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Empirical evidence of coercive tender offers in Japan

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ABSTRACT

This is an empirical investigation of the degree to which legal rules impact the welfare of minority shareholders in acquisitions. While an efficient market for corporate control is vital for an economy's growth and development, insufficient legal standards may permit coercive takeovers that have negative implications for capital markets. This research focuses on tender offers in Japan, where legal rules provide acquirers with the opportunity to make coercive takeovers that expropriate minority shareholder wealth. Japan's legal system changed in 2006 to introduce cash mergers to freeze-out remaining shareholders after successful takeovers, and in 2007 to require bidders making tender offers that seek more than two-thirds of the voting securities of a target to offer to buy all the shares. However, acquirers with the stated aim of securing less than two-thirds of voting securities have no such obligation. We find evidence that these acquirers tend to make coercive two-tier offers that expropriate the interests of minority shareowners. Our results suggest that avoiding coercive takeovers requires that laws force acquirers to provide full information concerning the clean-up merger conditions as well as to pay an equivalent amount in the clean-up to minority shareowners as was offered in the initial tender offer without ambiguity. These conclusions have relevance for all countries that have not fully considered the appropriate level of protection for minority shareholders.

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1. Introduction

This research examines the expropriation of minority shareholders by analyzing stock price after corporate takeovers. Our sample is tender offers in Japan, where the legal protection of minority shareholders is highly rated. Yet Japan's rules provide acquirers with the opportunity to make coercive takeovers that expropriate minority shareholder wealth. Japan recently changed its takeover rules in an effort to better protect minority shareholders; nevertheless, this change may not sufficiently protect shareholders from coercive tender offers. A takeover, or tender offer bid (TOB) is an important transaction whereby control of a target company is transferred to a purchaser who is expected to more effectively use the firm's resources.[1] Executing a TOB at a reasonably low cost from the acquirer's perspective is important to develop an active market for corporate control, and an appropriate legal system is essential to improve the efficiency of financial markets. Yet, the interests of minority shareholders must be considered as well. This is where legal systems dealing with takeovers and the protection of minority shareholders become important.[2] It is essential to design a system that balances the two goals of fostering an active market for corporate control and protecting minority shareholders.

On the whole, we find that Japanese corporate takeovers create value. However, this research demonstrates that the post-TOB value of target firms in Japan drops on average and that there is

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[1] The term "tender offer bid" or TOB is commonly used in Japan. In other countries, the terms "tender offer" and "takeover bid" are more often used. We use these terms interchangeably throughout this paper.

[2] The U.S., the U.K., and Japan have highly advanced stock markets and active mergers and acquisitions markets, yet Japan's market for corporate control became active only since the late 1990s. Although the three countries advocate active markets for corporate control to achieve economic efficiency, they differ in the details of protection provided to minority shareholders in takeovers. Japan's protection of minority shareholders is not weaker. For example, Djankov et al. (2008) rank Japan as having a higher anti-director rights index than the U.S. Spamman (2010). ranks Japan at the same level as the U.K. Nevertheless, the details of Japan's protection differ, particularly in terms of the fiduciary duty of block shareholders to minority shareholders.

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coercion on minority shareholders to participate in the TOB even when they are not satisfied with the terms. We find that the drop in the target's share price around the expiration date of the TOB is as large as 7 percent on average. The price drop is large when there is no information during the TOB about the price conditions of the clean-up merger following the TOB. In addition, for partial bids the price drop becomes large when prorationing occurs. Thus, lack of information about clean-up mergers and partial bids are probably the main causes of the target's stock price fall at the expiration of TOBs. We argue that these two causes result from coercion on minority shareholders in Japanese TOBs. Our results suggest that this coercion is due to Japan's insufficient legal protection of minority shareholder interests. This incomplete protection for minority shareholders arises from a lack of a fiduciary duty of block shareholders and incomplete legal restrictions on two-tier acquisitions. Fiduciary duty means that boards and influential controlling shareholders have a responsibility to act in the interests of all shareholders, not of only controlling shareholders. Controlling shareholders may not profit from their relationship with the firm; they may not favor themselves over other shareholders. One of the causes of this insufficient protection of minority shareholders in Japan is that there is no clear rule nor court precedent that establishes the fiduciary duty of controlling shareholders in the country. We argue that practical fiduciary duty means that minority shareholders must be protected against loss through expropriation by large block holders, must be given sufficient information to make value-preserving decisions with regard to clean-up mergers and must be provided with the opportunity to exit from takeovers at a fair value.

This research documents that Japanese TOBs have a disproportionate number of failures by these criteria. Our research suggests a different policy prescription from the now-classic reasoning offered by Barclay and Holderness (1992) that the premium over the market price for block shareholders need not be shared with minority shareholders through legislation. We argue that the different protection for minority shareholders in Japan justifies the concern that minority shareholders are unfairly exploited by large block shareholders.

