Takeovers

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Abstract

This paper reviews the existing literature on takeovers. Takeovers are a means to redeploy corporate assets more efficiently and to discipline incumbent management. However, an active market for corporate control also brings about potential inefficiencies. Takeovers may be undertaken for reasons other than value creation and the threat of a control change can induce inefficient actions on the part of target firm management and employees. The functioning of the market for corporate control is further impaired by incentive and coordination problems inherent in the takeover process. When the target firm is owned by many small shareholders, the free-rider problem prevents bidders firms from earning a profit on the tendered shares. We analyse implications of this problem as well as ways to overcome it. As widely held firms are atypical in many countries, we also discuss the impact that target ownership structure has on the incidence and efficiency of control transfers.

Keywords: takeovers, free-rider problem, efficiency of control transfers

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A takeover typically involves much more than the mere transfer of ownership since the acquired firm subsequently undergoes a major reorganization. Its divisions are merged with or subordinated to those of the acquiring firm, divested or even dissolved. Furthermore, such restructuring takes hold of entire industries as takeovers occur in waves and are within each wave clustered by industries (Andrade et al., 2001).

Whether these changes primarily create or destroy value, or redistribute wealth among different constituencies, such as employees and shareholders, is the subject of a long-standing debate. Initially, the controversy revolved around the gains from realizing economies of scale and scope on the one hand, and the cost of concentrated economic power to competitors, labour and consumers on the other hand. In the mid-1950s, tender offers emerged as a new form of takeover in the UK and some years later also in the US (Singh, 1971). Contrary to mergers, tender offers allow bidders to bypass management by making an offer directly to target shareholders. In this form, takeovers can have a motive apart from spurring firm growth or exploiting synergies, namely rectifying managerial failure.[1]

During the takeover wave of the 1980s hostile tender offers became a regular mode of acquisition in the UK and US. For instance, Mitchell and Mulherin (1996) report that almost a quarter of the large US corporations received a hostile bid during that time. To be certain, the majority of acquisitions during that time were friendly, negotiated with the target management.[2] Outside the UK and US, the incidence of takeovers during the 1980s was much lower and hostile takeovers – in the sense of tender offers launched in the market – were extremely rare if nonexistent. The 1990s saw takeover activities rebound to unprecedented levels in the US but with a substantially lower incidence of hostile bids (Holmström and Kaplan, 2001). Europe and Asia experienced a massive surge in takeover activity, though hostile bids outside the UK remained rare until the end of the 1990s. In 1999 a significant number of hostile bids occurred in continental Europe, including some high profile cases such as the Vodafone-Mannesmann deal.

Although hostile bids are primarily an Anglo-American phenomenon and occasional events even in these countries, they have long been at the centre of the takeover debate – at least among financial economists. This focus is in part a reflection of the media exposure, public interest and fierce criticisms that hostile takeovers in the 1980s provoked, notably those involving very large corporations, the heavy use of leverage and the subsequent sell-off of numerous divisions. More importantly, hostile takeovers are a mechanism to discipline manager and thereby address problems raised by the separation of ownership and control. Indeed, a functioning takeover market is the most direct way to achieve control contestability which many commentators consider an

[1] Prior to the appearance of tender offers, controlling blocks had to be accumulated through individual trades, and proxy fights - which is to say direct voting by the firm's existing shareholders - were the principal mechanism for a hostile change of management (Hansmann, 1996).

[2] Even at their peak hostile bids never represented more than 30 percent of all US transactions (Schwert, 2000). The small number of hostile takeovers underestimates, however, their impact as many friendly transactions would (may) not have been done but for the background threat of a hostile bid.

essential component of an effective governance system (Berglöf et al., 2003). In recent years, this view has also gained support among European regulators and politicians, as the discussions surrounding the European Takeover Directive show. In particular, the European Commission and its expert group sought to open up Europe for takeovers to promote restructuring.[3] According to the Commission, Europe badly needs more restructuring if it wants to accomplish the goal, set forth in the 2000 Lisbon Declaration, to become the world's most dynamic economic region.

The existing research on takeovers is vast and covers a wide range of topics. In this survey,[4] we focus on takeovers as a remedy for managerial failure and the incentive problems inherent in control transactions. Motivated by the evidence that widely held firms are atypical in many (European) countries (Denis and McConnell, 2003; Barca and Becht, 2001), the essay also discusses in some detail the impact of ownership structure on the incidence and efficiency of control transfers. We note the implications for regulatory policy throughout the paper.

This essay proceeds as follows. Section 1 introduces the concept of the market for corporate control and discusses the efficiency effects of takeovers. Section 2 examines the tender offer process, and Section 3 explores control transfers of firms whose ownership structure is not completely dispersed. Section 4 concludes.

1. EFFICIENCY OF TAKEOVERS

The academic literature on the market for corporate control and the term itself originate from Manne (1965). In this market shareholders can sell, possibly against the will of the incumbent management, the control (rights) over the firm to an outsider. Given that the share price reflects (expected) firm performance, an outsider who is better able to run the firm finds it profitable to acquire control in order to subsequently employ the firm's assets more profitably. Moreover, competition among outsiders or, in the parlance of Jensen and Ruback (1983), competing management teams ensure that resources flow to their highest-value use. Efficiency is increased ex-post by replacing managers who are either less competent or are not acting in the shareholders' best interest. Hence, the takeover mechanism ensures that firms which do not maximize profits do not survive, even if market forces on the product and input markets fail to eliminate them. In addition, the mere threat of a takeover raises efficiency ex-ante as it disciplines managers, thereby reducing the agency costs stemming from the separation of ownership and control (Grossman and Hart, 1980a; Scharfstein, 1988).

[3] After the European Parliament rejected the proposed directive in 2001, the Commission appointed a "High Level Group of Company Law Experts" under the chairmanship of Jaap Winter to provide independent advice. The Winter Report's most radical proposal is the so-called break-through rule (European Commission, 2002). It stipulates that a party owning a qualified majority (75 percent) of the equity capital can undo any statutory defenses, including any differentiation of votes. Due to tremendous opposition the break-through rule has been omitted from the Directive that was finally adopted on 22 December 2003.

This line of reasoning presupposes that takeovers are motivated by value improvements brought about either by exploiting synergies or correcting inefficient managerial behaviour. It further assumes that the takeover market operates efficiently, notably that a firm whose current share price is less than it could be under the control of a different party is indeed acquired by that party. The question whether or not these two conditions are met, or more generally, whether the market for corporate control operates efficiently, is the subject of numerous theoretical and empirical studies. The various caveats boil down to two assertions: On the one hand, frictions in the takeover market result in too few value-improving takeovers, and on the other hand, takeovers may succeed even though they do not create value. In addition, it is argued that the existence of the takeover threat may well exacerbate the agency conflict between managers and shareholders, rather than mitigate it. In what follows, we review the debate over the efficiency of the takeover mechanism in more detail. Due to the large representation of studies on US takeovers, the discussion relies heavily on the US experience, and reported findings refer to US evidence, unless stated otherwise.

1.1 Disciplinary Takeovers

As described above, one takeover motive is to improve target firm performance by altering the strategies of the incumbent managers and possibly replacing them. Such disciplinary takeovers occur when the firms' internal governance mechanisms fail to prevent managers from pursuing their own goals.[5] This problem is particularly pertinent for cash-rich firms that enable managers to undertake unprofitable but power-enhancing investments (Jensen, 1986).[6] Consequently, firms undertaking poor investments and, more generally, poorly performing firms are more likely to be the target of a (hostile) takeover bid.

These predictions are only partly supported by the available evidence. While studies on US and UK data consistently document that takeover targets are smaller than other firms, only some report that hostile takeovers tend to be directed towards poorly performing firms in troubled industries (e.g., Morck et al., 1988). Other studies find no significant difference in pre-takeover performance between targets and non targets, or between targets of friendly and of hostile bids (e.g., Comment and Schwert 1995; Martin and McConnell, 1991; Franks and Mayer, 1996). These

[4] There are several reviews of the theoretical and empirical research on takeovers, including Andrade et al. (2001), Bhagat et al. (1990), Becht et al. (2003), Bruner (2002), Holmström and Kaplan (2001), Hirshleifer (1995), Jensen (1988), McCahery et al. (2004), Scherer (1988) and von Thadden (1990).

