THE EFFECT OF THE HOSTILE TAKEOVERS ON COMPANIES’ CORPORATE GOVERNANCE

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LIST OF ABBREVIATIONS

Airgas: Airgas Inc.
Air Products: Air Products Chemicals, Inc.
Cadbury: Cadbury plc.
IRRC: Investor Responsibility Research Center
Kraft: Kraft Foods Inc.
NPV: Net Present Value
OCE: Office of the Chief Economist
R&D: Research and Development
SEC: Securities Exchange Commission
UK: United Kingdom
USA: United States of America
INTRODUCTION

The concepts of hostile takeovers and antitakeover defenses have being largely analyzed both by business and legal scholars. Along the years, many theories have been proposed about the effects of such attempts and measures for target shareholders, bidders and other stakeholders such as employees or creditors. The purpose of this thesis is to analyze the effects of hostile takeovers and antitakeover defenses specifically for the corporate governance of target companies.

In principle, the so-called market for corporate control, and more precisely hostile takeovers, are considered a mechanism to mitigate the Principal–Agent problem and reduce the subsequent agency costs. However, some authors have pointed out that unsolicited takeovers attempts and antitakeover defenses may accentuate management entrenchment, increase agency costs and even destroy target business.

Recently, the increase in hostile takeover attempts and the strength of classical and new takeover defenses have questioned who is in the best position or who should have the right to decide to sell the company. Distinct answers to such questions challenge whether unsolicited bids and/or antitakeover measures should be allowed at all or not. Furthermore, no agreement has been reached so far on the best way to regulate them both.

On that regard, the UK system considers that shareholders are company owners so they must decide whether to accept an unsolicited bid or not. Thus, directors are not allowed to implement antitakeover defenses without shareholders’ consent. On the other hand, the Delaware system understands that target managers may know better the company value and prospects so it has given them more power to decide on the convenience of a hostile offer. Moreover, in some cases target boards are not only allowed but also required to defeat an undervalued hostile bids. Nevertheless, the results of the significant completed hostile takeovers in the USA and the UK have proved that both systems have strengths and weaknesses.

Discussion about the convenience of hostile takeovers for corporate governance purposes is still ongoing. Because of that, we want to present in this thesis a closer approach to the hostile takeovers concept and antitakeover defenses in the Anglo American market. We will
also describe the main arguments in favor and against such mechanism as a weapon against the conflict of interest between shareholders and management. With these latest arguments we will try to reach a conclusion on whether their positive effects outweigh any negative consequences they may have.

In Section 1, we begin with a brief description of the ownership structure in a firm represented by the separation of ownership and control. We continue our analysis by making reference to the main consequence of such control structure: the Principal–Agent Problem. Such problem is created from the conflict of interests between shareholders, who want to maximize the value of the company and obtain high returns form their investment, and the management who tend to think more in their own interest, trying to get as many benefits from the company as possible and to keep their positions. Finally, we present the concept of Corporate Governance, considered the main solution to the Principal-Agent problem; and describe the main mechanisms implemented under Corporate Governance concept.

In Section 2, we go deep into the analysis of the hostile takeovers concept. We also analyze the main defensive measures against hostile takeovers implemented by target’s board of directors in such countries. As part of such analysis, we present a brief description of the legal treatment of such defenses in the USA and the UK. Finally, we include a couple of the most relevant hostile takeover examples that took place in such countries during the last five years.

In Section 3 we analyze the empirical data regarding the concrete effects of hostile takeovers along the years. We describe the most beneficial aspects of such transactions for the target company corporate governance. At the same time, we also present the main negative effects of such transactions, which could be considered a representation itself of the Principal Agent problem.
CHAPTER 1 - CORPORATE GOVERNANCE

1.1 Separation of Ownership and Control

Companies may assume different ownership structures depending on several factors. Among such factors we can find: dispersion of the shareholders, stake of each shareholder in the company, protection of rights of shareholders and other stakeholders in the respective jurisdiction, etc.

Publicly-held companies normally have thousands of shareholders with a very little stake in them. The most common ownership structure presents an almost complete separation of the cash flow and control rights. Cash flow rights represent the right to get dividends and the remaining assets of the company after its liquidation; they are attributed to the shareholders. Meanwhile, the control rights, which are the power of controlling the company main decisions, fall in the company management (board of directors and/or executives). This structure tends to be the most effective since the cost of controlling the company becomes very high for such small numerous shareholders.

Even when common stock shareholders have voting rights, the opportunity to exercise such rights has become quite rare in practice. As in presidential or parliament elections, minority shareholders tend to think that their vote is irrelevant, or that it will not change the result of the decision, and sometimes they rather not exercise their right to vote. In addition, many times shareholders meetings are held in locations not easily accessible to them. Due to travel expenses and/or time factors, foreign investors are discouraged to attend. Moreover, many of such shareholders may be just short-term investors aiming for a good return of their investment, but without experience in and/or interest on how to manage the company.

On the other hand, an additional factor leading to such ownership structure in publicly held companies might be the basic rules of capital markets applicable to investments in such companies: free alienability of shares and no requirement for the investors to get involved in the company activities. Fama and Jensen have pointed out that “The common stock residual claims of such organizations [among others, publicly held companies] are unrestricted in the sense that stockholders are not required to have any other role in the organization, and their

residual claims are freely alienable. As a result of the unrestricted nature of the residual claims of open corporations, there is almost complete specialization of decision management and residual risk bearing\(^2\).

In that scenario, Jensen and Fama identified the so-called “benefit of specialization”, which makes more efficient to allocate the company’s control of the decisions in the management, mainly the board of directors\(^3\). Shareholders trust the management to drive the company in the most optimal way and expect to receive the return of their participation via their cash flow rights.

In words of Fama and Jensen “Nearly complete separation and specialization of decision control and residual risk bearing is common in large open corporations (...) where most of the diffuse residual claimants are not qualified for roles in the decision process and thus delegate their decision control rights to other agents\(^4\).”

However, the complete separation of cash flow and control rights is certainly not common in family-owned and privately-held companies, or publicly-held companies with a large shareholder, such an institutional investor. In those cases, control will be normally concentrated in the large shareholder who will bear the biggest part of the company’s risk. In addition, in the case of family-owned companies, the respective family will have complete knowledge of the corporation’s business, and will be completely involved in its activities. Therefore, the large shareholder will have better incentives to exercise its voting rights, and to control the management and the company main decisions.

1.2 Principal-Agent Problem

This thesis will be focused on large publicly held companies, where investors trust in the management by financing them via capital contributions. Furthermore, investors expect the management to handle the corporation activities correctly to maximize its value and to return them profits for their investments.

\(^2\) Idem. p. 312.
\(^3\) Ibidem.
\(^4\) Idem. p. 309
However, as Rafael La Porta and others, quoting Jensen have pointed out, the return of profits from projects to shareholders cannot be taken for granted because managers of this kind of firms may use such resources for their own benefit⁵.

It is quite clear that a conflict of interest could arise between the management and the shareholders. Shareholders look for the maximization of the company value, high earnings and profits distributions. Conversely, management may think first in their own interest as professionals or employees, looking for higher salaries, benefits, and as mentioned by Jensen and Fama, even for perquisites⁶. All these items that shareholders and management wish for, would have to be covered with the same resources: the funds of the company.

This situation of conflict of interests is particularly dangerous in the case of complete separation of cash flow rights and control rights. In the words of Jensen and Fama: “the decision process is in the hands of professional managers whose interests are not identical to those of residual claimants [the shareholders]”⁷.

This problem between the shareholders (the principal) and the management (the agent) has been called as the Principal-Agent problem, or the agency problem.

The Principal-Agent problem is increased by the information asymmetry between the shareholders and management, when the latter controls the company main decisions. There are two aspects of the Principal-Agent problem typically discussed by the literature: the “moral hazard” and the “adverse selection”.

Kathleen M. Eisenhardt has described the moral hazard as the lack of effort on the managers (the agent) with regards to the position responsibilities undertaken in their contract: “The argument here is that the agent may simply not put forth the agreed-upon effort. That is, the agent is shirking”⁸. In principle, management does not bear the risk of the company results

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⁷ Idem. p. 332
and is indifferent to either positive or negative outcomes. Therefore, management has no incentive to act on the company’s benefit above its own interests.

Adverse selection, on the other hand, refers to the misrepresentation of management capabilities. In words of Eisenhardt: “The argument here is that the agent may claim to have certain skills or abilities when he or she is hired. Adverse selection arises because the principal cannot completely verify these skills or abilities either at the time of hiring or while the agent is working”\(^9\). In our case, investors trust the information about the skills and profile they receive from managers. However, such information could be misleading and shareholders may leave the control of the company in the hands of non-qualified or non-specialized people.

The Principal-Agent problem then may generate the expropriation of shareholders’ cash flow rights by the management. As mentioned, the direct expropriation of such rights is represented by the automatic granting of high salaries and benefits to management. Meanwhile, indirect expropriation could include company losses because of non-arm’s length transactions between the company and corporations related to the management -typically, in non-favorable conditions for the company.

However, the most classical ways in which the Principal-Agent problem could be represented are the so-called “empire building”, and risk adverse investments on the managers.

Empire building describes managers’ tendency to invest the company’s money, typically held as cash, in wasteful projects in order to create an empire, even when such empire could be unprofitable. Managers are attracted by the idea of driving a big company to improve or increase their reputation, and sometimes to obtain higher salaries. Gompers and others have mentioned “a substantial literature, dating back at least to Baumol [1959], Marris [1964], and Williamson [1964], holds that managers may undertake inefficient projects in order to extract private benefits. This problem is particularly severe when managers are entrenched and can resist hostile takeovers [Jensen and Ruback 1983; Shleifer and Vishny 1989]”\(^{10}\).

