Many studies of mergers, takeovers, acquisitions, divestitures, and the like—enhance shareholders’ value. They allow the businesses to be transferred to the control of new owners who can put business assets to work more efficiently. In most countries, however, the market for corporate control is significantly restricted by anti-takeover laws and business practices used to entrench management, such as poison pills, heavy debt, pyramid schemes, and cross-holdings of equity. The key to overcoming these obstacles is to restructure incentives—by requiring business groups to disclose intercorporate ownership and banks to limit connected lending, by ensuring that bankruptcy law allows effective transfer of control, and by removing regulatory barriers to takeovers.

Changes in corporate control—through mergers, takeovers, acquisitions, divestitures, and the like—enhance shareholders’ value. They allow the businesses to be transferred to the control of new owners who can put business assets to work more efficiently. In most countries, however, the market for corporate control is significantly restricted by anti-takeover laws and business practices used to entrench management, such as poison pills, heavy debt, pyramid schemes, and cross-holdings of equity. The key to overcoming these obstacles is to restructure incentives—by requiring business groups to disclose intercorporate ownership and banks to limit connected lending, by ensuring that bankruptcy law allows effective transfer of control, and by removing regulatory barriers to takeovers.

Despite its important role in corporate performance, the market for corporate control remains highly restricted in most countries. Even in such countries as Japan and the United States, regulatory impediments and business shields to prevent takeovers are widespread (see for example Jensen 1993 and Morck and Nakamura 1999). In part this reflects public distrust of big business. But it also reflects the success of corporate managers in lobbying legislators for protection.
Impediments in control markets

In most countries until recently, efforts to reform control markets have focused on anti-takeover laws. Now there is a broader perspective recognizing that firms have developed techniques that help them resist takeovers, even if they are in the interests of the firm and outside shareholders.

Firm-level devices

At the firm level, management and controlling shareholders can use devices to deter or reject a proposed control bid.

Poison pills. Poison pills are rights, generally given to management, to buy additional shares of the firm at a discount once any person owns more than a specified block of equity (often 20 percent). Poison pills dilute the interest of the bidder and make it necessary to buy more shares to get control. In effect, they allow managers to reject a bid without shareholders’ approval.

Debt. Managers—as well as controlling shareholders—can thwart takeover attempts by borrowing to increase their ownership stake. Management-led leveraged buyouts represent an extreme case. Debt allows managers to retain control over more resources without putting additional equity at risk.

The main restraint on leverage is the risk of losing control through bankruptcy. In many countries, however, this threat is weak. Legal frameworks are often dated and do not apply to contract and securities transactions. Even when the laws are relevant, the judiciary may be inefficient or corrupt. Since debtors can often prolong the litigation or pay the judge for a favorable ruling, default does not necessarily mean a loss of control. In these circumstances the use of debt becomes irresistible. In East Asia in 1996, corporate debt averaged 200 percent of equity in Indonesia, 240 percent in Thailand, and 350 percent in the Republic of Korea (Kawai 1999).

Pyramid schemes. Large shareholders or managers of a firm may also enhance their control through a pyramid scheme, which allows them to fortify their control of a firm or extend the reach of their control. As with leverage, pyramid schemes do not rule out takeovers. But the entrenched position of management signals that any takeover attempt may be costly.

Pyramid schemes generally involve using control of a publicly held firm to gain control of others. Suppose firm A owns 50 percent of firm B. Under a pyramid scheme firm A might use firm B’s assets to buy 50 percent of firm C. Firm A would then have effective control of firm C. Managers of firm A could also fortify their control of firm A by directing firms B and C to buy shares of it.

Cross-holdings. Intercorporate cross-holdings of equity—where firms hold shares in others in a group—are widespread in such countries as Japan and Korea and in continental Europe. Cross-holdings generally occur within a group of firms with family or business affinity, including producers of consumer products and suppliers of parts or raw materials. The ownership stakes held by individual firms may be relatively small, but they help to align the business interests of the group members.

It is sometimes suggested that with stable ownership, these arrangements promote long-term perspectives among firms. But if such groups are common, they can sharply restrict the scope for control transactions. Since members of the group generally act together, they can outvote non-members, including takeover bidders. Evidence suggests that in Japan the key reason for joining a business group—keiretsu—is to protect the managers from takeovers (Morck and Nakamura 1999). But as the performance of Japanese firms in the 1990s shows, stable intercorporate ownership does not ensure long-term profitability or shareholders’ value.

Regulatory barriers

Some regulatory rules inadvertently restrict the control market. Others are designed to deter
control transactions, usually to protect jobs and stakeholders’ interests. But the main result is to entrench the position of management and corporate insiders.

