

The Corporate Takeover Market

Common Takeover Tactics, Antitakeover Defenses, and Corporate Governance

Treat a person as he is, and he will remain as he is. Treat him as he could be, and he will become what he should be. —Jimmy Johnson

INSIDE M&A: KRAFT SWEETENS ITS OFFER TO OVERCOME CADBURY'S RESISTANCE

Despite speculation that offers from U.S.-based candy company Hershey and the Italian confectioner Ferrero would be forthcoming, Kraft's bid on January 19, 2010, was accepted unanimously by Cadbury's board of directors. Kraft, the world's second (after Nestlé) largest food manufacturer (after Nestlé), raised its offer over its initial September 7, 2009, bid to \$19.5 billion to win over the board of the world's second largest candy and chocolate maker. Kraft also assumed responsibility for \$9.5 billion of Cadbury's debt.

Kraft's initial bid evoked a raucous response from Cadbury's chairman Roger Carr, who derided the offer that valued Cadbury at \$16.7 billion as showing contempt for his firm's well-known brand, and dismissed the hostile bidder as a low-growth conglomerate. Immediately following the Kraft announcement, Cadbury's share price rose by 45% (7 percentage points more than the 38% premium implicit in the Kraft offer). The share prices of other food manufacturers also rose due to speculation that they could become takeover targets.

The ensuing four-month struggle between the two firms was reminiscent of the highly publicized takeover of U.S. icon Anheuser-Busch in 2008 by Belgian brewer InBev. The Kraft-Cadbury transaction stimulated substantial opposition from senior government ministers and trade unions over the move by a huge U.S. firm to take over a British company deemed to be a national treasure. However, like InBev's takeover of Anheuser-Busch, what started as a donnybrook ended on friendly terms, with the two sides reaching final agreement in a single weekend.

Determined to become a global food and candy giant, Kraft decided to bid for Cadbury after the U.K.-based firm spun off its Schweppes beverages business in the United States in 2008. The separation of Cadbury's beverage and confectionery units resulted in Cadbury

becoming the world's largest pure confectionery firm following the spinoff. Confectionery companies tend to trade at a higher value, so adding the Cadbury's chocolate and gum business could enhance Kraft's attractiveness to competitors. However, this status was soon eclipsed by Mars's acquisition of Wrigley in 2008.

A takeover of Cadbury would help Kraft, the biggest food conglomerate in North America, to compete with its larger rival, Nestle. Cadbury would strengthen Kraft's market share in Britain and would open India, where Cadbury is among the most popular chocolate brands. It would also expand Kraft's gum business and give it a global distribution network. Nestle lacked a gum business and was struggling with declining sales as recession-plagued consumers turned away from its bottled water and ice cream products. Cadbury and Kraft fared relatively well during the 2008–2009 global recession, with Cadbury's confectionery business proving resilient despite price increases in the wake of increasing sugar prices. Kraft had benefited from rising sales of convenience foods because consumers ate more meals at home during the recession.

The differences in the composition of the initial and final Kraft bids reflected a series of crosscurrents. Irene Rosenfeld, Kraft CEO, not only had to contend with vituperative comments from Cadbury's board and senior management, but also was soundly criticized by major shareholders who feared Kraft would pay too much for Cadbury. Specifically, the firm's largest shareholder, Warren Buffett's Berkshire Hathaway with a 9.4% stake, expressed concern that the amount of new stock that would have to be issued to acquire Cadbury would dilute the ownership position of existing Kraft shareholders. In an effort to placate dissident Kraft shareholders while acceding to Cadbury's demand for an increase in the offer price, Ms. Rosenfeld increased the offer by 7% by increasing the cash portion of the purchase price.

The new bid consisted of \$8.17 cash and 0.1874 new Kraft shares, compared to Kraft's original offer of \$4.89 cash and 0.2589 new Kraft shares for each Cadbury share outstanding. The change in the composition of the offer price meant that Kraft would issue 265 million new shares compared with its original plan to issue 370 million. The change in the terms of the deal meant that Kraft would no longer have to get shareholder approval for the new share issue, since it was able to avoid the NYSE requirement that firms issuing shares totaling more than 20% of the number of shares currently outstanding must receive shareholder approval to do so.

CHAPTER OVERVIEW

The corporate takeover has been dramatized in Hollywood as motivated by excessive greed, reviled in the press as a job destroyer, hailed as a means of dislodging incompetent management, and often heralded by shareholders as a source of windfall gains. The reality is that corporate takeovers may be a little of all of these things. This chapter discusses the effectiveness of commonly used tactics to acquire a company and evaluates the effectiveness of takeover defenses.

The market in which such takeover tactics and defenses are employed is called the *corporate takeover market* (also known as the market for corporate control), which serves two important functions in a free market economy. First, it facilitates the allocation of resources to sectors in which they can be used most efficiently. Second, it serves as a mechanism for disciplining

underperforming corporate managers. By replacing such managers through hostile takeover attempts or proxy fights, the corporate takeover market can help to promote good *corporate governance*, which in turn can improve corporate financial performance.¹

What is “corporate governance”? The common definition is fairly straightforward: The term refers broadly to the rules and processes by which a business is controlled, regulated, or operated. There is, though, no universally accepted goal for corporate governance. Traditionally, the goal has been to protect shareholder rights. More recently, this has expanded to encompass additional corporate stakeholders, including customers, employees, the government, lenders, communities, regulators, and suppliers. For our discussion here, corporate governance is about leadership and accountability, and it involves all factors internal and external to the firm that interact to protect the rights of corporate stakeholders.

Figure 3.1 illustrates the range of factors affecting corporate governance, including the corporate takeover market. A chapter review (including practice questions) is available in the file

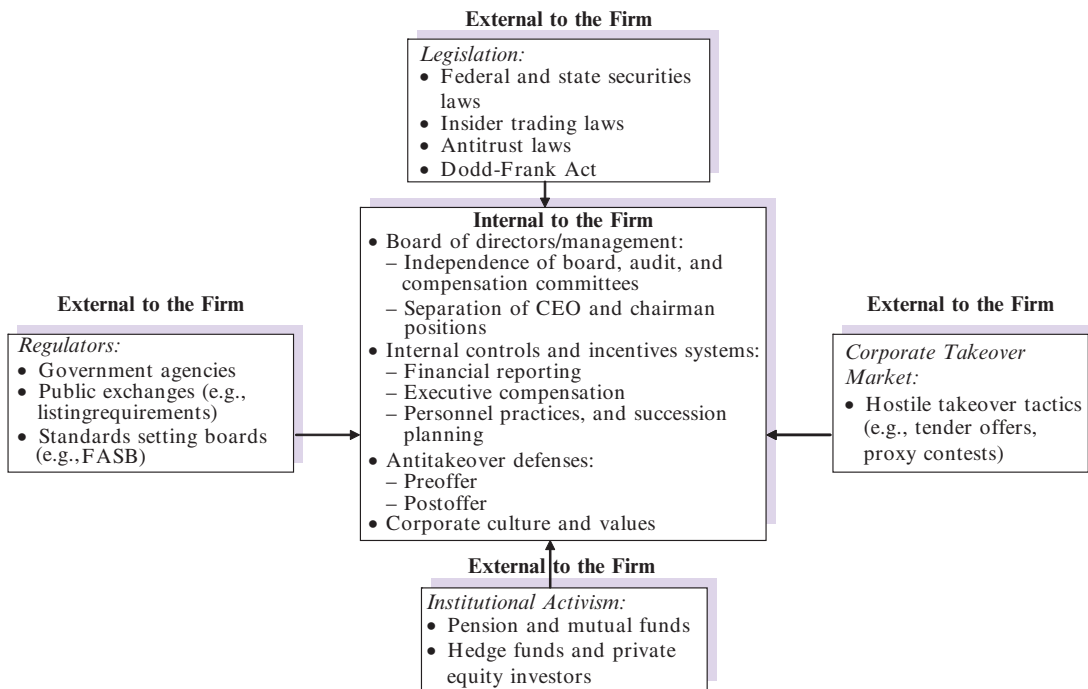


FIGURE 3.1 Factors that affect corporate governance.

¹ Carline et al. (2009) argue that mergers resulting in increased board equity ownership tend to promote improved firm performance because directors have a greater incentive to take a more proactive role in the firm. However, the relationship between board equity ownership and firm performance breaks down if the ownership becomes heavily concentrated in a few directors or if the size of the board increases significantly. Firm performance also benefits from an increase in the size of shareholdings in the hands of investors independent of the firm. Such large stockholders are likely to take a more active role in monitoring firm performance.

folder entitled Student Study Guide on the companion site to this book (www.elsevierdirect.com/companions/9780123854858). The companion site also contains a Learning Interactions Library, which gives students the opportunity to test their knowledge of this chapter in a “real-time” environment.

ALTERNATIVE MODELS OF CORPORATE GOVERNANCE

The ultimate goal of a successful corporate governance system should be to hold those in power accountable for their actions. Where capital markets are liquid, investors discipline bad managers by selling their shares; this is called the market model of corporate governance. Where capital markets are illiquid, bad managers are disciplined by those owning large blocks of stock in the firm or by those whose degree of control is disproportionate to their ownership position. This is called the control model of corporate governance, and it may develop through the concentration of shares having multiple voting rights (i.e., so-called supervoting shares) in the hands of a few investors. [Table 3.1](#) provides a summary of the characteristics of these two common corporate governance models.

FACTORS THAT AFFECT CORPORATE GOVERNANCE

The following sections describe those factors internal and external to the firm, including mergers and acquisitions, that impact corporate governance. While the discussion in this chapter deals primarily with domestic considerations, how cross-border transactions impact governance is described in considerable detail in Chapter 17.

Internal Factors

Corporate governance is affected by the integrity and professionalism of the firm’s board of directors, as well as by the effectiveness of the firm’s internal controls and incentive systems, takeover defenses, and corporate culture and values.

The Board of Directors/Management

The board advises the firm’s CEO, who runs the daily operations, and reviews the quality of recommendations the CEO receives from others in corporate management. The board also hires, fires, and sets CEO compensation. Moreover, the board is expected to oversee management, corporate strategy, and the company’s financial reports to shareholders, as well as deal

TABLE 3.1 Alternative Models of Corporate Governance

Market Model Applicable When	Control Model Applicable When
Capital markets are highly liquid	Capital markets are illiquid
Equity ownership is widely dispersed	Equity ownership is heavily concentrated
Board members are largely independent	Board members are largely “insiders”
Ownership and control are separate	Ownership and control overlap
Financial disclosure is high	Financial disclosure is limited
Shareholders focus more on short-term gains	Shareholders focus more on long-term gains

with situations in which managers, as agents of the shareholder, make decisions that are not in the best interests of shareholders (i.e., the agency problem discussed in Chapter 1).

Some board members may be employees or family members (most often from the extended family of the firm's founder). Other board members may be affiliated with the firm through a banking relationship, a law firm retained by the firm, or someone who represents a customer or supplier. Such members may be subject to potential conflicts of interest that cause them to act in ways not necessarily in the shareholders' best interests. This has led some observers to argue that boards should be composed primarily of independent directors and different individuals should hold the CEO and board chairman positions.² The empirical evidence that firm performance is improved by more independent boards and the separation of the CEO and board positions generally supports these conclusions.³ In the early 1990s, about 40% of boards were composed of senior corporate managers or individuals affiliated with the corporation. However, in recent years, more than 90% of boards have only one or two nonindependent directors.⁴

Today, boards average about ten members, about one-half of their average size during the 1970s. There is evidence that smaller boards tend to be more effective, since each member can wield more influence, thereby effectively reducing the power of the CEO. Smaller boards also are more likely to replace a CEO due to poor performance.⁵ However, more complicated firms may benefit from larger boards capable of providing a broader range of advice to the CEO.⁶

Internal Controls and Incentive Systems

Compensation is an integral part of the incentive systems internal to firms that are used to manage the firm in the manner the board deems most appropriate. In an attempt to rectify widespread abuses, a provision in the Dodd-Frank Act of 2010 (discussed in detail in Chapter 2) includes giving shareholders of publicly traded firms the right to vote on executive compensation (i.e., the so-called "say on pay"). Under the new rules, such votes must occur at least once every three years, beginning with the first shareholder meeting after January 21, 2011. Furthermore, companies are required to hold a "frequency" vote at least once every six years in order to allow shareholders to decide how often they would like to be presented with the "say on pay" vote.

² Various researchers (Hermalin, 2006; Huson et al., 2001) have documented a number of trends regarding board composition. The proportion of independent directors has steadily increased in the United States and in other countries; outside directors rose from an average of 35% in 1989 to 61% in 1999. Second, the use of incentive compensation for outside directors has increased significantly. Some 84% of firms reporting to a Conference Board Survey used stock-based compensation for outside directors in 1997 as compared to only 6% in 1989. Unfortunately, empirical studies have not consistently demonstrated that such proposals improve shareholder wealth (Economic Report to the President, 2003, p. 90).

³ Byrd and Hickman (1992), Yermack (1996), and Shivdani (1993) find that firm value is positively influenced by outsider-dominated boards. However, Masulis et al. (2007) find no statistically significant association between such a board structure and acquirer returns.

