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The white squire defense: Evidence from private investments in public equity ☆

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ABSTRACT

Firms can effectively stave off outside takeover bids using private investments in public equity (PIPEs) when they face strong takeover pressure. Greater takeover pressure makes PIPE issuers more likely to grant investors large blocks of shares, price discounts, generous dividends, and board seats. Takeover pressure also encourages issuers to place more shares with friendly investors such as managerial investors and strategic alliance investors. The evidence is consistent with the regular methods of the white squire defense. PIPEs can be a preferred method in the choice of a white squire defense when poorly performing and highly overleveraged firms face severe takeover pressure. There is a negative relation between takeover probability and post-issue performance of issuers, which supports the managerial entrenchment hypothesis over the shareholder interest hypothesis. Therefore PIPEs can increase, not mitigate, agency problems.

1. Introduction

A white squire acts as an ally in a possible firm takeover, but rather than take control of an entire company as in a white knight strategy, the squire buys a large block of shares in the firm. Common practice in the white squire defense is for the firm to grant a white squire a favorable share price, generous dividends, and a board seat in exchange for its help in strengthening the position of incumbent managers (Gaughan, 2011). Warren Buffett has played a white squire, selling protection to nervous companies at a handsome return for himself by gaining equity from firms at below-market prices.[2] Berkshire Hathaway's purchase of Salomon Brothers preferred stock came in the fall of 1987, when Buffett was looking for a place to park cash with a good guaranteed return (a 9% dividend). This is, one of a number of white squire buys Berkshire made, where received generous terms in return for being a friendly investor that did not pose a takeover threat.[3] In 1989 Buffett approached Gillette as a white squire. In that deal, Berkshire's insurance subsidiaries gained $600 million in stock, and Buffett filled a vacant seat on Gillette's twelve-member board.[4] Another example is Polaroid's preferred dividend payment of $10.1 million to Corporate Partners LP, a white squire investment fund that helped Polaroid fend off a takeover in 1989.[5]

Despite the many examples, empirical study of the white squire defense is rare. There is some research on employee stock ownership plans (ESOPs), a classic method of white squire defense. Pagano and Volpin (2005) argue that in this case employees are the active players, coming to the rescue of incumbent management as white squires to avert the risk that a raider might cut wages. If workers own shares, they can reduce the chances of a successful outside takeover defense by their own response to the bid. Setting up an ESOP is a way for managers to protect their own control. Rauh (2006) shows that employee ownership in

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2 "Buffett's savior role lands him deals other holders can't get," Wall Street Journal, August 14, 1989, and "Buffet takes stock," New York Times, April 1, 1990.

3 "Company news; Buffett wants more shares of Salomon," New York Times, August 17, 1993.

4 "Gillette sells 11% stake to Buffett," New York Times, July 21, 1989.

5 "American brief: Polaroid Corp.," Asian Wall Street Journal, July 16, 1992.

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defined-contribution plans reduces takeover probabilities. Yet, except for ESOPs, there is little evidence about other possible white squire defenses.

Beyond the ESOP, another white squire defense is private investment in public equity (PIPE). Firms can place shares with privately specific investors who promise to vote in favor of management. PIPEs generally involve the transfer of a block of shares, about 16% of total shares outstanding after an issue according to Hertzel and Smith (1993). Researchers have found large price discounts to the exchange price in PIPEs, averaging around 13% (Huson et al., 2010; Chakraborty and Gantchev, 2013; Finnerty, 2013).

In the U.S., PIPEs are private placements by public companies to accredited investors following Section 4 (2) and/or Regulation D of the Securities Act of 1933, which exemptions issuers from Section 5 registration may as long as the seller complies with a set of listed requirements.[6] The motives for issuing PIPEs include monitoring of managers, information asymmetry, managerial entrenchment, and cost considerations (see Dai, 2009, for a good survey). In this paper, we ask whether a PIPE can be an effective white squire defense.

What factors motivate firms to adopt a takeover defense? Rauh (2006) finds that companies with a higher probability of takeover are more likely to choose employee ownership in defined-contribution plans. Billett and Xue (2007) suggest that open market share repurchases are associated with the probability of takeover at a firm, and that the likelihood of takeover is a key driver of a takeover defense. Accordingly, firms that face a high likelihood of takeover may be likely to engage in a PIPE as a white squire defense. Our empirical results show that firms in the highest two quintiles of takeover probability that issue PIPEs will reduce the likelihood of receiving a takeover bid after stock issuance, indicating firms can effectively stave off outside takeover bids using this tactic when they face high takeover pressure.

What kinds of firms would prefer to issue PIPEs as a white squire defense? In an examination of choice of white squire method, the results show that firms with poor performance and that are over-leveraged prefer to use a PIPE over an ESOP as a white squire defense when they are classified in the top two quintiles of takeover probability.

