

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Mergers and Acquisitions

Volume Author/Editor: Alan J. Auerbach, ed.

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-03209-4

Volume URL: <http://www.nber.org/books/auer87-1>

Publication Date: 1987

Chapter Title: An Overview of Takeover Defenses

Chapter Author: Richard S. Ruback

Chapter URL: <http://www.nber.org/chapters/c5821>

Chapter pages in book: (p. 49 - 68)

---

# 3 An Overview of Takeover Defenses

Richard S. Ruback

## 3.1 Introduction

Takeover defenses include all actions by managers to resist having their firms acquired. Attempts by target managers to defeat outstanding takeover proposals are overt forms of takeover defenses. Resistance also includes actions that occur before a takeover offer is made which make the firm more difficult to acquire.

The intensity of the defenses can range from mild to severe. Mild resistance forces bidders to restructure their offers, but does not prevent an acquisition or raise the takeover price substantially. Severe resistance can block takeover bids, thereby giving the incumbent managers of the target firm veto power over acquisition proposals.

A natural place to begin the analysis of takeover defenses is with the wealth effects of takeovers. There is broad agreement that being a takeover target substantially increases the wealth of shareholders. Historical estimates of the stock price increases of target firms are about 20 percent in mergers and about 30 percent in tender offers.<sup>1</sup> More recently, premiums have exceeded 50 percent. It does not require a lot of complicated analysis to determine that the right to sell a share of stock for 50 percent more than its previous market price benefits target shareholders.

At first glance, the large gains for target stockholders in takeovers seems to imply that all takeover resistance is bad.

Richard S. Ruback is an associate professor of finance at the Sloan School of Management, Massachusetts Institute of Technology.

Resistance makes the firm more difficult to acquire. If the defense works, it lowers the probability of a takeover and stockholders are thus less likely to receive takeover premiums. Even for an economist, it is hard to argue that shareholders benefit by reducing their chance to sell shares at a premium.

But the issue is not that simple. Takeover resistance can benefit shareholders. Stockholders are concerned about the market value of the firm. The market value of any firm is the sum of two components: the value of the firm conditional on retaining the same management team; and the expected change in value of the firm from a corporate control change, which equals the probability of a takeover times the change in value from a takeover.

$$\text{Market value of the firm} = \text{Value of the firm with current managers} + \text{Probability of a control change} \times \text{Change in value from a control change}$$

Stockholders are concerned about how takeover defenses affect all three components of value: the value of the firm under current managers, the probability of an acquisition, and the offer price if a takeover bid occurs.

While takeover defenses may lower the probability of being acquired, they may also increase the offer price. Furthermore, takeover defenses can affect the value of the firm even if it is not acquired, that is, the value with its incumbent management team. For example, consider a defense that allows incumbent managers to completely block all takeover bids. This would reduce the probability of a control change to zero and eliminate the expected takeover premium. The market price of the firm would then consist entirely of the value with its incumbent managers. This value arguably could be affected in two opposite ways by the takeover defense. First, the value could decrease as managers enjoy the leisure that the isolation from being fired provides. Second, the value could increase as managers stop wasting time and corporate resources worrying about a hostile takeover.

It is difficult to determine a priori whether takeover defenses are good or bad for stockholders. But one way to assess a takeover defense is to examine the rationale for resistance. Managers resist takeovers for three broad reasons: (1) they believe the firm has hidden values; (2) they believe resistance will increase the offer price; and (3) they want to retain their positions.

### 3.1.1 Managers Believe the Firm Has Hidden Values

The managers of most corporations have private information about the future prospects of the firm. This information usually includes plans, strategies, ideas, patents, and similar items that cannot be made public. Even if efficient, market prices cannot include the value of information that the market does not have. When assessing a takeover bid, managers compare the offer price to their own estimate of the value of the firm. Their estimate, of course, includes the value of the private information that they possess. When the inside information is favorable, the managers' per share assessment of value will exceed the market price of the firm's stock. Offer prices above the market price of the stock could be below the managers' assessment of its value. In such cases, managers would help stockholders by actively opposing the offer.