\(^9\) Ibidem.

Dittmar, Mahrt-Smith, and Servaes have also added “managers like to hold a lot of cash because it reduces pressures to perform and allows them to spend these funds on projects that increase their non-pecuniary benefits, but have a negative impact on shareholder wealth”\textsuperscript{11}.

On the other hand, if management compensation is linked to the company results in order to reduce or eliminate the moral hazard risk, it is highly probable that managers will become risk adverse. Therefore, they will prefer to not invest the company’s money in risky projects, even when such project could have a positive NPV.

Last but not less important, Shleifer and Vishny pointed out that managers could also expropriate shareholders “by entrenching themselves and staying on the job even if they are no longer competent or qualified to run the firm”\textsuperscript{12}. This problem has become very serious \textit{bis a bis} the increase of staggered boards and other limitations of shareholders rights that will be described in later sections.

There are several mechanisms to reduce or eliminate the agency problem. However, such mechanisms could not always be implemented in every company, or the costs that they represent could be too high for the shareholders or the company.

Shareholders could control moral hazard and conflict of interest by appropriately monitoring the activities and decisions made by management. However, the cost-benefit analysis of monitoring management could discourage small investors from such task since they will get – on individual bases- a small benefit, if any. Therefore, shareholders with a little stake in the company will always expect other shareholders, normally with a significant stake and better incentives, to monitor management. This is the so-called “free raider problem”.

Other methods include: an audit of the company’s accounts and transactions by external advisors, software and other control systems, and compensation systems for the management that link their compensation (or permanence in the company) to the company results\textsuperscript{13}. With

\textsuperscript{11} Dittmar, Amy / Mahrt-Smith, Jan / Servaes, Henri. “International Corporate Governance and Corporate Cash Holdings” In: Journal of Financial and Quantitative Analysis, March 2003, Vol. 38, N° 1. p. 120.
\textsuperscript{13} Idem. p. 26
respect to this last method, Jensen and Meckling have pointed out that incentive contracts can take a variety of forms, including share ownership, stock options, or a threat of dismissal if income is low.\footnote{idem. p. 13.}

Bhagat and Bolton, citing Grossman and Hart, have mentioned, “In agency models, a divergence in the interests of managers and shareholders causes managers to take actions that are costly to shareholders. Contracts cannot preclude this activity if shareholders are unable to observe managerial behavior directly, but ownership by the manager may be used to induce managers to act in a manner that is consistent with the interest of shareholders.”\footnote{Bhagat, Sanjai / Bolton, Brian. “Corporate governance and firm performance”. In: Journal of Corporate Finance 2008, Vol. 14. p. 259.}

Thus, the Principal-Agent problem generates several direct and indirect costs—denominated agency costs—for the company and the shareholders. Direct agency costs are referred, among others, to the company expenses in the perquisites and management benefits, as well as to the losses in transactions with companies related to the management. On the other hand, indirect agency costs are related to the costs incurred by the company and shareholders in order to implement the above-mentioned mechanisms to reduce or eliminate the agency problem.

Agency costs will always affect the value of the shareholders’ investment and company’s value. Andrei Shleifer and Robert W. Vishny have mentioned that “since the current value of expected future monitoring expenditures by the outside equity holders reduce the value of any given claim on the firm to them dollar for dollar, the outside equity holders will take this into account in determining the maximum price they will pay for any given fraction of the firm’s equity.”\footnote{Shleifer, Andrei / Vishny, Robert (a). Op cit. p. 26.}

The concept of “Corporate Governance” is introduced as mechanisms through which shareholders, among other investors, protect themselves against expropriation by management.\footnote{La Porta, Rafael / Lopez-de-Silanes, Florencio / Shleifer, Andrei / Vishny, Robert (a). Op cit. p. 4}
1.3 Corporate Governance as a Mechanism to Reduce Agency Costs

1.3.1 Definition and Relevance

Corporate Governance has been defined a set of institutional and market mechanisms that aim at minimizing agency costs and thereby maximizing shareholder value\(^\text{18}\). Basically, corporate governance is required when two conditions are present: agency problems (or conflict of interest affecting the interest of the company), and transaction costs related to such problems that cannot be solved with contracts\(^\text{19}\).

Corporate governance mechanisms try to protect investors’ rights against, among others, the disadvantages that the conflict of interests between management and shareholders may arise. With this protection, shareholders can trust that management, who still controls the company’s main business decisions, will not expropriate their cash flow rights. Thus, shareholders will be keener to finance companies by means of capital contributions. La Porta and others have pointed out that better protection for investors increases their willingness to provide financing, and it should be reflected in lower costs and greater availability of external financing\(^\text{20}\).

In addition, corporate governance mechanisms do lead to a significant reduction of agency costs. For instance, Dittmar, Mahrt-Smith, and Servaes have found that firms in countries with highest levels of shareholder protection tend to hold significantly less cash than firms in countries in which shareholders enjoy little protection\(^\text{21}\). Distribution of cash not only benefits shareholders directly by giving them the returns of their investment, but also avoids the risk of empire building, overpayment in acquisitions to be performed the company, etc. Furthermore, many studies have proved that corporate governance mechanisms protecting rights of shareholders are positively related to performance of companies. Bhagat and Bolton, testing Gompers and others results, have found that “1% improvement in governance as measured by the G-Index is associated with a 0.854% change in operating performance in

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\(^{21}\) Dittmar, Amy/ Mahrt-Smith, Jan / Servaes, Henri. Op cit.
the current period, a 0.763% change in next year's operating performance, and a 0.287% change in the next two years' operating performance. To clarify, the G-Index was created by Gompers and others in 2003 with data from the IRRC in order to confirm the effect of corporate governance provisions in companies’ results. In this Index, firms received a certain number of points based on provisions applicable to them that reduced shareholders rights. Thus, firms with the highest scores were referred as having the highest Management power, and firms with the lowest scores were considered as entities with stronger shareholder rights. Provisions that reduce shareholders rights for the G-Index were classified as: tactics for delaying hostile bidders; limitation on voting rights; director/officer protection; other takeover defenses; and state laws (mostly, against hostile takeovers).

Gompers and others have also pointed out that corporate governance has an impact on companies’ value. They have mentioned that: “It is well established that state and national laws of corporate governance affect firm value. La Porta et al. [2001] show that firm value is positively associated with the rights of minority shareholders.”

1.3.2 Control Forces

According to Michael Jensen, “there are only four control forces operating on the corporation to resolve the problems caused by a divergence between managers' decisions and those that are optimal from society's standpoint. They are: (i) capital markets, (ii) legal/political/regulatory system, (iii) product and factor markets, and (iv) internal control system headed by the board of directors.”

First, capital markets force is related to the potential alignment of manager’s interest bis a bis the shareholder’s, motivated by a threat to management based on an specific action of the capital markets.

Second, a legal, political and regulatory system is, in words of La Porta, Lopez de Silanes and Shleifer “the protection of outside investors -whether shareholders or creditors- through the

\[\text{\cite{22 Bhagat, Sanjai / Bolton, Brian. Op cit. p. 267.}}\]

\[\text{\cite{23 Gompers, Paul / Ishii, Joy/ Metrick, Andrew. Op cit.}}\]

\[\text{\cite{24 Idem, p. 125.}}\]

\[\text{\cite{25 Jensen, Michael (a). Op cit. p. 850 – 851}}\]
legal system, meaning both laws and their enforcement\textsuperscript{26}. Examples of measure related to this mechanism are the Corporate Governance codes adopted in many jurisdictions, and sometimes, even the creation of capital markets regulators. For instance, Fama and Jensen pointed out the establishment of the SEC, as a potential consequence of shareholders exploitation risk (residual claimants) by opportunistc decision agents\textsuperscript{27}.

It is worth nothing that, from a corporate governance perspective, countries could choose between two different models of investor protection. On one hand, we find the capital-market control model, which is focused on protecting the shareholder rights. Such model has been implemented in Anglo American countries such as the UK and the USA. On the other hand, we have the bank-controlled model, which favors the protection of other stakeholders, such as employees, banks, etc. The bank-controlled model is common in countries such as Germany, The Netherlands, or Japan, in which companies typically have a large controlled shareholder.\textsuperscript{28}

As the third mechanism, we have product and factor markets forces. They could be seen as related to the auto regulation of the market theory. That is, companies that do not supply a competitively priced product required by the market or consumers will not be able to survive\textsuperscript{29}.

Finally, internal control system is referred to the internal changes in the strategy headed by the board of directors. According to Jensen, this mechanism is sometimes inefficient because companies normally use it when it is too late, i.e. the company is already in distress or is having significant losses\textsuperscript{30}.

Hostile takeovers appear as a disciplinary mechanism for the management, within the corporate governance’s capital market control force. Hostile takeovers represent a threat for managers; if they do not perform well, shareholders will sell the company to an unsolicited bidder. We will discuss this proposition in further detail in Chapter 3.

\textsuperscript{26} La Porta, Rafael/ Lopez-de-Silanes, Florencio/ Shleifer, Andrei/ Vishny, Robert (a). op cit.
\textsuperscript{27} Fama, Eugene/ Jensen, Michael (a). op cit. p. 312
\textsuperscript{28} La Porta, Rafael/ Lopez-de-Silanes, Florencio/ Shleifer, Andrei/ Vishny, Robert (a). op cit.
\textsuperscript{29} Jensen, Michael, op cit. p. 852
\textsuperscript{30} Ibidem.
CHAPTER 2 - HOSTILE TAKEOVERS AND DEFENSES

2.1 Hostile Takeovers

Hostile bids are unsolicited offers for a significant stake of the target shares that are not recommended or approved by the target company’s management\(^{31}\). Therefore, by means of the hostile tender offers, bidders try to acquire shares directly from target shareholders skipping target’s board\(^{32}\).