⁴ Gordon, 2007

⁵ Yermack, 1996

⁶ Coles et. al., 2008

While shareholder votes on executive pay and on golden parachutes are nonbinding on boards of directors under the new legislation, the potential for restraining the most egregious pay packages is significant based on the European experience. The United Kingdom has allowed shareholders to vote on executive pay since 2002. GlaxoSmithKline became the first firm to suffer a defeat at its annual shareholders meeting, when 50% of the votes cast were against the board's recommendation for the CEO's compensation package. Rather than ignore the vote, the board enlisted Deloitte & Touche to modify the compensation recommendations that were subsequently approved in the 2004 shareholders meeting.

Similar laws were passed throughout Europe and in Australia. In 2004, the Netherlands required companies to submit compensation to a binding vote; in 2005, Sweden and Australia both adopted requirements for nonbinding shareholder votes. Since then, Norway, Spain, Portugal, Denmark, and France have followed suit.

While shareholder interest in say on pay proposals escalated in Europe, perhaps contributing to comparatively smaller average executive pay packages in Europe than in the United States, it has been tepid in the United States. In 2008, Verizon saw its pay package, which it had voluntarily submitted for a shareholder vote, receive a 90% approval. Support for Bank of America's executive pay package topped 70%, despite the furor over the Merrill Lynch bonus debacle. In 2009, Goldman Sachs's executive compensation plan received 96% support from shareholders. About 85% of Citigroup's shareholders backed its pay proposal, despite the near financial collapse of the firm and subsequent government bailout.

The Dodd-Frank Act also requires publicly traded firms to develop mechanisms for recovering compensation based on inaccurate financial statements or if the recipient is fired due to misconduct. The act states that compensation paid during the three years prior to a corporate earnings restatement or from the date of dismissal of the employee is recoverable. Some firms have had mechanisms for recovering executive compensation even before "clawbacks" were required in the 2010 law. *Clawbacks* are ways of recovering executive compensation if it is later discovered that such compensation was paid in error. For example, most major banks put clawback mechanisms in place in 2009.

While clawback mechanisms provide a means of recovering compensation once the damage has been done, there are other ways to align managerial interests with those of shareholders. These include linking option strike prices (i.e., prices at which options can be converted into company shares) to the performance of the company's stock price relative to the stock market, ensuring that increases in the stock market do not benefit managers whose companies are underperforming. Another way to achieve this alignment is for managers to own a significant portion of the firm's outstanding stock or for the manager's ownership of the firm's stock to make up a substantial share of his or her personal wealth. On average, management in the United States tends to own about one-fifth of corporate shares outstanding.⁷

An alternative to concentrating ownership in management is for one or more shareholders who are not managers to accumulate a significant block of voting shares. Corporations having outside shareholders with large blocks of stock (so-called blockholders) may be easier to acquire, thereby increasing the risk to managers that they will be ousted for poor performance.

⁷ The proportion of shares owned by managers of public firms in the United States grew from an average of 12.9% in 1935 to an average of 21.1% in 1998 (Economic Report to the President, 2003, p. 86).

How board members are compensated also impacts firm value. There is evidence that boards in which equity stakes in the firm are more evenly distributed among the members tend to exhibit better operating performance than firms in which ownership tends to be concentrated among a few.⁸ This may reflect the tendency for a few board members owning controlling stakes to seek to entrench themselves and to extract benefits that accrue primarily to those with a controlling interest. This is discussed in more detail in Chapter 10.

Antitakeover Defenses

A firm's management and board may employ defenses to gain leverage in negotiating with a potential suitor or to solidify current management's position within the firm. There is a range of defensive actions; these are detailed later in this chapter.

Corporate Culture and Values

While internal systems and controls are important, good governance also results when the employee culture is instilled with appropriate core values and behaviors. Setting the right tone and direction comes from the board of directors and senior management and their willingness to behave in a manner consistent with what they demand from other employees. For a more detailed discussion of the role of corporate culture, see Chapter 6.

Factors External to the Firm

Federal and state legislation, the court system, regulators, institutional activists, and the corporate takeover market all play an important role in maintaining good corporate governance practices.

Legislation and the Legal System

In the United States, the Securities Acts of 1933 and 1934 form the basis for modern securities legislation; these acts created the Securities and Exchange Commission (SEC) and charged it with writing and enforcing securities regulations. The U.S. Congress has since transferred some enforcement tasks to public stock exchanges, such as the New York Stock Exchange (NYSE), which operate under SEC oversight as self-regulating organizations. The SEC itself has delegated certain responsibilities for setting and maintaining accounting standards to the Financial Accounting Standards Board.

Under the Sarbanes-Oxley Act (SOA) of 2002, the SEC is overseeing the new Public Company Accounting Oversight Board (PCAOB), whose primary task is to develop, maintain, and enforce standards that guide auditors in monitoring and certifying corporate financial reports. The aim of the Sarbanes-Oxley Act was to achieve greater corporate transparency with respect to financial statements, but the events of 2008 and 2009 in the financial and real estate markets underscore how legislated solutions often fail to achieve their intended results.

State legislation also has a significant impact on governance practices by requiring corporate charters to define the responsibilities of boards and of managers with respect to shareholders.

⁸ Carline, Linn, and Yadav, 2009

Regulators

The SEC, the Federal Trade Commission (FTC), and the Department of Justice (DoJ) can discipline firms with inappropriate governance practices through formal and informal investigations, lawsuits, and settlements. In mid-2003, the SEC approved new listing standards that would put many lucrative, stock-based pay plans to a shareholder vote, thus giving investors in more than 6,200 companies listed on the NYSE, Nasdaq, and other major markets significant control over CEO pay packages. In January 2007, the SEC implemented additional disclosure requirements for CEO pay and perks that exceed \$10,000 in value. The Dodd-Frank Act requires publicly traded or listed firms, through new rules adopted by the stock exchanges, to have fully independent compensation committees, based on new standards that consider the source of compensation for the director and whether the director is affiliated with the company.

In late 2010, the SEC voted to allow large shareholders to put their own nominees for board seats on the same ballot as those nominated by the board, allowing such shareholders to avoid the cost of promoting their own slate of candidates. To avoid a lengthy list of nominees, shareholders have to own a 3% stake in a company for at least three years to qualify. Shareholders cannot borrow stock to meet the minimum 3% level, and they will have to certify in writing that they do not intend to use the new rules to change control of the company or to gain more than 25% of the board seats.

Institutional Activists

Pension funds, hedge funds, private equity investors, and mutual funds have become increasingly influential institutions that can affect the policies of companies in which they invest. As discussed in Chapter 1, there is growing evidence that institutional activism, in combination with merger and acquisition activity, has become an important factor in disciplining underperforming managers.

The Corporate Takeover Market

Changes in corporate control can occur because of a hostile (i.e., bids contested by the target's board and management) or friendly takeover of a target firm or because of a proxy contest initiated by dissident shareholders. When a firm's internal mechanisms that govern management control are relatively weak, the corporate takeover market seems to act as a "court of last resort" to discipline inappropriate management behavior.⁹ Strong internal governance mechanisms, by contrast, lessen the role of the takeover threat as a disciplinary factor. Moreover, the disciplining effect of a takeover threat on a firm's management can be reinforced when it is paired with a large shareholding by an institutional investor.¹⁰

Several theories have been put forth to explain why managers might resist a takeover attempt. The *management entrenchment theory* suggests that managers use a variety of takeover defenses to ensure their longevity with the firm. Hostile takeovers, or the threat of such takeovers, have historically been useful for maintaining good corporate governance by removing bad managers and installing better ones.¹¹ Indeed, there is evidence of frequent management

⁹ Kini, Kracaw, and Mian, 2004

¹⁰ Cremers and Nair, 2005

¹¹ Morck, Shleifer, and Vishny, 1988

turnover even if a takeover attempt is defeated, since takeover targets are often poor financial performers.¹² An alternative viewpoint is the *shareholder interest's theory*, which suggests that management resistance to proposed takeovers is a good bargaining strategy to increase the purchase price to the benefit of the target firm's shareholders.¹³

Proxy contests are attempts by a dissident group of shareholders to gain representation on a firm's board of directors or to change management proposals. While those that address issues other than board representation do not bind a firm's board of directors, there is evidence that boards are becoming more responsive—perhaps reflecting fallout from the Enron-type scandals in 2001 and 2002.¹⁴ Even unsuccessful proxy contests often lead to a change in management, a restructuring of the firm, or investor expectations that the firm ultimately will be acquired. According to proxy solicitor Georgeson, Inc., the number of proxy contests in the United States rose from 25 in 2005 to a peak of 57 in 2009, before declining to 35 in 2010.

ALTERNATIVE TAKEOVER TACTICS IN THE CORPORATE TAKEOVER MARKET

As noted in Chapter 1, takeovers may be classified as friendly or hostile. The process for implementing a friendly takeover is described briefly in the next section and in considerable detail in Chapter 5. Hostile takeover tactics are described extensively in the following sections.

The Friendly Approach in the Corporate Takeover Market

In friendly takeovers, a negotiated settlement is possible without the acquirer resorting to aggressive tactics. The potential acquirer initiates an informal dialogue with the target's top management, and the acquirer and target reach an agreement on the key issues early in the process. Typically, these include the long-term business strategy of the combined firms, how they will operate in the short term, and who will be in key management positions. Often, a *standstill agreement* is negotiated in which the acquirer agrees not to make any further investments in the target's stock for a stipulated period. This compels the acquirer to pursue the acquisition on friendly terms alone, at least for the period covered by the agreement. It also permits negotiations to proceed without the threat of more aggressive tactics such as those discussed in the following sections.

The Hostile Approach in the Corporate Takeover Market

If initial efforts to take control of a target firm are rejected, an acquirer may choose to adopt a more aggressive approach. Several types of hostile takeover tactics may be used, including the bear hug, the proxy contest, and the tender offer.

¹² Economic Report to the President, 2003, p. 81

¹³ Franks and Mayer, 1996; Schwert, 2000

¹⁴ According to Ertimur (2008), boards implemented 41% of nonbinding shareholder proposals for majority voting in 2004, versus only 22% in 1997. A board was more likely to adopt a shareholder proposal if a competitor had adopted a similar plan.

The Bear Hug: Limiting the Target's Options

With a *bear hug*, the acquirer mails a letter that includes an acquisition proposal to the target company's CEO and board of directors. The letter arrives with no warning and demands a rapid decision. The bear hug usually involves a public announcement as well. The aim is to move the board to a negotiated settlement. Directors who vote against the proposal may be subject to lawsuits from target stockholders, especially if the offer is at a substantial premium to the target's current stock price.

Once the bid is made public, the company is effectively "put into play" (i.e., likely to attract additional bidders). Institutional investors¹⁵ and arbitrageurs add to the pressure by lobbying the board to accept the offer. Arbitrageurs ("arbs") are likely to acquire the target's stock and to sell the bidder's stock short in an effort to profit from the anticipated rise in the target's share price and the fall in the acquirer's share price. The accumulation of stock by arbs makes purchases of blocks of stock by the bidder easier, as they often are quite willing to sell their shares.

Proxy Contests in Support of a Takeover

There are three primary forms of the *proxy contest*. In one, dissident shareholders attempt to win representation on the board of directors. In another, they seek to change a firm's bylaws or force management to take some particular action (e.g., dividend payments and share repurchases) by obtaining the right to vote on behalf of other shareholders. Finally, proxy contests may concern management proposals (e.g., an acquisition). Most commonly, dissidents initiate a proxy fight to remove management due to poor corporate performance, or they to promote a specific type of restructuring of the firm (e.g., sell or spin off a business) or the outright sale of the business, or want to force a distribution of excess cash to shareholders.¹⁶

Proxy fights enable dissident shareholders to replace specific board members or management with those more willing to support their positions. By replacing board members, proxy contests can be an effective means of gaining control without owning 50.1% of the voting stock, or they can be used to eliminate takeover defenses, such as poison pills, as a precursor of a tender offer, or to oust recalcitrant target firm board members. For example, in late 2010, Air Products & Chemicals, after being rejected several times by Airgas Inc., succeeded in placing three of its own nominees on the Airgas board and, in doing so, voted to remove Peter McCausland, the founder and chairman of Airgas, who had led the resistance to the Air Products' offer.

Implementing a Proxy Contest

When the bidder is also a shareholder in the target firm, the proxy process may begin with the bidder attempting to call a special stockholders' meeting. Alternatively, the bidder may present a proposal to replace the board or management at a regularly scheduled stockholders' meeting. Before the meeting, the bidder may open an aggressive public relations campaign,

¹⁵ Institutional investors are organizations that pool large sums of money and invest those sums in companies. They include banks, insurance companies, retirement or pension funds, hedge funds, and mutual funds. Institutional investors now account, on average, for more than two-thirds of the shareholdings of publicly traded firms (Bogle, 2007).

¹⁶ Faley, 2004

with direct solicitations sent to shareholders and full-page advertisements in the press to convince shareholders to support the bidder's proposals. The target often responds with its own campaign. Once shareholders receive the proxies, they may choose to sign and send them directly to a designated collection point such as a brokerage house or bank. Shareholders may change their votes until they are counted—which often takes place under the strict supervision of inspectors to ensure accuracy. Both the target firm and the bidder generally have their own proxy solicitors present during the tabulation process.