Opposition based on "hidden values" is in the shareholders' interests only when the private information is valuable. A problem is that the general optimism of managers about the future of their firms clouds their perception of values. Most top managers usually argue that their firms are undervalued by the market. They believe the market is systematically inefficient—it always underestimates the value of their firm. But this optimism, or distrust of market prices, is an insufficient basis for opposing takeover bids.

To qualify as a potential stockholder wealth-increasing reason to oppose takeovers, the inside information must be of the type that an investor would pay to obtain.

### 3.1.2 Managers Believe Resistance Will Increase the Offer Price

In most transactions in which there is disagreement about value, it pays to haggle about price. Corporate takeovers are no exception. In mergers, the managers of the target and bidding firms negotiate directly. In tender offers, however, the haggling generally occurs in the newspapers. The bidder circumvents the target's managers by making an offer directly to the shareholders. The target shareholders, therefore, lack a centralized bargaining agent. But takeover defenses can help: by making takeovers more difficult, resistance can slow down a bidder. This gives potential competing bidders the oppor-

tunity to enter the auction for the target firm. The most common form of this behavior is soliciting an offer from a “white knight” after a hostile takeover bid.

This auction seems to increase the final offer prices for target shares. Ruback (1983) reports that the final offer price exceeded the initial offer by 23 percent in forty-eight competitive tender offers during the period 1962–81. More recently, Bradley, Desai, and Kim (1986) find that stockholder gains are substantially greater when there are multiple bids. They report gains of 24 percent for targets in single bidder tender offers and gains of 41 percent for targets in multiple bidder contests.<sup>2</sup> Since takeover defenses can encourage competitive bidders to make an offer, these data provide some support for the view that resistance leads to higher offer prices.

Some managers use this rationale to adopt extreme antitakeover defenses that virtually prevent hostile tender offers. They argue that without the board as a centralized bargaining agent, shareholders will sell out at too low a price. Such a view presumes that the market for corporate control is uncompetitive and inefficient. The weight of scientific evidence and the casual observation of control contests suggests that such a view is incorrect. Furthermore, extreme forms of takeover defenses can have some relatively severe side effects because it prevents the removal of inefficient managers.

### 3.1.3 Managers Want to Retain Their Positions

If the bidding firm plans to replace the target’s incumbent managers, the target’s managers have little incentive to endorse the takeover proposal. Such an endorsement would guarantee that they would lose the power, prestige, and value of the organization-specific human capital associated with their positions.

In addition to the desire to retain their positions, managers are likely to have the natural belief that they are the best managers of the firm. Loyalty to employees also encourages resistance. Finally, being taken over can be considered a sign of failure: The premium indicates that the bidder believes it can manage the firm better than the incumbent managers.

In summary, takeover resistance motivated by the first rationale of hidden values and the second rationale of inducing an auction can benefit target shareholders, although the man-

agers' natural bias is likely to result in opposition to some takeovers that would benefit target shareholders. The third reason for takeover defenses, managerial self-interest, benefits the stockholders only if resistance happens by chance to be the appropriate action for one of the first two reasons.

These three reasons for takeover defenses are not mutually exclusive—combinations of the three are often present in defense strategies. For example, managers may use takeover defenses because they prefer friendly, negotiated transactions. Negotiated acquisitions enable the target managers to share ideas and information with the bidding firm. Consistent with the first and second reasons, this may increase the offer price. It also increases the chances of retaining the target's management team, which is consistent with the third reason. Finally, a negotiated transaction is generally more civilized: to the managers that is like an increase in compensation.

There is very little general evidence to assess the overall impact of takeover resistance on stockholder values. However, Walkling and Long (1984) present some intriguing evidence: managers with large stockholdings in their firms are less likely to oppose takeovers than managers with small stockholdings. These data can be interpreted in two ways: either managers with large stockholdings oppose too little because they risk losing the big payoff from being acquired; or managers with small stockholdings oppose too much, because they care about their jobs and have no equity gains to offset the loss in compensation. While not resolving whether there is too much or too little opposition, the Walkling and Long study does suggest the importance of the effect of takeovers on managers in the decision process.<sup>3</sup>

The stock price evidence tends to focus on individual types of defensive actions. In the next section, I explain and evaluate pre-offer defenses. Section 3.3 does the same for post-offer defenses.