[5] Disciplinary takeovers are commonly associated with hostile bids, (initially) opposed by target board and management. In contrast, friendly takeovers are viewed as motivated by synergies arising from combining the firms' assets (Morck et al., 1988). In practice, many takeovers contain elements of both friendly and hostile bids. Indeed, Schwert (2000) finds hostile and friendly takeovers to be indistinguishable in economic terms. He argues that the choice of hostile (friendly) offer is largely a reflection of the acquiring firm's negotiation strategy.

[6] According to Jensen (1988, 1993), the 1980s takeovers in the US were caused by a failure of internal governance mechanisms to bring about the restructuring required to meet the technological and regulatory changes.

results suggest that the selection process in the market for corporate control relies more on size than performance.

As for unprofitable investments by target firms, the evidence is also mixed. On the one hand, takeover targets are more likely to have made poor acquisitions previously, notably poor diversification acquisitions (Mitchell and Lehn, 1990; Berger and Ofek, 1996).[7] These findings suggest that recouping equity value lost through poor acquisitions is one source of takeover gains. In support of this interpretation, Allen et al. (1995) document that a major source of gains from spin-offs is the reversal of earlier unwise acquisitions. On the other hand, large firms in the gas and oil industry apart, there is no systematic evidence that takeover targets overinvest in internally developed projects or that capital expenditures change after the takeover (Servaes, 1994; Healy et al., 1992; Bhagat, et al.,1990).

In summary, the empirical evidence lends only limited support to the notion that takeovers are directed at underperforming firms or at firms with a poor investment record.[8] Even if takeovers may not be an effective means to correct inefficiencies, they may nonetheless create value by, for instance, exploiting synergies.

1.2 Takeover Gains

To assess the economic consequences of takeovers, a plethora of empirical studies examines stock returns surrounding the announcement dates. These event studies document unanimously that target shareholders gain substantially from takeovers. For US takeovers, average abnormal returns for target shareholders are typically found to be in the range of 15 to 30 percent (Andrade et al., 2001; Brunner, 2002). The findings for the UK are similar to those for the US (McCahery et al., 2004), while target shareholder returns in continental European takeovers are lower but still substantial at around 10 percent (Goergen and Renneboog, 2004; Campa and Hernando, 2004).

The evidence on acquiring firms' shareholder return is far less conclusive. Some studies report positive abnormal bidder returns (e.g., Goergen and Renneboog, 2004; Schwert, 1996), others document negative bidder returns (e.g., Andrade et al., 2001), and still others find no significant effects (e.g., Stulz et al., 1990). Whether positive or negative, bidder returns are small, ranging from +5 to –5 percent.[9] There is more consensus about the net shareholder wealth effect

[7] Some recent studies (e.g., Campa and Keida, 2002), however, suggest that the diversification discount is due to the diversifying firms being different, rather than to diversification being value-destroying.

[8] Managerial turnover has been found to increase in target firms following the completion of the takeover, particularly if the pre-takeover performance has been poor (e.g., Martin and McConnell, 1991). An inverse relation between forced CEO turnover and firm performance has also been documented for firms that are not takeover targets (see the survey by Murphy, 1999). This suggests that both internal and external control mechanisms serve to monitor and discipline managers.

[9] While many studies do not distinguish between (friendly) mergers and (hostile) tender offers, those that do tend to find higher target as well as bidder returns in hostile takeovers and tender offers than in friendly acquisitions and mergers (McCahery et al., 2004). In addition, target and/or acquiring firms' announcement returns are found to vary systematically with other characteristics, such as means of payments (Travlos, 1987), relatedness of bidder's and target's businesses (Comment and Jarrell, 1995), book-to-market value ratios (Rau and Vermaelen, 1998).

of takeovers. Most studies report that the combined average abnormal returns are positive but relatively small ranging from 1 to 3 percent (e.g., Andrade et al., 2001; Campa and Hernando, 2004).

Overall, the studies on announcement period stock returns suggest that takeovers create gains to shareholders, but that these gains accrue (almost) entirely to target shareholders.[10] These gains are the evidence upon which Jensen (1988) among others base the claim that takeovers create value. The inference from observed stock price increases to efficiency improvements relies, however, on some stringent (implicit) conditions, in particular informationally efficient stock markets and the absence of externalities and redistribution.

The efficient market hypothesis has been challenged by long-run performance studies documenting abnormal positive and negative stock returns following different corporate events, such as equity issues, stock splits and acquisitions. These findings suggest that investors systematically misjudge the impact of corporate events. Accordingly, short-term announcement period returns are flawed measures of shareholder wealth effects of corporate events.[11] In their review of the literature on long-run stock returns following acquisitions, Agrawal and Jaffee (2000) argue that there is evidence of abnormal under-performance in mergers but that share prices during tender offer announcements do not overestimate future gains. Compared to other studies, Mitchell and Stafford (2000) find smaller - often insignificant - abnormal returns and less variation across subsamples of acquisitions, e.g. cash-financed versus stock-financed. Overall, their study suggests that long-run abnormal stock returns following acquisitions are limited to small acquiring firms.

Irrespective of how accurately positive abnormal stock returns during the announcement period reflect the long-run wealth effects, documented shareholder gains are merely suggestive of efficiency improvements. Event studies cannot reveal the source of the shareholder gains. These gains may arise from the correction of mismanagement or from synergies or may stem from expropriation of target stakeholder or from transfers at the expense of the acquiring firms' shareholders.

Accounting-data based studies attempt to identify the source of gains by comparing firm performance before and after the takeover. If shareholder gains reflect true value creation, improvements in operating performance should be the counterpart of these gains. However, operating performance studies offer conflicting evidence.[12] Some studies report improvements in

[10] One problem when interpreting stock returns is that takeover announcements also reveal information about the stand-alone value of target and bidder firms. When correcting for the revelation bias, Bhagat et al. (2005) find larger combined abnormal returns than the returns found in earlier studies using traditional announcement period estimation methods (e.g., Bradley et al., 1988).

[11] This literature has itself come under attack from studies documenting the sensitivity of long-term performance estimates to modifications of either the sample or the methodology. For a discussion of these issues, see Fama (1998).

[12] An exception are leveraged buyouts (LBOs) for which the available evidence documents improvements in operating performance (Holmström and Kaplan, 2001).

operating cash flows of the combined firms relative to their industry peers (e.g., Healy et al., 1992) and productivity improvement at the plant level (Lichtenberg and Siegel, 1987 1989). Others studies do not find evidence of improved performance (e.g., McGuckin and Nguyen, 1995, Schoar, 2002) or even document a post-takeover decline in the target's performance compared to non-acquired comparable firms (e.g., Ravenscraft and Scherer, 1988).

When interpreting the different findings, it should be borne in mind that poor post-takeover performance does not necessarily imply value destruction. If industry shocks are the source of takeovers, firms consolidating via takeovers should not necessarily be expected to outperform a pre-shock benchmark (Mitchell and Mulherin, 1996). Nonetheless, the lack of clear evidence in support of performance improvements is puzzling in view of the documented large (target) shareholder gains and casts some doubt on the claim that takeovers create value. Indeed, it has been contended that takeover premia reflect redistributive gains rather than efficiency improvements.

Transfers from acquiring firms are one possible explanation for low returns to their shareholders but high returns to target shareholders. Managers of acquiring firms may overestimate their ability to improve the target firm's operation and as a result pay a too high acquisition price (Roll, 1986). Alternatively, takeovers can be a manifestation of the managers' ability to pursue their own interest at the expense of the shareholders. Such acquisitions serve the purpose of empire-building (Marris, 1963, 1964), diversification of the manager's human capital risk (Amihud and Lev, 1981), or simply reflect the availability of excess cash (Jensen, 1986).[13]

Empirical studies strongly suggest that managerial self-interest can trigger or even drive takeovers, and that such acquisitions generate low if not negative returns to acquiring shareholders. Previously discussed evidence in support of the notion that takeovers can be a manifestation of agency problems within in the acquiring firm includes the mixed evidence on post-takeover performance, the high degree of overlap between target and bidder firms, and the target firms' poor record of past acquisitions. Other findings also indicate that managerial self-interest matters for takeovers. Bidding firms tend to have large amounts of free cash flow and relatively low leverage, and firms with more excess cash are more likely to make acquisitions with poor returns for their shareholders (Harford, 1999; Lang, et al., 1991; Bruner, 1988). Furthermore, bidder returns are higher when managers of the acquiring firm own larger shareholdings (Healy et al., 1997; Lewellen et al., 1985). Thus, managerial motives appear to be an important determinant of takeover activity. The positive combined shareholder returns reject, however, the hypothesis that target shareholders gain purely at the expense of the acquiring firm’s shareholders.

