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Takeover law to protect shareholders: Increasing efficiency or merely redistributing gains?

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ABSTRACT

We construct a dynamic takeover law index using hand-collected data on legal provisions and empirically examine the effect of takeover regulation to protect shareholders on shareholder wealth for bidders and targets in a multi-country setting. We find that a stricter takeover law increases the wealth gains to the shareholders of the combined bidder and target firm, which suggests that stronger shareholder protection in the takeover bid process increases the efficiency of the takeover market. In contrast to our hypothesis, results show that stricter takeover law does not hurt bidders. Its effect on target announcement returns is significantly positive and economically large. Our findings on individual provisions suggest that the mandatory bid rule and ownership disclosure increase overall synergistic gains in takeovers, while the fair-price rule and squeeze-out rights may reduce them. Further results show that stricter takeover regulation increases competition in the market for corporate control and reduces the time to successful completion of a takeover bid, which explains increased combined wealth gains under stricter takeover regulation.

1. Introduction

Since the US and the UK introduced their first national takeover regulations in the late 1960s, policymakers and regulators have aimed to provide a takeover law that protects shareholders in a takeover bid while facilitating the market for corporate control and maintaining the integrity of financial markets. Recently, the development and implementation of the EU Takeover Directive (hereafter the Directive),[2] which was intended to promote the integration of European capital markets and harmonize takeover regulation in Europe, has highlighted the ongoing struggle in takeover regulation to find an optimal takeover law that addresses the concerns of member states and provides for an efficient market for corporate control (Enriques et al., 2014; Humphery-Jenner, 2012; Clerc et al., 2012).

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[2] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, O.J. 2004 L 142/12. Member states were required to transpose relevant provisions into local law by May 2006.

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Stricter takeover law, defined as laws and regulations that provide more protection to target shareholders in a takeover, has attracted criticism because it increases legal barriers in the market for corporate control either by introducing more provisions or making existing rules more stringent. It may lead to overall efficiency losses due to higher transaction costs or result in greater agency costs and overbidding because of the increased competition among bidders. On the other hand, shareholder protection may be a zero-sum game in which increased protection benefits target shareholders at the expense of bidders, transferring gains from bidders to targets and leaving total synergies unchanged, or increase overall gains from improved deal execution with efficient takeover regulation. In this paper, we explore the convergence of takeover regulation in Europe towards greater protection of target shareholders and test whether it has improved the efficiency of takeovers or increased the potential for value destruction through greater deal complexity or entrenched managers – and possibly shifted the allocation of wealth generation from bidder shareholders to increasingly protected target shareholders. We further investigate which of the main takeover law provisions contribute to these effects.

The optimality of takeover regulations has been explored from a theoretical perspective and through empirical studies using broad shareholder protection indices or time fixed effects. Taking a theoretical approach, Bergström and Högfeldt (1997) and Bergström et al. (1997) model the impact of the equal bid rule and the mandatory bid rule on the value of the firm and conclude that the actual effect of an enactment of these rules may ultimately make the target shareholders less wealthy. Martynova and Renneboog (2011a) and Goergen et al. (2005) document how, in the 1990–2005 period, countries across Europe have caught up with the UK towards the Anglo-American system of corporate governance when improving the legal position of shareholders. In their empirical examination of cross-border takeovers in the 1993–2001 period, Martynova and Renneboog (2008b) find some evidence of a positive effect of shareholder protection on targets and an insignificant one on bidders. They obtain these results from broad indices of shareholder rights (e.g., appointment rights, decision rights, and transparency) and minority shareholder protection (voting and other decision rights, trusteeship rights and rights in the event of a takeover). By contrast, Humphery-Jenner (2012) focuses specifically on takeover regulation and finds a negative effect on bidder returns when using a more recent sample to estimate the impact of the EU Takeover Directive. He attributes this to increased managerial entrenchment in bidders and greater legal uncertainty created by the Directive.

To the best of our knowledge, there are no studies that attempt to assess the effects of takeover law on total shareholder wealth in targets and bidders combined and separately, estimate the impact of individual legal provisions, or control for time and country heterogeneity. The aim of this paper is to fill these gaps by empirically evaluating the efficiency of takeover regulation as a whole as well as the effects of individual provisions governing takeover bids on the distribution of wealth in takeovers. Examining takeover gains to the shareholders of the combined bidder and target firm and identifying the division of such gains are of importance to policymakers and managers because the combined gains measure the value creation or destruction resulting from takeovers (Andrade et al., 2001). The heterogeneous capital markets in Europe provide an opportunity to explore the effects of takeover regulation in a set of countries over time and during a critical phase of the development of their capital markets. The available sample of takeovers spans the most active period of legal developments in takeover regulation and covers all critical sub-periods over the past few decades. Specifically, we aim to answer the following questions by identifying whether takeover regulation creates or reduces shareholder wealth: (1) Does stricter takeover law reduce the combined synergistic gains to shareholders involved in takeovers? (2) Does stricter takeover law hurt bidding firms and lead to wealth losses for bidders? (3) Does stricter takeover law protect minority shareholders and generate a higher return for target shareholders? (4) Which legal provisions matter most in explaining the variation of takeover gains to targets and bidders?

To answer these questions, we construct a dynamic takeover law index using hand-collected data on legal provisions that reflect the evolution and quality of takeover laws in EU economies over the 1986–2010 period. The index, which focuses on key takeover law provisions that affect the process and the (re-)distribution of wealth in takeovers, includes six provisions: ownership disclosure, mandatory bid, fair price for the minority shareholders, squeeze-out rights, sell-out rights, and management neutrality. A higher index score represents a more stringent takeover regulation in a given country, in other words, a market for corporate control more favorable to target shareholders. This is the first study to create a comprehensive and dynamic takeover law index, which enables a straightforward comparison and analysis between countries in terms of their market regulations for corporate control transfers. To measure wealth effects, we use announcement returns as a proxy for expected wealth generation and wealth transfer in takeovers.

Results show that stricter takeover regulation increases the total wealth gain for the combined firm. Combined announcement returns for bidders and targets increase by 4.5 percentage points when transitioning from weak shareholder protection to a high-protection environment, which indicates that stricter takeover law facilitates value-enhancing takeovers and improves the efficiency of the takeover market. Our empirical investigation of which takeover law provisions matter most for this wealth effect shows that the ownership disclosure rule and the mandatory bid rule are of crucial importance for achieving higher combined announcement returns. In our further examination of the total wealth effects of takeover law for non-UK targets, we find a statistically positive and economically stronger effect of our takeover law index, the ownership disclosure rule and the mandatory bid rule on the combined announcement returns. The fair price rule and the squeeze-out rights rule tend to reduce the total wealth of the combined companies when we exclude UK targets. The decreasing effect of the fair price rule provides empirical evidence supporting prior studies (e.g., Bergström and Högfeldt, 1997) that argue the equal bid rule makes transactions more expensive and may reduce the overall efficiency of the takeover market.

We find that a stricter takeover regulation does not hurt bidders but benefits targets. Results show that a stricter takeover law does not reduce bidders' returns where previous research that did not control for time heterogeneity finds a detrimental effect on acquirers' performance when studying the EU Takeover Directive (Humphery-Jenner, 2012). Stringent takeover regulation