities subcommittee, has indicated great interest in the idea. A bill requiring purchase of all remaining shares once a stockholder controls 30% of a corporation has recently been passed by large margins in both houses of the Pennsylvania state legislature, and now awaits the approval of the governor. On the other hand, other people, such as Lipton's chief opponent Joseph Flom, strongly criticize the forced tender-offer rule, maintaining that front-end-loaded or partial tender offers are viable mechanisms and function to compensate bidders for undertaking the costly process of searching and bidding for takeover targets. This section will consider the relative merits of these arguments and the proposed "10% solution."

Those in the Lipton camp argue that the two-tier, front-end-loaded takeover technique - such as the Mesa Petroleum tender offers for Cities Service, General American Oil and Gulf Oil - abuse target stockholders. The device allows professional investors to take advantage of the many small, unsophisticated stockholders by rushing them into tendering their shares early and to avoid the fear of having

to be bought out at the lower second-step merger price. Critics maintain that the bidders do not take sufficient risks in these offers because they use the target's own balance sheet to finance the raid, often creating highly leveraged companies with enormous debt. The Lipton camp argues that all stockholders should be treated equally, which seems quite democratic. The "10% solution" would accomplish this by forcing anyone wanting to acquire more than 10% to buy the entire company at one price to all stockholders.

The other side of the argument is that bidders incur substantial costs in prospecting these takeover targets, in making their bids, and in developing alternative plans to better utilize the target's assets. To accomplish this position, the bidder needs only to obtain a controlling interest in the target. Those stockholders who tender their shares to the bidder share in the economic gains brought about by the bidder's more efficient management. On the other hand, those stockholders who do not tender and intend to "free-ride" on the monitoring and better management of the bidder may not deserve to receive as substantial a takeover premium. The non-tendering stockholders have not committed their wealth nor have they incurred the costs associated with making the takeover bid. They are "free-riders." By allowing two-tier, front-end-loaded tender offers, the incentives for prospective bidders are increased, and conse-

quently, the entire economy is made better off by their existence. Furthermore, in a market system where stock trades at different prices each day, it is difficult to recognize why all stockholders should necessarily be paid the same price for their shares in a takeover offer.

In addition to front-end-loaded takeover offers, the "10% solution" is targeted at the practice of "greenmail" - legal corporate blackmail by raiders who accumulate 10-25% of a company's stock and then threaten a takeover or proxy fight if not bought out at a premium. Lipton argues that this "greenmail" technique preempts the ability of the target's board of directors to establish long-range plans for the firm and to determine the desirability, price, form and timing of a merger. Because Lipton believes that antitakeover defensive tactics benefit the long-term interests of stockholders by avoiding the costly takeover process and maintaining the target firm's independence, he argues that the target has the duty to repel the "greenmail" raider even if it involves paying a premium to the greenmailer. Lipton poses the following question to stockholders: "Would you rather that corporate management focus on new plants, new products and increased employment or would you rather they divert their attention to the latest shark repellent charter amendments and other means of defending against corporate raiders?"

Of course, the answer is the former. But only given the insecurity of possibly having a takeover bid made for

one's company can stockholders rest assured that the incumbent managers will put forward their best efforts in managing the firm's assets and will minimize their consumption of perquisites. The empirical evidence in this thesis has shown that stockholders suffer a wealth loss when the target managers buy out at a premium the minority positions of greenmailers. With the possible exception of some antitakeover charter amendments which function to discourage frivolous bids, the majority of antitakeover defensive tactics harm target stockholders and tend to serve only the interests of the incumbent managers.

Ultimately, the target management's best and only defense against a takeover bid is a high stock price. High stock prices are the result of good management and efficient use of corporate assets. Directors should view a new minority position or takeover bid not as a threat, but as an indicator that business operations may need a critical reappraisal because the market price seems low to an informed investor. It should not be a signal to build artificial and costly defenses. Antitakeover defensive tactics are likely to lead investors, in the aggregate, to lower stock prices to compensate for the higher takeover premiums and costs resulting from the target manager's defensive tactics.

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ADDENDUM

For those readers who have not yet determined why target managers use antitakeover defensive tactics after reading this lengthy thesis, possibly this piece from The New Yorker will prove explanatory:



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