In an influential paper, Shleifer and Summers (1988) expound the concern that takeovers can be a means to redistribute wealth from target stakeholders to shareholders. They argue that

[13] In Jensen's (1986) view such acquisitions are the lesser of two evils. They involve less waste than unprofitable internal projects and disgorge cash to investors if not purely made with shares (share exchange offers).

bidders, notably in hostile bids, renege on existing contracts, either explicit or implicit, and expropriate rents from the target stakeholders. Anticipating this breach of contract, target shareholders demand higher prices from the bidders, and thus the post-acquisition transfers show up as (part of) the takeover premia. Potential victims of such redistributions are employees, creditors, consumers, and the tax authorities.

The empirical evidence on transfers from stakeholders as the primary motivation for takeovers is not convincing. Generally neither blue-collar layoffs nor wage cuts are found to explain more than a small fraction of the takeover premium (Brown and Medoff, 1988; Kaplan, 1989a; Lichtenberg and Siegel, 1989; Rosett,1993). In hostile takeovers cutbacks, disproportionately targeted at white-collar employees, are more important and account for 11 to 26 percent of the premium on average (Bhagat, et al., 1990).[14]

Bondholders may be hurt by increased leverage in takeovers because of the higher default risk. In addition, the higher levels of debt may itself induce shareholders or managers acting on their behalf to opt for riskier ventures, further increasing the likelihood of a future bankruptcy (Jensen and Meckling, 1976). Studies on leverage buyouts document reductions in corporate bond prices during the announcement period but these losses are very small relative to the shareholder gains (Marais, et al., 1989; Warga and Welch,1993).

As takeovers often involve firms in the same or closely related industries (Bhagat et al., 1990), shareholder gains may also reflect increased extraction of consumer surplus. To test for market power, empirical studies examine the stock market reaction of rival firms in response to takeover announcements. The underlying idea is that an anti-competitive takeover raises product prices and thus benefits all firms in the industry. Using this approach, Stillman (1983) and Eckbo (1983, 1985) reject the market power hypothesis. Later studies question the reliability of the approach and find evidence of anti-competitive effects (McAfee and Williams, 1988; Mullin et al., 1995). While the evidence on market power is not conclusive, transfers from consumers are most likely not an important effect of takeovers.

Takeovers can generate tax benefits through increased utilization of tax loss and tax credit carry-forwards or through higher interest deductions associated higher debt levels. The available evidence suggests that takeovers benefited from tax savings, amounting in some cases to more than a quarter of the takeover premium (Bhagat et al., 1990). Although tax advantages are a source of takeover gains,[15] they do not seem to be a major force behind the takeover activity.

In conclusion, empirical studies find that stakeholders indeed experience wealth losses in takeovers. As major restructuring typically follows a takeover, such losses are – to some extent –

[14] Employees may also be harmed by reductions in pension provisions following a takeover. Empirically, pension reversions neither are a primary motivation for takeovers nor an important source of gains, accounting for about one percent of the total premia (Ippolito and James, 1992; Mitchell and Mulherin, 1989; Pontiff, et al., 1990).

[15] According to Kaplan (1989b, 1991), tax savings account for most of the premium in management buyouts. These benefits are, however, significantly reduced by the rapid debt repayment.

inevitable but have to be accounted for then assessing the efficiency effects of takeovers. On balance, stakeholder losses explain, however, only a modest fraction of the total gains to shareholders, suggesting that efficiency improvements clearly outweigh redistribution away from stakeholders.

1.3 Takeover Threat

The market for corporate control has not only a profound impact on target and acquiring firms but also on non-transacting firms. That is, the mere threat or possibility of a takeover can induce managers to alter their behaviour. Whether the resulting effects are primarily beneficial or detrimental is at least as controversial as the efficiency effects of actually completed takeovers. On the one hand, it is argued that the takeover threat deters managers from pursuing their own interests at the expense of the shareholders. For instance, the large scale restructuring carried out by incumbent managers during the 1980s is attributed to the concurrent real takeover threat (Holmström and Kaplan, 2001).

On the other hand, it is contended that the takeover threat may induce managers to distort their behaviour rather than promote profit maximizing actions. First, incumbent managers can use anti-takeover measures, like poison pills, stock repurchases or litigation to fend off hostile takeovers.[16] Furthermore, if takeovers are undertaken for reasons other than reversing inefficiencies, acting in the shareholders' best interest need not be an effective protection against a takeover. In fact, the above evidence that size consistently reduces the takeover probability (and more so than good performance) implies that growth rather than efficiency is a viable defence strategy. Alternatively, managers may entrench themselves by tailoring the firm's operations more to their own abilities to become less easily replaceable, even though this course of action reduces firm value (Shleifer and Vishny, 1989).

Second, the possibility of losing the job, may discourage managers from investing in firm-specific human capital. More generally, if takeovers imply some form of contract renegotiation the firm's stakeholders are reluctant to undertake firm-specific investments, thereby reducing ex ante efficiencies (Shleifer and Summers, 1988).

Finally, the takeover pressure may induce managers to sacrifice long-term profitability to boost short-term earnings (Stein, 1988). Moreover, such short-termism may be in the shareholders' best interest. For example, suppose that the manager has superior information about the value of the firm, and that the sale of an asset is the only way to credibly convey the actual value to uninformed shareholders. Although this short-term action is costly, i.e., the sold asset is worth less outside the company, it is a best response to an imminent takeover. The loss incurred through costly signaling is more than offset by the takeover returns, as it prevents the bidder from acquiring

[16] By the end of the 1980s, most S&P 500 firms and a vast majority of those firms listed on the NYSE or Amex were covered by several anti-takeover devices, ranging from poison pills, supermajority amendments to state anti-takeover laws (Danielson and Karpoff, 1998).

the firm at a too low price. More generally, a takeover threat may hinder firms from pursuing profitable long-term strategies, such as investment in R&D.

To assess the impact of the takeover threat, empirical studies examine the effects that firm-specific takeover defences and anti-takeover legislation have on stock returns, firm performance and operating decisions. The conflicting views on this topic may be summarized by two hypotheses. The entrenchment hypothesis holds that anti-takeover provisions are detrimental: they raise the cost of a takeover and hence reduce the disciplinary force of the market for corporate control. This hinders an efficient redeployment of corporate assets and allows managers to pursue their own interests to a larger extent. As a result, firms covered by defensive devices are less efficient and their value is correspondingly lower.[17] Under the shareholder interest hypothesis, defensive devices allow for more efficient contracting with the manager, thereby encouraging firm-specific human capital investment (Knoeber, 1986), prevent coercive bids (Bebchuk and Hart, 2001), make the manager a tougher negotiator in the takeover (Harris, 1990)[18] and promote competition among bidders once the company has come into play (Shleifer and Vishny, 1986a). Moreover, defensive devices protect managers (and firms) from the disruptive effects of takeovers, enabling them to focus on long-term profitable strategies.

The shareholder wealth effects of firm-specific takeover defences are examined in numerous studies, surveyed by Coates (2000) and Weston et al. (2003, Chapter 19). Early studies (e.g., Malatesta and Walkling, 1988; Ryngaert 1988) tend to find that the adoption of takeover defences is associated with small negative abnormal returns of less than one percent. However, later studies (e.g., Comment and Schwert, 1995; Heron and Lie, 2006) report insignificant average stock price reactions but higher takeover premia. This suggests that takeover defences strengthen the target firms' bargaining position without preventing many takeovers. Overall, the evidence is mixed, ranging from small negative to nonexistent abnormal stock returns, and difficult to interpret because the adoption of a takeover defence may simultaneously signal that management expects a takeover bid.[19]

Several studies attempt to determine the impact of anti-takeover statutes on stock returns. By and large, these studies find abnormal negative stock returns (e.g., Szewczyk and Tsetsekos, 1992; Karpoff and Malatesta, 1989, Ryngaert and Netter, 1988), though some report no significant

[17] In this view, the wide-spread use of takeover defences and the increase in anti-takeover legislation are one of the reasons both for the ending of the 1980s takeover wave and for the paucity of hostile bids during the 1990s takeover wave (Holmström and Kaplan, 2001).

