



Antitakeover provisions in corporate spin-offs

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ARTICLE INFO

Article history:

Received 6 October 2008

Accepted 14 September 2009

Available online 17 September 2009

JEL classification:

G30

G34

G38

Keywords:

Spin-offs

Antitakeover provisions

Managerial entrenchment

Shareholders' interest

ABSTRACT

We analyze the relation between antitakeover provisions (ATPs) and the performance of spin-off firms. We find that firms protected by more ATPs before spin-offs have higher abnormal announcement returns and greater improvements in post-spin-off operating performance than firms with fewer ATPs. Further, firms that reduce the number of ATPs after spin-offs have greater improvements in operating performance than firms that do not reduce the number of ATPs. Finally, CEOs of pre-spin-off firms tend to retain more ATPs in parent firms and assign fewer ATPs to the spun-off units if they remain as the CEOs of the parents but not the spun-off units. Overall, our results indicate a positive relation between ATPs and the value gains to spin-offs.

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1. Introduction

Whether antitakeover provisions (ATPs) increase or decrease shareholder value is an open and much debated issue (Field and Karpoff, 2002; Core et al., 2006). A number of studies have analyzed why firms adopt ATPs in the context of various corporate events (Garvey and Hanka, 1999; Masulis et al., 2007; Harris and Glegg, 2009). The broad view emerging from these empirical analyses is that ATPs reduce shareholder value because they entrench managers by insulating them from the market for corporate control. However, other studies argue that firms can use ATPs to enhance shareholders' wealth for various reasons. First, ATPs can increase the bargaining power of the target firm and the takeover premium in a takeover battle (Comment and Schwert, 1995). Second, ATPs may enhance long-term firm value in the hands of high ability managers, since ATPs allow such managers to create value for the firm by investing in risky, long-term projects (Chemmanur and Jiao, 2005).

We shed new light on the use of ATPs by studying the role of ATPs in corporate spin-offs. The opposing views outlined above on the relation between ATPs and shareholder value have different

predictions on the performance of spin-offs among firms with different numbers of ATPs. The “managerial entrenchment hypothesis” predicts that firms with more ATPs before spin-offs have higher abnormal returns around spin-off announcements than firms with fewer ATPs (**H1a**). More entrenched managers in high-ATP firms are less subject to the market for corporate control and therefore manage the firms less efficiently, so that the potential gains from spin-off may be greater. For example, Chemmanur and Yan (2004) argue that a spin-off increases the probability of the parent or the subsidiary becoming takeover targets.¹

In contrast, the “shareholders' interest hypothesis” predicts no difference in abnormal returns around spin-off announcements between high-ATP and low-ATP firms (**H1b**). The shareholders' interest hypothesis argues that firms optimally choose ATPs based on their characteristics (growth opportunities, market valuation, etc.) to protect shareholder value instead of entrenching the management. Therefore, ATPs are not related to the inefficiency in the firm and gains from the spin-off, and we expect no difference in

¹ Because a spin-off would seem to be against the interests of an entrenched management, the natural question is why such managers would ever do one. One answer is that because of the growth in equity-based compensation, managers increasingly face a trade-off between the benefits from perquisite consumption and stock price gains. A second answer is that a firm's board may impose spin-offs on an incumbent management that is particularly inefficient at managing one or more divisions of the firm.

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abnormal returns around spin-off announcements between high-ATP and low-ATP firms.

The managerial entrenchment hypothesis predicts that high-ATP firms have poorer operating performance before spin-offs, and greater improvement in operating performance after spin-offs, compared to low-ATP firms (**H2a**). The poor operating performance before spin-offs in high-ATP firms is due to higher degrees of management entrenchment in these firms. Prior studies show that the operating performance improves after spin-offs (Ahn and Denis, 2004; Chemmanur and Nandy, 2006). Because there are more inefficiencies in high-ATP firms before spin-offs, we expect greater improvements in operating performance in high-ATP firms than in low-ATP firms. On the other hand, the shareholders' interest hypothesis does not view ATPs as a measure of management entrenchment and a source of inefficiency. Rather, firms optimally choose ATPs to increase their bargaining power in a takeover battle or to implement risky, long-term projects, and ATPs are not related to the firm's operating performance. Therefore, the shareholders' interest hypothesis predicts no difference in operating performance before spin-offs and no difference in the improvement in operating performance after spin-offs between high-ATP and low-ATP firms (**H2b**).