From a board of director’s perspective, some reasons to reject a bid include: the low value of the offer, the threat that the offer may represent to long term plans or culture of the company, or the possibility to find a better bidder or partner. From the shareholders’ point of view, managers or directors will typically try to impede the company takeover because managers do not want to lose their positions and the benefits of control.

Therefore, from a corporate governance perspective, hostile takeovers are mechanisms to eliminate the inefficiency of target firms’ management. In addition, as we will describe in Chapter 3, it is considered that hostile takeovers help to generate profit distribution to shareholders from time to time.

Nevertheless, there are other ways to reduce agency costs. For instance, shareholders can monitor the board and management’s activities. In addition, interested third parties, or an insurgent incumbent shareholders group, may try to gain control of the target and replace the inefficient management via proxy contest. However, as pointed out by Hart, the main problems of such mechanisms are the free ride problem. That is, the parties who spend the resources disciplining the management will only get in the end, a partial gain of such change\(^{33}\). Conversely, hostile takeovers are a more attractive weapon for management improvement since those who incur the cost of disciplining management, by acquiring an underperforming target, will gain a significant reward\(^{34}\).

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\(^{33}\) Hart, Oliver. Op cit. p. 684

\(^{34}\) Ibidem
Consequently, and due to the increase of hostile takeovers in many relevant markets over the last decade\(^{35}\), we have considered convenient to focus this thesis in hostile attempts to acquire a controlling stake in target companies.

### 2.2 Defenses

Hostile takeover defenses are mechanisms by means of which the management of the target company tries to thwart or impede an unsolicited offer.

Among other classifications, hostile takeovers defenses can be classified as pre-bid defenses and post-bid defenses. The company, usually the board of directors, establishes pre-bid defenses before any hostile bid threatens it. Management can create pre-bid defenses just as a sign of trust in the company’s results and growth, or as a result of agreements executed with friendly bidders in order to perform mergers and acquisitions transactions. Conversely, post-bid defenses are adopted by the target after the formal or informal announcement of the hostile bid by the potential purchaser.

As a general approach, hostile takeover defenses are against good corporate governance. In principle, they restrict shareholders’ rights by frustrating the hostile bid, and thus,impeding shareholders to sell their shares to the hostile bidder. Moreover, although the target’s company management always argue objective reasons to oppose to the respective bid, defenses are normally seen as a tool of the target’s board of directors to entrench themselves in their positions.

Nevertheless, academics have deeply discussed the real effect of hostile takeovers defenses. As described by Malatesta and Walkling, “the managerial entrenchment hypothesis holds that takeover defenses raise the cost of displacing inefficient management and reduce stockholder wealth. Under the stockholder interests hypothesis, on the other hand, takeover

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\(^{35}\) According to Sparks, Nichols and Arsht & Tunnerll LLP, the number of hostile takeovers in the USA has been increasing the recent years. Indeed, as pointed out by them, “hostile bids accounted for 47% of the M&A transactions in the first two months of 2009, compared with 24% in 2008 and 7% in 2004. For further detail please review: “Responding to unsolicited takeover offers”. In: The Harvard Law School Forum on Corporate Governance and Financial Regulation website. July, 2009. Available at: [http://blogs.law.harvard.edu/corpgov/2009/07/16/responding-to-unsolicited-takeover-offers/](http://blogs.law.harvard.edu/corpgov/2009/07/16/responding-to-unsolicited-takeover-offers/)
defenses enable stockholders to secure a higher control premium in the event of a takeover bid and to contract more efficiently with managers.”

In Section 2.2.1, we will explain further the most common and powerful defenses adopted by target companies. In principle, all the defenses measures to be described below are legal. However, in certain circumstances and in certain jurisdictions, they can be declared invalid if they do not comply with the applicable requirements.

2.2.1 Most Relevant Defenses

(a) Poison Pills

Poison pills, also called Shareholders Right Plans, are considered one of the most powerful defenses against hostile takeovers. They were invented in the 1980’s by Mr. Martin Lipton as a defense mechanism from El Paso Corp. against the hostile bid launched by Burlington Northern Railroad.

Poison pills provide a right -in the way of dividend- to the company shareholders by means of which each shareholder receives an option to acquire common company shares at price significantly above market value. Such right becomes effective when a potential acquirer or shareholder increases its participation in the company above a specific threshold (usually between 10% to 20%) within a certain period. Rights provided by the poison pills are not granted to the potential acquirer; so if triggered, the pill will cause the dilution of the acquirer stake.

Poison pills provision can be created for a specific term, typically a short period, or can be dropped at any point by the authorized body. The cost of redeem the pill is usually very low for the company.

38 The final acquisition of common shares may be completed directly (when the pill grants an option to acquire common shares) or by means of the ultimately conversion of preferred shares (when the pill grants an option to acquire a fraction of a preferred share).
39 Hanks, James J. Jr. Note and Questions on Shareholder Right Plans (“Poison Pills”). Published as part of the International Mergers and Acquisitions course reading materials for the Master in Law and Business of Bucerius Law School and WHU Otto Beisheim School of Management. Part I. 2011/2012"
The most common types of poison pills are the “flip in” and the “flip over” plans. Flip in plans grant target’s shareholders, other than the potential acquirer, the right to purchase target company shares once the threshold has been reached. This plan is applicable when the target stands as the surviving and operating company after the acquisition and/or business combination. On the contrary, flip over plans are applicable to the cases where the target company disappears or transfers a significant part of its assets to a related company after the acquisition and/or business combination. When triggered, flip over pills grant target’s shareholders (again, other than the acquirer) the right to acquire shares of the resulting or surviving operating company.  

In practice, poison pills can be adopted prior to the threat of a hostile bid or after the unsolicited has been announced. Generally, a board of directors can adopt the poison pills without the consent of the Shareholders Meeting. Consequently, the consent of the target board of directors is required in order to redeem the pill or obtain exclusion.

In Delaware, poison pills are legal and may be upheld by the courts if they are properly structured and administered.

Poison pills *per se* do not prohibit takeovers, but they make the acquisition prohibitively expensive for hostile bidders. As stated by Ryngaert, poison pills are so named “because they economically ‘poison’ an acquirer who engages in certain control transactions.” The poison pills dilution effect will cause the unsolicited bidder, after acquiring a large stake in the target, to acquire more shares to recover its significant participation. Poison pills also impede the acquisition of a significant stake in the target company via the capital markets without paying a control premium for its shares. Furthermore, they thwart any kind of two tiered offers that may discriminate shareholders.

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40 Ibidem.
Therefore, since the board of directors is generally the only body capable to redeem the pill, poison pills would force unsolicited bidders to negotiate the transaction directly with the target board, and not with the shareholders\textsuperscript{44}.

Nonetheless, if hostile bidders have the support of the target shareholders, they still have an option against poison pills. By means of the proxy contest, the hostile bidder can try to remove the members of the incumbent target board and appoint new friendly directors who will either redeem the pill or make an exception in favor of such bidder. However, in order to neutralize these risks, the board of directors could take advantage of the classified board provisions, when available, so that hostile bidders will have to wait at least two periods in order to take control of the target board\textsuperscript{45} (please see also section 2.2.1(b)).

In addition, proxy contests powers may be limited by the so-called dead hand pills. The strongest version of such type of poison pills can only be redeemed by the directors who adopted it ("continuing director" clause), or by the new directors appointed by the board who adopted the pill\textsuperscript{46}. It should be noted, however, that the legality of such type of pills is still under discussion in the USA.

It is worth nothing that markets have created specific perception about the poison pills when it comes to hostile takeover scenarios. Some expert M&A lawyers in the USA have considered that maintaining a pill signals the hostile bidders that the board will "not go easy" if an unsolicited offer is made and that, conversely, not adopting a pill or (even worse) dropping an existing pill could be interpreted as a message that incumbents are "soft" and "lack resolve"\textsuperscript{47}. For Ryngaert, such kind of perceptions or signals tends to affect the target company stock price during the bidding process\textsuperscript{48}.

\textsuperscript{44} Ryngaert, Michael. Loc cit.
\textsuperscript{48} Ryngaert, Michael. Op cit.
(b) **Classified Boards**

Also called staggered boards, this defensive measure seek to impede that all the board of directors members, or a majority of them, can be removed and reappointed at the same time by the shareholders meeting.

Under this measure, the board members are classified into different classes –normally three- and according to the company bylaws or charter, only one class of directors can be reelected every period. Thus, as pointed out by Bebchuk and others, “As a result [of the classified board provision], shareholders cannot replace a majority of the directors in any given year, no matter how widespread the support among shareholders for such a change in control”\(^{49}\).

In the context of hostile takeovers, the real effect of staggered boards is that bidders will have to wait at least two periods, and win at least two directors elections in order to gain control of the target board. This holds true even when bidders hold a significant stake in the target company, or when they count with the support of the target shareholders.

Even when this measure delays acquiring real control of the target at least for two periods, by itself, it has been considered somehow weak. Robert Clark and Ronald Gibson have mentioned that “if a bidder were to acquire a majority of the shares of a company with a staggered board, it would not in fact take the buyer two elections to gain control of the board because the board could be expected to resign”\(^{50}\). The board will resign mainly because of the reputational costs of being an illegitimate director, and because there is not much an illegitimate board can make against the new major shareholder plans\(^{51}\).