In a typical squire defense, a firm grants to the squire a large block of shares at a favorable price together with generous dividends and a board seat. To examine whether PIPEs are a white squire defense, we test the relation between the probability of takeover and these characteristics. The results indicate a positive relation between the PIPE fraction placed and the takeover probability, suggesting that takeover pressure leads firms to sell more shares in the form of a PIPE. The empirical results also indicate that PIPE issuers facing a higher probability of takeover provide investors with favorable prices (price discounts), generous dividends, and board seats.

A white squire acts as an ally in the takeover process. PIPE issuers should be more likely to grant shares to friendly investors if the issuer is operating in a high-takeover environment. While friendly investors are difficult to define, we examine two particular types of investors that are likely to be friendly: managerial investors and strategic alliance partners. Selling shares to current managers or to strategic alliance partners can be an anti-takeover device if the main purpose is for a firm to place some of its stock in stable and friendly hands (Stulz, 1988; Rauh, 2006; Moffett et al., 2008; Johnson et al., 2015).[7] We find a significantly positive relation between the probability of takeover and the likelihood that a PIPE firm will place shares with managerial investors or strategic alliance investors. The results indicate that strong takeover pressure motivates PIPE issuers to place more shares with friendly investors.

The use of PIPEs as a takeover defense may diminish or enhance shareholder wealth. The managerial entrenchment hypothesis argues that takeover defenses serve primarily to entrench managers at shareholders' expense (e.g., Masulis et al., 2007; Bebchuk et al., 2009). This hypothesis suggests a negative relation between the probability of takeover and firm performance after the PIPE issuance. The shareholder interest hypothesis, on the other hand, suggests a positive relation. Takeover defenses can create shareholder value because they make managers more able to extract higher premiums in the event of takeover (DeAngelo and Rice, 1983; Morck et al., 1988; Stein, 1988; Comment and Schwert, 1995). We find that PIPE firms with a higher probability of takeover experience poorer post-issue stock returns and operating performance. The results are robust to use of different benchmarks. Our evidence suggests that the motivation for managers to conduct PIPEs is better explained by the managerial entrenchment hypothesis than by the shareholder interest hypothesis.

Two empirical issues must be addressed. One is why we treat PIPEs as a pre-offer takeover defense. The other deals with endogeneity. First, why do we treat PIPEs as a pre-offer takeover rather than post-offer takeover defense?[8] The answer is that typical PIPE issuers are troubled firms with high levels of information asymmetry and poor operating performance (Dai, 2007; Brophy et al., 2009; Chaplinsky and Haushalter, 2010; Chen et al., 2010; Chakraborty and Gantchev, 2013). These characteristics may make it more likely that a firm will be acquired (DeAngelo, 1988; Nuttall, 1999; Billett and Xue, 2007; Cremers et al., 2009; DePamphilis, 2011; Oberhofer, 2013). PIPE issuers thus face strong takeover pressure from the market before equity issuance even if no formal bid is made. To limit the sample to issuers that are a takeover target may ignore the takeover deterrence effect of PIPE issue for firms that face strong takeover pressure but do not receive a takeover bid. PIPEs also give a firm greater flexibility to act without shareholder approval and without the need for public registration.[9,10] This may effectively deter would-be acquirers, as the potential target can respond quickly by issuing private equity. Finally, the trade press has reported that as poison pills and staggered boards have dropped to their lowest levels in more than a decade, firms face investor pressure against the institution of broad takeover defenses, even while they feel some need to have weapons at the ready to fight

6 (1) The offer must be made to a limited number of accredited investors or financially sophisticated investors (those with, sufficient knowledge and experience in financial and business matters to make them capable of evaluating the merits and risks of the prospective investment); (2) offer must not involve any general advertising or general solicitation; and (3) investors are given information relevant to the investment.

7 Unlike Krishnamurthy et al. (2005) who suggest that placements to incumbent managers can improve the alignment between manager and shareholder objectives, we recognize that selling shares to incumbent managers can be a takeover defense in the presence of high takeover pressure.

8 A pre-offer takeover defense is used to slow the pace of a takeover attempt and make it more costly for an acquirer. A post-offer takeover defense is a defense adopted once a possible acquirer has approached a firm.

9 If more equity is authorized in a firm's certificate of incorporation than is outstanding, the firm can issue common stock without shareholder approval unless common stock or securities exercisable or convertible into common stock on the NYSE, AMEX, or Nasdaq represent at least 20% of the common stock or at least 20% of voting power outstanding prior to issuance, and the offering is sold for less than the greater of book or market value of the stock. See Rule 312.03 of the NYSE Listed Company Manual, Section 713 of the AMEX Company Guide, and Nasdaq Marketplace Rule 4350 (i).

10 PIPEs are private placements by public companies to accredited investors made in reliance on Section 4 (2) and/or Regulation D of the Securities Act of 1933. In contrast to a traditional private placement, such a closing does not depend upon the SEC review process, making PIPE issuance a time-efficient mechanism by which small companies that would have difficulty paying for SEC registration can raise capital.