### **3.2 Pre-Offer Takeover Defenses**

In this section I describe several types of takeover defenses that occur prior to an actual takeover bid. These defenses are summarized in table 3.1. The table contains a brief description of the defense and its defensive impact, whether shareholder

**Table 3.1**      **Summary of Pre-Offer Takeover Defenses**

Type of Defense	Description	Defensive Impact	Shareholder Approval	Stock Price Effect <sup>a</sup>	Potential Effectiveness
Staggered board	Board is classified into three equal groups. Only one group is elected each year.	Bidder cannot obtain control of the target immediately after obtaining a majority of shares.	Required	- 1% <sup>b</sup>	Moderate
Super-majority	A high percentage of shares required to approve a merger, usually 80%. Board can void the clause.	Increases the number of shares required to obtain control in hostile takeovers.	Required	- 5%* <sup>b</sup>	Mild
Fair price	Super-majority provisions waived if bidder pays all stockholders the same price.	Prevents two-tier takeover offers.	Required	- 1% <sup>b</sup>	Mild
Poison pill	Rights to preferred stock issued to shareholders. Rights can be exercised after a tender offer or the accumulation of a large block of shares by an outside party. In flip-over plans exercised rights can be used to purchase stock in the bidder on favorable terms. In flip-in plans exercised rights are repurchased by the issuing firm at a substantial premium. The bidding firm or large shareholder is excluded from the repurchase.	Makes hostile tender offer prohibitively expensive.	Not required	? <sup>c</sup>	Severe

Dual class recapitalization	Distributes a new class of equity to stockholders with superior voting rights but inferior dividends or marketability. Allows shareholders to exchange the new shares for ordinary common stock.	Allows incumbent managers to obtain a majority of votes without owning a majority of the common stock.	Required	2%* <sup>d</sup>	Severe
-----------------------------	--	--	----------	------------------	--------

---

<sup>a</sup>An asterisk indicates statistical significance.

<sup>b</sup>See DeAngelo and Rice (1983), Linn and McConnell (1983), and Jarrell and Poulsen (1986).

<sup>c</sup>See Malatesta and Walkling (1985), Ho (1986), Kidder, Peabody (1986), and SEC (1986).

<sup>d</sup>See Partch (1986).

approval is required, the stock price effect, and its potential effectiveness. The stock price effects are my round number summary of the detailed empirical studies. An asterisk indicates statistical significance.

The potential effectiveness measure in table 3.1 is intended to capture the degree to which the defense would be effective, *assuming that the incumbent management team uses it fully*. I have described defenses as mild when they inconvenience bidders or force them to restructure their bids without raising the takeover price significantly. Severe defenses give the incumbent managers absolute veto power of corporate control changes.

The potential effectiveness rating will differ from the stock price effect in at least three circumstances. First, the market may believe that the courts will prevent the incumbent managers from using the device, so that a very effective device will be associated with a small stock price effect. Second, the stock price effect might be small for an effective device because the adoption was anticipated. Third, the stock price effect could be small because the change in the probability of being acquired, and thus the change in expected premium, is too small to be reliably measured for even a very effective device. This is most likely to occur when the firm is not the subject of takeover speculation.

### 3.2.1 Staggered Board Elections

In this corporate charter provision, the board of directors is classified into three groups. Each year only one of the groups, or one-third of the directors, is elected. This makes it difficult for a hostile bidder to gain immediate control of the target firm, even if the bidder owns a majority of the common stock. About one-half of Standard & Poors 500 firms have adopted this type of takeover defense.<sup>4</sup>

My estimate of the stock price effect of adopting a staggered board is  $-1$  percent, which is not statistically significant. DeAngelo and Rice (1983) examine the stock returns for 100 firms that adopted antitakeover corporate charter amendments; 53 of these included staggered boards. They find no significant stock price response to the adoption of the amendments around the proxy mailing date. Similarly, Linn and

McConnell (1983) find no stock price effects for a sample of 388 antitakeover amendments around the proxy mailing date. However, they find significantly positive returns over the interval from the proxy mailing date to the stockholder meeting date. More recently, Jarrell and Poulsen (1986) report negative, but insignificant returns of about  $-1$  percent for twenty-eight firms that have adopted classified boards since 1980.