Legal Filings in Undertaking Proxy Contests

SEC regulations cover proxy solicitations under Section 14(A) of the Securities Exchange Act of 1934. All materials distributed to shareholders must be submitted to the SEC for review at least ten days before they are distributed. The party attempting to solicit proxies from the target's shareholders must file a *proxy statement* and Schedule 14(A) with the SEC and mail it to the target's shareholders. Proxy statements may be obtained from the companies involved and on the SEC's website,¹⁷ and they are excellent sources of information about a proposed transaction.

The Impact of Proxy Contests on Shareholder Value

Only one-fifth to one-third of all proxy fights actually result in a change in board control. Despite this low success rate, there is some empirical evidence that proxy fights result in positive abnormal returns to shareholders of the target company regardless of the outcome.¹⁸ The reasons for these gains may include the eventual change in management at firms embroiled in proxy fights, the tendency for new management to restructure the firm, investor expectations of a future change in control due to M&A activity, and possible special cash payouts for firms with excess cash holdings. When management prevails in proxy contests, shareholder value often tends to decline, since little changes in terms of how the firm is being managed.¹⁹

The Hostile Tender Offer

A *hostile tender offer* is a deliberate effort to go around the target's board and management to reach the target's shareholders directly with an offer to purchase their shares. In a traditional merger, minority shareholders are said to be frozen out of their positions, since they must agree to the terms of the agreement negotiated by the board once the majority of the firm's shareholders approve the proposal. This majority approval requirement is intended to prevent minority shareholders from stopping a merger until they are paid a premium over the purchase price agreed to by the majority. Following the tender offer, the target firm becomes a partially owned subsidiary of the acquiring company.

¹⁷ www.sec.gov

¹⁸ In studies covering proxy battles during the 1980s through the mid-1990s, abnormal returns ranged from 6 to 19%, even if the dissident shareholders were unsuccessful in the proxy contest (Mulherin and Poulsen, 1998; Faleye, 2004).

¹⁹ Listokin, 2009

While target boards often discourage unwanted bids initially, they are more likely to relent when a hostile tender offer is initiated.²⁰ Although they have become more common in recent years, hostile takeovers are relatively rare outside the United States.

Pretender Offer Tactics: Toehold Bidding Strategies

Potential bidders may purchase stock in a target before a formal bid to accumulate stock at a price lower than the eventual offer price. Such purchases are normally kept secret to avoid driving up the price and increasing the average price paid for such shares. The primary advantage to the bidder of accumulating target stock before an offer is the potential leverage achieved with the voting rights associated with the stock it has purchased. This voting power is important in a proxy contest to remove takeover defenses, win shareholder approval under state antitakeover statutes, or elect members of the target's board. In addition, the bidder can sell this stock later if the takeover attempt is unsuccessful. Toehold positions also may discourage competing bids.

Once the bidder has established a toehold ownership position in the voting stock of the target through open-market purchases, the bidder may attempt to call a special stockholders' meeting in an effort to replace the board of directors or remove takeover defenses. The conditions under which such a meeting can be called are determined by the firm's articles of incorporation governed by the laws of the state in which the firm is incorporated.²¹

While rare in friendly takeovers, toehold bidding strategies are commonplace in hostile transactions, comprising about one-half of all such takeovers. In friendly transactions, bidders are concerned about alienating a target firm's board and management with such actions; however, in potentially hostile situations, the target firm would have rejected the initial bid under any circumstances. On average, toehold positions represent about 20% of the target's outstanding shares in hostile transactions and about 11% in friendly takeovers. The frequency of toehold bidding has declined since the early 1990s in line with the widespread adoption of takeover defenses and a decline in the frequency of hostile transactions.²²

Implementing a Tender Offer

Tender offers can be for cash, stock, debt, or some combination of the three. Unlike mergers, tender offers frequently use cash as the form of payment. Securities transactions involve a longer period to complete the takeover because new security issues must be registered with and approved by the SEC and because states have their own security registration requirements. If the tender offer involves a share-for-share exchange, it is referred to as an *exchange offer*. Whether cash or securities, the offer is made directly to target shareholders,

²⁰ In a study of 1,018 tender offers in the United States between 1962 and 2001, Bhagat et al. (2005) found that target boards resisted tender offers about one-fifth of the time. In a study of 49 countries, Rossi and Volpin (2004) found that only about 1% of 45,686 M&A transactions considered between 1990 and 2002 were opposed by target firm boards.

²¹ A copy of a firm's articles of incorporation can usually be obtained for a nominal fee from the Office of the Secretary of State in the state in which the firm is incorporated.

²² Betton, Eckbo, and Thorburn, 2009

is extended for a specific period, and may be unrestricted (any-or-all offer) or restricted to a certain percentage or number of the target's share.

Tender offers restricted to purchasing less than 100% of the target's outstanding shares may be oversubscribed. Because the Williams Act of 1968 requires equal treatment of all shareholders tendering shares, the bidder may either purchase all of the target stock that is tendered or purchase only a portion of the tendered stock. For example, if the bidder has extended a tender offer for 70% of the target's outstanding shares, and 90% of the target's stock actually is offered, the bidder may choose to prorate the purchase of stock by buying only 63% (i.e., 0.7×0.9) of the tendered stock from each shareholder.

If the bidder chooses to revise the tender offer, the waiting period is automatically extended. If another bid is made to the target shareholders, the waiting period must also be extended by another 10 days to provide adequate time to consider the new bid. Once initiated, tender offers for publicly traded firms are usually successful, although the success rate is lower if it is contested.²³

Multitiered Offers

The form of the bid for the target firm can be presented to target shareholders either as a one- or as a two-tiered offer. In a *one-tiered offer*, the acquirer announces the same offer to all target shareholders, which offers the potential to purchase control of the target quickly and thus discourage other potential bidders from attempting to disrupt the transaction.

In a *two-tiered offer*, the acquirer offers to buy a certain number of shares at one price and more shares at a lower price at a later date. The form of payment in the second tier may also be less attractive, consisting of securities rather than cash. The intent of the two-tiered approach is to give target shareholders an incentive to tender their shares early in the process to receive the higher price. Furthermore, since those shareholders tendering their shares in the first tier enable the acquirer to obtain a controlling interest, their shares are worth more than those who may choose to sell in the second tier.

Once the bidding firm accumulates enough shares to gain control of the target (usually 50.1%), the bidder may initiate a so-called *back end merger* by calling a special shareholders' meeting seeking approval for a merger in which minority shareholders are required to accede to the majority vote. Alternatively, the bidder may operate the target firm as a partially owned subsidiary, later merging it into a newly created wholly owned subsidiary.

Many state statutes have been amended to require equal treatment for all tendering shareholders as part of two-tiered offers. Many states also give target shareholders *appraisal rights* that allow those not tendering shares in the first or second tier to ask the state court to determine a "fair value" for the shares. The minority shares may be subject to a "minority discount," since they are worth less to the bidder than those acquired in the process of gaining control. State statutes may also contain *fair price provisions* in which all target shareholders, including those in the second tier, receive the same price and redemption rights, enabling target shareholders in the second tier to redeem their shares at a price similar to that paid in the first tier.

²³ According to Mergerstat, the success rate of total attempted tender offers between 1980 and 2000 was more than 80%, with the success rate for uncontested offers more than 90% and that for contested offers (i.e., those by the target's board) slightly more than 50%.

An acquirer seeking a controlling interest in the target firm may initiate a *creeping takeover strategy*, which involves purchasing target voting stock in relatively small increments until the acquirer has gained effective control of the firm. This may occur at less than 50.1% if the target firm's ownership is widely dispersed. If about 60% of a firm's eligible shareholders vote in elections for directors, a minority owning as little as 35% can elect its own slate of directors.

Minority shareholders have demonstrated an ability to exercise significant bargaining power and obtain decent financial returns in freeze-outs or situations in which the acquirer is increasing ownership incrementally. U.S. freeze-out bids have shown approximate 15% excess returns²⁴; excess financial returns approaching 12% have been found in other countries with well-developed stock markets and good governance practices.²⁵

There are a number of disadvantages to owning less than 100% of the target's voting stock. These include the potential for dissident minority shareholders owning significant blocks of stock to disrupt efforts to implement important management decisions, the cost incurred in providing financial statements to both majority and minority shareholders, and current accounting and tax rules. Owning less than 50.1% means that the target cannot be consolidated for purposes of financial reporting but instead must be accounted for using the equity method. Since the equity method will include the investor's share of the target's income, it will not change consolidated income; however, the target's assets, liabilities, revenues, and expenses are not shown on the investor's financial statements. Consequently, potential increases in borrowing capacity from showing a larger asset or sales base would not be realized. Furthermore, target losses cannot be used to offset bidder gains, since consolidation for tax purposes requires owning 80.1% of the target.

In 2011, Panasonic Corporation spent \$8.4 billion to buy out the remaining shares of both Sanyo Electric Company and Panasonic Electric Works Company, in which it owned a narrow majority of the outstanding shares. By converting these units into wholly owned subsidiaries, Panasonic hopes to facilitate decision making and to reduce administrative overlap as it shifts from its traditional focus on the home electronics market to renewable energy products. See Case Study 6.6 in Chapter 6 for more details.

Legal Filings in Undertaking Tender Offers

Federal securities laws impose a number of reporting, disclosure, and antifraud requirements on acquirers initiating tender offers. Once the tender offer has been made, the acquirer cannot purchase any target shares other than the number specified in the tender offer. Section 14(D) of the Williams Act requires that any individual or entity making a tender offer resulting in owning more than 5% of any class of equity must file a Schedule 14(D)-1 and all solicitation materials with the SEC.

Advantages of the Hostile Takeover

Although hostile takeovers today are more challenging than in the past, they have certain advantages over the friendly approach. One is that the friendly approach surrenders the element of surprise. Even a few days' warning gives the target's management time to take

²⁴ Bates et. al., 2006

²⁵ Croci and Petmezas, 2009

action to impede the actions of the suitor. Negotiation also raises the likelihood of a leak and a spike in the price of the target's stock as arbs seek to profit from the spread between the offer price and the target's current stock price. The speculative increase in the target's share price can add dramatically to the cost of the transaction. The bidder's initial offer generally includes a premium over the target's current share price, and because that premium usually is expressed as a percentage of the target's share price, a speculative increase in the target firm's current share price will add to the overall purchase price paid by the acquiring firm. For these reasons, a bidder may opt for a hostile approach.

WHAT MAKES THE AGGRESSIVE APPROACH SUCCESSFUL?

Successful hostile takeovers depend on the premium offered to target shareholders, the board's composition, and the composition, sentiment, and investment horizon of the target's current shareholders. Other factors include the provisions of the target's bylaws and the potential for the target to implement additional takeover defenses.

The target's board will find it more difficult to reject offers exhibiting substantial premiums to the target's current stock price. Despite the pressure of an attractive premium, the composition of the target's board also greatly influences what the board does and the timing of its decisions. A board that is dominated by independent directors, nonemployees, or nonfamily members is more likely to resist offers in an effort to induce the bidder to raise the offer price or to gain time to solicit competing bids than to protect itself and current management.²⁶

Furthermore, the final outcome of a hostile takeover is heavily dependent on the composition of the target's stock ownership, how stockholders feel about management's performance, and how long they intend to hold the stock. Firms held predominately by short-term investors (i.e., less than four months) are more likely to receive a bid and exhibit a lower average premium of as much as 3% when acquired, and researchers speculate that firms held by short-term investors have a weaker bargaining position with the bidder due to the limited loyalty of short-term shareholders.²⁷

To assess these factors, an acquirer compiles (to the extent possible) lists of stock ownership by category: management, officers, employees, and institutions such as pension and mutual funds. This information can be used to estimate the target's *float*—the number of shares that are outstanding, are not held by block shareholders, and are available for trading by the public. The larger the share of stock held by corporate officers, family members, and employees, the smaller the number of shares that are likely to be easily purchased by the bidder, since these types of shareholders are less likely to sell their shares.

Finally, an astute bidder will always analyze the target firm's bylaws (often easily accessible through a firm's website) for provisions potentially adding to the cost of a takeover. Such provisions could include a staggered board, the inability to remove directors without cause, or super-majority voting requirements for approval of mergers. These and other measures are detailed later in this chapter.

²⁶ The shareholder gain from the inception of the offer to its resolution is 62.3% for targets with an independent board, as compared with 40.9% for targets without an independent board (Shivdasani, 1993).

²⁷ Gaspara and Massa, 2005

OTHER TACTICAL CONSIDERATIONS

The average time between signing the initial agreement and completing or terminating an agreement is about six months, which gives both buyer and seller an incentive to hold up a deal to renegotiate the terms based on new information. Several strategies have been designed to minimize this so-called “hold-up problem.”

To heighten the chance of a successful takeover, the bidder will include a variety of provisions in a *letter of intent* (LOI) designed to discourage the target firm from backing out of any preliminary agreements. The LOI is a preliminary agreement between two companies intending to merge that stipulates major areas of agreement between the parties, as well as their rights and limitations. It may contain a number of features protecting the buyer; among the most common is the *no-shop agreement*, which prohibits the target from seeking other bids or going public with information not currently readily available.