[18] Takeover defences can also resolve information problems to the benefit of target shareholders (Sarig and Talmor, 1997) and to the benefit of both target shareholders and acquiring firms (Hirschleifer and Titman, 1990).

[19] Claessens et al. (2002) and Gompers et al. (2003) among others document that firms with good corporate governance, as measured by various proxies, earn significantly higher returns and are more highly valued over a long horizon. These results suggest that anti-takeover devices, being a reflection of poor governance, have an adverse impact on firm performance. However, the results may also reflect changes in the business environment not directly related to firm governance (Becht et al., 2003).

effects (e.g., Margotta et al., 1990; Pugh and Jahera, 1990).[20] Overall, the studies appear to favour the entrenchment hypothesis, though some caution seems in place also because the different states' anti-takeover statutes vary in the extent to which they are a deterrent to would-be acquiring firms (Daines and Klausner, 2001).

A smaller body of work examines the effects of firm-specific takeover defences and anti-takeover legislation on firm performance and managerial decisions. The adoption of firm-specific takeover defences is found to be associated either with no subsequent decline in firm performance (Johnson and Rao, 1997) or with a subsequent improvement (Field and Karpoff, 2002; Danielson and Karpoff, 2006). In contrast, Betrand and Mullainathan (2003) report that that total factor productivity declines in firms after they are covered by anti-takeover laws. Moreover, anti-takeover statutes lead to fewer new investments and fewer disinvestments. This result suggests that managers, shielded from the takeover threat, do not behave like empire-builders, but tend to become sluggish. Garvey and Hanka (1999) document that firms protected by anti-takeover laws substantially reduce their leverage. This suggests that legal barriers to takeovers increase financial slack.

The evidence on the argument that the takeover threat causes managers to behave myopically is scarce and divided.[21] Meulbroek, et al., (1990) find a decrease in R&D expenditures following the adoption of firm-level takeover defences. Using a broader measure of R&D expenditure, Pugh et al. (1992) present contrary results, consistent with the notion that the takeover threat forces managers to sacrifice long-term investments.

Finally, managers of firms that adopt takeover defences (Borokhovich, et al., 1997) or are covered by anti-takeover laws (Betrand and Mullainathan, 1998) receive higher salaries. These findings are consistent with the view that takeover defences increase agency costs (entrenchment hypothesis). Wage increases following the introduction of anti-takeover statutes are not restricted to CEOs. Betrand and Mullainathan (1999) find that anti-takeover laws raise annual wages by one to two percent. As the associated increase in the total wage bill exceeds the negative share price reaction to these laws, the wage increase does not represent pure transfers but also leads to higher profits. This is consistent with view that a reduced takeover risk encourages valuable firm-specific human capital investment (Shleifer and Summers, 1988).

[20] Compared to firm-specific takeover defence studies, these studies avoid problems of mixed signals and selection bias. Their main difficult is to choose, i.e., assume, the date at which the market became aware of a new anti-takeover statute and impounded the effect into the stock prices (Bertrand and Mulllainathan, 2003).

[21] Shares prices are found to react positively (negatively) to the announcement of an increase (decrease) in investment expenditures (McConnell and Muscarella, 1985). This finding is inconsistent with the view that the stock market has a myopic time horizon. It is, however, also compatible with managers acting myopically (Stein, 1988). If managers are reluctant to invest, the present value of those few projects that they undertake is very high, and the market should hence react positively to the announcement of such investments.

In sum, the evidence on the effects of anti-takeover devices is too inconclusive to draw general or strong conclusions. In particular, the results are not sufficiently strong to infer that anti-takeover devices necessarily harm shareholders and degrade firm performance. They seem to be associated with higher takeover premia and in some cases with benefits that exceed the loss in share value.

When debating the effects of defensive measure it is important to distinguish between the impact of defensive measures and the power to undertake them. The conflict of interests between managers and shareholders is particularly pronounced in takeovers: managerial turnover increases significantly following the completion of a takeover, and those managers who lose their jobs do not easily find another senior executive position (Martin and McConnell, 1991; Agrawal and Walkling, 1994). Hence, if a manager can apply defences without shareholder ratification, he may abuse this discretion. Indeed, managers seem less inclined to resist when they gain financially more from a successful bid (Cotter and Zenner, 1994; Song and Walkling, 1993). Consequently, shareholders need to supervise the manager's defensive actions closely, and to facilitate this task, defensive measures should be subject to shareholder ratification.

2. TENDER OFFER PROCESS

In addition to takeovers being motivated by value improvements, the tenet of an efficient market for corporate control relies on the assumption that a party who can improve the firm's market value finds it profitable to launch a takeover and succeeds in doing so. High transaction costs which are involved in takeovers particularly of large firms are one reason why the allocation of control may not be efficient. Another related reason concerns the division of takeover gains between target and acquiring firms. Indeed, if the acquiring firm appropriates a too small fraction of the surplus to cover its costs, it does not make a bid, even if the takeover were to create value. Grossman and Hart (1980b) and Bradley (1980) argue that such an unequal distribution of takeover gains is not simply a remote possibility but inherent to the tender offer process. Their argument therefore offers a rationale for why – as recounted in the previous section - nearly all the takeover gains accrue to the target shareholders. Ultimately, this implies that managers who are either inefficient or pursue self-serving actions need not be vulnerable to a takeover bid. Subsequently, we review the analysis of Grossman and Hart (1980b) as it is central to the understanding of the tender offer process and represents - to the current day - the point of reference for many issues in the takeover debate.

2.1 Free-rider Problem

Grossman and Hart (1980b) consider a firm with a completely dispersed ownership that is approached by an outside buyer, henceforth the rival. Let X_I denote the firm's stock market value

under the incumbent management and X_R its market value under the rival's control. The corresponding per share values are x_I and x_R respectively, where by assumption $x_R > x_I$.[22] That is, we restrict attention here to the commonly considered case of a value-increasing takeover.

To gain control, a rival has to win the approval of a majority of shareholders and to outbid any competing offer.[23] To focus on the target shareholders' impact on the tender offer outcome, we abstract for the time being from competition by another would-be acquirer and discuss it later. Hence, the rival gains control if he succeeds in inducing shareholders to tender at least 50 percent of the shares. (All shares carry the same number of votes.) To this end, the rival makes an unrestricted tender offer with a price p for each share, conditional on getting (at least) 50 percent of the shares. The rival does not own any shares prior to the bid and incurs a takeover cost $C > 0$. Shareholders do not coordinate their response to the offer, but decide non-cooperatively and simultaneously whether to tender their shares. Given the large (infinite) number of shareholders, each of them rightly presumes that his decision does not affect the tender offer outcome. For simplicity, firm (share) values X_I and X_R (x_I and x_R) and the takeover cost C are known to all parties.

When deciding whether or not to accept the offer, each shareholder compares the benefits and costs of tendering in case of success and failure of the takeover. If less than 50 percent of the shares are tendered, the offer is void, and each individual shareholder's decision is immaterial. Incumbent management remains in control and the share value is x_I. If the offer succeeds, a shareholder receives the offered price p when tendering and the post-takeover share value x_R when retaining his share. Consequently, he prefers to retain his share for any price p below x_R. As all shareholders behave in the same manner, the lowest price at which the rival can succeed is $p = x_R$. At this price the rival does not only make no profit but incurs a loss due to the takeover cost C.[24]

Thus, we have replicated the seemingly paradoxical result of Grossman and Hart (1980b): A value-increasing takeover of a completely dispersed firm cannot succeed because of the small shareholders' free-riding behaviour. The success of the takeover is a public good, but each individual shareholder prefers to hold out to extract the maximum gain. As a result, the rival cannot

[22] For simplicity, we also assume that the current share price is not forward-looking, i.e., does not incorporate the possibility of a takeover, but is equal to x_I. The qualitative arguments would not change if we were to include the impact that the prospect of a takeover has on the current share price.

