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Who monitors the monitor? The use of special committees by target firms in corporate takeovers☆

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ABSTRACT

This paper extends the corporate governance literature such as Alchian and Demsetz (1972) by analyzing the use of special committees of disinterested directors by target firms during corporate takeovers. Our sample spans post Sarbanes–Oxley from 2003 through 2007, under which boards of directors are subject to increased scrutiny and additional regulatory mandates. This period is also characterized by a high level of management buyout activity that can exacerbate conflicts. Our results show that special committee use is positively related to conflicts and negatively related to factors and situations where insider knowledge is particularly valuable. Moreover, the propensity to form a committee is negatively related to the board's overall independence; hence special committees substitute for the monitoring not found in the overall board composition. Special committees, on average, are formed well in advance of the merger agreement, employ additional financial advisors, and are more likely to run an auction process. Target returns in deals with special committees are no different than deals without special committees. The evidence indicates that special committees enable target boards to adapt to situational conflicts, which helps explain when independent directors matter for corporate governance.

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1. Introduction

Armen Alchian offered path breaking insights on the structure of the modern day corporation. Writing in the 1960s, Alchian turned on its head the literature in the Berle–Means tradition that lamented the presence of separation of ownership and control.[1] In his flowing rhetorical style, Alchian (1969, p.229)[2] queried, "Surely the music about separation of ownership and control requires more lyrics than that stockholding is dispersed among many stockholders." He further asked (1969, p. 223), "We should wonder why stockholders whose interests are less heeded by the top management would purchase stock in such corporations." In other words, the fundamental question is: How has the modern corporate form managed to survive?[3]

In his seminal 1972 collaboration with Harold Demsetz, Alchian formally addressed the survivorship characteristics of the modern corporation.[4] Alchian and Demsetz (1972, p.782) framed their analysis around the insightful question: Who will monitor

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[1] Berle and Means (1932) was the text in Alchian's first upper division Economics course in 1934. See Alchian (1978) which is reprinted in Alchian (2006).

[2] The 1969 paper entitled "Corporate Management and Property Rights," like many of Alchian's important work, is reprinted in the 1977 collection, *Economic Forces at Work*. The page numbers refer to the 1977 collection. The initial formulation of Alchian's thoughts on property rights and economic organization can be found in Alchian (1961), which is reprinted in Alchian (2006).

[3] Alchian's (1950) paper was a forerunner in placing survival as an important factor to consider in economic research.

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the monitor? They argued that title to the residual claim on the corporation, and the ability to sell that residual claim, provide incentives for individuals to specialize in monitoring within a corporation. Moreover, the transferability of shares also induces monitoring by outsiders who can engage in a proxy battle or corporate takeover in the event the outsiders gauge that the existing monitors of the corporation are not performing up to par.

In subsequent analysis, Fama and Jensen (1983) delve further into the survivorship characteristics of the modern corporation. They note that the organizational architecture of the corporation is rather complex and emphasize the central function played by the board of directors. They highlight the important role played by outside directors that are independent of corporate management in stemming the divergence of interests created by the separation of ownership and control. In particular, Fama and Jensen (1983, p.315) predict that outside board members will "carry out tasks that involve serious agency problems between internal managers and residual claimants".

More recent theoretical analysis considers both a monitoring role as well as an advising role of the board of directors. This research suggests that factors such as CEO bargaining power and firm complexity will impact the number of independent board members on a given corporate board. (See, for example, Hermalin and Weisbach (1998), Raheja (2005), Adams and Ferreira (2007), and Harris and Raviv (2008).) While independent directors can mitigate agency problems via their monitoring effort, such directors possess less information relative to insiders as to a firm's available projects. Hence, the greater a firm's information asymmetry, the lower is the demand for outside board members relative to insiders. In such cases, the theory suggests that other methods besides board composition will be used to lessen agency problems. As noted by Adams and Ferreira (2007, p.242), "When a management friendly board is optimal, one should expect other governance mechanisms to take up the slack."