Contracts often grant the target the right to forgo the merger and pursue an alternative strategy and the acquirer to withdraw from the agreement. However, the right to break the agreement is usually not free. *Breakup or termination fees* are sums paid to the initial bidder or target if the transaction is not completed. They include legal and advisory expenses, executive management time, and the costs associated with opportunities that may have been lost to the bidder who was involved in trying to close this deal.²⁸

Termination fees are used more frequently on the target side than on that of the acquirer because targets have greater incentives to break contracts and seek other bidders. Such fees give the target firm some degree of leverage with the bidder. Averaging about 3% of the purchase price and found in about two-thirds of all M&A deals, such fees tend to result in an approximately 4% higher premium paid to target firms. The higher premium represents the amount paid by the bidder for “insurance” that it will be compensated for expenses incurred if the transaction is not completed and for motivating the target to complete the deal.²⁹

Breakup fees paid by the bidder to the target firm are called *reverse breakup fees*, and they have become more common in recent years as buyers, finding it increasingly difficult to finance transactions, have opted to back out of signed agreements. Pharmaceutical behemoth Pfizer’s 2009 purchase agreement to buy Wyeth contained a reverse termination fee in which Pfizer could withdraw from the contract only if it received a credit rating downgrade and its lenders refused to extend loans based on the downgrade. Had this happened, Pfizer would have been legally bound to pay Wyeth a \$4.5 billion payment equal to an eye-popping 6.6% of the \$68 billion purchase price.

The *stock lockup*, an option granted to the bidder to buy the target firm’s stock at the first bidder’s initial offer, is another form of protection for the bidder. It is triggered whenever the target firm accepts a competing bid. Because the target may choose to sell to a higher bidder, the stock lockup arrangement usually ensures that the initial bidder will make a profit on its purchase of the target’s stock. The initial bidder also may require that the seller agree to a

²⁸ In a sample of 1100 stock mergers between 1994 and 1999, Hotchkiss, Qian, and Song (2004) found a target termination or breakup fee included in the initial agreement in 55% of all deals, while in 21% of the deals both target and acquirer termination fees were included.

²⁹ Officer, 2003

crown jewels lockup, in which the initial bidder has an option to buy important strategic assets of the seller, if the seller chooses to sell to another party. Target firms may use lockup options to enhance their bargaining power in dealing with a bidding firm.³⁰

DEVELOPING A BIDDING OR TAKEOVER STRATEGY

The tactics that may be used in developing a bidding strategy should be viewed as a series of decision points, with objectives and options usually well defined and understood before a takeover attempt is initiated. A poorly thought-out strategy can result in unsuccessful bidding for the target firm, which can be costly to CEOs, who may lose their jobs.³¹

Common bidding strategy objectives include winning control of the target, minimizing the control premium, minimizing transaction costs, and facilitating postacquisition integration. If minimizing the purchase price and transaction costs, while maximizing cooperation between the two parties, is considered critical, the bidder may choose the “friendly” approach, which has the advantage of generally being less costly than more aggressive tactics and minimizes the loss of key personnel, customers, and suppliers during the fight for control of the target. Friendly takeovers avoid an auction environment, which may raise the target’s purchase price. Moreover, friendly acquisitions facilitate premerger integration planning and increase the likelihood that the combined businesses will be quickly integrated following closing.

If the target is unwilling to reach a negotiated settlement, the acquirer is faced with the choice of abandoning the effort or resorting to more aggressive tactics. Such tactics are likely to be less effective because of the extra time they give the target’s management to put additional takeover defenses in place. In reality, the risk of loss of surprise may not be very great because of the prenotification requirements of current U.S. law.

Reading [Figure 3.2](#) from left to right, the bidder initiates contact casually through an intermediary (sometimes called a *casual pass*) or through a more formal inquiry. If the target’s management and board reject the bidder’s initial offer, the bidder’s options under the friendly approach are to either walk away or adopt more aggressive tactics. In the latter case, the bidder may undertake a simple bear hug, hoping that pressure from large institutional shareholders and arbs will nudge the target toward a negotiated settlement.

If the bear hug fails to convince the target’s management to negotiate, the bidder may choose to buy stock in the open market in order to accumulate a toehold in the target’s stock. This is most effective when ownership in the target is concentrated among relatively few shareholders. The bidder may accumulate a sufficient number of voting rights to call a special stockholders’ meeting if a proxy fight is deemed necessary to change board members or dismember the target’s defenses. In addition, such maneuvers may discourage competing bids.

If the target’s defenses are viewed as relatively weak, the bidder may forgo a proxy contest and initiate a tender offer for the target’s stock. If the target’s defenses appear formidable, however, the bidder may implement a proxy contest and a tender offer concurrently. That,

³⁰ Burch, 2001

³¹ In a sample of 714 acquisitions between 1990 and 1998, Lehn and Zhao (2006) found that 47% of acquiring firm CEOs were replaced within five years. Moreover, top executives are more likely to be replaced at firms that have made poor acquisitions sometime during the previous five years.

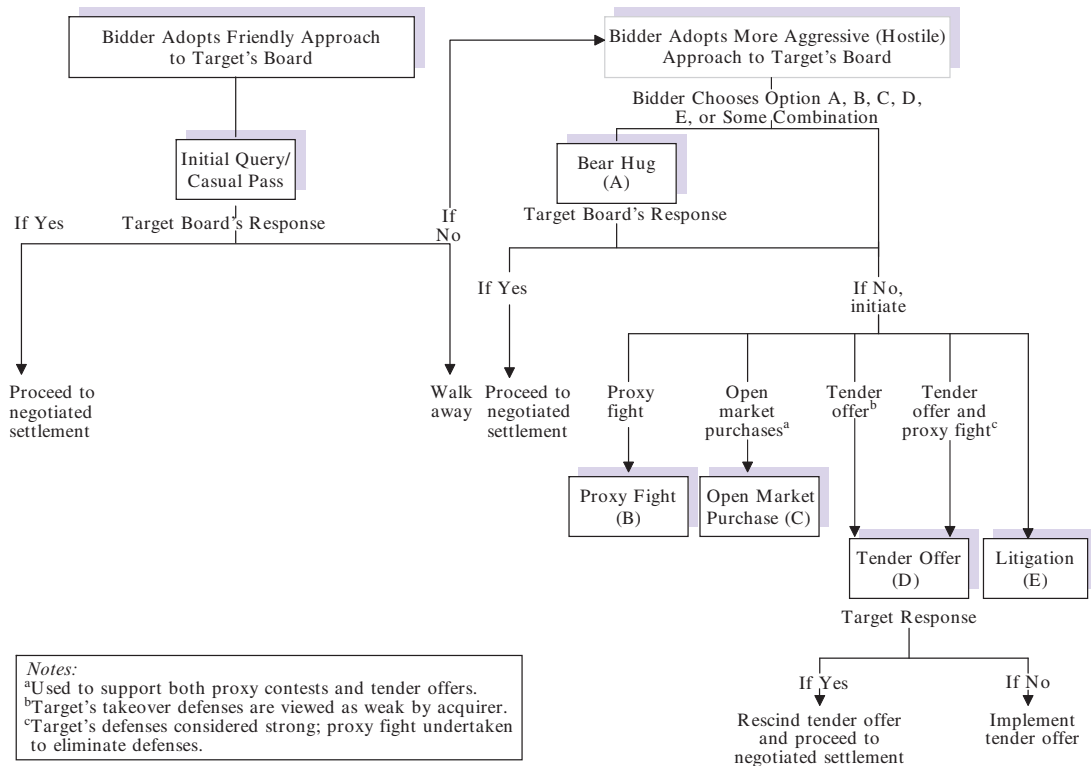


FIGURE 3.2 Alternative takeover tactics.

however, is a very expensive strategy. Tender offers are costly because they are offers to buy up to 100% of the target's outstanding stock at a significant premium. A proxy fight, while less expensive, may still be costly, reflecting extensive litigation, which is likely.

Litigation is a common tactic used to pressure the target board to relent to the bidder's proposal or remove defenses. It is most effective if the firm's defenses appear to be especially onerous. The bidder may initiate litigation that accuses the target's board of not giving the bidder's offer sufficient review, or the bidder may argue that the target's defenses are not in the best interests of the target's shareholders and serve only to entrench senior management. Table 3.2 summarizes common bidder objectives and the advantages and disadvantages of the various tactics that may be employed to achieve these objectives.

ALTERNATIVE TAKEOVER DEFENSES IN THE CORPORATE TAKEOVER MARKET

Takeover defenses are impediments to potential bidders and are designed either to slow down an unwanted offer or to force a suitor to raise the bid to get the target's board to rescind the defense. Takeover defenses can be grouped in two categories: those put in place before

TABLE 3.2 Advantages and Disadvantages of Alternative Takeover Tactics

COMMON BIDDER STRATEGY OBJECTIVES		
	<ul style="list-style-type: none"> • Gain control of the target firm • Minimize the size of the control premium • Minimize transactions costs • Facilitate postacquisition integration 	
Tactics	Advantages	Disadvantages
Casual Pass (i.e., informal inquiry)	May learn target is receptive to offer	Gives advance warning
Bear Hug (i.e., letter to target board forcefully proposing takeover)	Raises pressure on target to negotiate a deal	Gives advance warning
Open Market Purchases (i.e., acquirer buys target shares on public markets)	<ul style="list-style-type: none"> • May lower cost of transaction • Creates profit if target agrees to buy back bidder's toehold position (i.e., greenmail) • May discourage other bidders 	<ul style="list-style-type: none"> • Can result in a less than controlling interest • Limits on the amount that can be purchased without disclosure • Some shareholders could hold out for higher price • Could suffer losses if takeover attempt fails • Could alienate target management and make a friendly takeover even more difficult
Proxy Contest (i.e., effort to obtain target shareholder support to change target board)	<ul style="list-style-type: none"> • Less expensive than tender offer • May obviate need for tender offer 	<ul style="list-style-type: none"> • Relatively low probability of success if target stock widely held • Adds to transactions costs
Tender Offer (i.e., direct offer to target shareholders to buy shares)	<ul style="list-style-type: none"> • Pressures target shareholders to sell stock • Bidder is not bound to the purchased tendered shares unless the desired number of shares is tendered 	<ul style="list-style-type: none"> • Tends to be most expensive tactic • Disruptive to postclosing integration due to potential loss of key target management, customers, and suppliers
Litigation (i.e., lawsuits accusing target board of improper conduct)	<ul style="list-style-type: none"> • Puts pressure on targeted board 	<ul style="list-style-type: none"> • Expenses

receiving an offer (preoffer) and those implemented after receipt of an offer (postoffer). Table 3.3 shows the most commonly used pre- and postoffer defenses; companies use, on average, three of these when confronted with a takeover attempt.³² As you will learn later in this chapter, they are effective to varying degrees.

³² Field and Karpoff, 2002

TABLE 3.3 Alternative Preoffer and Postoffer Takeover Defenses

Preoffer Defenses	Postoffer Defenses
<i>Poison Pills</i> ^a : Flip-Over Rights Plans Flip-In Rights Plans	<i>Greenmail</i> (bidder's investment purchased at a premium to what they paid as inducement to refrain from any further activity.)
<i>Shark Repellents</i> (implemented by changing bylaws or charter): Strengthening the Board's Defenses Staggered or Classified Board Elections "For Cause" Provisions Limiting Shareholder Actions Calling Special Meetings Consent Solicitations Advance Notice Provisions Super-Majority Rules Other Shark Repellents Antigreenmail Provisions Fair Price Provisions Supervoting Stock Reincorporation	<i>Standstill Agreements</i> (often used in conjunction with an agreement to buy bidder's investment.)
<i>Golden Parachutes</i>	Pac-Man Defense White Knights Employee Stock Ownership Plans Leveraged Recapitalization Share Repurchase or Buyback Plans Corporate Restructuring Litigation

^a While many different types of poison pills are used, only the most common forms are discussed in this text. Note also that the distinction between pre and postoffer defenses is becoming murky as poison pill plans are increasingly put in place immediately following the announcement of a bid. Pills can be adopted without a shareholder vote because they are issued as a dividend and the board has exclusive authority to issue dividends.

Preoffer Defenses

Preoffer defenses are used to prevent a sudden, unexpected hostile bid from gaining control of the company before management has time to assess its options properly. If the preoffer defenses succeed in delaying the change in control, the target firm has time to erect additional defenses after the unsolicited offer has been received. Such defenses generally fall into three categories: poison pills, shark repellents, and golden parachutes.

Poison Pills

Often referred to as shareholder rights plans, poison pills are a new class of securities that a company issues to its current shareholders. Because pills are issued as a dividend and the board has the exclusive authority to issue dividends, a pill can often be adopted without a shareholder vote (unless the firm's bylaws limit such action). Consequently, poison pills can be adopted not only before but also after the onset of a hostile bid, which means that even

a company that does not have a poison pill in place can be regarded as having a “shadow poison pill” that could be used in the event of a hostile bid.³³ Such pills could be issued as rights offerings to the firm’s current shareholders, other than the bidder, which if exercised would substantially dilute the bidder’s ownership position.