Staggered boards are a moderately effective takeover defense. By preventing a majority holder from obtaining control of the board for two years, this defense hinders the bidder's ability to make significant changes in the corporation immediately. This limitation may in turn reduce the bidder's willingness to bid, and may increase the bidder's difficulty in getting financing.

### 3.2.2 Super-Majority Provisions

These corporate charter provisions require a very high percentage of shares to approve a merger, usually 80 percent. These provisions are also typically accompanied by lock-in provisions that require a super-majority to change the anti-takeover provisions. Some super-majority provisions apply to all mergers. Others are only applied at the board's discretion to takeovers that they oppose or that involve a large stockholder. Hostile takeover bidders require a higher percentage of shares to obtain control of the target firm when the firm has a super-majority amendment.

The samples of antitakeover amendments examined by DeAngelo and Rice (1983) and Linn and McConnell (1983) both included super-majority provisions. Both studies found no significant negative stock price effects. But Jarrell and Poulsen (1986) argue that these earlier amendments did not generally include an escape clause for the board. They report that super-majority amendments with escape clauses are associated with a statistically significant return of  $-5$  percent, whereas super-majority amendments without escape clauses are associated with insignificant returns of  $-1$  percent.

In spite of the significant stock price response, I consider a super-majority amendment a mild takeover defense. Bidders can respond to this amendment by simply tendering for the whole firm. This need not increase the total cost of the ac-

quisition. Without a super-majority amendment, a partial offer could be used to obtain control. In this case, all stockholders would tender and receive a weighted average of the offer price and the postexpiration price. The bidder can respond to the super-majority amendment by simply offering this average price to all shareholders.

### 3.2.3 Fair Price Amendments

In these corporate charter changes, a fair price is defined as the same price. That is, a super-majority provision is waived if the bidder pays all stockholders the same price. About 35 percent of firms have these amendments.

Fair price amendments are designed to prevent two-tier takeover offers. In such offers, the bidding firm makes a first-tier tender offer for a fraction of the target's common stock. The tender offer includes provisions for a second-tier merger. The merger price in the second tier is substantially below the first-tier tender offer price. This provides an incentive for stockholders to tender to receive the higher price. Since most stockholders tender, and since the bidder accepts shares on a pro rata basis, most shareholders get a weighted average of the first and second tier offer prices, or the blended price.

Jarrell and Poulsen (1986) report insignificant stock price changes of  $-0.65$  percent for 143 fair price amendments. Consistent with this insignificant stock price effect, fair price amendments are a mild takeover defense. By requiring the same price for all shares, the bidder is forced to offer all shareholders the blended price. This restructures the offer, but does not raise the cost of acquiring the target.

### 3.2.4 Poison Pills

These are preferred stock rights plans adopted by the board of directors; shareholder approval is not generally required. However, the plans usually use "blank check preferred stock," securities authorized by stockholders and whose terms are determined by the board prior to issuance. In a poison pill, rights to preferred stock are issued to stockholders. The rights are inactive until they are triggered. A triggering event occurs when a tender offer is made for a large fraction of the firm, usually 30 percent, or after a single shareholder accumulates a large block of the firm, usually 20 percent. The

triggered rights can be redeemed by the board of directors for a short time after the triggering event occurs. If the rights are not redeemed, they can be exercised. There are two different plans for using exercised rights: flip-over plans and flip-in plans.

In flip-over plans the exercised rights are used to purchase preferred stock, for, say, \$100. The preferred stock is then convertible into \$200 of equity in the bidding firm in the event of a merger. The primary effect of this plan is to raise the minimum offer price that shareholders would accept in a tender offer. For example, suppose a target's stock price was \$50. Shareholders would choose not to tender their shares for any offer price less than the \$150 payoff they would get from exercising the right (\$50 of stock plus \$200 of equity in the bidder minus the \$100 cost of exercising the right). The minimum premium, therefore, is 200 percent.