However, staggered boards become particularly powerful when the target company has also implemented a poison pill. As previously mentioned, the target board of directors is the body that normally creates the pills and thus, is the only one authorized to redeem it, or make exceptions to its application. Thus, when a hostile bidder confronts a target company with a poison pill: it can sue the target board of directors for any misconduct, or for the breach of its


\(^{51}\) Ibidem.
fiduciary duties, if that’s the case; or it may try to remove the members of such board in order to appoint new friendly directors willing to help with the pill. Typically, for purposes of such removal, a proxy contest against the current board will be initiated. However, if the company bylaws or charters contemplate a classified board and say there are three director classes, only one third of the board can be replaced per period. Moreover, the hostile bidder must wait at least two periods in order to reach a majority in the target company’s board of directors. Such majority would help the bidder to control the pill, and thus, to succeed in its offer.

On the other hand, classified boards have also a non-takeover related effect, which can make such mechanism a positive tool for corporate governance. First, classified boards assure the permanence of independent directors for at least for three years, even if there is any eventual change of control in the company or any action by the executive directors. Second, classified boards help to maintain stability by guaranteeing that experienced directors will manage the company.\(^5\)

Contrary to the poison pills, in order to implement this measure, the consent of the shareholders meeting is generally required. In such context, classified boards are typically created at the company incorporation and not when the company faces the threat of a hostile takeover.

In the USA, staggered boards are quite common among publicly held companies. In fact, one of the most important recent cases in which such mechanism was attacked was the case of the Air Products hostile bid for Airgas. A more detailed description of such case can be found in section 2.3.1.

In the UK, however, classified boards are not as efficient as in the USA. In fact, according to Companies Act 2006, the members of the board of directors can be removed at any time by the shareholder meeting.\(^5\)

\(^{52}\) Idem. p. 8-9

(c) **Golden Parachutes**

Golden parachutes are special contractual provisions in favor of a company’s top managers. Such provisions establish significant payments to such managers in case they are dismissed from, or resign to, the company in the context of a change of corporate control. As mentioned by Machlin and others, “the golden parachute may consist of the base salary, bonuses, pension benefits, and fringe benefits such as medical insurance, life insurance, stock options, and stock buy-back plans.”

Like poison pills, golden parachutes are normally adopted by the board of directors and may be created before the threat of a hostile takeover or when facing it. Notwithstanding that, this contingent compensation may also benefit the firm executive directors in their condition of officers.

Golden parachutes seek to either frustrate or make more difficult a takeover attempt. It is likely that, if successful in its bid, a hostile bidder will be keen to remove the incumbent target management in order to have its own management driving the whole resulting firm (post acquisition). However, the high cost of such removal, or of managers’ resignation when golden parachutes have been provided, may significantly reduce the expected potential benefits of such acquisition. Therefore, significant golden parachutes in favor of the target managers may dissuade potential hostile bidders from launching an offer, or may reduce the price they will be keen to pay for the company shares, making the offer non-attractive for the target’s shareholders.

With such effect *bis a bis* unsolicited bids, golden parachutes may increase the Principal-Agent problem between shareholders and directors. As pointed out by Bebchuk and others, they might “(...) have an adverse effect by increasing slack on the part of managers as a result of being less subject to discipline by the market for corporate control.”

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56 Bebchuk, Lucian / Cohen, Alma / Allen, Ferrell. Op cit. 794
Notwithstanding the above, agency theorists have held that golden parachutes may actually have positive results for target’s shareholders. For instance, Jensen has pointed out that while managers may oppose bids for the company based on the concern of losing their jobs and their compensations, the golden parachutes benefits may compensate such losses and lead them to act in benefit of the shareholders\textsuperscript{57}. In the same way, Lambert and Larcker have held that such contractual provisions may be considered as a bribe to managers and directors from shareholders in cases of hostile takeovers\textsuperscript{58}. Under such analysis, executive directors and top executives will be less interested in resisting hostile bids because if the bids are successful, top management will have the chance to obtain their golden parachutes benefits. Both propositions become more accurate if, once the hostile bidder acquires the target company, managers and non-independent directors will probably have to leave the company anyway.

Nevertheless, there is still some concern about the optimal value that golden parachutes should have. On that regard, Machlin and others have pointed out that “Golden parachute contracts offering minimal payouts provide little incentive for managers to represent the interests of shareholders, while golden parachute contracts offering extremely large payouts might encourage managers to accept inadequate bids”\textsuperscript{59}. There are some theories proposing mechanisms to determine such optimal level; however, they are not the main focus of this thesis.

\subsection*{2.2.2 Regulation in the USA and the UK}

Both the USA and the UK apply the Anglo American corporate governance system: market controlled or market oriented. They also have in common the widespread ownership of their major public held firms.

However, as we will describe in this section, the USA and the UK have a different regulation when it comes to hostile takeovers. The USA has been considered as a manager oriented system, with regulation against hostile takeovers in most of its States. Conversely, the UK has established a shareholders protection regime, in which defensive measure against hostile takeovers are not allowed, without consent of the target shareholders.

\textsuperscript{57} Machlin, Judith C. / Choe, Hyuk / Miles, James A. loc cit. p. 862  
\textsuperscript{58} Shleifer, Andrei / Vishny, Robert (a). op cit. p. 11.  
\textsuperscript{59} Machlin, Judith C. / Choe, Hyuk / Miles, James A. op cit. p. 872
For Armour and others, the difference in models is attributed to the influence of institutional investors in business law and corporate governance regulation in both jurisdictions. Institutional investors, in their shareholders role and representing shareholders’ interest as a class, have significantly influenced the British corporate governance system since the latter part of the 20th century. On the contrary, in the USA, institutional investors have gotten involved in corporate governance much more recently and, for different reasons, they have much limited possibility of influence takeover laws.  

We will briefly describe the regulation of hostile takeover defenses in both the UK and the USA.

(a) United States of America

In the USA, the Williams Act of 1968 is the most important source of federal regulation with regards to tender offers. Hostile takeovers rules, however, are not a matter of federal law; no significant regulation in connection with takeover defenses can be found in the Williams Act. On the contrary, hostile takeover regulation in the USA is in the hands of each State, and in many of them, even in the hands of its respective courts.

As of today, the majority of states in the USA is against hostile takeovers and has strict regulation discouraging them. Armor and Skeel have written, “Nearly every state has enacted antitakeover legislation that is designed to slow down unwanted takeovers. These laws use a wide variety of techniques to make it easier for managers to resist takeovers, ranging from provisions authorizing managers to take non-shareholder interest into account when they decide whether to resist a bid, to fair-price provisions limiting a bidder’s flexibility to effect a subsequent combination after acquiring control, and control share provisions that strip the bidder of voting rights unless the remaining shareholders approve.”

In such scenario, however, Delaware appears to be the most flexible state on hostile takeovers regulation. Delaware courts have issued several resolutions ruling management behavior when facing a hostile takeover as well as the application of defensive measures. Since

61 Armour, John / Skeel, David A. Jr. op cit. p. 1735
Delaware is the state where more than 60% of the most important publicly held companies are incorporated, we will focus our analysis of American hostile takeover regulation on the Delaware rules.

The USA regulates the Principal-Agent problem of shareholders and managers through the so-called “Business Judgment Rule”. The business judgment rule, including the standards by which the conduct of a board of directors is judged, entails a presumption that in making a business decision, the directors act on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company. Under such rule, it is understood that the board’s decisions may not be perfect, but as long as they do not represent a breach of its fiduciary duties, its decisions should be respected. Thus, except in certain cases, board of directors’ decisions cannot be substitute by the Court.

One of the cases in which the Courts can review the board’s decisions can be when companies face a hostile takeover. In those cases, there is a high probability of conflict of interests between management and shareholders. It is likely that the target board of directors acts in order to protect its own interests (i.e. avoid being removed from their positions) instead of the company and shareholders’ interests. Consequently, when companies are facing a hostile takeover, the Courts have the right to perform a deeper review of the target board’s behavior, using the Unocal standard, the Revlon standard and/or the Blasius standard as applicable62.

As described by Armour and others, “the Unocal standard applies in cases where the board adopts a defense intended to preserve the company’s independence. The Revlon standard governs where the board decides, in response to a hostile bid, to sell the company or commit it to a change of control transaction. And finally, the Blasius standard controls where the board engages in defensive conduct that intentionally interferes with the shareholders’ voting franchise, in particular, their right to elect a different board”63.

The Unocal standard (also called Unocal test) was defined in the case of Unocal Corp. v. Mesa Petroleum Co. and requires the target board’s behavior to be reasonable when approving defenses against hostile takeovers. Under the Unocal test, to be entitled to the

62 Armour, John / Jacobs, Jack B. / Milhaupt, Curtis J. op cit. 244
63 Idem. p. 245
business judgment standard of judicial review, directors must show that the decisions and measures adopted against unsolicited offers: (a) were passed because such offers represented a threat to the target’s corporate policy and effectiveness, and (b) were reasonable and proportional in relation to the threat. With regards to requisite (a), directors must prove that they performed a reasonable investigation and were well informed about the offer, and that they acted in good faith. In connection with requisite (b), it has been established that draconian and coercive measures will not meet the reasonableness standard.\footnote{Unocal v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)}

On the other hand, in the case of Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., the Delaware Supreme court established that in certain cases, it is the board of directors’ responsibility to get the highest value reasonably available for the shareholders. The so-called “Revlon duty” of the target board is triggered, without excluding other possibilities, when: (i) a corporation has initiated an active bidding process seeking to sell itself or to effect a business reorganization involving a clear company breakup, (ii) in response to a bidder’s offer, a target abandons its long-term strategy and seeks an alternative transaction involving the company breakup, and (iii) the corporation undertakes a transaction, which will cause a change in corporate control.\footnote{Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986)} As pointed out by Armour and others, when Revlon duty is triggered, “the court must review the reasonableness of the board’s choice of transaction (and transaction partner), as to both process and price, with the board having the burden to prove that its decision was reasonable in both respects.”\footnote{Armour, John / Jacobs, Jack B. / Milhaupt, Curtis J. p. 246}

Finally, in the case of Blasius Industries, Inc. v. Atlas Corp, Delaware courts stated that any board’s defensive actions that intentionally interfere with shareholders right to elect its members, among other decisions, should be declared invalid unless compelling justification is proved by the board.\footnote{Blasius Industries, Inc. v. Atlas Corp. 564 A.2d 651 (Del.Ch. 1988)}

In summary, despite some limitations applicable in certain specific cases, boards of directors play a significant role when it comes to hostile takeovers involving Delaware companies. In most of the cases, provided that directors’ behavior meets the reasonableness standard, and no breach of their fiduciary duties can be proved, board of directors are allowed to interpose...
defensive measures against unsolicited offers and to choose the right bidder partner for the target company. As pointed out by Matteo Tonello, “it is underscore that in Delaware, directors are tasked with managing the affairs of a corporation –even in the realm of takeover defense- and directors can exercise their “managerial discretion, so long as they are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact finding and enhanced scrutiny of their defensive actions).”68

However, as pointed out by Armour and others, in recent years the increasing influence of institutional investors in the USA, both as litigants and as activist shareholders, is turning the model into a one more favorable for shareholders’ interest69.