Poison pill securities have no value unless an investor acquires a specific percentage (sometimes as low as 10%) of the target firm’s voting stock. If this threshold percentage is exceeded and the pill is a so-called *flip-in pill*, the poison pill securities are activated and typically allow existing target shareholders to purchase additional shares of the target firm’s common stock at a discount from the current market price. Alternatively, if the pill is a *flip-over pill*, existing shareholders may purchase additional shares of the acquirer or surviving firm’s common shares (i.e., the shares of the combined companies), also at a discount.

Triggering the flip-in pill increases the acquirer’s cost of the transaction by increasing the number of target shares that need to be purchased for cash in a cash-for-share exchange or the number of new shares that must be issued by the acquirer in a share-for-share exchange. In a cash-for-share exchange, the change in the acquirer’s cash outlay will depend on the number of target shareholders exercising their right to buy additional target shares. For example, if the number of target shares outstanding doubled and the price per share offered by the acquirer remained unchanged, the amount of cash required to buy all or a specific portion of the target’s shares would double. In share-for-share exchange, the increased number of acquirer shares issued imposes a cost on acquirer shareholders by diluting their ownership position. News Corp. was using the flip-in poison pill when the firm announced on November 8, 2004, that it would give its shareholders the right to buy one share of the firm’s stock at half price for each share they owned in the event any party sought to buy a 15% stake in the firm. Assuming all shareholders exercised their rights, this would effectively double the cost of a takeover. The pill would exclude the purchaser of the 15% stake.

Table 3.4 illustrates the dilution of the acquirer’s shareholders ownership position resulting from a poison pill in a share-for-share exchange offer. Assume that the acquirer has 1 million shares currently outstanding and has agreed to acquire the 1 million shares of target stock outstanding by exchanging one share of acquirer stock for each share of target stock. To complete the transaction, the acquirer must issue 1 million shares of new stock, with the target’s stock being cancelled. The total number of shares outstanding for the new company would be 2 million shares (i.e., 1 million of existing acquirer stock plus 1 million in newly issued shares). Target company and acquirer shareholders would each own one-half of the new company. However, if target company shareholders were able to buy 1 million new shares of target stock at a nominal price because of a flip-in pill, the number of shares that now must be acquired would total 2 million. The total number of shares of the new company would be 3 million, of which the target company’s shareholders would own two-thirds and acquirer shareholders one-third.

Note that a flip-in or flip-over pill has the same dilutive effect on acquirer shareholders. With the flip-in pill, target shareholders purchased 1 million new shares of target stock, while

³³ Coates, 2000. According to *sharkrepellent.com*, almost one-fourth of first-time pill adoptions in 2007 were implemented when the firm was “in play.” This compares to about 3% of all first-time pill adoptions in 2002.

TABLE 3.4 Acquirer Shareholder Dilution Due to Poison Pill

Flip-In Pill Defenses ^b	New Company Shares Outstanding ^a		Ownership Distribution in New Company (%)	
	Without Pill	With Pill	Without Pill	With Pill
Target Firm Shareholders				
Shares Currently Outstanding	1,000,000	2,000,000	50	67 ^c
Total Shares Outstanding	1,000,000	2,000,000		
Acquiring Firm Shareholders				
Shares Currently Outstanding	1,000,000	1,000,000		
New Shares Issued	1,000,000	2,000,000	50	33
Total Shares Outstanding	2,000,000	3,000,000		
Flip-Over Pill Defense ^d	Without Pill	With Pill	Without Pill	With Pill
Target Firm Shareholders				
Shares Currently Outstanding	1,000,000	1,000,000	50	67
Total Shares Outstanding	1,000,000	1,000,000		
Acquiring Firm Shareholders				
Shares Currently Outstanding	1,000,000	1,000,000	50	33
New Shares Issued	1,000,000	2,000,000		
Total Shares Outstanding	2,000,000	3,000,000		

^a Acquirer agrees to exchange one share of acquirer stock for each share of target stock. The target shares outstanding are cancelled.

^b Poison pill provisions enable each target shareholder to buy one share of target stock for each share they own at a nominal price.

^c 2,000,000/3,000,000

^d One million new shares must be issued to target shareholders exercising their right to buy shares in the surviving or new company at a nominal price.

for a flip-over pill they bought 1 million new shares of the acquirer or surviving firm's shares. In either case, the acquirer had to issue 1 million new shares.

Proponents of the pill defense argue that it prevents a raider from acquiring a substantial portion of the firm's stock without board permission. Since the board generally has the power to rescind the pill, bidders are compelled to negotiate with the target's board, which could result in a higher offer price. Pill defenses may be most effective when used with staggered board defenses, in which a raider would be unable to remove the pill without winning two successive elections; this increases the likelihood of remaining independent.³⁴ Detractors argue that pill defenses simply serve to entrench management and encourage disaffected shareholders to litigate.

Shark Repellents

Shark repellents are specific types of takeover defenses achieved by amending either a *corporate charter* or the *corporation bylaws*. The charter gives the corporation its legal existence. The corporate charter consists of the *articles of incorporation*, a document filed with a state government by the founders of a corporation, and a *certificate of incorporation*, a document received from the state once the articles have been approved. The corporation's powers thus

³⁴ According to Bebchuk et al. (2002), the likelihood of remaining independent rises from 34 to 61% with such a combination of defenses, and the probability that the first bidder will be successful drops from 34 to 14%.

derive from the laws of the state and from the provisions of the charter. Rules governing the internal management of the corporation are described in the corporation's bylaws, which are determined by the corporation's founders.

Shark repellents are put in place largely to reinforce the ability of a firm's board of directors to retain control. They predate poison pills as a defense, and their success in slowing down takeovers and making them more expensive has been mixed—which, in fact, partly explains why the poison pill and other more creative defenses were developed.

Today, shark repellents have largely become supplements to poison pill defenses. Their primary role is to make it more difficult to gain control of the board through a proxy fight at an annual or special meeting. In practice, shark repellents as described here require amendments to the firm's charter, which necessitate a shareholder vote. Although there are many variations of shark repellents, the most typical are staggered board elections, restrictions on shareholder actions, antigreenmail provisions, supervoting, and debt-based defenses. [Table 3.5](#) summarizes the primary advantages and disadvantages of each type of shark repellent defense in three categories: those that strengthen the board's defenses, those that limit shareholder actions, and all others. Table 3.5 also includes poison pills and golden parachutes (detailed below).

Strengthening the Board's Defenses

Corporate directors are elected at annual shareholder meetings by a vote of the holders of a majority of shares, who are present and entitled to vote. However, the mechanism for electing directors differs among corporations, with voting shares being cast either through a straight vote or cumulatively. With straight voting, shareholders may cast all their votes for each

TABLE 3.5 Advantages and Disadvantages of Preoffer Takeover Defenses

Type of Defense	Advantages for Target Firm	Disadvantages for Target Firm
Poison Pills: Raising the Cost of Acquisition		
Flip-Over Pills (rights to buy stock in the acquirer, activated with 100% change in ownership)	Dilute ownership position of current acquirer shareholders Rights redeemable by buying them back from shareholders at nominal price	Ineffective in preventing acquisition of <100% of target (bidders could buy controlling interest only and buy remainder after rights expire) Subject to hostile tender contingent on target board's redemption of pill Makes issuer less attractive to white knights
Flip-In Pills (rights to buy stock in the target, activated when acquirer purchases <100% change in ownership)	Dilute target stock regardless of amount purchased by potential acquirer Discriminatory as not given to investor who activated the rights Rights redeemable at any point prior to triggering event	Not permissible in some states due to discriminatory nature No poison pill provides any protection against proxy contests

Continued

TABLE 3.5 Advantages and Disadvantages of Preoffer Takeover Defenses—Cont'd

Type of Defense	Advantages for Target Firm	Disadvantages for Target Firm
Shark Repellents: Strengthening the Board's Defenses		
Staggered or Classified Boards	Delay assumption of control by a majority shareholder	May be circumvented by increasing size of board unless prevented by charter or bylaws
Limitations on When Can Remove Directors	"For cause" provisions narrow range of reasons for removal	Can be circumvented unless supported by a super-majority requirement for repeal
Shark Repellents: Limiting Shareholder Actions		
Limitations on Calling Special Meetings	Limit ability to use special meetings to add board seats, remove, or elect new members	States may require a special meeting if a certain percentage of shareholders request a meeting.
Limiting Consent Solicitations	Limits ability of dissident shareholders to expedite a proxy contest process	May be subject to court challenge
Advance Notice Provisions	Give board time to select its own slate of candidates and to decide an appropriate response	May be subject to court challenge
Super-Majority Provisions	May be applied selectively to events such as hostile takeovers	Can be circumvented unless a super-majority of shareholders is required to change provision
Other Shark Repellents		
Antigreenmail Provision	Eliminates profit opportunity for raiders	Eliminates greenmail as a takeover defense
Fair Price Provisions	Increase the cost of a two-tiered tender offer	Raise the cost to a White Knight, unless waived by typically 95% of shareholders
Supervoting Stock	Concentrates control by giving "friendly" shareholders more voting power than others	Difficult to implement because requires shareholder approval and only useful when voting power can be given to pro-management shareholders
Reincorporation	Takes advantage of most favorable state antitakeover statutes	Requires shareholder approval; time consuming to implement unless subsidiary established before takeover solicitation
Golden Parachutes	Embolden target management to negotiate for a higher premium and raises the cost of a takeover to the hostile bidder	Negative public perception; make termination of top management expensive; cost not tax deductible

member of the board of directors, thereby virtually ensuring that the majority shareholder(s) will elect all of the directors. For example, assume that a corporation has four directors up for election and has two shareholders, one owning 80 shares (i.e., the majority shareholder) and one owning 20 shares (i.e., the minority shareholder); with each share having one vote, the majority shareholder will always elect the director for whom it casts its votes.

In contrast, *cumulative voting* systems are designed to allow for minority participation. Cumulative voting in the election of directors means that each shareholder is entitled to as many votes as shall equal the number of shares the shareholder owns, multiplied by the number of directors to be elected. Furthermore, the shareholder may cast all of these votes for a single candidate or for any two or more candidates. With cumulative voting, all directors are elected at the same time. Using the same example, the majority shareholder will have 320 votes (80×4), and the minority shareholder will have 80 votes (20×4). If the minority shareholder casts all of her votes for herself, she is assured of a seat, since the majority shareholder cannot outvote the minority shareholder for all four board seats. That is, while there are many possible combinations, if the majority shareholder were to cast 81 votes for each of three seats, he would have only 77 votes remaining (i.e., $320 - 243$) for the last seat. As the number of directors increases, it becomes easier for the minority shareholder to win a seat (or seats), since the majority shareholder's votes must be spread over more directors to block the minority shareholder. Consequently, it is generally easier to win seats as the number of directors up for election increases.

In states where cumulative voting is mandatory, companies sometimes distribute the election of directors over a number of years to make it harder for a dissident minority shareholder to gain control of the board. This makes it more difficult for the minority shareholder to elect a director when there is cumulative voting because there are fewer directors to be elected at one time. A *staggered or classified board election* involves dividing the firm's directors into a number of different classes. Only one class is up for reelection each year. For example, a 12-member board may have directors divided into four classes, with each director elected for a four-year period. In the first year, the three directors in what might be called "Class 1" are up for election; in the second year, "Class 2" directors are up for election; and so on.

This means that an insurgent stockholder, even one who holds the majority of the stock, would have to wait for three election cycles to gain control of the board. Moreover, the size of the board is limited by the firm's bylaws to preclude the insurgent stockholder from adding board seats to take control of the board. The likelihood of litigation is highest, and pressure on the board is greatest, whenever the offer price for the target is substantially above the target firm's current share price. Studies show that staggered boards can be effective in helping a target to ward off a hostile takeover attempt.³⁵

Opposition to staggered boards has been growing over time. According to proxy solicitor Georgeson Inc., the average share of votes cast in favor of declassifying boards in the 187 shareholder proposals to declassify boards between 2006 and 2010 averaged 65%. FactSet Research Systems has noted that between 2000 and 2009, the number of S&P 500 companies with classified boards declined from 300 to 164.

³⁵ Bebchuk, Coates, and Subramanian, 2002 and 2003

For cause provisions specify the conditions for removing a member of the board of directors, narrowing the range of permissible reasons and limiting the flexibility of dissident shareholders in contesting board seats.

Limiting Shareholder Actions

The board can also reinforce its control by restricting the ability of shareholders to gain control of the firm by bypassing the board altogether. Limits can be set on shareholders' ability to call special meetings, engage in consent solicitations, and use super-majority rules (explained below). Firms frequently rely on the conditions under which directors can be removed (i.e., the "for cause" provision discussed earlier) and a limitation on the number of board seats as defined in the firm's bylaws or charter.

In some states, shareholders may take action—without a special shareholders' meeting—to add to the number of seats on the board, remove specific board members, or elect new members. These states allow dissident shareholders to obtain shareholder support for their proposals simply by obtaining the written consent of shareholders under what is known as *consent solicitation*, a process that still must abide by the disclosure requirements applicable to proxy contests. The process circumvents delays inherent in setting up a meeting to conduct a stockholder vote.

There is an important difference between a consent solicitation and a proxy contest. Whereas the winning vote in a proxy fight is determined as a percentage of the number of votes actually cast (unless majority voting rules are in place, which require the counting of votes withheld), the winning vote in a consent solicitation is determined as a percentage of the number of shares outstanding. A dissident shareholder may, therefore, find it easier to win by initiating a proxy contest because many shareholders simply do not vote.