The two hypotheses also have different predictions about the change in the number of ATPs after spin-offs. According to the managerial entrenchment hypothesis, more ATPs lead to more inefficiencies in firms before spin-offs. Hence, value-maximizing firms tend to reduce the number of ATPs in high-ATP firms after spin-offs to remove the inefficiencies. Firms with fewer ATPs before spin-offs have less inefficiencies and are less likely to reduce their ATPs. That is, we expect a positive relation between the improvement in operating performance after spin-offs and the reduction in the number of ATPs. Therefore, the managerial entrenchment hypothesis predicts that high-ATP firms are more likely to reduce the number of ATPs than low-ATP firms after spin-offs, and the improvement in operating performance after spin-offs is positively related to the decrease in the number of ATPs (**H3a**). In contrast, the shareholders' interest hypothesis contends that ATPs are not a source of inefficiency, and the hypothesis predicts no change in the number of ATPs after spin-offs because the gains from spin-offs are not related to ATPs. The hypothesis also predicts no relation between the improvement in operating performance after spin-offs and the change in the number of ATPs. To summarize, the shareholders' interest hypothesis predicts no change in the number of ATPs after spin-offs and no relation between the improvement in operating performance and the change in the number of ATPs (**H3b**).

Finally, the two hypotheses have different implications on the number of ATPs of the post-spin-off parent and the spun-off unit. The managerial entrenchment hypothesis argues that managers use ATPs to entrench themselves and extract private benefits from shareholders. Therefore, if the CEO of the pre-spin-off firm continues to be the CEO of either the post-spin-off parent or the spun-off unit (but not both), he will assign more ATPs to the unit in which he remains as CEO and fewer ATPs to the other unit; we will not see such difference if he remains as the CEO of both the parent and the spun-off unit or neither. Therefore, the managerial entrenchment hypothesis predicts that the CEO of the pre-spin-off firm will assign more ATPs to the unit in which he remains as CEO, and fewer ATPs to the unit in which he will no longer be the CEO (**H4a**). In contrast, the shareholders' interest hypothesis argues that CEOs use ATPs to benefit shareholders, not to entrench themselves. Therefore, the numbers of ATPs assigned to the parent and the subsidiary after spin-offs are not related to whether the CEO continues to be the CEO of the parent or the spun-off unit. As a result, the shareholders' interest hypothesis predicts no relation between the difference in ATPs between the parent and

spun-off unit and whether the CEO of the pre-spin-off firm continues to be the CEO of the parent or the spun-off unit (**H4b**).

We test the predictions of the two competing hypotheses using a sample of 139 spin-offs announced between 1990 and 2000. We find that firms with more ATPs have significantly higher abnormal returns around spin-off announcements. The average three-day abnormal return is 4.96% for firms with a large number of ATPs (the top one-third) and about 0% for firms with a small number of ATPs (the bottom one-third). High-ATP firms, on average, underperform firms in the same industry with similar size by 5.9% in operating performance as measured by operating cash flow returns in the two-year period before the spin-off. In contrast, low-ATP firms do not have abnormal operating performance before the spin-off. High-ATP firms also have greater improvement in operating performance after the spin-off than low-ATP firms. Our findings on announcement returns and operating performance support the managerial entrenchment hypothesis instead of the shareholders' interest hypothesis.

Our analyses also show that high-ATP firms tend to reduce the number of ATPs after spin-offs, whereas this is not the case for low-ATP firms. Further, we find a positive relation between the decrease in the number of ATPs and the improvement in operating performance after spin-offs. We also find that the CEO of the pre-spin-off firm puts more ATPs in the unit in which he continues to be the CEO after the spin-off. The evidence suggests that the CEOs may use ATPs to entrench themselves. Our findings on the number of ATPs in firms after spin-offs also support the managerial entrenchment hypothesis instead of the shareholders' interest hypothesis.

Like other studies in corporate finance, our analyses are complicated by the endogenous relation between corporate decisions and the control forces operating on the firm; see, for example, Wintoki et al. (2008) on the importance of controlling for endogeneity in the context of board structure and firm performance. In the context of spin-offs, ATPs *per se* may not cause entrenchment/inefficiency in the firm and drive the spin-off decision. Rather, certain firm and industry characteristics endogenously determine both whether a firm conducts a spin-off and how many ATPs a firm adopts. To address these concerns, we predict firms' ATP levels using management quality and firms' business environments (such as industry Tobin's Q, industry leverage, and industry free cash flows) or other corporate governance measures (production market competition, board characteristics). We still find a positive relation between unpredicted ATP levels and abnormal announcement returns and improvements in operating performance after spin-offs.²

We structure the rest of the paper as follows: We discuss the related literature and our contribution in Section 2. We describe the sample selection in Section 3 and the abnormal announcement return in Section 4. We analyze the relation between ATPs and operating performance in Section 5. In Section 6, we examine the change in ATPs around spin-offs. We address in Section 7 the endogeneity issue. Section 8 concludes.

2. Related literature and our contribution

Our study is related to several strands of literature. The first strand is the large body of work documenting that the stock market

² However, it is possible that we fail to capture all the factors that determine whether a firm conducts a spin-off and how many ATPs it adopts, and the relation between ATPs and spin-off performance could be spurious. Reverse causality is another possibility. Specifically, poor performance before spin-offs may prompt firms to increase their ATPs, and it is not the ATPs that cause the poor performance. In light of the above possibilities, one should be cautious in interpreting our results as evidence that ATPs cause poor firm performance. We thank an anonymous referee for pointing this out.

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