[23] To succeed an offer also has to overcome managerial resistance. However, as tender offers are directly addressed to shareholders, incumbent managers cannot unilaterally discard a tender offer once it is made. Nonetheless, incumbent managers can resort to various defensive tactics to influence the shareholders' perception of an offer, to solicit a competing offer, or even to deter a bid in the first place. Some of these defensive tactics and their likely effects have been discussed in the previous section.

[24] This result is independent of the value improvement $x_R - x_I$ that the rival can realize. Moreover, even if shareholders do not know the post-takeover share value x_R, they can anticipate that it must exceed the offered price because the bidder would otherwise make a loss.

appropriate any fraction of the value improvement and has therefore no incentives to undertake the takeover in the first place.[25] That is, there are too few takeovers.

2.2 Acquirer Gains

The theoretical literature on takeovers suggests several ways how the free-rider problem may be overcome. Common to all the different proposals is that they increase the share of the gains appropriated by the rival and consequently reduce that of the target shareholders. Grossman and Hart (1980b) propose to allow the rival to withhold part of the proceeds from the minority shareholders. Dilution creates a wedge between the post-takeover share value to the rival and that to minority shareholders, enabling the rival to make a profit. More specifically, suppose that the rival can divert a fraction $\phi \in (0,1)$ of the proceeds V_R generated under his control as private benefits B_R. For instance, the rival could pay minority shareholders only $(1-\phi)$ of the dividends that he collects.[26] Consequently, investors price the share after the takeover at $x_R = (1-\phi)v_R$, and each shareholder is willing to tender at a price $p = x_R$. Provided that the private benefits are sufficient to cover the takeover cost ($\phi V_R > C$), the rival finds it profitable to undertake the bid.[27]

The proposal of Grossman and Hart (1980b) makes the fundamental trade-off between promoting takeovers and protecting minority shareholder interests very transparent. To the extent that (target) shareholder protection amounts to granting them a substantial share of the gains, it necessarily discourages would-be acquirers. Hence, an active takeover market relies on ceding acquirers benefits that do not accrue to other shareholders on a pro-rata basis. As a corollary, it follows that maximum shareholder protection need not be in the shareholders' best interest. Banning all extraction, i.e., imposing $\phi = 0$, prevents the rival from making a profit, thereby frustrating takeovers. This is also costly for the target shareholders, as they forgo the takeover premium.

A closely related point is that minority protection aimed at restricting the dilution of minority shares does not serve as a screening device (Berglöf and Burkart, 2003). Better minority protection

[25] With a finite rather than infinite number of shareholders, each individual shareholder takes into account that his decision is with positive probability pivotal for the aggregate outcome. Hence, he is willing to tender at a price (slightly) below the post-takeover share value, leaving the bidder some profits (Bagnoli and Lipman, 1988; Holmström and Nalebuff, 1992). In support of this prediction, acquirers of unlisted firms earn positive abnormal announcement returns (Faccio et al., 2005; Moeller et al., 2004).

[26] Discriminatory dividends are merely an illustrative example of private benefit extraction that should not be taken literally. While the law in most countries forbids overt minority shareholder expropriation, there are various more subtle forms that are either difficult to prove in court, or even not against the letter of the law. For instance, the rival can sell at below market prices output or assets of the target firm to another firm under his control. Other forms of dilution are investment in unprofitable ventures (empire-building), excessive salaries to the executive, the consumption of perks and the appointment of friends or family members to management positions.

[27] Bid price and shareholder wealth do not depend on upon whether the bid is unrestricted or restricted (to 50 percent). In either case, the rival offers a price equal to the post-takeover minority share value, and the shareholders neither gain nor lose from tendering their shares.

does not frustrate those bids where the acquirer is the primary recipient of the takeover gains without discouraging even more those bids where the gains are more evenly shared.

Another way to overcome the free-rider problem is to finance the takeover with debt, backed by the assets of the target firm (Mueller and Panunzi, 2004). Since debt is senior to equity, leverage reduces the post-takeover share value. Thus, loading debt on the target reduces the bid price, while the acquirer receives (part of) the proceeds from the debt issue.

Yet another way to exclude target shareholders from part of the takeover gains is to grant successful acquirers a squeeze-out right, i.e., the right to compel remaining minority shareholders to sell their shares (Yarrow, 1985; Amihud et al., 2004).[28] When an offer conditional upon acceptance of the freeze-out fraction succeeds, the rival has the option to squeeze-out the remaining minority shareholders. As a result, these shareholders realize at most a return equal to the bid price p and may therefore as well accept the offer. This holds true also for bid prices below the post takeover share value ($p < x_R$). That is, a takeover conditioned on the squeeze-out threshold prevents shareholders from becoming minority shareholders, thereby solving the free-rider problem.

Direct dilution of minority shareholder rights, debt financing, and the squeeze-out rule all solve or mitigate the free-rider problem by reducing the post-takeover share value. Another somewhat distinct solution is the acquisition of a stake prior to the tender offer (Shleifer and Vishny, 1986b; Chowdhry and Jegadeesh, 1994). Suppose the rival already owns a stake in the target firm before mounting the tender offer. Even if the rival cannot dilute minority shareholder rights and has to offer the full post-takeover value ($p = v_R$), the takeover may be profitable. While the rival makes zero profit on the shares acquired in the tender offer, he captures (some of) the value improvement of his initial stake, provided the pre-takeover price of the stake is relatively low.[29] This argument shows that the possibility to (secretly) acquire shares prior to the offer is an important source of acquirers' profit. Indeed, pre-takeover holdings are found to have a positive impact on bidder gains and on the success probability of takeovers (Stulz, et al., 1990; Choi, 1991).

The ease and extent to which an acquirer can accumulate an initial stake through secret open market purchases depend on the market depth and the disclosure requirement. Once an acquirer has to disclose his identity and holdings, further open market purchases become increasingly less attractive. As disclosure requirements limit the numbers of shares that an acquirer can secretly accumulate prior to a bid, they affect the division of takeover gains. Loose disclosure

[28] The European Takeover Directive (article 14) introduces the squeeze-out right with a threshold of 90 percent of the equity capital, but grants Member States the discretion to apply in some circumstances a higher threshold with an upper limit of 95 percent.

[29] Kyle and Vila (1991) show that noise trading allows the bidder to acquire an initial stake at favourable prices so that the takeover becomes profitable. Complementing this result, Cornelli and Li (2002) demonstrate that trading by risk arbitrageurs in the post-announcement market facilitates takeovers of firms with an initially dispersed ownership.

standards allocate a larger share of the takeover gains to the bidder, thereby promoting takeovers market. This, however, comes at the expense of those shareholders that sold their shares prior to the bid, thereby forgoing the takeover premium.

These extensions and modifications of the Grossman and Hart (1980b) model show that takeovers of widely held firms can be profitable. They do, however, not alter the basic insight that the free-rider behaviour prevents an acquirer from making a profit on those shares that he purchases in the tender offer. This holds true irrespective of the extent to which (and the ploy with which) the acquirer excludes minority shareholders from the takeover gains. Once the acquirer has control and extracts private benefits ϕV_R, he values the shares (not needed for having control) at $x_R = (1-\phi)v_R$, the price that he has to offer the shareholders. The large takeover premia seem to suggest that the possibilities to expropriate target shareholders are - at least in advanced market economies – limited. Hence, the acquirers' profit prospects are small and too few value-increasing takeovers occur as posited by Grossman and Hart (1980b).