In flip-in plans, the rights are repurchased from the shareholders by the issuing firm at a substantial premium, usually 100 percent. That is, the \$100 of preferred stock would be repurchased for \$200. The triggering firm that made the offer, or the triggering large shareholder, is excluded from the repurchase. This repurchase price sets a lower bound on the minimum offer price that shareholders will accept. It also dilutes the value of the bidding firm's equity position in the target. Flip-in plans often contain flip-over provisions that are effective for mergers.

Poison pills are relatively recent phenomena. Prior to the Delaware Chancery Court decision in 1985 that upheld the legality of the plans, there were only three such plans. Currently, there are over 200 poison pill plans. Because these plans are so new, there is limited empirical evidence on them. In a study of 12 early plans, Malatesta and Walkling (1985) find negative abnormal returns associated with the adoption of poison pills. Ho (1986) finds no abnormal returns for a sample of 23 poison pills. The SEC's study of 37 pills finds returns of -1 percent for all pills and larger negative returns for firms that were subject to takeover speculation. A study of 167 poison pills by Kidder, Peabody, and Company finds no stock price impact. But this study is methodologically flawed, so that its conclusions are unreliable. The impact of these plans, therefore, is currently unknown.

Both forms of poison pills are severe takeover defenses. These plans have the potential to insulate incumbent managers completely from hostile takeovers. The plans cannot be circumvented by restructuring bids. Flip-in plans are slightly more effective than flip-over plans because they prevent the creeping acquisitions of the type Sir James Goldsmith used in his attack on Crown-Zellerbach.

### 3.2.5 Dual Class Recapitalizations

These plans restructure the equity of the firm into two classes with different voting rights. Usually, the class with inferior voting rights has one vote per share and the class with superior voting rights has ten votes per share. The superior voting stock is typically distributed to shareholders. It can then be exchanged for ordinary common stock. The superior voting stock generally has lower dividends or reduced marketability; this induces stockholders to exchange their superior voting stock for inferior voting common stock. The managers of the firm do not participate in the exchange. This shifts the voting power of the corporation. Managers with relatively small equity holdings can control a majority of the votes after the recapitalization. This gives managers veto rights over control changes.

Firms with dual class equity are relatively rare. Partch (1986) reports that forty-three firms issued limited voting stock over the period of 1962–84. However, recently the New York Stock Exchange has requested permission from the SEC to change their one share, one vote rule to allow NYSE firms to adopt such dual class equity structures. These recapitalizations, therefore, could become much more common in the near future.

The empirical evidence presented by Partch (1986) is mixed. She reports a significant positive return of about 2 percent for the forty-three firms that adopted dual class plans. However, there are about as many increases as decreases in stock prices and the median is only about one-half of 1 percent. She concludes that the weight of the evidence suggests no significant stock price changes. Furthermore, these historical estimates may not be relevant for assessing the impact of a dual class recapitalization for a typical firm. As Partch emphasizes, the firms in her sample are atypical. They generally have substantial inside or family ownership; on average the managerial

ownership was 49 percent of the firm prior to the recapitalization. Thus, the plans may not have substantially changed the probability of being taken over for these firms. The managers' approval would be required with or without the dual class equity.

Dual class recapitalizations can be very effective takeover devices. By concentrating voting power in the hands of incumbent managers, the device prevents bidders from obtaining control by tendering for the outside shares. Even if a bidder were successful in acquiring all of the outside equity, it would not have sufficient votes to replace the incumbent managers or merge with the target.

### **3.3 Post-Offer Takeover Defenses**

After a bidder makes a hostile tender offer, the defensive actions include many of the pre-offer defenses, as well as several actions that can be directed at a specific bidder. Table 3.2 summarizes these post-offer defensive responses.

#### **3.3.1 Targeted Repurchases**

These transactions, popularly called greenmail, occur when a firm buys a block of its common stock held by a single shareholder or a group of shareholders. The repurchase is often at a premium, and the repurchase offer is not extended to other shareholders. Targeted repurchases can be used as a takeover defense by offering an inducement to a bidder to cease the offer and sell its shares back to the issuing firm at a profit.