We apply these models of the corporation and corporate boards, which we collectively label the monitoring/information hypothesis, to the decision by target firms to use a special committee during a corporate takeover. A special committee is a sub-committee of a target firm's board that is composed of independent, disinterested directors that are not part of management and are not participants in the buyout of the target. The use of special committees has evolved since the growth of the takeover market in the 1980s. Writing in 1980, SEC Chairman Harold Williams forecast that special committees of independent directors were a possible response to conflicts of interest in corporate takeovers. As noted in the SEC 14d9 tender offer filing dated August 2, 1985, related to the management buyout of Levi Strauss (page 4): "The practice of appointing a committee of directors, like the special committee, and seeking a fairness opinion from an independent investment banker has developed in recent years as part of a body of law designed to deal with potential conflicts of interest that may arise in corporate transactions involving directors, officers or major shareholders of a corporation." For detailed legal background on special committees, see McGuinness and Rehbock (2005), Simpson (1988), and Varallo et al. (1998).

A recent example of the use of a special committee is found in the buyout of Dell Inc., described in the SEC DEFM14A filing dated May 31, 2013. In that deal, founder Michael Dell combined with the private equity firm Silver Lake to propose a buyout of the firm. Because of Michael Dell's conflict in being both a director and part of the buyout group, the board of Dell Inc. formed a special committee of four independent directors to act in the interest of the firm's shareholders other than Michael Dell. The special committee hired a separate investment bank and conducted an auction to seek bids superior to the Michael Dell proposal.

The Dell case adds a wrinkle to the original question posed by Alchian and Demsetz (1972): Who will monitor the monitor? In cases with conflicts such as management buyouts, residual claimancy is not enough to monitor corporate management. Indeed, residual claimancy in such cases may actually heighten agency costs.[5] Hence, as suggested by Fama and Jensen (1983), in such cases, target firms can be expected to rely on independent directors when agency costs are high. The use of a special committee of independent, disinterested directors is one such reliance.

The most basic prediction of the monitoring/information hypothesis is that the likelihood that a special committee is used by a target firm is directly related to the conflicts of interest in a given deal. An alternative theory, which we label the entrenchment hypothesis, contrastingly predicts that target management with the greatest conflicts will be more likely to resist the use of a special committee.[6] In essence, the difference between these two hypotheses is the question as to whether the potential conflicts of interests inherent in a corporate takeover are mitigated via organizational devices or instead go unchecked to the detriment of target shareholders. As described in more detail below, our proxies for conflicts of interest encompass CEO bargaining power, the private benefits of block ownership, and self-dealing by target management.

The monitoring/information hypothesis generates additional hypotheses regarding the use of special committees. The model of Adams and Ferreira (2007) implies that special committees will be more likely on management friendly boards, predicting a negative relation between the use of special committees and the target firm's overall board independence. Models such as Raheja (2005), Adams and Ferreira (2007), and Harris and Raviv (2008) would predict that the use of a special committee is inversely related to the information asymmetry of a target firm.

To test these empirical predictions, we form a sample of 845 takeovers from 2003 to 2007, which is a particularly salient time period. First, the period is consistently post Sarbanes Oxley (SOX) which added regulation on board structure for listed firms (Linck et al., 2009). Second, the period was characterized by a high rate of private equity transactions (Boone and Mulherin, 2011), which are subject to potentially large conflicts of interest. Third, the time period is prior to the market downturn beginning in 2008.

[5] In a similar vein in the franchise setting, Klein, 1980footnote 2, describes the "superhighway problem", where a franchisee whose location does not have many repeat customers may be motivated by residual claimancy to free-ride on the brand name of the franchise. In such settings, the franchise is more likely to have a company-owned operation, where the employees are not compensated by profit-sharing.

[6] The seminal paper by DeAngelo and Rice (1983) is among the first to test the contrasting predictions regarding whether merger-related contractual provisions act in shareholder interest or instead entrench management.

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