(b) United Kingdom

In the UK, regulation on hostile takeovers is much simpler and more straightforward than in the USA. The main rules applicable to board’s behavior before unsolicited offers are established in the British Companies Act -as modified by the Directive 2004/25/EC of the European Parliament and of the Council70- and in the Takeover Code. Moreover, controversies regarding the target management or bidder’s behavior are solved by the Takeover Panel, instead of civil courts.

As a general rule, “under the British system, the company belongs to its shareholders and they should determine the outcome of a takeover bid”71. Such premise has been translated in the principle that the British target company’s board of directors must act in the interests of the target as a whole and must not deny the holders of securities the opportunity to decide on the merits of a bid (General Principle 3, the Takeover Code).

In the same regard, the Companies Act 2006 establish that: “Directors are under the general duty always to act in the way they consider, in good faith, would be most likely to promote the

69 Armour, John / Jacobs, Jack B. / Milhaupt, Curtis J. op cit. p. 267
70 Directive 2004/25/EC of the European Parliament and of the Council on takeover bids –applicable to all the European Union countries-, establishes that the board of the target company shall obtain the prior authorisation of the shareholders meeting before taking any action, other than seeking alternative bids, which may result in the frustration of the bid. However, such rule is an opt out provision, so that Members States are allowed not to require companies in their territories to apply it.
success of the company for the benefit of its members as a whole, and to act within their powers as directors for the purposes for which they are conferred (sections 171 and 172, 2006 Act)\textsuperscript{72}.

With regards to hostile takeovers, this General Principle is reflected on the rule that, when facing an unsolicited offer, the target board cannot pass any defensive measure without the consent of the shareholder meeting. According to the Rule 21.1 of the Takeover Code, during the course of an offer, or even before the date of the offer, if the target board has reasons to believe that a bona fide offer might be imminent, it must not take any action which may result in such offer or possible offer being frustrated, or in shareholders being denied the opportunity to decide on its merits, without the approval of the shareholders meeting.

After this general restriction, the Takeover Code details the defensive measures or transactions that, in such cases, cannot be adopted by the Board (including indirect reference to poison pills, sale of jewel crowns, etc.). As established by the same Rule 21.1, there are only two exceptions to such “board neutrality rule”. First, the proposed board action is in pursuance of a contract entered into earlier or another pre-existing obligation. Second, a decision to take the proposed action had been passed before the beginning of the period above referred which: (a) has been partly or fully implemented before the beginning of that period, or (b) has not been partly or fully implemented before the beginning of that period but is in the ordinary course of business. In those cases, the consent of the Takeover Panel must be obtained.

It is clear that under British laws, board of directors are more restricted in their powers when facing hostile bids. They are neither allowed to reject nor to thwart any bid that they may consider inadequate. Directors cannot impose any typical defense measure that may not be acceptable for the company’s shareholders. Instead, if they want to dissuade shareholders from accepting any specific bid, directors shall return to more basic methods also promoted by corporate governance. Such methods include good communication with shareholders and complete information disclosure to shareholders about the company’s situation and its real value. In that respect, Fairfiel and Askarpour have pointed out that “One of the most commonly used tactics in a hostile bid situation is simply a board’s communications to its shareholders.”

\textsuperscript{72} Fairfiel, Gillian / Askarpour, Shazi. Op cit. p. 5
shareholders. Throughout the bid defense, the target board will use the defense documents it publishes to persuade shareholders that the unsolicited offer should be firmly rejected, that the offer substantially undervalues the target, that the target’s long term prospects are good and that the target board is unwavering in its intention for the target to remain independent”.\textsuperscript{73} Other acceptable methods may be lobbying shareholders or administrative authorities against hostile bids or to recommend shareholders other bids\textsuperscript{74}.

For Fairfiel and Askarpour, the restriction in directors’ powers before hostile bids has been based on the British investors’ preference to maintain shares liquidity rather than keeping the possibility of defending the company from hostile offers\textsuperscript{75}. Some experts consider this model much democratic for shareholders (\textit{bis a bis} American model). However, as cited by the New York Times, professor Jeffrey A. Sonnenfeld, from the Yale School of Management considers that “\textit{the push for shareholder democracy may create a perverse incentive system so that short-term shareholders can end up determining the long-term fate of the company.}”\textsuperscript{76}

The case of Kraft hostile bid for the British company Cadbury on the 2010 (later described in section 2.3.2) raised the point about of who should decide the future of the company.

Kraft - Cadbury case arose many questions about the convenience of takeover defenses and hostile bids. Indeed, it generated some changes in the Code by the Takeover Panel imposing higher standards in the preparation of information that should be disclosed by bidders in the context of takeovers. However, the Panel discarded to amend the fundamental principle of shareholders deciding about the outcome of takeovers, which would have eliminated or reduced the risk of short-term investors or arbitrageurs deciding the company’s future.\textsuperscript{77}

Nevertheless, Kraft takeover of Cadbury gave rise to the so-called Cadbury law proposed by the UK Labor Party. Among others, such law aimed to protect certain kinds of British companies against hostile takeovers, especially by foreign investors. Cadbury law proposed to require a super majority of votes in the Shareholder Meeting (at least 60%) to pass a

\textsuperscript{73} Idem. p. 4
\textsuperscript{74} Ibidem.
\textsuperscript{75} Ibidem.
\textsuperscript{76} Davidoff, Steven. Loc cit
\textsuperscript{77} Armour, John / Jacobs, Jack B. / Milhaupt, Curtis J. op cit. p. 238
company takeover. Furthermore, such super majority should be composed by votes of long-term shareholders. Among other arguments, Cadbury law detractors alleged management entrenchment when hostile takeovers are not allowed or are difficult to succeed\textsuperscript{78}. In the end, Cadbury law did not succeed.

2.3 Examples of Relevant Hostile Takeovers

2.3.1 Airgas-Air Products\textsuperscript{79}

Airgas vs. Air Products may be considered a case that evidences the benefits and advantages of the Delaware takeover model.

This case showed us that, when rejecting an unsolicited offer, target management is not always seeking for entrenchment into its positions or is only thinking about its own interests. This story began with the perception of a target board “just saying no” to a non-coercive, all cash, fully financed offer, with no justified reason. However, the case outcome proved instead that such board was fighting in good faith, having performed reasonable investigation and with strong specialized support, against an offer that did threaten the target long-term values and corporate policy.

Moreover, Airgas vs. Air Product case is a clear example of the positive effects for the target company of the defensive measures that we have described. In this hostile bid, the rejection of Airgas board to Air Products offers, including Airgas defensive measures, not only impede that Airgas was sold below its real intrinsic value, but also helped Airgas to reflect such real value in its trading share price.

Prior to the commencing of the Airgas-Air Products battle, which lasted more than 16 months, Airgas had already adopted several antitakeover defenses; the most relevant being a poison pill, a classified board, and a supermajority requirement to approve mergers.

This story began in October 15, 2009 when Air Products CEO informally met with Airgas CEO and founder, to propose a potential merger of both companies. Air Products was willing

\textsuperscript{78} Fairfiel, Gillian / Askarpour, Shazi. Op cit.

\textsuperscript{79} The description of this case is based on the Delaware Chancery Court Resolution in No. 5249-CC dated February 15, 2011 in the case of Air Products and Chemicals Inc. v. Airgas, Inc.
to pay US$ 60 per Airgas share, in stocks of Air Products, although Airgas shares were trading at that point at around US$ 42 each. Airgas board met at the beginning of November for strategic planning retreat and, after reviewing Airgas five-year strategic plan as well as the analysis on the future stock price of the company prepared by the management, it concluded that Air Products first offer was too far from the fair value of the company. This decision was informed to Air Products CEO.

The offer was resent to the Airgas board in writing for a formal response by the end of November 2009. In December, Airgas board informed Air Products that it still considered Air Products offer not attractive. In mid December, Air Products improved its offer for Airgas shares to US$ 62 per share, offering to pay half of such price in cash. It also expressed its intention to meet and negotiate with Airgas board, in order to review any incremental value for Airgas shares that such board may have in mind. After a couple of meetings and Air Products review of the financial analysis offer prepared by Airgas investment bankers, Airgas board informed Air Products that it was not interested in the offer. Airgas board concluded that the real value of the company was at least US$ 78 per share, so with such low offer, there was no reason to meet with Air Products principals.