Closely related to the failure of value-increasing bids is another - diametrically opposed - inefficiency, namely the success of value-decreasing bids. To assess this possibility, we replicate the above analysis under with the assumption of a value-decreasing rival ($x_R < x_I$). Anticipating failure, each shareholder is indifferent between tendering and retaining and may as well retain his shares. Hence, failure of a value-decreasing bid is an equilibrium outcome. However, anticipating success, each shareholder prefers to tender if the rival offers at least the post-takeover share value. Thus, success of a value-decreasing bid (marginally) above the post-takeover share value ($x_I > p > x_R$) is also an equilibrium outcome, even though it is against the collective interest of the shareholders. Confronted with such a bid, shareholders face a pressure-to-tender problem (Bebchuk, 1988). Tendering becomes individually rational to avoid being in a less favourable minority position ($p > x_R$). As for the rival, he obviously attempts such a bid only if its success entails substantial private benefits. While success of a value-decreasing bid is an equilibrium outcome of the takeover game, its empirical relevance seems questionable in view of the consistently documented large gains to target shareholders.

As noted in the literature (e.g., Bebchuk and Hart, 2001), the success of a value-decreasing bid has the same cause as the failure of a value-increasing bid: Each shareholder bases his tendering decision only on a comparison between bid price p and post-takeover share value x_R, without taking the pre-takeover share value x_I into account. As a result, a shareholder retains his shares even though he prefers the bid to succeed (free-rider problem) or he tenders his shares even though he prefers the bid to fail (pressure-to-tender problem).[30]

[30] Both problems can be resolved by making target shareholder approval by a majority vote a necessary and sufficient condition for an offer to be accepted (Bebchuk and Hart, 2001). The pressure-to-tender problem is also removed by a mechanism that requires approval by majority vote and (at least) a

A different limitation of the takeover mechanism is identified by Burkart et al. (1998) who examine the implications of the post-takeover incentive problems on part of the successful acquirer. As for the dilution of shareholder rights, the discussion so far implicitly assumed that the extraction of private benefits is efficient, that is, each dollar withheld from the shareholders yields one dollar of private benefit. By contrast, Burkart et al. (1998) assume that such extraction is inefficient and exhibits decreasing marginal returns. As the rival owns more shares, he internalizes more of this inefficiency and therefore extracts less private benefits, which implies a higher post-takeover share value. Thus, private benefit extraction with a convex deadweight loss is but one way of formalizing the alignment effect: A corporate insider with a larger equity stake is more prone to act in the (outside) shareholders' interest (Jensen and Meckling, 1976).

As in Grossman and Hart (1980b), target shareholder do not tender unless the bid price matches the post-takeover minority share value. The free-rider behaviour has two consequences. First, the equilibrium supply of shares is increasing in the bid price. Since the post-takeover share value increases in the acquirer's final holding, the number of shares tendered has to increase with the price to preserve that the post-takeover share value equals the bid price. Second, the rival cannot make any profit on the tendered shares, and the private benefits constitute his only profit. As a result, the rival takes control by purchasing as few shares as necessary, i.e., 50 percent, thereby maintaining high incentives to extract private benefits. From a social point of view, the ownership structure is not sufficiently concentrated as private benefit extraction entails a deadweight loss. However, the socially efficient ownership concentration is not feasible because the rival makes no profit if he acquires all the shares.

3. SHARE BLOCKS AND CONTROL TRANSFERS

The preceding analysis of the tender offer process presumes target firms with dispersed ownership. Yet, companies with diffuse ownership are infrequent. Outside the UK and US, widely dispersed ownership, even among the largest corporations, is not the prevalent organizational form (e.g., Barca and Becht, 2001; La Porta et al., 1999). But even in the US and the UK where publicly traded corporations stand out as having a more widely dispersed ownership, many listed firms have a shareholder owning 5 to 10 percent (Gadoum et al., 2005; Holderness, 2005).

The free-rider problem, caused by dispersed ownership, and its solution by means of a pre-bid stake may suggest that the presence of a blockholder facilitates a takeover. Instead of accumulating an initial stake through open market purchases, an acquirer can negotiate a block sale with its current owner. While the blockholder may capture some of the subsequent gains, the block trade enables the acquirer to purchase shares below their post-takeover value, making a bid

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majority of shares tendered separately, such as a sell-out right with a 50 percent threshold (Burkart and Panunzi, 2004).

more (likely to be) profitable. Moreover, if the share block is sufficiently large, the acquirer can gain (de facto) control through a block trade, circumventing the free-rider problem altogether.[31] Though, casual observations seem to defy this conjecture. The volume of takeover activity in the UK and especially the US has been much higher than in other countries. In fact, the low level of takeover activity in these countries is commonly attributed to the predominance of concentrated ownership structures, often enhanced with dual class shares, pyramiding or cross-holdings.[32] Thus, while blockholders have the ability to promote a takeover by either selling or tendering their shares, they also have the power to impede or block it, and experience indicates that the latter outcome prevails.

When comparing cross-country takeover activity, it should, however, be noted that blocks may be traded without a full-scale takeover occuring. Indeed, an active market for large share blocks is documented for European countries, such as Belgium, France, Germany, and the UK (e.g., Dherment-Ferere et al., 2001; Goergen and Renneboog, 2000). Moreover, block sales tend to be related to poor past performance and followed by increased management turnover (Köke, 2000; Franks et al., 2002). Subsequently, we discuss how the presence of a blockholder affects the incidence and efficiency of control transfers.

3.1 Sales of Controlling Blocks

Obviously, a blockholder's influence over the control allocation increases with the block size, or more precisely, with the number of votes. If the incumbent blockholder holds a majority of the votes - the associated fraction of shares can be (substantially) smaller due to a dual class share structure - a control transfer can only take place with his consent. As shown by Kahan (1993) and Bebchuk (1994), the incidence and efficiency of majority block transactions depend on the regulatory regime as regards the obligation to buy-out minority shareholders. If the rival is not obliged to let the minority shareholders participate in the control transaction, he can simply buy the majority block at any price the incumbent blockholder is willing to sell. Consequently, a control transfer takes place when the controlling block has a higher value under the rival's than under the incumbent's control. How incumbent and rival split this surplus determines the block price. Having purchased the controlling block, the rival has always the option to buy-out the minority shareholders. However, the rival cannot gain from making a voluntary tender offer because the small shareholders do not sell unless the price equals the share value under the rival's control.

Since the value of the controlling block comprises all the private benefits but only part of the firm's market (share) value, a surplus from a block trade does not imply efficiency nor does efficiency imply a surplus. In particular, when the incumbent's private benefits are relatively small

[31] Control over a firm does not necessarily require a majority of the shares (votes), in particular, when the remaining shares are dispersed.

[32] Takeover barriers other than concentrated ownership and takeover defences include close bank-firm relationships, co-determination and the relative small number of listed firms. For a brief discussion see Berglöf and Burkart (2003).

compared to the rival's private benefits, a control transfer can be mutually beneficial even if the loss in share value exceeds the increase in private benefits. Conversely, when the rival's private benefits are relatively small compared to the incumbent's private benefits, incumbent and rival may not want to trade the block even though a control transfer would add value.

Under the mandatory bid rule as formulated in, e.g., the European Takeover Directive (Article 5), the rival cannot purchase the controlling block without offering all small shareholders the same per-share considerations. In such a regime, a control transfers takes place if, as before, it is beneficial to the rival and the incumbent, and if the rival earns a profit when having to offer small shareholders the same per-share price. These two conditions imply a total acquisition price above the total firm value under the incumbent's control, including his private benefits. Hence, the mandatory bid rule prevents inefficient control transfers. However, it also makes it more likely that an efficient control transfers is frustrated.[33] The obligation to offer all shareholders the same per-share price may increase the total acquisition price beyond the rival's willingness-to-pay, even though a control transfer would be efficient. Thus, the mandatory bid rule can also be to the disadvantage of the small shareholders since they may forgo share value improvements. Furthermore, the impact of the mandatory bid rule is also sensitive to changes in the (assumed) setting (Burkart and Panunzi, 2004). For instance, if the private benefits of the incumbent and rival are of the same order of magnitude, it is impossible that a block trade generates a surplus but the control transfer is inefficient. Thus, the mandatory bid rule loses in this case its beneficial effect of preventing inefficient control transfers.

Empirical studies on block trades in the US find that such trades are on average associated with abnormal share price increases. Moreover, the abnormal returns are smaller, but still positive, when no subsequent takeover occurs (Holderness, 2003). This evidence suggests that improved management rather than extraction of private benefits is the primary source of gains in block trades. Studies on block trades in other countries find the share price reaction to be positive or insignificant and to vary with the identity of the buyer (e.g., Banerjee et al., 1997; Trojanowski, 2002). Overall, the evidence does not support the claim that block trades are primarily undertaken with the purpose of looting companies at the expense of small shareholders.

