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Shareholder litigation in mergers and acquisitions

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ABSTRACT

Using hand-collected data, we examine the targeting of shareholder class action lawsuits in merger and acquisition (M&A) transactions, and the associations of these lawsuits with offer completion rates and takeover premia. We find that M&A offers subject to shareholder lawsuits are completed at a significantly lower rate than offers not subject to litigation, after controlling for selection bias, different judicial standards, major offer characteristics, M&A financial and legal advisor reputations as well as industry and year fixed effects. M&A offers subject to shareholder lawsuits have significantly higher takeover premia in completed deals, after controlling for the same factors. Economically, the expected rise in takeover premia more than offsets the fall in the probability of deal completion, resulting in a positive expected gain to target shareholders. However, in general, target stock price reactions to bid announcements do not appear to fully anticipate the positive expected gain from potential litigation. We find that during a merger wave characterized by friendly single-bidder offers, shareholder litigation substitutes for the presence of a rival bidder by policing low-ball bids and forcing offer price improvement by the bidder.

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1. Introduction

Merger and acquisition (M&A) activity has transformed the global business landscape in its pursuit of economic gain. Nonetheless, public announcements of M&A proposals are associated with a non-trivial number of target shareholder class action lawsuits against their boards of directors. In these suits, it is generally alleged that target firm directors breached their fiduciary duties to their shareholders by agreeing to sell the company for too low a price. To further understand the causes of this litigation and to determine whether shareholder litigation significantly protects shareholder value, we examine this form of litigation in the relatively recent fifth U.S. merger wave (1993–2001). Using hand-collected data, we document a number of factors that influence the likelihood of target shareholder class action lawsuits and then explore the economic impacts of such litigation on M&A offer outcomes, specifically, offer completion rates and takeover premia. We believe that this is the first study to carefully investigate these questions.

Litigation is the subject of numerous empirical studies in the law literature. Cox and Thomas (2009), Thomas and Thompson (2012) and Choi (2004) provide surveys of the findings of earlier studies of securities fraud class actions, which have advanced our understanding of the issues surrounding this form of litigation. Unfortunately, M&A litigation is only incidentally covered in these class action litigation studies, representing a small portion of all such suits.

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Empirical analysis of the effects of M&A lawsuits is also rather sparse in the financial economics literature. In an early study, Jarrell (1985) reports that target managements litigate in roughly a third of all takeover attempts. Rosenzweig (1986) examines a sample of unsuccessful hostile tender offers and finds that in several cases a bid is defeated either directly or indirectly as a result of relief granted by the court. Both studies, however, predate the important development in the mid-1980s of the widespread use of Shareholder Rights Plans (poison pills) as takeover defenses. Prior to that time, experienced takeover practitioners routinely recommended that target companies file litigation to stop or delay unwanted tender offers (Wachtell, 1977). But since the adoption of poison pills, target initiated litigation is a much less common defensive strategy. Poison pills enable target boards to block unwanted offers or to force bidders to negotiate with target boards without the need for target initiated litigation. Indeed, only 2% of all lawsuits are initiated by targets in our sample period. This makes the relevance of these earlier studies to the current environment doubtful. Shareholder class action lawsuits form the vast majority of M&A lawsuits in our more recent sample period, and they are the focus of our study.

Using hand collected data on lawsuits related to every U.S. M&A transaction involving public targets during and 2000 (a representative period for studying M&A litigation in the fifth merger wave, as argued 1999in the next section), we first document that about 10% of all M&A offers result in shareholder class action lawsuits. Exploring the types of bids likely to trigger litigation, we find that shareholder litigation is significantly more likely to occur in

(a) larger offers (for two potential reasons: larger offers may stem from empire building objectives, and lawsuits may be the most efficient mechanism for settling disputes when more dispersed shareholders in large firms are involved), hostile offers (that raise questions about board entrenchment motives), and tender offers (that are often associated with unsolicited bids and which can trigger special bidder obligations under the Williams Act);
(b) offers with prior bidder shareholdings in a target (that can antagonize entrenched target managers), rival bidders (that can create disputes regarding which bid is in the best interests of shareholders), and target paid termination fees (that can trigger challenges over the preclusive nature of large fees under the Unocal judicial standard); and
(c) offers involving relatively more cash financing (that can trigger strict Revlon duties for target boards of directors, and also can be used to expropriate wealth from the minority target shareholders by controlling shareholders), top-tier target and bidder legal advisors (more likely in legally complex deals) and controlling shareholder squeeze-outs (where dominant shareholders can craft deal terms in their favor, which can adversely affect minority shareholders).

M&A activity in the fifth U.S. merger wave is one in which the vast majority of offers involved a single friendly bidder. Thus, in the absence of bidder competition, a key question is whether target shareholder litigation substitutes for the presence of a rival bidder, and polices low ball offers, leading to improved terms in completed deals? Examining the full sample of M&A offers, we find the deal completion rate is significantly lower and takeover premia in completed deals are significantly higher for litigated offers.

To alleviate the concern that litigation could appear to be associated with certain deal outcomes simply because litigation occurs more frequently in certain types of offers, we examine various sub-samples of offers differentiated by alternative measures of offer complexity (that can affect offer outcomes). We find that the deal completion rate is significantly lower for litigated offers, when we examine only (a) larger offers (defined as those with above-median offer size that often elicit more scrutiny and resistance), (b) offers that involve top target law firms or top bidder law firms (legally complex offers that could benefit from top legal expertise), (c) offers by bidders that have more entrenched management (firms that are more likely to indulge in unprofitable empire-building acquisitions), and (d) controlling shareholder squeeze-outs (for which the judicial standard of scrutiny is most stringent). Takeover premia are significantly higher in litigated offers when we separately examine (a) larger offers, (b) hostile offers, (c) single or competing bidder offers, (d) squeeze-out offers by controlling shareholders, (e) deals involving top legal advisors, or (f) deals involving more entrenched target managers.

While the subsample results are reassuring, nonetheless, we carefully control for self-selection, deals falling under different judicial standards and offer features that can affect deal outcomes in our multivariate analysis. The first issue is controlling for selection bias. However, all the offer characteristics that we examine can be argued to be related to one or both of the deal outcome variables, invalidating their use as instruments for both deal outcomes, under the exclusion requirement for standard endogeneity adjustments. To overcome this problem, we construct instruments that are based on bidder and target industries that recently experience relatively greater M&A litigation activity. Economically, the choice of our instruments is justified because industries that have recently attracted substantial M&A litigation are more likely to continue to attract litigation in future. However, there is no compelling reason to expect past industry associations with litigation to be related to current M&A deal outcomes, once we control for current offer characteristics and the current deal litigation indicator. Statistically, we fail to reject the null hypothesis that our instruments are uncorrelated with the error terms of the M&A outcome equations. Hence, our instruments satisfy the exclusion requirement.

The second issue is the effects of the Unocal/Revlon judicial standard used in many acquisitions and that of the much stricter Weinberger judicial standard used generally in controlling shareholder squeeze-outs. Given the differences in judicial standards across M&A deal types, we carefully control for shareholder squeeze-out offers and cash financed offers, to better understand how shareholder litigation affects M&A offer outcomes.

The third issue is that several deal characteristics are related to deal completion and takeover premia, and hence we need to control for them. Completion rates are significantly lower for hostile and multiple-bidder offers, but significantly higher for offers with target termination fees, tender offers and intra-industry offers. Deal completion rates are among the highest for controlling shareholder squeeze-out offers relative to other M&A offer types because a controlling shareholder can unilaterally insure that

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