Tax disincentives. In many developing countries tax considerations make control transactions financially unattractive. Business reorganizations, including mergers and acquisitions, are treated as taxable events involving realized capital gains or losses. The target firm’s shareholders do not have the option of a tax-free exchange of securities. For the sellers, the transaction could produce a tax liability for which they have no cash to pay. For the bidder, the taxes represent an extra cost and make it necessary to offer cash as part of the deal.

Control share rules. In some jurisdictions the ownership rights of a takeover bidder are restricted. Often the shares purchased within a certain period (usually twelve months) of a control contest have no voting rights. This rule makes it easier for management to defeat takeover bids, even if the bids are in the interest of the firm and minority shareholders. In many emerging markets foreigners face rules, both formal and implicit, that limit their participation in the control market.

Auctions for control. Some jurisdictions encourage auctions for the target firm by delaying the completion of takeover bids. The delay may be mandated as a waiting period or through pre-merger notification and reporting requirements. In the interim the information revealed in the original offer makes a new bid, possibly at a higher offer price, far more likely. Such rules are supposed to favor shareholders. In practice, however, they deter takeover attempts by increasing uncertainty and the cost of acquisition.

Nonshareholder interests. Many jurisdictions require or allow boards of directors to consider the interests of stakeholders other than shareholders. Thus directors might reject a takeover bid if conditions set by workers and the community are not met, such as conditions ruling out plant closings and layoffs. But the main beneficiaries are again management and insiders.

Management becomes more immune to shareholders’ lawsuits for opposing value-enhancing offers. And the restrictions on the restructuring of the target firm reduce the value of control (Romano 1992).

Reviving control transactions

While the reform measures differ, revitalizing the control market is similar to liberalizing markets for goods and services. Success depends on an informed climate of opinion to create the political support needed to overcome resistance by vested interests. In addition, growing global competition and the search for efficiency can add impetus to the reform.

Dealing with firm-level impediments

Although such business practices as leveraging, pyramid schemes, and cross-holdings impede control transactions, they often serve useful purposes. Heavy-handed regulation to end them may impose economic costs that outweigh the benefits. The key to addressing these impediments is to restructure incentives so that firms will change their practices voluntarily.

Bankruptcy systems. In weak bankruptcy systems borrowers seldom lose control to creditors, even under default and insolvency. But when the consequences of default are swift and certain, borrowers’ incentives change significantly. They must weigh the threat of takeovers against the risk of bankruptcy, each of which involves a loss of control.

Although bankruptcy provisions vary from one country to another, the essential features are efficient procedures and predictable outcomes. Also critical are honest and knowledgeable judges and professional insolvency practitioners, lawyers, and accountants. In some countries it may take many years of institution and capacity building before the insolvency regime becomes effective.

Prudent banking practices. Where prudential regulation fails to maintain adequate lending
Transparency. Publicly held firms’ policy on control transactions is important to their investors. It is essential that these firms reveal not only their basic financial position (including debt and loan guarantees for other firms), but also the extent to which they own or are owned by other firms (pyramiding and cross-holdings), their principal shareholders, and their membership in a business group. In addition, each member of a group should be required to make a statement about its investment principles and the extent to which its membership in a group affects the way it exercises rights of ownership in its investee companies. Such disclosure serves two key purposes. First, it informs investors about the limited scope for value-enhancing control transactions, and may depress securities prices. Second, it affects the reputations of insiders. This can raise the cost of financing, making it costly for managers to shield themselves against takeovers.

Requiring disclosure does not ensure its reliability, however. Equally important are the process and the incentives of the parties involved. Management must be held accountable for any misrepresentation, with criminal sanctions for fraud. Accountants and auditors found to be negligent should face disciplinary action as well as the risk of liability. Transparency improves in the presence of reputational agents such as investment bankers, securities analysts, credit rating agencies, and free financial media. Where these agents are missing, their services initially may need to be imported.

Repealing regulatory barriers

There is a clear case for abolishing regulations and tax rules that erode shareholders’ value. The reforms needed vary from one country to another. In many developing countries the priority may be to allow tax-free exchanges of securities for legitimate business reorganization. Some of the more advanced markets may need to reverse laws designed to deter control transactions. They should remove any control share rules that discriminate against new or foreign shareholders; allow boards to fulfill their fiduciary responsibility to shareholders in considering takeover bids, unhindered by conditions set by other stakeholders; and do away with waiting periods for completing control transactions. In some countries new legislation or court decisions may be needed to curb the use of poison pills designed to reduce the scope for control transactions.

References


