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Do takeover laws matter? Evidence from five decades of hostile takeovers☆

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ABSTRACT

This study evaluates the relation between hostile takeovers and 17 takeover laws from 1965 to 2014. Using a data set of largely exogenous legal changes, we find that certain takeover laws, such as poison pill and business combination laws, have no discernible impact on hostile activity, while others such as fair price laws have reduced hostile takeovers. We construct a Takeover Index from the laws and find that higher takeover protection is associated with lower firm value, consistent with entrenchment and agency costs. However, conditional on a bid, firms with more protection achieve higher premiums, consistent with increased bargaining power.

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1. Introduction

In 1985, businessman Ronald Perelman made a hostile bid for Revlon, the cosmetics company. The Chief Executive Officer (CEO) of Revlon at the time responded with disdain and arranged for the Revlon board of directors to adopt a number of takeover defenses, including an early form of the poison pill, to fight off Perelman's bid. The contest was resolved in Perelman's favor when the Delaware courts intervened, adopting the so-called Revlon rule, which requires that when a company puts itself up for sale, it must sell for the highest price reasonably available (Bruck, 1988). The adoption of the Revlon rule occurred at a time of heightened hostile takeover activity, when many rules governing hostile takeovers were adopted by both state legislatures and courts. However, while the time of the Revlon decision marked a surge in the number of these laws, the legal environment around takeovers has been evolving for approximately 50 years.

The varying effect of takeover laws has implications for the theory that the takeover market is an external disciplinary mechanism for corporate governance (Manne, 1965). Numerous studies have used variation in specific takeover defenses or antitakeover laws as a proxy for

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changes in firm corporate governance (e.g., Bertrand and Mullainathan, 1999, 2003; Schwert, 2000; Karpoff and Malatesta, 1989). Lel and Miller (2015) provide evidence that links takeover activity and managerial discipline to the legal environment in an international setting. As they point out in their study, the use of an external influence, such as takeover laws, has come into favor to sidestep the endogeneity problem that arises when measuring takeover defenses at the firm level (see also Core et al., 2006). But, while specific studies have focused on individual or selected antitakeover statutes, none has examined the full array of takeover laws, and remaining unexplored is how the full spectrum of the legal environment impacts hostile takeover activity over an extended period of time. Moreover, Coates (2000) criticizes many studies of antitakeover provisions for failing to have a longitudinal time frame sufficient to account for changes in legal regimes and markets. Our study addresses these gaps in the literature.

We use a data set of 17 different takeover laws and court decisions from 1965 through 2014 to measure the variation in takeover laws and their long-term impact on hostile activity. We also utilize a novel data set of Merger and Acquisition (M&A) hostility back to 1965. We find that the general susceptibility to a hostile takeover peaked in 1973 and has varied substantially since then. As a proportion of total M&A equal-weighted volume, hostile activity peaked in 1967 at 40% immediately prior to the enactment of the Williams Act and declined to about 8.6% in 2014. Although hostile activity is less common than it once was, it has certainly not disappeared.

Bertrand and Mullainathan (1999) use variation in the timing and adoption of business combination (BC) laws by states to proxy for corporate governance quality of firms incorporated in each state. Numerous studies conducted since then rely on business combination laws as a plausibly exogenous proxy for governance quality (Karpoff and Wittry, 2015). However, the relation between these laws and actual levels of takeover activity remains questionable, with Comment and Schwert (1995) concluding that the passage of business combination laws had no discernible deterrence effect on overall M&A rates. We find similar results for hostile takeover rates. Moreover, the value-weighted proportion of firms covered by these laws jumped from 0% pre-1985 to over 95% by 1990. Thus, BC laws alone seem unlikely to provide a reliable measure of external pressures on firms' corporate governance, casting doubt on the relevance of this proxy in academic research.

We continue our analysis by examining the extent to which a wide array of takeover legislation and case law has influenced hostile activity levels over the past five decades. This analysis includes the Williams Act in 1968, the first-generation takeover laws and their repeal, business combination laws, fair price provisions, control share acquisition statutes, control share cash-out statutes, poison pill cases and statutes, mandatory classified board laws, expanded constituency laws, disgorgement provisions, anti-greenmail laws, golden parachute restrictions, tin and silver parachute blessings, assumption of labor contract laws, and the Revlon, Unocal, and Blasius standards of review (based on Revlon, Inc. v. MacAndrews & Forbes Holdings; Unocal v. Mesa Petroleum; and Blasius Industries v. Atlas Corp., respectively). By focusing on state-level variation in the takeover environment that is largely exogenous to firm-level decisions, we are able to more cleanly measure the true impact on hostile activity, takeover premiums, and firm value.

Following the analysis of which takeover laws matter, we turn to constructing a firm-level index of takeover susceptibility from the impactful legal determinants in the hostile takeover models (hereafter, Takeover Index), in conjunction with other plausibly exogenous determinants of takeover susceptibility. We then examine the relation between the Takeover Index and firm-level economic outcomes. To mitigate omitted variables bias, the index is constructed using legal determinants as well as other control variables such as aggregate capital liquidity (Harford, 2005) and firm age (Shumway, 2001) that impact the probability of hostile takeover but are not functions of firm choice. Variation in takeover susceptibility results from three sources in this model: (1) the legal determinants, (2) a macroeconomic factor (capital liquidity), and (3) a firm-specific factor that is not subject to firm choice (firm age). In this way, the index represents a middle ground between existing governance proxies such as the Governance Index (G-Index) (Gompers et al., 2003), that are subject to endogeneity concerns and single law proxies, such as BC laws, that are plausibly exogenous but lack power.

The emphasis on hostile activity instead of all M&A transactions is important in the development of the index for two reasons. First, we make no prediction for the relation between antitakeover laws and overall merger activity. For example, if a 100% bullet-proof antitakeover law were passed, no more hostile takeovers would be expected. However, a continuation of M&A activity in aggregate would still be expected as managers seek to maximize shareholder value by pursuing synergies. The volume of total M&A transactions is influenced by numerous factors that are unrelated to takeover laws such as industry technological shifts (Harford, 2005), whereas bidders' ability to pursue these transactions via hostile means is related much more directly to the legal environment. Second, as we seek to create an index related to governance, it is important to focus on takeovers that could be disciplinary in nature. As discussed by Hartzell et al. (2004), target CEOs typically receive wealth gains roughly equivalent to their expected lifetime income stream in their sample of primarily negotiated (friendly) takeovers. Thus, interpreting friendly acquisitions as a corporate governance mechanism is difficult. We therefore isolate hostile deals for the development of the index and then turn to a full sample of M&A transactions in subsequent tests because the level of protection can have implications for premiums in both friendly and hostile takeovers.

We find that firm value is positively associated with susceptibility to hostile takeovers. The relation is significant in three of four decade subperiods and is significant when estimated on our entire sample. The result is robust to inclusion of indices of firm-level defenses such as the G-Index or Entrenchment Index (E-Index). Shareholders thus appear to value the disciplinary market for corporate control, and the secular decline in hostile takeover rates in recent years could perpetuate agency problems related to

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