However, evidence presented by Mikkelson and Ruback (1986) indicates that only about 5 percent of 111 repurchases occurred after the announcement of a takeover attempt. About one-third of the repurchases occurred after some less overt form of attempts to change control, such as preliminary plans for an acquisition attempt or proxy contests. Since two-thirds of targeted repurchases do not involve any indication of a brewing control contest, the classification of these transactions as takeover defenses is questionable.

Empirical studies by Dann and DeAngelo (1983), Bradley and Wakeman (1983), and Mikkelson and Ruback (1985a, 1986)

**Table 3.2 Post-Offer Takeover Defenses**

Type of Defense	Description	Defensive Impact	Stock Price Effect <sup>a</sup>
Targeted repurchase	Repurchase of block of shares held by a shareholder, usually at a premium.	Eliminates a potential bidder.	- 3% <sup>b</sup>
Standstill agreement	Limits ownership by a given firm for a specified time period. May include an agreement with a large shareholder to vote holdings with the board.	Eliminates a potential bidder.	- 4% <sup>c</sup>
Litigation	Suit filed against bidder for violating antitrust or securities laws.	Delays bidder.	0% <sup>d</sup>
Asset restructuring	Assets bought that a bidder does not want or that will create antitrust problems. Assets sold that the bidder wants.	Makes the target less valuable.	- 2%* <sup>c,e</sup>
Liability restructuring	Shares issued to a friendly third party or number of shareholders increased. Shares repurchased at a premium from existing shareholders.	Makes it more difficult to obtain the number of shares required for a hostile bidder to achieve control.	- 2%* <sup>c</sup>

<sup>a</sup>An asterisk indicates statistical significance.

<sup>b</sup>See Dann and DeAngelo (1983), Bradley and Wakeman (1983), and Mikkelsen and Ruback (1985a, 1986).

<sup>c</sup>See Dann and DeAngelo (1983).

<sup>d</sup>See Jarrell (1985).

<sup>e</sup>See Dann and DeAngelo (1986).

report significant stock returns of about  $-3$  percent at the announcement of the targeted repurchase. But Mikkelson and Ruback (1986) report that this loss is more than offset by stock price increases associated with the initial purchase of the block and other intervening events. The negative stock price reaction to the targeted repurchase announcement, therefore, seems to be caused by the reversal of takeover expectations formed at the initial investment. Overall, the total return associated with these transactions, including the initial investment, intervening events, and targeted repurchase is 7 percent, which is statistically significant. Consistent with this positive overall stock price effect, repurchasing firms seem to have a higher frequency of control changes subsequent to the targeted repurchase.

### 3.3.2 Standstill Agreements

These agreements limit the ownership by a given firm for a specified period of time. The agreement may involve allocating a number of seats on the board of directors to the large shareholder. Also, the shareholder may agree to vote with management. These agreements serve as a takeover defense by eliminating, at least temporarily, a potential bidder. The shareholder may, however, gain some control over corporate assets through seats on the board. Thus, a standstill agreement is more like a treaty than a defense.

Empirical results by Dann and DeAngelo (1983) show that the adoption of standstill agreements is associated with a significant fall in stock prices of about  $-4$  percent. Furthermore, Mikkelson and Ruback (1986) find that the negative returns in response to targeted repurchases are much greater when they are accompanied by standstill agreements. These agreements, therefore, seem to reduce the wealth of target stockholders. But this stock price fall could simply reflect the market's disappointment that an expected takeover will not occur. Like the targeted repurchase finding, the negative returns may just represent the reversal of favorable expectations.

### 3.3.3 Litigation

Perhaps the most common form of post-offer defense is to file some sort of suit against the bidding firm. Jarrell (1985)

reports such litigation occurs in about one-third of all tender offers made between 1962 and 1980. The suits charge the bidder firms with fraud, violation of antitrust or securities regulations, and so on.