If a large shareholder does not own a majority block, a would-be acquirer does not have to seek his consent to take over the firm. That is, control is contestable. Confronted with a takeover attempt, a minority blockholder can respond in different ways. He may choose to compete with the rival, negotiate a block sale, accept or reject the rival's tender offer. The possible responses are

[33] Both effects are diluted by less stringent versions of the mandatory bid rule. If some discrimination between the per-share price in the block trade and the subsequent tender offer is allowed, fewer efficient control transfers are frustrated and some inefficient transfers are not prevented.

distinct, and accordingly the presence of a minority blockholder can have diverse effects on the takeover outcome, as the following discussion shows.

3.2 Bidding Competition

Obviously, a bidding contest does not only emerge in the presence of a minority blockholder but can just as likely take place between two outside parties, neither of whom owns an initial stake. Most research on bidding competition consider this latter case and abstracts from the free-rider problem. Instead, it is assumed that the target accepts the highest bid, provided it offers a premium relative the current market value.[34] The bidding contest which yields the winning offer is commonly modeled as an English auction. In simple versions, bidders make offers and counter-offers at no cost, each offer incrementally higher than the previous, until the bidder with the highest valuation wins at a price equal to the valuation of the second highest bidder. Thus, competition leads to an efficient control allocation. It also benefits target shareholders as bids and counter bids drive up the price that the winner (highest valuation bidder) has to pay. Empirical evidence shows that target shareholders earn higher returns in multiple bidder contests (e.g., Bradley, et al., 1988; Franks and Harris, 1989; Stulz et al., 1990).

In the English auction analysis, an initial bidder should bid low until competitors arrive in which case each bidder should increase the previous bid only by a small increment. The strategies provide, however, a poor description of actual takeover contests in which initial bidders typically offer a substantial premium and each successive bid entails a sizeable increase over the last preceding bid. These patterns obtain in richer frameworks where bidders have to incur costs to revise their bids or to learn their (private) valuation of the target. In models with costly bid revision or costly investigation, large bid-increases and high initial bids signal a high willingness-to-pay and may therefore induce other bidders to quit the contest or not to enter (e.g., Fishman, 1988). Such preemptive bids reduce efficiency and expected target shareholder wealth because a bidder other than the highest valuation bidder can take over the target at a price below the valuation of the second highest bidder.[35] High initial offers are found to be associated with a lower likelihood of competing offers (Jennings and Mazzeo, 1993).

Inefficient bidding outcomes can also be caused by the firm's security-voting structure, or more specifically, by deviations from the one share - one vote rule (Grossman and Hart, 1988; Harris and Raviv, 1988). When a firm has several classes of shares, bidding competition can lead to the same distortions as majority block trades. The value of control to a bidder - like the value of a majority block - comprises all the private benefits but only part of the firm's market value. Hence, the bidder with the larger private benefits may win the takeover contest instead of the bidder under

[34] Effective competition among rivals by definition implies that the requirement to outbid, rather than winning shareholder approval, determines the bid price. Hence, ruling out the free-rider problem should be viewed as a simplification rather than a restrictive assumption.

[35] For an extensive discussion of multi-bidder models see Spatt (1989) and Hirshleifer (1995).

whose control total firm value is highest. By contrast, the one share - one vote rule gives equal weight to private benefits and to the firm's market value in determining each bidder's willingness-to-pay. Accordingly, the bidder under whose control total firm value is highest is always able to outbid any competitor, ensuring an efficient control allocation. By contrast, deviations from the one share - one vote rule can benefit target shareholders because it may intensify competition, thereby allowing them to extract a larger share of the winning bidder's private benefits. However, such a surplus extraction strategy runs the risk of an inefficient control allocation in which case target shareholders are also worse off than under the one share – one vote rule.[36]

As for the role of minority blockholders in bidding contests, their stake gives them an advantage over would-be competitors as they need to acquire fewer shares to attain majority control (Dewatripont, 1993; Ravid and Spiegel, 1999). Moreover, a bidder with an initial stake has an incentive to bid more aggressively, in fact, to bid more than his valuation of the target firm (Burkart, 1995; Singh, 1998). Such overbidding aims at provoking a counter-bid, and thereby increasing the returns when losing the bidding contest. However, the bidder may actually win the contest, instead of merely improving the selling price. In this case, the takeover outcome may be inefficient and the winning bidder (with an initial stake) may make a loss. Thus, overbidding brought about by initial stakes provides an explanation why acquirers sometimes overpay that is consistent with profit-maximizing behaviour.

Initial stakes may not only distort the outcome of bidding contests, but can also prevent them. Overbidding reduces the expected gains for a potential competitor as he has to pay a higher price when winning. As a result, he may be deterred from incurring the costs to participate in the contest. Compared to the private value setting, the deterrence effect is amplified in the common value auction framework because overbidding exacerbates the winner's curse problem for the competitor, inducing him to bid more conservatively (Bulow et al., 1999). Empirical studies document that initial stakes are on average larger in single-bidder takeovers than in multi-bidder contests (Stulz et al., 1990; Betton and Eckbo, 2000).

As bids and counter-bids drive up the tender price, takeover contests undoubtedly benefit target shareholders and on the whole also improve efficiency, notwithstanding the distortions inherent in the bidding process. By contrast, competition is undesirable from the bidders' perspective; they may come away empty-handed, have to pay a higher price to acquire the target, or - in case of minority blockholders - have to increase their holdings to defeat an attempted takeover by another bidder. Interestingly, even if a large minority blockholder is outbid by a rival and sells his block, the takeover contest may not be in his best interest (Burkart et al., 2000). Instead of engaging the rival in a bidding contest, the blockholder can (reluctantly) hand over

[36] Field and Karpoff (2002) document that over 5 percent of the 1019 industrial firms that went public in the US between 1988 to 1992 had dual class share structures. Furthermore, many firms had takeover defences in place at the time of the IPO.

control in a private block trade.[37] When private benefit extraction is inefficient, the crucial difference between these two transaction modes concerns the fraction of shares that the rival ultimately owns. The block trade preserves the low ownership concentration, inducing more private benefit extraction. In contrast, the competitive pressure in the tender offer forces the rival to make a bid that leads to more shares being tendered. As a result, the rival owns a larger fraction of the shares and therefore diverts less private benefits. Although total firm value is higher following a tender offer, the blockholder and the rival strictly prefer to trade the block. It allows them to appropriate a larger share of the takeover gains because the block trade bypasses the small shareholders who would otherwise free-ride. Thus, Burkart et al., (2000) show that the choice how to transfer corporate control may itself be subject to agency problems. Consequently, the reported gains for small shareholders in block trades do neither imply that firm value is maximized nor that a block trade is the best feasible outcome.

3.3 Tendering Minority Blocks

Once negotiations over the block trade have failed, say due to inefficient bargaining, the minority blockholder has the option to compete for control or to decide whether to accept the rival's (uncontested) offer. He may choose not to compete because he lacks the financial resources or managerial capabilities. Alternatively, he may be an institutional investor, such as a pension fund, that is prevented from taking over a firm. In what follows, we explore how the presence of a "passive" minority shareholder who merely decides whether or not to tender affects the outcome of the tender offer.

Relative to the outcome with a fully dispersed ownership, the presence of a minority shareholder is immaterial if, as in Grossman and Hart (1980b), private benefits and post-takeover share value are exogenous. To succeed, the rival must attract enough shares from the small shareholders. Hence, he must offer a price equal to the post-takeover share value, which is given and independent of the rival's final shareholdings. The minority blockholder's tendering decision is irrelevant, as he is not decisive for the outcome.

The presence of a "passive" minority blockholder only matters if the supply of tendered share increases with the bid price. As shown in section 2.2, inefficient extraction of private benefits generates an upward sloping supply curve. Using this framework, Burkart et al. (2006) show that the presence of a minority shareholder can increase the bid price.[38] Since the rival must induce

[37] Jenkinson and Ljungqvist (2001) document that many seemingly friendly block transfers in Germany involve a considerable amount of hostility.