Corporate bylaws may include *advance notice provisions* that require shareholder proposals and board nominations to be announced well in advance, sometimes as long as two months, of an actual vote. This buys time for the target's management. *Super-majority rules* require a higher level of approval than is standard to amend the charter or for certain types of transactions, such as a merger or acquisition. Such rules are triggered when an "interested party" acquires a specific percentage of the ownership shares (e.g., 5 to 10%). Super-majority rules may require that as many as 80% of the shareholders approve a proposed merger, or a simple majority of all shareholders except the "interested party."

Other Shark Repellents

Other shark repellent defenses include antigreenmail provisions, fair price provisions, supervoting stock, reincorporation, and golden parachutes.

Antigreenmail Provisions

During the 1980s, many raiders profited by taking an equity position in a target firm, threatening takeover, and subsequently selling their ownership position back to the target firm at a premium over what they paid for the target's shares. The practice was dubbed "greenmail"—derived from "blackmail" and "greenback." In response, many corporations adopted charter amendments called *antigreenmail provisions* that restrict the firm's ability to repurchase shares at a premium.

Fair Price Provisions

Requirements that any acquirer pay minority shareholders at least fair market price for their stock are called *fair price provisions*. The fair market price may be expressed as some historical multiple of the company's earnings or as a specific price equal to the maximum price paid when the buyer acquired shares in the company. In two-tiered tender offers, the fair price provision forces the bidder to pay target shareholders who tender their stock in the second tier the same terms offered to those tendering their stock in the first tier.

Supervoting Stock

A firm may create more than one class of stock for many reasons, including separating the performance of individual operating subsidiaries, compensating subsidiary operating management, maintaining control with the founders, and preventing hostile takeovers. As a takeover defense, a firm may undertake a *dual class recapitalization*, the objective of which is concentrating stock with the greatest voting rights in the hands of those who are most likely to support management. One class of stock may have 10 to 100 times the voting rights of another class of stock. Such stock is called *supervoting stock*.

Supervoting stock is issued to all shareholders along with the right to exchange it for ordinary stock. Most shareholders are likely to exchange it for ordinary stock because the stock with the multiple voting rights usually has a limited resale market and pays a lower dividend than other types of voting stock the corporation issues. Typically, management retains the special stock, which effectively increases the voting control of the corporation in the hands of management. Ford Motor's class B common stock, which is not publicly traded but is held by the Ford family, has 40% of the voting power even though it represents less than 10% of the firm's total outstanding stock.

Under the voting rights policies of the SEC and major public exchanges, U.S. firms are allowed to list dual class shares. Once such shares are listed, however, firms cannot reduce the voting rights of existing shares or issue a new class of superior voting shares. Several hundred U.S. companies have issued dual class shares, including the *New York Times*, Dow Jones, the *Washington Post*, Coors, Tyson Foods, Facebook, Adelphia, Comcast, Viacom, Ford, and Google. Still, such shares are far more common in other countries.³⁶

Reincorporation

In some instances, a potential target firm may change the state within which it is incorporated to one where the laws are more favorable for implementing takeover defenses. This is done by creating a subsidiary in the new state, into which the parent is merged at a later date. Several factors need to be considered in selecting a state for such *reincorporation*, including how the state's courts have ruled in lawsuits alleging breach of corporate director fiduciary

³⁶ Research by Gompers, Ishii, and Metrick (2010) suggests that firms with dual class shares often underperform in the overall stock market. This may result from efforts to entrench controlling shareholders by erecting excessive takeover defenses and policies that are not in the best interests of noncontrolling shareholders, such as excessive compensation for key managers and board members. Moreover, such firms often have excessive leverage due to an unwillingness to raise additional funds by selling shares that could dilute the controlling shareholders' power.

responsibility in takeover situations, as well as the state's laws pertaining to poison pills, staggered boards, and hostile tender offers. Reincorporation requires shareholder approval.

Golden Parachutes

Employee severance arrangements that are triggered whenever a change in control takes place are called *golden parachutes*. A change in control usually is defined as any time an investor accumulates more than a fixed percentage of the corporation's voting stock. A golden parachute typically covers only a few dozen employees, who are terminated following the change in control and to whom the company is obligated to make a lump-sum payment. They are designed to raise the bidder's cost of the acquisition, rather than to gain time for the target board. Such severance packages may serve the interests of shareholders by making senior management more willing to accept an acquisition.

The 1986 Tax Act imposed stiff penalties on these types of plans if they create payments that exceed three times the employee's average pay over the previous five years, and it treats them as income and thus not tax-deductible by the paying corporation. The employee receiving the parachute payment must pay a 20% surcharge in addition to the normal tax due on the parachute payment. More recently, the Dodd-Frank bill of 2010 gives shareholders the opportunity to express their disapproval of golden parachutes through a nonbinding vote.

Postoffer Defenses

Once an unwanted suitor has approached a firm, there are a variety of additional defenses that can be introduced. These include greenmail to dissuade the bidder from continuing the pursuit; defenses designed to make the target less attractive, such as restructuring and recapitalization strategies; and efforts to place an increasing share of the company's ownership in friendly hands by establishing employee stock ownership plans (ESOPs) or seeking white knights. [Table 3.6](#) summarizes the advantages and disadvantages of these postoffer defenses.

Greenmail

Greenmail (introduced earlier) is the practice of paying a potential acquirer to leave you alone. It consists of a payment to buy back shares at a premium price in exchange for the acquirer's agreement not to commence a hostile takeover. In exchange for the payment, the potential acquirer is required to sign a *standstill agreement*, which typically specifies the amount of stock, if any, the investor can own, the circumstances under which the raider can sell stock currently owned, and the terms of the agreement. Courts view greenmail as discriminatory because not all shareholders are offered the opportunity to sell their stock back to the target firm at an above-market price. Nevertheless, courts in some states (e.g., Delaware) have found it to be an appropriate response if done for valid business reasons. Courts in other states (e.g., California) have favored shareholder lawsuits, contending that greenmail breaches fiduciary responsibility.³⁷

³⁷ Wasserstein, 1998, pp. 719–720

TABLE 3.6 Advantages and Disadvantages of Postoffer Takeover Defenses

Type of Defense	Advantages for Target Firm	Disadvantages for Target Firm
Greenmail	Encourages raider to go away (usually accompanied by a standstill agreement)	Reduces risk to raider of losing money on a takeover attempt; unfairly discriminates against nonparticipating shareholders; often generates litigation; triggers unfavorable tax consequences and negative publicity
Standstill Agreement	Prevents raider from returning for a specific time period	Increases amount of greenmail paid to get raider to sign standstill; provides only temporary reprieve
White Knights	May be a preferable to the hostile bidder	Involves loss of target's independence
ESOPs	Alternative to white knight and highly effective if used in conjunction with certain states' antitakeover laws	Employee support not guaranteed; ESOP cannot overpay for stock because transaction could be disallowed by federal law
Recapitalization	Makes target less attractive to bidder and may increase target shareholder value if incumbent management motivated to improve performance	Increased leverage reduces target's borrowing capacity
Share Buyback Plans	Reduce number of target shares available for purchase by bidder, arbs, and others who may sell to bidder	Securities laws limit ability to self-tender without SEC filing once hostile tender under way; reduction in the shares outstanding may facilitate bidder's gaining control
Corporate Restructuring	Going private may be an attractive alternative to bidder's offer for target shareholders and for incumbent management	Going private, sale of attractive assets, making defensive acquisitions, or liquidation may reduce target's shareholder value vs. bidder's offer
Litigation	May buy time for target to build defenses and increases takeover cost to the bidder	May have negative impact on target shareholder returns

White Knights

A target company seeking to avoid being taken over by a specific bidder may try to be acquired by a *white knight*: another firm that is considered a more appropriate suitor. To complete such a transaction, the white knight must be willing to acquire the target on terms more favorable than those of other bidders. Fearing that a bidding war might ensue, the white knight often demands some protection in the form of a lockup. This may involve giving the white knight options to buy stock in the target that has not yet been issued at a fixed price, or the option to acquire specific target assets at a fair price. Such lockups usually make the target less attractive to other bidders. If a bidding war does ensue, the knight may exercise the stock options and sell the shares at a profit to the acquiring company. German drug and chemical firm Bayer AG's white knight bid for Schering AG in 2006 (which was recommended by the Schering board) was designed to trump a hostile offer from a German rival, Merck KGaA—and it succeeded in repelling Merck.

Employee Stock Ownership Plans

ESOPs are trusts that hold a firm's stock as an investment for its employees' retirement program. They can be established quickly, with the company either issuing shares directly to the ESOP or having an ESOP purchase shares on the open market. The stock held by an ESOP is likely to be voted in support of management in the event of a hostile takeover attempt.

Leveraged Recapitalization

A company may recapitalize by assuming substantial amounts of new debt, which is used to either buy back stock or finance a dividend payment to shareholders. The additional debt reduces the company's borrowing capacity and leaves it in a highly leveraged position, making it less attractive to a bidder that may have wanted to use that capacity to help finance a takeover. Moreover, the payment of a dividend or a stock buyback may persuade shareholders to support the target's management in a proxy contest or hostile tender offer. The primary differences between a leveraged recapitalization and a leveraged buyout are that the firm remains a public company and that management does not take a significant equity stake in the firm. Recapitalization may require shareholder approval, depending on the company's charter and the laws of the state in which it is incorporated.³⁸

Share Repurchase or Buyback Plans

Firms repurchase shares to reward shareholders, signal undervaluation, fund ESOPs, adjust capital structure, and defend against unwanted takeovers.³⁹ These repurchases can be executed either through a tender offer or by direct purchases of shares in public markets. When used as an antitakeover tactic, share repurchase or buyback plans aim to reduce the number of shares that could be purchased by the potential acquirer or by arbitrageurs who will sell to the highest bidder. This tactic reflects the belief that when a firm initiates a tender offer for a portion of its own shares, the shareholders who offer their shares for sale are those who are most susceptible to a tender offer by a hostile bidder. This leaves the target firm's shares concentrated in the hands of shareholders who are less likely to sell, thereby reducing float. So for a hostile tender offer to succeed in purchasing the remaining shares, the premium offered would have to be higher. The resulting higher premium might discourage some prospective bidders.

There is considerable evidence that buyback strategies are an effective deterrent.⁴⁰ The repurchase tactic, however, may be subject to the "law of unintended consequences."

³⁸ Whether the recapitalization actually weakens the target firm over the long term depends on its impact on shareholder value. Shareholders will benefit from the receipt of a dividend or from capital gains resulting from a stock repurchase. Furthermore, the increased debt service requirements of the additional debt will shelter a substantial amount of the firm's taxable income and may encourage management to be more conscientious about improving the firm's performance. Thus, the combination of these factors may result in current shareholders benefiting more from this takeover defense than from a hostile takeover of the firm.

³⁹ According to Billett and Xue (2007), firms frequently increase their share repurchase activities when confronted with an imminent takeover threat.

⁴⁰ Potential acquirers are less likely to pursue firms with substantial excess cash, which could be used to adopt highly aggressive share repurchase programs (Harford, 1999; Pinkowitz, 2002; Faleye, 2004).

Reducing the number of shares on the open market makes it easier for the buyer to gain control because fewer shares have to be purchased to achieve 50.1% of the target's voting shares.

Corporate Restructuring

Restructuring may involve taking the company private, selling attractive assets, undertaking a major acquisition, or even liquidating the company. "Going private" typically involves the management team's purchase of the bulk of a firm's shares. This may create a win-win situation for shareholders, who receive a premium for their stock and management, which retains control. To avoid lawsuits, the price paid for the stock must represent a substantial premium to the current market price. Alternatively, the target may make itself less attractive by divesting assets the bidder wants.

The cash proceeds of such sales could fund other defenses, such as share buybacks or payment of a special stockholder dividend. A target company also may undertake a so-called *defensive acquisition* to draw down any excess cash balances and to exhaust its current borrowing capacity. A firm may choose to liquidate the company, pay off outstanding obligations to creditors, and distribute the remaining proceeds to shareholders as a *liquidating dividend*. This makes sense only if the liquidating dividend exceeds what the shareholders would have received from the bidder.

Litigation

Takeover litigation often includes antitrust concerns, alleged violations of federal securities laws, inadequate disclosure by the bidder as required by the Williams Act, and alleged fraudulent behavior. Targets often seek a court injunction to stop the takeover attempt, at least temporarily, until the court has decided the merits of the allegations. By preventing the potential acquirer from acquiring more stock, the target firm is buying more time to erect additional defenses. While litigation is seldom successful in preventing a takeover, it may uncover additional information such as inadequate disclosure by the bidder through the ensuing discovery or fact-finding process that enables more substantive lawsuits.

THE IMPACT OF TAKEOVER DEFENSES ON SHAREHOLDER AND BONDHOLDER VALUE

Chapter 1 discussed the dramatic increase in abnormal financial returns—more than 30%, on average—since the 1960s to target shareholders around the time of a hostile tender offer announcement. Meanwhile, average abnormal returns to acquirer shareholders have deteriorated from marginally positive to slightly negative. Abnormal returns to target shareholders in friendly takeovers have remained at about 20%. What has spurred this increase in target company shareholder returns when hostile bids are at work? It could be potential improvements in efficiency, tax savings, or market power. However, if any of these were the explanation, we would be right to expect abnormal returns for mergers to show a correspondingly large increase over time—which they have not. Consequently, the explanation must lie elsewhere.