The litigation seems to serve two purposes. First, it delays the bidder, thereby encouraging the entry of competing bidders. Consistent with this view, Jarrell reports that the frequency of competing bids is 62 percent for tender offers involving litigation and 11 percent for tender offers without litigation. Second, the litigation encourages the bidder to raise the offer price to induce the target to drop the suit and thereby avoid legal expenses. Jarrell reports that the stock price effect associated with filing the suit is about zero, on average, for seventy-one such litigations. This suggests that the defense is roughly a fair gamble.

### 3.3.4 Acquisitions and Divestitures

These changes in the firm's asset structure can be used to defend against a takeover bid. Such tactics include divesting an asset that the bidder wants, buying assets that the bidder does not want, or buying assets that will create antitrust or other regulatory problems. Each of these actions make the target less attractive to the bidding firm, and reduces the price the bidder is willing to pay for the target. Data provided by Dann and DeAngelo (1986) for twenty such transactions indicate that they reduce stock prices by about 2 percent, which is statistically significant.

### 3.3.5 Liability Restructuring

Issuing voting securities can increase the number of shares required by a hostile bidder. Typically, the firm places these voting securities in friendly hands that agree to support the incumbent managers. Repurchase can also be used to reduce the number of public shares, making it more difficult to buy enough shares to obtain control. Such repurchases are often financed by debt issues that may make the firm less attractive to potential bidders. These restructures seem to reduce stockholder wealth. Dann and DeAngelo (1986) report stock price declines of 2 percent on average for thirty-one such restructurings.

### 3.4 Conclusions

I wish I could conclude that takeover defenses are generally good or bad for stockholders. But the answer is not that simple. Furthermore, there isn't enough evidence of experience with takeover defenses for precise conclusions. I do, however, think that the analysis and evidence support three propositions.

First, defenses that give incumbent managers the power to veto hostile takeovers seem to be harmful. Of course, there are circumstances where such defenses can help stockholders, but I think those circumstances are relatively rare. Poison pills and dual class recapitalizations are cause for particular concern. There may be a way to circumvent the power that the incumbent managers have with these defenses, but no one has discovered it yet.

Second, defenses that destroy assets are probably bad. This category includes assets sold below their values or assets purchased above their values simply to thwart a takeover. Similarly, liability restructuring to the extent that it interferes with investment also destroys assets. Once again there are circumstances where such actions may help stockholders, but these cases are very rare.

Third, defenses which do not give managers veto power and do not destroy assets, such as antitakeover corporate charter changes, are probably not harmful. These defenses may cause bidders to restructure offers. They may even result in slightly higher offer prices. Their major cost is that the defenses will reduce the benefit from being an acquiring firm and thereby reduce takeover activity.<sup>5</sup> However, there is no evidence that the frequency of takeovers has been reduced by antitakeover corporate charter amendments.

In summary, some takeover defenses seem to be harmful. Perhaps not surprisingly, the most harmful tactics seem to be the most recent innovations, such as poison pills. This is disturbing because these defenses are not subject to shareholder vote and thus are especially difficult to control. Of course, they may just *seem* powerful because participants in the market have not yet had the opportunity to design tactics to circumvent the defenses.

## Notes

I would like to thank Paul Healy, James Poterba, and Nancy Rose for comments on previous drafts. The support of the National Science Foundation Grant #SES 84020677 is gratefully acknowledged.

1. See Jensen and Ruback (1983) for a review of the evidence on takeovers.
2. The stock returns are measured over the interval beginning five days before the first offer and ending forty days after it.
3. See Mikkelson and Ruback (1985b) for a more detailed discussion of management compensation and takeovers. See also Lewellen et al. (1985).
4. Frequency estimates are based on data published by the Investor Responsibility Research Center, Inc., Washington, D.C.
5. See Easterbrook and Fischel (1981a, 1981b), Gilson (1982), Bebchuk (1982a, 1982b), and Ruback (1984).