Two significant concerns arise from our results. The first is the hold-up problem under incomplete contracts involving minority shareholders in public firms.[3] This reduces the willingness of outside investors to invest in the Japanese stock market, potentially raising the cost of capital to Japanese companies. Second is the possibility that acquirers will adopt the two-tier bid format that facilitates the expropriation of the interests of the remaining minority shareholders after the TOB and leads to lower acquisition costs compared to any-or-all bids. We find that this problematic partial bid format accounts for about half of our sample of takeovers. This is quite a large portion compared to the TOBs in the U.S, or U.K. Inoue and Ikeda (2016) report that the portion of partial bids for TOBs are less than 4 percent in the U.S., and less than 1 percent in the U.K. between 2010 and 2014.[4] These partial bids make the conflict of interest between large shareholders and minority shareholders worse and limit the efficiency gain from the acquisition.[5] Consequently, to make acquisitions markets efficient and eliminate the concerns of outside investors, it is desirable to strengthen the legal protection of minority shareholders in takeovers in Japan to at least match the levels of the U.S. and the U.K. We suggest this strengthening be done with dexterity because taken too far, some value enhancing acquisitions might be discouraged. The logic of this argument also applies to other countries that have not yet introduced regulations that attempt to balance the interests of minority shareholders against benefits of increasing the number of value enhancing takeovers.

The next section outlines the literature concerning takeovers and the legal protection of shareholders; it also explains the logic of coercive takeovers. The third section discusses the current legal situation of takeovers in Japan. The fourth section describes our hypothesis and methodology. The fifth section describes our sample of tenders and shows our empirical analysis. The last section offers conclusions and suggests changes to Japan's takeover laws.

2. Theoretical discussion and the literature

The tender offer price presented by the acquirer in a TOB is an important indication of an acquirer's potential managerial capabilities. The minority shareholders of a company targeted by a TOB may choose one of several options: sell their shares for an acquisition premium, reject the offer to wait for a better bidder to appear who is willing to pay a higher premium, or free ride on the value created by the acquirer without tendering their shares. If many minority shareholders choose the last option, the number of tendered shares may not reach the number sought by the acquirer, and thus prevent the execution of a value enhancing takeover. A freeze-out could restrict free riding on the part of minority shareholders.[6] Conversely, if the judgment of minority shareholders in regard to tendering their shares is somehow distorted, the acquisitions market itself may be prevented from functioning efficiently. In a typical case, if the acquirer makes changes to lower shareholder value after the TOB, tendering shares even at a price much lower than their reservation price becomes the optimal choice for minority shareholders. If the TOB is a success and the acquirer accumulates enough shares to control the target firm, the acquirer may then engage in opportunistic behavior that dilutes the interests of the remaining minority shareholders. In such cases, minority shareholders are pressured into tendering their shares, thus distorting their decision with respect to the tender.

Research by Grossman and Hart (1980) is the foundation of modern analysis of the regulation of transfers of control of companies. They showed that free riding by target firm shareholders can prevent value-enhancing transfers of control. The essential idea is that shareholders of poorly managed firms will not sell their shares unless the offer price matches the post-takeover share value. An acquirer who can better manage the firm will have to share the increase in firm value with these free-riding shareholders.[7] Burkart et al. (1998) extended their analysis but reached a very different conclusion. Acquirers will maximize their

[3] See Becht et al. (2007).

[4] Inoue and Ikeda (2016) analyzed takeovers which had values of more than USD 10 million.

[5] See Burkart et al. (1998).

[6] ; Burkart (1999) and Burkart et al. (1998) discuss the implications of freeze-out regulations in detail.

[7] Grossman and Hart argued that dilution of minority owners' interests provides a solution to the free-rider problem. Their research was extended by Burkart et al. (1998), who arrived at very different conclusions. They argued that free-riding behavior by minority shareholders has two results. The equilibrium supply of shares will be increasing in bid price. This happens because shareholders will be indifferent between selling at a low price and retaining their shares only when they expect a low minority share value; consequently, only a small proportion of these shareholders will sell. Yet, as the bid price increases, the minority share value that makes them indifferent increases as well. Similarly, the fraction of shares that will be tendered will increase. Secondly, because the improvement in value will be shared with the minority owners, the bidder will rationally attempt to maximize his private gains from the takeover. He will do this by acquiring the minimum percentage of voting shares necessary for control of the target firm (say 51 percent of voting shares). Burkart et al argued that this is an inefficient equilibrium with a smaller efficiency gain than that which would be expected if the acquirer gets full ownership rights of the target after the TOB and concentrates on maximizing the value of the target firm.

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