Hostile takeover defenses that maximize shareholder wealth

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

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

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

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

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

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

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

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

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

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

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

Takeover motivations and mechanics

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

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

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

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