[38] Models with atomistic shareholders who have different (expected) opportunity costs of tendering due to varying liquidity needs or tax-rates also yield an upward-sloping supply curve (Stulz, 1988; Hirshleifer and Titman, 1990). In such a setting, the presence of minority blockholder can also affect the equilibrium bid price. For example, if the blockholder has the highest opportunity cost of tendering, the bid securing a 50 percent supply of the shares increases (Stulz, 1988; Stulz et al., 1990).

(some of) the small shareholders to tender, their free-riding behavior implies that the bid price must equal the post-takeover share value. As a result, the rival's optimal strategy is to acquire as few shares as necessary. He cannot make a profit on the tendered shares and the private benefits decrease with his final holding.

The positive relationship between post-takeover share value and the rival's final holding implies that the blockerholder's tendering decision interacts with those of the small shareholders. If the blockholder tenders more shares, the small shareholders tender fewer shares to restore the match between post-takeover share value and bid price.

Relative to the small shareholders, the blockholder has stronger incentives to tender his shares, given that the bid succeeds. His gains from tendering additional shares are twofold; the bid price for these shares and the value appreciation of all his remaining retaining shares, as the additional tendered shares increase the rival's final holding, leading to a higher post-takeover share value. This implies that, in equilibrium, the blockholder sells all his shares in a successful takeover.

Since the rival attempts to take over the firm with as few shares as necessary, selling all shares can make the blockholder decisive for the tender offer outcome. If the blockholder anticipates that he is decisive, he does not tender unless the bid price is above the (per-share) value of his block prior to the takeover. Hence, his presence imposes an additional condition that a successful bid must satisfy. The condition can be binding because the blockholder enjoys private benefits. In this case, the rival has to increase the bid price either until the blockholder favors the offer as he is compensated for the forgone private benefits, or until the offer attracts enough shares (50%) from the small shareholders, making its success independent of the blockholder's decision. A larger minority stake and larger private benefits increase the bid premium that the rival has to offer to succeed.

From the small shareholders' perspective, such blockholder resistance comes with the benefit of a higher takeover premium but also with the cost of a reduced takeover likelihood. The empirical research on the impact of managerial and outside blockownership offers conflicting findings. For instance, Stulz et al. (1990) document that institutional ownership affects target firms' gains negatively, in conflict with the findings of Gaspar et al. (2005). Mikkelson and Partch (1989) and Song and Walkling (1993) show that targets have lower managerial ownership than non-targets, while Ambrose and Megginson (1992) find that neither managerial ownership nor institutional holdings are related to takeover likelihood.

Finally, the presence of a blockholder also constitutes a binding constraint for value-decreasing rivals. As above, the rival must increase the bid price either to win the blockholder's support or to attract enough shares from the small shareholders. The higher price may deter some value-decreasing rivals. Otherwise, it reduces or even eliminates takeover losses for target

shareholders. Thus, the presence of a minority blockholder mitigates the pressure-to-tender problem.

4. CONCLUDING REMARKS

Manne (1965) argues that the market for corporate control promotes efficient utilization of corporate resources. Takeovers remove managers who either pursue their own goals or fail to make the best use of the firm's resources. In addition, the mere threat of a takeover disciplines managers and thereby mitigates agency problems in large public corporations. This view is, however, too narrow and biased, as closer examination of the takeover process in subsequent research reveals. There are impediments to an effectively operating takeover market such as the free-rider problem pointed out by Grossman and Hart (1980b). In addition, the existence of a market for corporate control can induce behaviour that is detrimental to efficiency like managerial entrenchment or underinvestment in firm-specific human capital. Thus, the overall conclusion is ambivalent: The takeover mechanism gives rise to both beneficial and adverse effects: it disciplines managers and allows a more efficient use of corporate assets, but it also exacerbates the agency problem and triggers inefficient actions. Moreover, the empirical evidence on many controversial issues is not conclusive enough to give clear answers.

On reflection, the inconclusive verdict is hardly surprising. The separation of ownership and control inevitable entails agency problems, and takeovers are a mechanism to mitigate these problems. However, takeovers, like other governance mechanisms such as boards or large active shareholders, are not free of agency problems. For instance, most takeovers are not undertaken by corporate raiders but by firms headed by professional managers (Shleifer and Vishny, 1991). Hence, takeovers may also serve the purpose of empire-building. That is, takeovers can be the cure of an agency problem, but also the symptom of an(other) agency problem. Similarly, the bidders' ability to divert corporate resources as private benefits helps to overcome the free-rider problem. While this promotes takeovers and enhances their disciplinary power, it also creates or exacerbates the agency problem between shareholders and the new controlling party.

Among a number of unresolved issues in the takeover literature, two stand out as the most fundamental. First, empirical studies document substantial gains to target shareholders, but the source of these gains have not been fully identified. On the one hand, there is no systematic evidence that improvements in post-takeover operating performance can account for the target shareholder gains. On the other hand, the documented losses to stakeholders, such as employees or bondholders, only explain a modest fraction of the shareholder gains. Clearly, a better understanding of how takeovers create shareholder wealth is important and a prerequisite for a more informed assessment of their efficiency effects.

Second, theoretical work puts forward that the takeover threat gives rise to various conflicting effects, such as disciplining manager vs. sacrificing long-term profitability. As many of

these benefits and costs of an (in)active takeover market are indirect and economy-wide, they are difficult to prove or refute empirically. Indeed, there is still little consensus about the effects of takeover defences on shareholder wealth, despite the large number of papers on this topic. This applies also to the broader question of the efficiency effects of takeover defences on operating decisions and firm performance, and more generally, the question of the impact that the takeover threat and variations thereof have on firm behaviour. More work addressing these challenging issues is warranted.

This essay also discusses the much smaller body of work, analysing takeovers of firms whose ownership structure is not completely dispersed. When the blockholder owns a majority of the votes, control is obviously not contestable, and a control transfer only occurs with his consent. Inefficient control transfer can take place and efficient control transfer may fail to take place because the trading parties do not take into account that a control transfer has a negative or positive externality on the wealth of the minority shareholders.

If control is contestable, the presence of a minority blockerholder can promote or hinder a control transfer. In case of a substantial minority block, control can be transferred either through a (hostile) tender offer or through a block trade. Both blockholder and new controlling party prefer to trade the block because it excludes the small shareholders from a larger share of the takeover gains. That is, the acquirer benefits from the presence of a blockholder as it enables him to circumvent the free-rider problem. The reverse conclusion obtains in cases where a tender offer is, for one reason or another, the only option available to an acquirer. In case of a passive blockholder who values the status quo highly, the acquirer must offer a higher price either to win the blockholder's support or to attract enough shares from the small investors so that this support is no longer needed. In case of a competing blockholder, the bidding contest is biased against the acquirer as the initial stake commits the blockholder to bid aggressively. Thus, fewer takeovers occur when ownership is partially concentrated, compared to the case of completely dispersed ownership.

These predictions are consistent with broad-brush empirical evidence. For instance, the level of takeover activity in continental European countries is lower than in the US or UK, though there seems to exist an active market for share blocks.

Large (controlling) shareholders are an obstacle to an active market for corporate control. Accordingly, breaking up concentrated ownership structures to promote takeovers has been advocated in the (European) governance debate as a means to further restructuring and, more generally, the capacity for adaptation (e.g., European Commission, 2002). However, any proposal must take into account that corporate governance systems vary from country to country. Each system consists of many interacting components, making the effectiveness of a given mechanism highly dependent on the overall system. That is, the absence of large shareholders per se neither ensures that an active takeover market evolves, nor that it performs its desired governance role.

An effective takeover mechanism requires further institutions, such as strong (legal) protection of investors, transparency, disclosure, and unbiased enforcement of contracts. Furthermore, in (continental European) countries, where these institutions are weaker, partial ownership and control concentration is the main mechanism to constrain managerial behaviour. Thus, the role of takeovers - or large shareholders for that matter – as a disciplining mechanism must ultimately be analysed within the overall governance system. Obtaining a better understanding of the interaction among different mechanisms and of the relative performance of different systems is the fundamental challenge that corporate governance research faces.

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