It is probably more than coincidental that the increase in abnormal returns began with the introduction of the 1967 Wallace Act prenotification period, which provides a respite for target firms to erect takeover defenses and search for other potential bidders. Takeover defenses such as poison pills, although unlikely to prevent a takeover, can add significantly to the overall purchase price. The purchase price can be boosted even further by an auction that might take place, as the initial bidder loses precious time in trying to overcome myriad defenses the target may be employing. Thus, the increasing sophistication of takeover defenses since 1980 would seem to be a highly plausible explanation—that is, at least intuitively—for the sustained increase in abnormal returns to target shareholders following the announcement of a hostile tender offer.

Unfortunately, this is a difficult intuitive argument to substantiate. Some empirical evidence seems to suggest that takeover defenses in general have virtually no statistically significant impact on shareholder returns.⁴¹ Other evidence points to poison pills having a positive impact.⁴² Studies that find a positive return seem to support the idea that incumbent management acts in the best interests of shareholders (the shareholder's interest hypothesis), while those studies that find a negative return seem to support the notion that incumbent management acts in its own interests (the management entrenchment hypothesis).

Overall, despite multiple studies, the research is largely contradictory.⁴³ While some studies demonstrate a correlation between firm performance and takeover defenses, it is difficult to substantiate that the correlation is a result of takeover defenses protecting incompetent management or simply reflecting the tendency of poorly managed firms to have takeover defenses.

⁴¹ DeAngelo and Rice (1983) found no statistically significant negative results. Karpoff and Walkling (1996) found that shareholder efforts to remove takeover defenses had no significant impact on shareholder returns, suggesting that such efforts were viewed by investors as largely inconsequential. Field and Karpoff (2002), in a study of 1,019 initial public offerings between 1988 and 1992, found that takeover defenses had no impact on the takeover premiums of firms acquired after the IPO.

⁴² Comment and Schwert (1995) found that poison pills would have a positive impact on shareholder returns if their addition by the target were viewed by investors as a signal that a takeover was imminent or that the firm's management would use such a defense to improve the purchase price during negotiations. The existence of poison pills often requires the bidder to raise its bid or to change the composition of its bid to an all-cash offer to put the target's board under pressure to dismantle its pill defenses. Timing also is important. For example, whenever a merger announcement coincided with the announcement of a poison pill, abnormal returns to target shareholders increased by 3 to 4%. Several studies suggest that investors react positively to the announcement of the adoption of takeover defenses if the firm's management interests are viewed as aligned with those of the shareholders, and negatively if management is viewed as seeking to entrench itself (Boyle et al., 1998; Malekzadeh et al., 1998).

⁴³ Comment and Schwert (1995) present a comprehensive review of previous studies, including Malatesta and Walkling (1988), Ryngaert (1988), Karpoff and Malatesta (1989), and Romano (1993). From these studies, the authors found that most takeover defenses, such as staggered boards, super-majority provisions, fair-price provisions, reincorporation, and dual capitalization resulted in a slightly negative decline in shareholder returns of about 0.5%.

Takeover Defenses May Destroy Shareholder Value

Despite the largely mixed results from earlier studies, more recent research suggests that takeover defenses may actually destroy shareholder value. For instance, the creation of a detailed “management entrenchment index” revealed that during the 1990s, firms at which management’s interests are more aligned with those of the shareholders (i.e., firms employing good governance practices) had larger positive abnormal returns than firms with a high entrenchment index (i.e., those not employing good governance practices).⁴⁴ However, the close correlation between a firm’s governance practices and abnormal returns disappeared in the 2000s, since investors had already bid up the prices of those firms that had implemented good governance practices in the 1990s and penalized those that had not.⁴⁵

Another large study provides additional evidence of the destructive effect of takeover defenses, finding that managers at firms protected by takeover defenses are less subject to the disciplinary power of the market for corporate control and are more likely to engage in “empire building” acquisitions that destroy shareholder value.⁴⁶

When firms move immediately from staggered board elections to annual elections of directors, they experience a cumulative abnormal return of 1.82%, reflecting investor expectations that the firm is more likely to be subject to a takeover. Often, such firms come under considerable pressure from activist shareholders, and the presence of a greater proportion of independent directors means that these firms are often more willing to submit to the demands of those activists.⁴⁷

Takeover Defenses and Public Offerings

Event studies (a research approach introduced in Chapter 1) examine only how takeover defenses affect shareholder wealth after the corporation has been formed, shareholders have purchased its stock, and employees and managers have been hired. It may be the case, though, that takeover defenses create significant firm value at the very point the firm is formed. Consequently, fully evaluating the impact of takeover defenses on firm value requires giving consideration both to the potentially beneficial effects before the event of a takeover attempt and to the potentially destructive effects on firm value after the announcement. Takeover defenses may add to firm value before a takeover attempt if they help the firm

⁴⁴ Bebchuk et al. (2005) created a management entrenchment index in an effort to assess which of 24 provisions tracked by the Investor Responsibility Research Center (IRRC) had the greatest impact on shareholder value. The index, which is negatively correlated with firm value between 1990 and 2003, comprises staggered boards, limits to shareholder bylaw amendments, super-majority requirements for mergers, super-majority requirements for charter amendments, poison pills, and golden parachutes. No correlation between firm value and 18 other IRRC provisions during the sample period was found. The researchers note that the mere existence of correlation does not necessarily mean that these takeover defenses cause a reduction in the value of the firm. The correlation could reflect the tendency of underperforming firms that are likely to be takeover targets to adopt takeover defenses.

⁴⁵ Bebchuk, Cohen, and Wang, 2010

⁴⁶ Masulis et al., 2007

⁴⁷ Guo et al., 2008

attract, retain, and motivate effective managers and employees. Furthermore, such defenses give the new firm time to implement its business plan fully and invest in upgrading the skills of employees.⁴⁸ There is also evidence that investors may prefer the adoption of takeover defenses during the early stages of a firm's development.⁴⁹

Takeover Defenses and Bondholders

Companies with limited takeover defenses are often vulnerable to hostile takeovers, which may hurt bondholders.⁵⁰ While the increased potential for takeover may benefit shareholder investors, existing bondholders stand to lose if the takeover results in a significant increase in leverage. This is typical of a leveraged buyout. Higher leverage can reduce the value of outstanding debt by increasing the potential for future bankruptcy.

SOME THINGS TO REMEMBER

The market in which takeover tactics and defenses are employed is called the corporate takeover market, which in a free market economy facilitates the allocation of resources and disciplines underperforming managers. By replacing such managers, the corporate takeover market can help protect stakeholder interests by promoting good corporate governance. In addition to the corporate takeover market, other factors external to the firm—such as federal and state legislation, the court system, regulators, and institutional activism—serve important roles in maintaining good corporate governance practices. Corporate governance is also affected by the integrity and professionalism of the firm's board of directors, as well as the effectiveness of the firm's internal controls and incentive systems, takeover defenses, and corporate culture.

Takeovers often are divided into friendly and hostile categories. If the friendly approach is considered inappropriate or is unsuccessful, the acquiring company may attempt to limit the options of the target's senior management by making a formal acquisition proposal, usually involving a public announcement, to the target's board of directors. Alternatively, the bidder may undertake a proxy contest, to change the composition of the target's board, or a tender offer, to go directly to shareholders.

Takeover defenses are designed to raise the overall cost of the takeover attempt and provide the target firm with more time to install additional takeover defenses. Preoffer defenses usually require shareholder approval and fall into three categories: poison pills, shark repellents, and golden parachutes. Postoffer defenses are those undertaken in response to a bid.

⁴⁸ Stout, 2002

⁴⁹ This is suggested by the finding of Coates (2001) that the percentage of IPO firms with staggered boards in their charters at the time of the initial public offering rose from 34% in the early 1990s to 82% in 1999.

⁵⁰ Cremers et al., 2004

DISCUSSION QUESTIONS

- 3.1 What are the management entrenchment and shareholder's interests hypotheses? Which seems more realistic in your judgment? Explain your answer.
- 3.2 What are the advantages and disadvantages of the friendly and hostile approaches to a corporate takeover? Be specific.
- 3.3 What are proxy contests and how are they used?
- 3.4 What is a tender offer? How does it differ from open market purchases of stock?
- 3.5 How are target shareholders affected by a hostile takeover attempt?
- 3.6 How are bidder shareholders affected by a hostile takeover attempt?
- 3.7 What are the primary advantages and disadvantages of commonly used takeover defenses?
- 3.8 Of the most commonly used takeover defenses, which seem to have the most favorable impact on target shareholders? Explain your answer.
- 3.9 How may golden parachutes for senior management help a target firm's shareholders? Are such severance packages justified in your judgment? Explain your answer.
- 3.10 How might recapitalization as a takeover defense help or hurt a target firm's shareholders?
- 3.11 Anheuser-Busch (AB) rejected InBev's all-cash offer price of \$65 per share on June 30, 2008, saying it undervalued the company, despite the offer representing a 35% premium to AB's preannouncement share price. InBev refused to raise its offer, while repeating its strong preference for a friendly takeover. Speculate as to why InBev refused to raise its initial offer price. Why do you believe that InBev continued to prefer a friendly takeover? What do you think InBev should have done to raise pressure on the AB board to accept the offer?
- 3.12 What do you believe are the primary factors a target firm's board should consider when evaluating a bid from a potential acquirer?
- 3.13 If you were the CEO of a target firm, what strategy would you recommend to convince institutional shareholders to support your position in a proxy battle with the bidding firm?
- 3.14 Anheuser-Busch reduced its antitakeover defenses in 2006, when it removed its staggered board structure. Two years earlier, it did not renew its poison pill provision. Speculate as to why the board acquiesced in these instances. Explain how these events may have affected the firm's vulnerability to a takeover.
- 3.15 In response to Microsoft's efforts to acquire the firm, the Yahoo! board adopted a "change in-control" compensation plan in May 2008. The plan stated that if a Yahoo! employee's job is terminated by Yahoo! without cause (i.e., the employee is performing his or her duties appropriately) or if an employee leaves voluntarily due to a change in position or responsibilities within two years after Microsoft acquires a controlling interest in Yahoo!, the employee will receive one year's salary. Also, the plan provides for accelerated vesting of all stock options. Yahoo! notes that the adoption of the severance plan is an effort to ensure that employees are treated fairly if Microsoft wins control. Microsoft views the tactic as an effort to discourage a takeover. With whom do you agree and why?

Answers to these Chapter Discussion Questions are available in the Online Instructor's Manual for instructors using this book.

CHAPTER BUSINESS CASES

CASE STUDY 3.1

Mittal Acquires Arcelor—A Battle of Global Titans in the European Corporate Takeover Market

Ending five months of maneuvering, Arcelor agreed on June 26, 2006, to be acquired by larger rival Mittal Steel Co. for \$33.8 billion in cash and stock. The takeover battle was one of the most acrimonious in recent European Union history. Hostile takeovers are now increasingly common in Europe. The battle is widely viewed as a test case as to how far a firm can go in attempting to prevent an unwanted takeover.

Arcelor was created in 2001 by melding steel companies in Spain, France, and Luxembourg. Most of its 90 plants are in Europe. In contrast, most of Mittal's plants are outside of Europe in areas with lower labor costs. Lakshmi Mittal, Mittal's CEO and a member of an important industrial family in India, started the firm and built it into a powerhouse through two decades of acquisitions in emerging nations. The company is headquartered in the Netherlands for tax reasons. Prior to the Arcelor acquisition, Mr. Mittal owned 88% of Mittal's stock.

Mittal acquired Arcelor to accelerate steel industry consolidation and thus reduce industry overcapacity. The combined firms could have more leverage in setting prices and negotiating contracts with major customers, such as auto and appliance manufacturers, and suppliers, such as iron ore and coal vendors, and they could eventually realize \$1 billion annually in pretax cost savings.

After having been rebuffed by Guy Dolle, Arcelor's president, in an effort to consummate a friendly merger, Mittal launched a tender offer in January 2006 consisting of mostly stock and cash for all of Arcelor's outstanding equity. The offer constituted a 27% premium

over Arcelor's share price at that time. The reaction from Arcelor's management, European unions, and government officials was swift and furious. Guy Dolle stated flatly that the offer was "inadequate and strategically unsound." European politicians supported Mr. Dolle. Luxembourg's prime minister, Jean Claude Juncker, said a hostile bid "calls for a hostile response." Trade unions expressed concerns about potential job loss.

Dolle engaged in one of the most aggressive takeover defenses in recent corporate history. In early February, Arcelor doubled its dividend and announced plans to buy back about \$8.75 billion in stock at a price well above the then current market price for Arcelor stock. These actions were taken to motivate Arcelor shareholders not to tender their shares to Mittal. Arcelor also backed a move to change the law so that Mittal would be required to pay in cash. However, the Luxembourg parliament rejected that effort.