At the beginning of February 2010, when the Airgas share price was closing at more than US$ 43.50 in the NYSE, Air Products decided to take its offer to the company shareholders. So it send a public letter to Airgas board announcing its intention to acquire all Airgas shares for US$ 60, paying the whole price in cash. In addition, Air Products insisted on its willingness to review such price in order to reflect any additional value of the company that Airgas board may accredit. A day after the announcement, Airgas share was trading at more than US$ 62.50. Airgas board met to discuss this revised offer and, after their advisors analysis it was considered inadequate, and Airgas board ended up rejecting Air Products revised offer once again.

Nonetheless, on February 11, 2010, Air Products launched its full cash tender offer for Airgas shares at US$ 60 in cash per share. The offer was subject to several conditions, including the tendering of the majority of Airgas shares into the offer, the redemption of Airgas poison pill (or the declaration of such pill not being applicable to Air Products), and the approval of the deal by Airgas board. In addition, some days prior to the launching of it tender offer, Air
Products filed a complain before the Delaware Chancery Court against Airgas and its directors seeking to remove, or deem Airgas poison pill inapplicable.

At the end of February 2010, after new reviews of Airgas financial advisor presentation about Air Products revised offer, Airgas board decided to publicly recommend its shareholders not tender its shares since Air Products’ offer was opportunistic and “grossly undervalues Airgas”.

On March 2010, Air Products started a proxy fight against Airgas board looking towards Airgas annual shareholder meeting to be held in September. First, Air Products nominated three independent directors for the Airgas board. Second, Air Products proposed an amendment to Airgas bylaws to require Airgas to hold its 2011 and each subsequent annual meetings in January (instead of September). In the 2011 annual meeting another three members of the board of directors would be appointed. By means of these proposals, Air Products sought to gain control of Airgas board of directors in a shorter period so that it could redeem, or obtain an exception, from the Airgas poison pill.

Airgas improved its offer for Airgas shares in July and September 2010 offering US$ 63.50 and US$ 65.50, in cash per share, respectively. Both revised offers were rejected by Airgas board, which considered them too low. In both cases, Airgas board met to discuss, together with its financial and legal advisors, the convenience of Air Products offers. In addition, during the bidding process, Airgas disclosed the company’s situation, projections and earnings to its shareholders.

At the Airgas annual shareholder meeting, Air Products obtained the appointment of its nominees as directors of Airgas, as well as the amendment to the date of its annual shareholder meeting. Nevertheless, almost two months later, Delaware Supreme court declared such amendment as invalid since it prematurely terminated the term of three incumbent Airgas directors by eight months.

At the beginning of December 2010, with its nominees acting as independent directors of Airgas, Air Products raised its tender offer price to US$ 70 per share as the “best and final offer”. One week later, at the request of Air Products nominees, Airgas board hired a third financial advisor for the independent directors in order to issue an opinion regarding such
offer. By that point, after the new director’s orientation sessions, even Air Products nominees were convinced of the following: Airgas accurate position regarding the company real value, and of Air Products’ undervalued offers. Therefore, after a new thoughtful evaluation of the Air Products revised offer, Airgas board unanimously decided to reject it.

On February 15, 2011, Air Products allowed its tender offer to expire. After such date and several months later, Airgas share was traded at more than US$ 63.30 per share.

During the analysis of Air Products complaint regarding Airgas board behavior and responses towards its offers, and Airgas poison pill, the Chancellery Court found that Airgas board acted in good faith, always complied with its fiduciary duties and met the above-described Unocal test.

2.3.2 Kraft-Cadbury

Kraft acquisition of Cadbury has been one of the most important cross border transactions involving the UK and the USA. The relevance of such transaction is related not only to the nature of the players involved, one American giant and one 180-years-old British icon, but also to the transaction outcome that evidenced the alleged weaknesses of the British takeover system.

On 7 September 2009, Kraft disclosed that it was considering making an offer for Cadbury at pounds 10.5 billions (around 7.55 pounds per share). However, the formal bid was announced in November 2009 after the deadline for an official announcement (“put up or shut up”) established by the Takeover Panel. Cadbury’s board announced its opposition to Kraft’s offer since they considered it too low. According to the board, the real value of Cadbury shares was at least 10 pounds.

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80 Blackaby, Anna, ANNA. “One year on - 'Cadbury Law' could still save other UK firms”. January 2011. Available at: http://www.thefreelibrary.com/One+year+on++'Cadbury+Law'+could+still+save+other+UK+firms.-a0246999181

In early November, Kraft announced a “derisory” bid for 9.8 billion pounds alleging that Cadbury share price had fallen since August. Cadbury board also rejected such offer.\textsuperscript{82}

During December of the same year, Cadbury implemented its official defense against Kraft hostile bid by offering Cadbury’s shareholders attractive dividends. In addition, at the beginning of January 2010, Cadbury’s management started looking for a “white knight”, holding meetings with Hershey and other chocolate market players regarding a potential deal, which could impede Kraft takeover.\textsuperscript{83}

One of the major criticisms to the Kraft acquisition of Cadbury was the high probability of job losses in Cadbury after the transaction was completed. However, Kraft’s response to this concern was always that they would seek to increase jobs for the British market.\textsuperscript{84} In fact, during the bidding process, Kraft held meetings with Cadbury management about the closure plan of the Cadbury Sommerdale chocolates facility (located in Bristol, UK) already approved by Cadbury’s management. Kraft stated in the offer announcements, documents and revised documents that, if successful in its bid, it would not continue with such closure plan. Kraft announced that it would keep the Sommerdale plant running so no jobs would be lost.\textsuperscript{85}

Finally, in mid January 2010, the board of Cadbury ended up approving a friendly sale of the company to Kraft, agreeing with the revised price of 11.9 billion pounds (8.40 pounds per share) and recommending Cadbury’s shareholders to tender their shares. The acquisition was completed early in the 2010.\textsuperscript{86}

Nevertheless, some weeks after acquiring Cadbury, Kraft announced that the plans to close the Sommerdale facility were well advanced, and the impact of reversing them would be too high for the company. Therefore, Kraft would still close the Sommerdale facilities and would move Cadbury manufacturing activities to Poland. Further announcements of job cuts in

\textsuperscript{82} Blackaby, Anna. Op cit.
\textsuperscript{83} Ibidem
\textsuperscript{84} Patrone Michael R. “Sour Chocolate: The U.K. Takeover Panel’s Improper Reaction to Kraft’s Acquisition of Cadbury”. In: International Law & Management Review 2011, Vol. 64. p. 64
\textsuperscript{86} Patrone Michael R. loc cit.
Cadbury came in the following months\textsuperscript{87}. Those announcements bothered local workforce and unions generating a sense of nationalism.

After Kraft’s announcement of the Sommerdale facilities closure, the Takeover Panel began an investigation process against Kraft. In the end, evidencing its limited powers, the Takeover only criticized Kraft for breaching Rule 19.1 of the Takeover Code (regarding the standards of announcements and statements made by bidders during the course of offers)\textsuperscript{88}. In addition, as a consequence of such case, some minor amendments were made to the Takeover Code and the Cadbury law was proposed (for further detail, see Section 2.3.2 of this Chapter).

It has been said that in the Kraft-Cadbury transaction, the decision to sell the company was made by short-term shareholders and arbitrageurs ignoring Cadbury’ board claims about the undervaluation of the company by Kraft offers\textsuperscript{89}. Therefore, although the Cadbury law did not succeed, many players have challenged the British takeover system after the Kraft-Cadbury transaction; aiming for more protection to companies from shareholders short-termism and hostile takeovers.

\textsuperscript{87} Idem. p. 65.
\textsuperscript{88} The Takeover Panel. Op cit.
\textsuperscript{89} Patrone Michael R. op cit. p. 65
CHAPTER 3 - HOSTILE TAKEOVERS INFLUENCE IN CORPORATE GOVERNANCE

3.1 General Comments

Since the second part of the 20th century, when the first cases of hostile takeovers appeared in the UK and the USA, there has been a lot of discussion regarding their real effects for target companies’ corporate governance.

As mentioned in the previous chapter, most of the American States do not like unsolicited bids and they have enacted several antitakeover regulation. On the other hand, in the UK, where they were always friendly to hostile bids, Kraft takeover of Cadbury raised many critics against them. In fact, some British stakeholders required UK system to prohibit hostile takeovers.

At this point, there is almost consensus about the high premium that hostile bids offer to shareholders, despite the discussion about where such premium comes from90. However, the question remains whether hostile takeovers help to reduce agency costs for shareholders or to increase Principal-Agent problems between shareholders and managers.

In such context, and to answer that question, we will describe the main positive and negative effects for corporate governance attributed to unsolicited offers.

3.2 Positive Effects

3.2.1 Remove Managerial Inefficiency

In principle, managerial inefficiency should be corrected by the internal control systems of corporations. Companies have the board of directors, which should supervise company management and its performance. Shareholders meetings may monitor directors and managers as well. Moreover, investors can implement compensation-linked to performance

90 For some authors, premiums paid to target’s shareholders in the framework of successful hostile takeovers do not represent social gain or an “increase in the cake”. On the contrary, such premium often comes from layoff of employees, reduction of company useful expenses, etc. Moreover, hostile bidders may extract such premium – post acquisition- from company contracts with other stakeholders like creditors or suppliers. For further detail please review: Shleifer, Andrei / Lawrence, H. Summers. “Breach of Trust in Hostile Takeovers”. In: National Bureau of Economic Research 1988, Working Paper 2342.
systems, or external auditing of managers activities. But what happens when none of such mechanisms work appropriately and the costs for shareholders of controlling incompetent and dishonest management outweigh the returns of their participation in the company? In such cases, it is said, hostile takeovers represent a mechanism to eliminate such agency costs and correct inefficiencies via the replacement of the entire control system\textsuperscript{91}.