## References

- Bebchuk, Lucian. 1982a. "The Case for Facilitating Competing Tender Offers: A Reply and Extension." *Stanford Law Review* 35:45.
- . 1982b. "The Case for Facilitating Competing Tender Offers," *Harvard Law Review* 95:1028–56.
- Bradley, Michael, Anand Desai, and E. Han Kim. 1986. "Gains from Corporate Acquisitions and Their Division between Target and Acquiring Firms." Mimeo, July.
- Bradley, Michael, and L. Macdonald Wakeman. 1983. "The Wealth Effects of Targeted Share Repurchases." *Journal of Financial Economics* 11 (April): 301–28.
- Dann, Larry Y., and Harry DeAngelo. 1983. "Standstill Agreements, Privately Negotiated Stock Repurchases, and the Market for Corporate Control." *Journal of Financial Economics* 11 (April): 275–300.
- . 1986. "Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure." Working paper 86-11. Managerial Economics Research Center of the University of Rochester, August.
- DeAngelo, Harry, and Edward M. Rice. 1983. "Antitakeover Charter Amendments and Stockholder Wealth." *Journal of Financial Economics* 11 (April): 329–59.
- Easterbrook, Frank H., and Daniel R. Fischel. 1981a. "The Proper Role of a Target's Management in Responding to a Tender Offer," *Harvard Law Review* 94 (April): 1161–1204.
- . 1981b. "Takeover Bids, Defensive Tactics, and Shareholders' Welfare." *Business Lawyer* (July): 1733–50.
- Gilson, Ronald J. 1982. "Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense." *Stanford Law Review* 35:51–67.
- Ho, Michael J. 1986. "Share Rights Plans: Poison Pill, Placebo, or Suicide Tablet?" Masters thesis, Massachusetts Institute of Technology, Sloan School of Management.

- Jarrell, Gregg A. 1985. "The Wealth Effects of Litigating by Targets: Do Interests Diverge in a Merge?" *Journal of Law and Economics* 28 (April): 151-77.
- Jarrell, Gregg A., and Annette B. Poulsen. 1986. "Shark Repellents and Stock Prices: The Effects of Antitakeover Amendments Since 1980." Mimeo, August.
- Jensen, Michael C., and Richard S. Ruback. 1983. "The Market for Corporate Control: The Scientific Evidence." *Journal of Financial Economics* 11 (April): 5-50.
- Kidder, Peabody, and Company. 1986. "Impact of Adoption of Stockholder Rights Plans on Stock Price." June.
- Lambert, Richard A., and David F. Larker. 1985. "Golden Parachutes, Executive Decision-Making, and Shareholder Wealth." *Journal of Accounting and Economics* 7: 179-203.
- Lewellen, Wilbur, Claudio Loderer, and Ahron Rosenfeld. 1985. "Merger Decisions and Executive Stock Ownership in Acquiring Firms." *Journal of Accounting and Economics* 7 (April): 209-31.
- Linn, Scott C., and John J. McConnell. 1983. "An Empirical Investigation of the Impact of Antitakeover Amendments on Common Stock Prices." *Journal of Financial Economics* 11 (April): 361-99.
- Malatesta, Paul H., and Ralph A. Walkling. 1985. "The Impact of 'Poison Pill' Securities on Stockholder Wealth." Working paper, University of Washington, July.
- Mikkelson, Wayne, and Richard S. Ruback. 1985a. "An Empirical Analysis of the Interfirm Equity Investment Process." *Journal of Financial Economics* 14 (December): 523-53.
- . 1985b. "Takeovers and Managerial Compensation: A Discussion." *Journal of Financial Economics* 14 (December): 523-53.
- . 1986. "Targeted Repurchases and Common Stock Returns." Working paper #1707-86, Massachusetts Institute of Technology, Sloan School of Management, June.
- Partch, Megan. 1986. "The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth." Working paper, University of Oregon, May.
- Ruback, Richard S. 1983. "Assessing Competition in the Market for Corporate Acquisitions." *Journal of Financial Economics* 11 (April): 141-53.
- . 1984. "An Economic View of the Market for Corporate Control." *Delaware Journal of Corporate Law* 9 (May-August): 613-25.
- Securities and Exchange Commission. Office of the Chief Economist. 1986. "The Economics of Poison Pills," March.
- Walkling, R. A., and M. S. Long. 1984. "Agency Theory, Managerial Welfare, and Takeover Bid Resistance." *Rand Journal of Economics* 15 (Spring): 54-68.

This Page Intentionally Left Blank