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# Let's make a deal! How shareholder control impacts merger payoffs ☆

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**Abstract**

Mergers and acquisitions are well-suited events for a detailed study of the valuation effects of corporate governance structures. Using a sample of 388 takeovers announced in the friendly environment of the 1990s, I empirically show that target shareholder control, proxied by low target chief executive officer share ownership, low fractions of inside directors, and the presence of large outside blockholders, is positively correlated with takeover premiums. In contrast, studies of takeovers in the hostile environment of the 1980s have shown a negative relation between target shareholder control and takeover premiums.


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## 1. Introduction

How much control of a firm should rest in the hands of its managers, and how much should be retained by its shareholders? This question, and how to implement the optimal balance of power, has long been central not only to the corporate governance literature, but also to active investors and securities legislation. In this paper, I empirically examine how the balance of power between target chief executive officers (CEOs) and target shareholders affects takeover premiums in mergers and acquisitions in the 1990s.

Mergers and acquisitions are in many ways ideal natural experiments to test the valuation effects of corporate governance structures.[1] First, a merger generally requires the active participation of all decision makers, namely, managers, directors, and shareholders. Managers usually negotiate the merger, directors have to endorse it and are sometimes involved in the negotiations, and shareholders have to either vote on it or decide whether to tender their shares. Second, the effect of the corporate governance structure on the value of the target, given adequate control for other influences, is immediately observable in the takeover premium. Third, a merger announcement is a clearly defined and, in most cases, a surprising event.

Intuitively, higher shareholder control should lead to higher shareholder value. Therefore, we should only observe corporate governance structures with high levels of shareholder control in the long run. However, maximum shareholder control might not be optimal in all situations. In an environment without takeover defenses, for example, the United States before the late 1980s, even if a target CEO is opposed to a takeover, large takeover premiums help hostile bids succeed by inducing target shareholders to fight the CEO's resistance. The more powerful the target CEO and the weaker the target shareholders, the higher the takeover premium that is required to motivate shareholders to overturn the CEO's opposition. Shleifer and Vishny (1986) and Stulz (1988) provide theoretical rationales for this result, and Song and Walkling (1993) have empirical evidence. Therefore, giving target CEOs power to make decisions that are costly to overturn for shareholders can be valuable. However, a great change is evident in the characteristics of mergers and acquisitions over the past two decades. Merger and acquisition activity in the 1980s was characterized by spectacular hostile transactions, while in the 1990s the vast majority of transactions were done on friendly terms.[2]

In the 1990s, effective takeover defenses were widely available and hostile offers had only a small chance of success. With this shift in the balance of power toward target CEOs, bidders had to focus their efforts on convincing target CEOs to agree to deals versus enticing target shareholders through large takeover premiums. One way to solicit a target CEO's merger approval at a reduced takeover price is for the

[1] I use the terms "merger," "acquisition," and "takeover" synonymously.

[2] The friendliness of the transactions is initially surprising, because, as Agrawal and Walkling (1994) find, CEOs of target firms who lose their jobs generally fail to find another senior executive position in any public corporation within three years after a bid. Schwert (2000) finds little economic difference between friendly and hostile transactions.