According to Manne’s opportunity value theory, the inefficiency of the company’s managers will typically be reflected in the low price of company’s shares (\textit{bis a bis} the price of other company’s shares of the same industry or the market as a whole). In such context, other players in the market will be attracted by the capital gain represented by the difference between such low price and that of a share under better management\textsuperscript{92}. Therefore, competing managers, which are able to identify such inefficiencies and the potential capital gains, will approach target shareholders generally via a takeover attempt. Such takeover offer will represent higher value alternatives, both for target and bidders shareholders\textsuperscript{93}.

The preceding paragraph confirms Manne’s proposition about the existence of an active market for corporate control. In such market, the control of underperforming companies becomes a valuable asset for investors able to correct inefficiencies of the targets\textsuperscript{94}. Indeed, within such market, multiple teams of managers will compete and pay for the chance to manage underperforming companies and obtain the capital gains that the sole improvement of management performance will bring to them\textsuperscript{95}. Generally, bidders who pay the higher premium or offer better performance will gain such chance.

The market for corporate control mechanism will act through hostile bids -and not friendly or negotiated mergers-, since the managers from the underperforming target will likely reject any offer, which sole purpose may be to replace them. Consequently, competing management teams will have to present their offers and negotiate directly to target shareholders.

\textsuperscript{91} Jensen, Michael C. / R. Ruback. op cit. p. 44
\textsuperscript{93} Jensen, Michael C. / R. Ruback. loc cit.
\textsuperscript{94} Manne, Henry, “Mergers and the Market for Corporate Control”. In: Journal of Political Economy 1965, Vol. 75. p. 112
\textsuperscript{95} Jensen, Michael (b). “Takeovers: Their Causes and Consequences”. In: The Journal of Economic Perspectives 1988, Vol. 2. p. 27
Unsatisfied shareholders of underperforming companies with lazy or incompetent managers will find protection from them in the market for corporate control. Hostile takeovers would represent for them a useful mechanism to either liquidate their investment in such targets with a high premium, or to transfer control to competing teams. Such teams will typically be able to correct target inefficiencies via reorganizations, cost savings, among others, and increase the value of the company.

Therefore, the transfer of control of a company with an inefficient management to a bidder with a better management will represent a “win-win” situation for both parties. On one side, target shareholders will realize the profit of their underperforming investment or will enjoy the increase of their shares value with the new management. According to Jensen, there is scientific evidence, which proves that takeovers almost always represent an increase in target’s shareholders wealth. On the other side, bidder shareholders will obtain the benefits resulting from the reduction in target’s agency costs and from the improvement of target performance\textsuperscript{96}.

Besides according to Scharfstein, takeover mechanism is not only an efficient weapon but also a fair one to correct management inefficiency. Takeovers only penalize management when the company’s value is poor because of management underperformance. Takeovers do not penalize management when the value of the firm is low because of the unfavorable environment surrounding the target\textsuperscript{97}. On that regard, Scharfstein pointed out that: “If firm value is low because the manager shirked, the probability of a takeover is high; shareholders tender their shares at a low price because they perceive the value of the firm to be low, while the raider knows that the value of the firm (if run properly) is high. In contrast, if firm value is low simply because the environment is unfavourable, the probability of a takeover is low; shareholders still tender their shares at a low price, but the raider does not value the firm as highly. (...) Takeovers are beneficial because they make compensation depend not just on managerial performance, but also on the privately observed state of the world.”\textsuperscript{98}

\textsuperscript{96} Jense, Michael (b). loc cit.
\textsuperscript{98} Idem. p. 186
In this context, and in accordance with Manne’s neoclassical theory, takeovers should be considered as a mechanism that increases shareholders’ wealth via appropriate management work.  

3.2.2 Improve Target’s Performance

In the previous section, we have presented hostile takeovers as a mechanism to remove inefficient management. However, the target’s managers do not want to be removed from their positions and lose their compensation; so they will try to avoid the target being acquired by an unsolicited bidder. In such context, as pointed out by Bandow, the best way for managers to defeat a hostile bid will be to improve target’s performance and obtain the increase in its share value. Therefore, in these cases, the threat of a hostile takeover—and of the subsequent dismissal of the target’s management—can also act as a mechanism that encourages management to align its interest with that of the shareholders.

Hostile takeovers should then be considered as a “wake up call” for inefficient managers to analyze firm strategies and change what they are not doing correctly. Sayan and others analyzed hostile bids effects in a final sample of 76 firms that remained independent after takeover attempts between 1981 and 1991. They found that, after such attempts, the majority of them adjusted their strategy in order to make the company more profitable and therefore, avoid a new hostile takeover attempt. Consequently, in their opinion, “a takeover attempt can serve to reduce agency costs by exposing suboptimal diversification (or suboptimal financing), which provides motivation to management and the board to adjust the strategy in order to prevent further takeover attempts and reduce employment risk.”

It is worth noting that, according to Sayan and others reports, firms with higher percentages of non-independent managers were more willing to make those changes than firms with boards controlled by independent directors.

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102 Idem. p. 92-94
103 Idem. p. 94
104 Ibidem.
Denis and others also studied the diversification tendency of companies that had been target of hostile bids or others disciplinary events. As they explained, diversification generally benefits managers. Among others, diversification gives them high compensations and prestige related to the managing of a big company. So managers will tend to keep a diversification strategy, although it also affects shareholders wealth. 105

On that regard, Denis and others’ results reported that 19% of companies that were target of a takeover attempt decreases in diversification the year after such attempt. Furthermore, 80% of such attempts were hostile bids. 106

Other similar studies have been made with regards to leverage ratios. As stated by Grossman and Hart, increase in leverage ratios in companies that remained independent after takeovers attempt may be interpreted as a commitment of the target management to make improvements in the company. 107 Such improvements may include the changes and measures that the hostile bidder may have implemented in the target to increase its value after the takeover.

From a sample of 328 companies that were target of failed takeover attempts during 1982 and 1991, Safieddine and others found that more than 60% increased their leverage ratios after the takeover attempt. The increase in leverage (debt–book value ratio) was in almost 12% from the year previous to the hostile bid, to the year following the bid. Furthermore, Safieddine and others found that the improvement in operating performance and cash flow of the companies in such sample was positively related to increases in companies’ leverage ratios. 108

Hence, takeover attempts appear as the perfect medicine for inefficient management to reflect on its former behavior and start maximizing shareholder value. Cuts in unprofitable investments, reduction of costs, and sale of underperforming assets, among other measures, can lead to company improvement in performance and help them to keep away hostile bidders. As stated by Bandow “(…), hostile takeovers would be relatively insignificant if

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106 Idem. p. 153
business managers did their job right.” So, according to Forbes magazine, the best way for most executives in the USA to keep their jobs will be: “to make a company so efficient, so profitable that a raider simply cannot afford to pounce.”

3.2.3 Distribution of Cash Flow

According to the free cash flow theory, free cash flow is the cash flow that the company keeps in excess of the funds that it actually needs to invest in projects that generates positive results. Thus, in order to make the company efficient and increase shareholders wealth, the free cash flow should be distributed to shareholders via any of the payout mechanisms. However, as previously mentioned, Principal-Agent problem may cause management to retain such cash flow to cover management perquisites and/or to avoid losing power when asking capital markets for further funds for new projects.

In retaining free cash flow, managers are also lead by their empire building wishes. They will invest such cash in projects that, even though may not have positives NPV, can make the company grow in size. Company’s growth will increase managers’ power and reputation and in some cases may also increase their compensations. Harford’s found that firms with significant amounts of cash are more willing to attempt acquisitions, normally overpaying for the target shares. Overall, bad post acquisition performance evidences the high agency cost of such empire-building tendency.

Therefore, management cash retention inclination may cause shareholders not to receive the return of their investments, even when the company is performing well. Even worse, cash retention may cause management to lead the company to inefficient investments that will affect its results in the medium or long term.

In such context, the threat of a hostile takeover, or the launching of such hostile offer itself, acts again as a disciplinary mechanism for inefficient or ambitious managers. When facing the threat of an unsolicited bid, target management will look for shareholders satisfaction.

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109 BANDOW, Doug. Op cit. p 48
110 Ibidem.
111 Jensen, Michael (b). p. 28
113 Dittmar, Amy / Mahrt-Smith, Jan / Servaes, Henri. Op cit. p. 112
regarding their investment results as well as its managers’ performance. Therefore, target management will tend to distribute shareholders from time to time the free cash flow of the company, and to use its money only for positive NPV projects. Furthermore, in many cases, management of target companies tried to dissuade shareholders from tendering their shares into the hostile bidder offer by offering them increases in the distribution of profits.

In addition, Oliver Hart pointed out that, after a hostile bid announcement, target managers that used free cash flow to build unprofitable empires, may also sell parts of such empire in order to reduce target’s agency costs and distribute shareholders such free cash flow\(^{114}\).

Finally, takeovers may also help to eliminate agency costs even when managers are not willing to distribute free cash flow or correct negative NPV investments voluntarily. In cases when are successful, takeovers may allow target shareholders to realize the profits of their investment in the company that otherwise were retained by the incumbent target management. That means that, via the sale of shares to the hostile bidder, target shareholders may receive, as a part of the purchase price for their shares, the excess cash that should have been distributed as dividends or repurchase of their shares.

Hence, hostile takeovers should be seen a good weapon against free cash flow retention and the agency costs associated with management’s empire building inclinations. Target shareholders may find in hostile takeovers a way to obtain the distribution of target profits or the efficient company resources investment.