To counter these moves, Mittal Steel said in mid-February that if it received more than one-half of the Arcelor shares submitted in the initial tender offer, it would hold a second tender offer for the remaining shares at a slightly lower price. Mittal pointed out that it could acquire the remaining shares through a merger or corporate reorganization. Such rhetoric was designed to encourage Arcelor shareholders to tender their shares during the first offer.

In late 2005, Arcelor outbid German steelmaker Metallgesellschaft to buy Canadian steelmaker Dofasco for \$5 billion. Mittal was proposing to sell Dofasco to raise money

CASE STUDY 3.1 *(cont'd)*

and avoid North American antitrust concerns. Following completion of the Dofasco deal in April 2006, Arcelor set up a special Dutch trust to prevent Mittal from getting access to the asset. The trust is run by a board of three Arcelor appointees. The trio has the power to determine if Dofasco can be sold during the next five years. Mittal immediately sued to test the legality of this tactic.

In a deal with Russian steel maker OAO Severstahl, Arcelor agreed to exchange its shares for Alexei Mordashov's 90% stake in Severstahl. The transaction would give Mr. Mordashov a 32% stake in Arcelor. Arcelor also scheduled an unusual vote that created very tough conditions for Arcelor shareholders to prevent the deal with Severstahl from being completed. Arcelor's board stated that the Severstahl deal could be blocked only if at least 50% of all Arcelor shareholders would vote against it. However, Arcelor knew that only about one-third of its shareholders actually attend meetings. This is a tactic permissible under Luxembourg law, where Arcelor is incorporated.

Investors holding more than 30% of the Arcelor shares signed a petition to force the company to make the deal with Severstahl subject to a traditional 50.1% or more of actual votes cast. After major shareholders pressured the Arcelor board to at least talk to Mr. Mittal, Arcelor demanded an intricate business plan from Mittal as a condition that had to be met. Despite Mittal's submission of such a plan, Arcelor still refused to talk. In late May, Mittal raised its bid by 34% and said that if the bid succeeded, Mittal would eliminate his firm's two-tiered share structure, giving the Mittal family shares ten times the voting rights of other shareholders.

A week after receiving the shareholder petition, the Arcelor board rejected Mittal's sweetened bid and repeated its support of the Severstahl deal. Shareholder anger continued, and many investors said they would reject the share buyback. Some investors opposed the buyback because it would increase Mr. Mordashov's ultimate stake in Arcelor to 38% by reducing the number of Arcelor shares outstanding. Under the laws of most European countries, any entity owning more than a third of a company is said to have effective control. Arcelor cancelled a scheduled June 21 shareholder vote on the buyback. Despite Mr. Mordashov's efforts to enhance his bid, the Arcelor board asked both Mordashov and Mittal to submit their final bids by June 25.

Arcelor agreed to Mittal's final bid, which had been increased by 14%. The new offer consisted of \$15.70 in cash and 1.0833 Mittal shares for each Arcelor share. The new bid is valued at \$50.54 per Arcelor share, up from Mittal's initial bid in January 2006 of \$35.26. The final offer represented an unprecedented 93% premium over Arcelor's share price of \$26.25 immediately before Mittal's initial bid. Lakshmi Mittal will control 43.5% of the combined firm's stock. Mr. Mordashov will receive a \$175 million breakup fee due to Arcelor's failure to complete its agreement with him. Finally, Mittal agreed not to make any layoffs beyond what Arcelor already has planned.

Discussion Questions

1. Identify the takeover tactics employed by Mittal. Explain why each one was used.
2. Identify the takeover defenses employed by Arcelor. Explain why each was used.
3. Using the information in this case study, discuss the arguments for and against

CASE STUDY 3.1 *(cont'd)*

- encouraging hostile corporate takeovers. Be as specific as possible.
4. Was Arcelor's board and management acting to protect their own positions (i.e., according to the management entrenchment hypothesis) or the best

interests of the shareholders (i.e., the shareholder's interests hypothesis)? Explain your answer.

Answers to these questions are found in the Online Instructor's Manual available to instructors using this book.

CASE STUDY 3.2

Verizon Acquires MCI—The Anatomy of Alternative Bidding Strategies

While many parties were interested in acquiring MCI, the major players included Verizon and Qwest. U.S.-based Qwest is an integrated communications company that provides data, multimedia, and Internet-based communication services on a national and global basis. The acquisition would ease the firm's huge debt burden of \$17.3 billion because the debt would be supported by the combined company with a much larger revenue base and give it access to new business customers and opportunities to cut costs.

Verizon Communications, created through the merger of Bell Atlantic and GTE in 2000, is the largest telecommunications provider in the United States. The company provides local exchange, long distance, Internet, and other services to residential, business, and government customers. In addition, the company provides wireless services to over 42 million customers in the United States through its 55%-owned JV with Vodafone Group PLC. Verizon stated that the merger would enable it to more efficiently provide a broader range of services, give the firm access to MCI's business customer base, accelerate new product development using MCI's fiber-optic network infrastructure, and create substantial cost savings.

By mid-2004, MCI had received several expressions of interest from Verizon and Qwest regarding potential strategic relationships. By July, Qwest and MCI entered into a confidentiality agreement and proceeded to perform more detailed due diligence. Ivan Seidenberg, Verizon's chairman and CEO, inquired about a potential takeover and was rebuffed by MCI's board, which was evaluating its strategic options. These included Qwest's proposal regarding a share-for-share merger, following a one-time cash dividend to MCI shareholders from MCI's cash in excess of its required operating balances. In view of Verizon's interest, MCI's board of directors directed management to advise Richard Notebaert, the chairman and CEO of Qwest, that MCI was not prepared to move forward with a potential transaction. The stage was set for what would become Qwest's laboriously long and ultimately unsuccessful pursuit of MCI, in which the firm would improve its original offer four times, only to be rejected by MCI in each instance even though the Qwest bids exceeded Verizon's.

After assessing its strategic alternatives, including the option to remain a standalone company, MCI's board of directors concluded

CASE STUDY 3.2 *(cont'd)*

that the merger with Verizon was in the best interests of the MCI stockholders. MCI's board of directors noted that Verizon's bid of \$26 in cash and stock for each MCI share represented a 41.5% premium over the closing price of MCI's common stock on January 26, 2005. Furthermore, the stock portion of the offer included "price protection" in the form of a collar (i.e., the portion of the purchase price consisting of stock would be fixed within a narrow range if Verizon's share price changed between the signing and closing of the transaction).

The merger agreement also provided for the MCI board to declare a special dividend of \$5.60 once the firm's shareholders approved the deal. MCI's board of directors also considered the additional value that its stockholders would realize, since the merger would be a tax-free reorganization in which MCI shareholders would be able to defer the payment of taxes until they sold their stock. Only the cash portion of the purchase price would be taxable immediately. MCI's board of directors also noted that a large number of MCI's most important business customers had indicated that they preferred a transaction between MCI and Verizon rather than a transaction between MCI and Qwest.

While it is clearly impossible to know for sure, the sequence of events reveals a great deal about Verizon's possible bidding strategy. Any bidding strategy must begin with a series of management assumptions about how to approach the target firm. It was certainly in Verizon's best interests to attempt a friendly rather than a hostile takeover of MCI, due to the challenges of integrating these two complex businesses. Verizon also employed an increasingly popular technique in which the merger agreement includes a special dividend payable by the target firm to its shareholders contingent upon their approval of the transaction. This

special dividend is an inducement to gain shareholder approval.

Given the modest 3% premium over the first Qwest bid, Verizon's initial bidding strategy appears to have been based on the low end of the purchase price range it was willing to offer MCI. Verizon was initially prepared to share relatively little of the potential synergy with MCI shareholders, believing that a bidding war for MCI would be unlikely in view of the recent spate of mergers in the telecommunications industry and the weak financial position of other competitors. SBC and Nextel were busy integrating AT&T and Sprint, respectively. Moreover, Qwest appeared to be unable to finance a substantial all-cash offer due to its current excessive debt burden, and its stock appeared to have little appreciation potential because of ongoing operating losses. Perhaps stunned by the persistence with which Qwest pursued MCI, Verizon believed that its combination of cash and stock would ultimately be more attractive to MCI investors than Qwest's primarily all-cash offer, due to the partial tax-free nature of the bid.

Throughout the bidding process, many of the hedge funds criticized MCI's board publicly for accepting the initial Verizon bid. Since its emergence from Chapter 11, hedge funds had acquired significant positions in MCI's stock, with the expectation that MCI would constitute an attractive merger candidate. In particular, Carlos Slim Helu, the Mexican telecommunications magnate and largest MCI shareholder, complained publicly about the failure of MCI's board to get full value for the firm's shares. Pressure from hedge funds and other dissident MCI shareholders triggered a shareholder lawsuit to void the February 14, 2005, signed merger agreement with Verizon.

In preparation for a possible proxy fight, Verizon entered into negotiations with Carlos Slim

CASE STUDY 3.2 (cont'd)

Helu to acquire his shares. Verizon acquired Helu's 13.7% stake in MCI in April 2005. Despite this purchase, Verizon's total stake in MCI remained below the 15% ownership level that would trigger the MCI rights plan.

About 70% (i.e., \$1.4 billion) of the cash portion of Verizon's proposed purchase price consisted of a special MCI dividend payable by MCI itself when the firm's shareholders approved the merger agreement. Verizon's management argued that the deal would cost their shareholders only \$7.05 billion (i.e., the \$8.45 billion purchase price consisting of cash and stock, less the MCI special dividend). The \$1.4 billion special dividend reduced MCI's cash in excess of what was required to meet its normal operating cash requirements.

Qwest consistently attempted to outmaneuver Verizon by establishing a significant premium between its bid and Verizon's, often as much as 25%. Qwest realized that its current level of indebtedness would preclude it from significantly increasing the cash portion of the bid. Consequently, it had to rely on the premium to attract enough investor interest, particularly among hedge funds, to pressure the MCI board to accept the higher bid. However, Qwest was unable to convince enough investors that its stock would not simply lose value once more shares were issued to consummate the stock and cash transaction.

Qwest could have initiated a tender or exchange offer directly to MCI shareholders, proposing to purchase or exchange their shares without going through the merger process. The tender process requires lengthy regulatory approval. However, if Qwest initiated a tender offer, it could trigger MCI's poison pill. Alternatively, a proxy contest might have been preferable because Qwest already had a

bid on the table, and the contest would enable Qwest to lobby MCI shareholders to vote against the Verizon bid. This strategy would have avoided triggering the poison pill.

Ultimately, Qwest was forced to capitulate simply because it did not have the financial wherewithal to increase the \$9.9 billion bid. It could not borrow any more because of its excessive leverage. Additional stock would have contributed to earnings dilution and caused the firm's share price to fall.

It is unusual for a board to turn down a higher bid, especially when the competing bid is 17% higher. In accepting the Verizon bid, MCI stated that a number of its large business customers had expressed a preference for the company to be bought by Verizon rather than Qwest. MCI noted that these customer concerns posed a significant risk in being acquired by Qwest. The MCI board's acceptance of the lower Verizon bid could serve as a test case of how well MCI directors conducted their fiduciary responsibilities. The central issue is how far boards can go in rejecting a higher offer in favor of one they believe offers more long-term stability for the firm's stakeholders.

Ron Perlman, the 1980s takeover mogul, saw his higher all-cash bid rejected by the board of directors of Revlon Corporation, which accepted a lower offer from another bidder. In a subsequent lawsuit, a court overruled the decision by the Revlon board in favor of the Perlman bid. Consequently, from a governance perspective, legal precedent compels boards to accept higher bids from bona fide bidders where the value of the bid is unambiguous, as in the case of an all-cash offer. However, for transactions in which the purchase price is composed largely of acquirer stock, the value is less certain. As a

CASE STUDY 3.2 *(cont'd)*

result, the target's board may rule that the lower bidder's shares have higher appreciation potential or at least are less likely to decline than those shares of other bidders.

MCI's president and CEO Michael Capellas and other executives could collect \$107 million in severance, payouts of restricted stock, and monies to compensate them for taxes owed on the payouts. In particular, Capellas stands to receive \$39.2 million if his job is terminated "without cause" or if he leaves the company "for good reason."

Discussion Questions

1. Discuss how changing industry conditions have encouraged consolidation within the telecommunications industry.
2. What alternative strategies could Verizon, Qwest, and MCI have pursued? Was the decision to acquire MCI the best alternative for Verizon? Explain your answer.
3. Who are the winners and losers in the Verizon–MCI merger? Be specific.
4. What takeover tactics were employed or threatened to be employed by Verizon? By Qwest? Be specific.
5. What specific takeover defenses did MCI employ?
6. How did the actions of certain shareholders affect the bidding process? Be specific.
7. In your opinion, did the MCI board act in the best interests of their shareholders? Of all their stakeholders? Be specific.
8. Do you believe that the potential severance payments that could be paid to Capellas were excessive? Explain your answer. What are the arguments for and against such severance plans for senior executives?
9. Should the antitrust regulators approve the Verizon–MCI merger? Explain your answer.
10. Verizon's management argued that the final purchase price from the perspective of Verizon shareholders was not \$8.45 billion but rather \$7.05 billion. This was so, they argued, because MCI was paying the difference of \$1.4 billion from their excess cash balances as a special dividend to MCI shareholders. Why is this misleading?

Answers to these discussion questions are available in the Online Instructor's Manual for instructors using this book.