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Ownership structure, shareholder intervention, and success in takeovers☆

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Abstract

We consider a situation in which a raider attempts to seize corporate control from a leading large shareholder who chooses between undertaking intervention in the management of the firm and selling its stake to increase its expected payoff. A takeover is more likely to succeed the lower is the ownership concentration of the target firm. However, the higher are the costs of a takeover, the greater must the ownership concentration be for the raider to attempt a takeover. If there is a takeover, the value of the target firm is lower the greater is its ownership concentration.

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1. Introduction

Both academic and popular commentators recognize that outside large shareholders, such as institutional investors, play an important role in corporate governance. Given their large stakes, large shareholders can exercise their ownership rights over poorly performing firms in their portfolios. That is, they can undertake *shareholder intervention* or *activism* by intelligently pressurizing firms to act in the shareholders' interest. Anecdotal evidence suggests that shareholder intervention disciplines the manager of the target firm. However, in practice, shareholder intervention has limitations. For example, Karpoff (1998) concluded in his survey of

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shareholder activism that managerial replacement achieved by active shareholders has a negligible impact on shareholder values.[1] This suggests that it is either too difficult or too costly for active shareholders to replace incumbent managers. Rather than replace managers, active shareholders may also pressure managers into improving their performance. However, managers with outside options that make them better off – for example, offers of executive positions in other firms – prefer to leave rather than to remain in their firms. If shareholder intervention hardly enhances share values, shareholders may do better by selling their stakes for a price tendered by potential acquirers. This is because even if large shareholders increase share values through costly interventions, they only acquire a share of the value in proportion to their stakes. Consequently, large shareholders choose between undertaking intervention in the management of the firm and selling their holding blocks subject to a tender price offered by potential acquirers. We investigate how a target firm's ownership concentration affects a potential acquirer's decision about whether to engage in takeover activity. We also discuss how the ownership structure of the target firm affects the tender price and the probability of a successful takeover following a tender offer by an acquirer.

It is generally accepted that corporate takeovers improve resource allocation and enhance the shareholder values of underperforming firms. In practice, takeover contests for more than 50 percent of corporate shares are rare. Often, a party who acquires a significant (controlling) block of shares, say 20–30 percent rather than 50 percent, becomes the *leading* shareholder.[2] We show that even though potential acquirers allow existing shareholders of the target firm to participate in decision making by making a public tender offer, the allocation of corporate control is determined solely by the leading large shareholder's tendering decision.

If undertaking takeovers is costly, a potential acquirer must offer a tender price below the postraid value of the target firm; otherwise, the acquirer earns no profit by making a tender offer. However, for such a price, dispersed small shareholders do not tender their own stakes even though they know that a takeover would increase the value of the firm. This problem is known as the *holdout problem*, which was introduced by Grossman and Hart (1980). Because each dispersed small shareholder holds an infinitesimally small stake that is not sufficient to affect the allocation of corporate control, these shareholders prefer to hold their own stakes and wait for others to tender if the tender price is lower than the postraid value of the firm. By contrast, because shareholder intervention is costly, large shareholders may do better by selling their stakes for a price below a firm's postraid value. Hence, although a potential acquirer offers a tender price below the postraid value of the firm, takeover occurs if a large shareholder tenders its stake for such a price.

Along these lines, we model a situation in which a raider seeks to take control of a target firm held by a leading large shareholder and dispersed small shareholders. The firm is run by a manager who makes gains from incumbency. The large shareholder has an incentive to increase its expected payoff by adopting an 'exit and voice' strategy, which involves deciding whether to sell its stake in a public tender offer made by a value-enhancing raider ('exit') or to intervene in the incumbent's management of the firm in order to get the manager to pay out the gains from incumbency as additional dividends ('voice'). Shareholder wealth, including the managerial gains from incumbency, is larger than that realized under the raider's control. However, since the

[1] Surveys of shareholder activism by Black (1998) and Gillan and Starks (1998) draw similar conclusions.

[2] The strategy of becoming the leading shareholder was first discussed by Dewatripont (1993). The model developed by Burkart et al. (2000) applies this strategy in the context of the dynamic transfer of corporate control.

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