3.2.4 Improvements in Information and Reporting

Prior, we mentioned that hostile takeovers attempt may represent a wake up call for inefficient managers to improve company’s performance if they do not want to lose their positions. However, the threat of a hostile bid not only may lead to improvements in management performance but also can help to improve the relationship between shareholders and management.

As described in Chapter 1, there is a significant information asymmetry between shareholder, who bear the risk of company performance, and management who has been provided with the

\(^{114}\) Hart, Oliver. Op cit. p. 685.
powers to control the company business activities. This information asymmetry may sometimes generate conflicts between them, since shareholders do not know what exactly managers are doing with company’s funds. Shareholders also generally do not know about the firm’s prospects, its projects or its real value. Therefore, such conflicts and the lack of shareholders’ information can lead them to overvalue a hostile offer, and sale their shares at a very low price.

A good way to keep away the threat of hostile bids, or even to defend the company’s interests in the framework of a hostile takeover attempt, may be to reduce the information asymmetry between managers and shareholders. Managers could increase the information and reporting provided to them about the company results, its projects and prospects. In such way, shareholders will be more aware about the real value of their investments.

For Gilchrist and others, managers should maintain good communication with market players. The credibility that they can maintain before investors, analysts and other market players could make a difference when dealing with an unsolicited bid. Indeed, “Investor relations teams, in particular, can help corporate leaders identify key shareholder allies and nurture those relationships, for example, by regularly informing them (...) on new business decisions affecting strategy and long-term shareholder value as well as the financial metrics and valuations on which those decisions were based”.115

Both information and reporting become an important weapon to fight against unsolicited bids, particularly in systems where antitakeover defenses are not allowed. In such cases, managers will not be able to use poison pills or to sell the “crown jewels” without the consent of target shareholders (such as in the UK). Therefore, the only way to persuade target shareholders about the under value of the offer, or the threat that it represents for the company long-term plans, will be to disclose to the shareholders all the information available regarding the target real value (including earnings, sales and growth) and its prospects.

3.3  Negative Effects

3.3.1  Accentuation of Principal-Agent Problems

Notwithstanding the positive effects of hostile takeovers attempts in target companies, detractors of such mechanism consider that hostile bids can accentuate Principal-Agent problems and may increase target agency costs. For such detractors, unsolicited bids lead management to act in their best interest and not in the best interest of the company.

It is alleged that hostile takeovers, and the subsequent takeover defenses may destroy target business, force managers to involve the company in inefficient projects and distract the target resources in activities or transactions that are not part of their business.

For Shleifer and others, the threat of hostile bids may lead managers to involve the target in the so-called Manager Specific Investments. According to such theory, in order to keep their positions, managers will try to make themselves more valuable to the company so shareholders will not want to, or will not be able to remove them. Thus, managers will have an incentive to invest more of the target resources in businesses where they are considered as great performers even when such business may not have a positive NPV overall. In addition, if they perceive that their counterparts outperform them in the target main business, they will tend to diversify target activities to businesses where they may be considered experts. Such diversification will normally not bring positive results for the target. Furthermore, managers will try to sign contracts that bind them more to the company, either through their covenants, or because they are implicit and only they can completely interpret or execute them.\(^\text{116}\) The consequences of the hostile takeovers in these cases will have more an entrenchment effect rather than reducing the agency costs.

On the other hand, managers may respond to unsolicited offers with announcements of restructuring plans in the target. Such plans generally involve assets and capital structure changes, and frequently seek to create antitrust issues in the target acquisition. Dann and others studied a sample of 19% of the listed companies involved in hostile takeovers attempts between 1962 and 1983, and 36% of targets of such attempts during 1980 and 1983. On

average, they found that target shareholders’ wealth decline in 2% to 3% after the restructuring plans were announced. This decline was likely because the restructuring plans represent an entrenchment maneuver of the management and, thus, an inferior company policy choice. Moreover, Dann and others found that unsolicited bids are unlikely to succeed when target management implemented such plans.\(^{117}\)

In some cases, the threat of a hostile takeover attempt may also even lead management to cut ongoing investments projects or to sell the target’s main assets or business lines (“selling of crown jewels” defensive measures). These tactics, which may be seen by some authors as the elimination of inefficiencies, are often criticized for hostile takeovers detractors since they could destroy target business or frustrate good projects that were the source of significant income for the company.\(^{118}\)

Finally, hostile bids may generate agency costs for the target by distracting its management and resources. When facing a hostile takeover attempts, managers (officers and directors) are forced to spend long time evaluating the offer convenience as well as the mechanisms they can use to defeat it. Moreover, in responding to such attempts, targets typically spend significant amounts of money, paying to well-known and sophisticated lawyers and financial advisors. However, the time and money spent in discussing and responding to the hostile offer may be worth used in target business and growth.

In summary, hostile takeovers become very dangerous for target companies whenever their management is willing to do anything to keep their jobs. In those cases, hostile takeovers not only generate high agency costs for the target but also may end up destroying its business.

### 3.3.2 Incentivize Short-Termism

Another fear about hostile takeovers is that they can discourage target managers to invest in long-term projects although they may be positive for their companies.

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Some authors have stated that security markets are “myopic” or shortsighted so they tend to prefer short-term over long-term returns\textsuperscript{119}. That means that institutional investors and other market players may overvalue short-term projects and undervalue more profitable long-term investments.

In that context, management of potential target firms may be pushed to focus more on short-term earnings, rather than in efficient long-term projects. Although profitable, long-term investments may reduce the value of target equity before the market. Meanwhile, the undervaluation of its share price not only discourages target shareholders from keeping their investment in the company but also makes the firm more attractive for hostile bidders. With such combination, the completion of the hostile takeover attempt becomes easier, and the chances of managers losing their jobs increase\textsuperscript{120}.

Consequently, market myopic may affect overall target shareholders wealth. On one side, they may see outperforming long-term projects being sacrificed for short-term investments with mediocre immediate results\textsuperscript{121}. On the other side, if managers decide to invest in long-term projects anyway and the hostile bid was made before the results of such project are known, target shareholders will end up receiving a price per share that does not reflect the company real value\textsuperscript{122}.

On the other hand, the threat that hostile takeovers represent in connection with market myopic may discourage managers to think in long-term jobs within the target and to establish long-term goals with future compensations. That also makes managers less loyal with the company and increases the risk of having non-experienced people in key positions\textsuperscript{123}.

Finally, it is said that market shortsightedness and the subsequent managers’ tendency to avoid long-term results may imply as well in the reduction in R&D investments\textsuperscript{124}.

\textsuperscript{119} Idem. P 151
\textsuperscript{123} Shleifer, Andrei / Vishny, Robert (d). loc cit.
\textsuperscript{124} Ibidem.
Nevertheless, according to Jarrel and others, results of empirical studies do not reflect short-term view of markets. For instance, and study of the SEC’s OCE of 117 takeover companies between 1981 and 1984 evidenced, among others that: “(...) (3) firms with high research and development expenditures are not more vulnerable to takeovers; and (4) stock prices respond positively to announcements of increases in research and development expenditures”\(^{125}\).

\(^{125}\) Jarrel, Gregg / Brickley James A. / Netter Jeffry. loc cit.
CONCLUSION

In this thesis, we presented a general overview of the main aspects of hostile takeovers and antitakeover defenses. The purpose of this document has been to analyze the hostile bids’ effects as a mechanism to reduce the agency costs associated with the Principal-Agent problem between shareholders and managers.

Although many corporate governance academics have highlighted the advantages of the market for corporate control mechanism, there are still some important criticism to hostile takeovers attempts and the defenses that they arise.

Unsolicited bids supporters argue that hostile takeovers should be seen as a “wake up call” for inefficient managers in order for them to refocus target strategy and not lose their jobs. If such refocus is not achieved, and management continues to be lazy and incompetent, hostile takeovers will act as a mechanism to remove them. In both cases, hostile offers will help shareholders to reduce their agency costs. Moreover, hostile bids allow shareholders to receive the target exceeding cash, otherwise retained by the management to cover perquisites or to finance empire-building tendencies.

Meanwhile, detractors allege that the threat of hostile bids, and the consequent management fear of being dismissed from the target, can lead managers to do anything to keep their jobs. Therefore, this threat, together with the market myopic, may end up encouraging management short-termism. Such shortsighted view will cause managers to discard efficient long-term projects and instead choose mediocre investments with immediate results. This tendency results may clearly affect target’s prospects and shareholders’ wealth. Furthermore, the defensive measures or actions from the target’s managers against hostile takeovers can lead them to sell the main assets or company business lines, consequently destroying the target business.

Nevertheless, recent significant takeovers attempts and the increasing sophistication of antitakeover defenses tell us that the legal regulation on such topics also plays a significant role in the overall effects of hostile takeovers. In such context, the hostile takeovers positive or negative effects may be accentuated or mitigated by: (i) the control on hostile bidders actions or on management defenses, (ii) the powers of regulators to impede or allow takeover
attempts, and (iii) the efficiency of the systems in solving controversies arose in the framework of hostile bids.

Having reviewed the main aspects of the British and American systems on hostile takeovers, we find it hard to define which one deals better with takeover attempts. Indeed, positives and negatives aspects of both systems are now under scrutiny; and in the end, it seems both models will get closer.

Overall, our conclusion is that hostile takeovers and subsequent takeovers defenses should not be banned. In principle, hostile offers allow long-term target shareholders to decide whether to sell the company or not. At the same time, antitakeover measures impede that arbitragers ambitious affect the real value of the target and/or its long-term prospects.

From a corporate governance point of view, it is quite clear that the positive effects of hostile takeovers do outweigh their negative impacts. Moreover, it seems like such alleged negative effects could be controlled or mitigated by other corporate governance mechanism such as golden parachutes, stock option plans, and the appropriate regulation.
Articles


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