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The effect of poison pill adoptions and court rulings on firm entrenchment

Randall A. Heron [a,*], Erik Lie [b,1]

[a] Kelley School of Business, Indiana University, 801 W. Michigan Street, Indianapolis, IN 46202, United States
[b] Henry B. Tippie College of Business, University of Iowa, Iowa City, IA 52242-1000, United States

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ABSTRACT

We challenge a common presumption that poison pills and two Delaware case rulings in 1995 validating such pills materially entrench firms. Based on unsolicited takeover attempts from 1985 to 2009, we find that poison pills enhance takeover premiums, but do not reduce completion rates. Furthermore, the 1995 Delaware rulings affected neither the use of poison pills among the targets, the effectiveness of the pills that were used, the completion rate of the takeover attempts, nor the takeover premiums.

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1. Introduction

Two landmark Delaware Supreme Court rulings in 1985 have played significant roles in corporate control contests during the ensuing decades. In the first case, *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court established guidelines for what constitutes a legitimate response to a perceived takeover threat by the target's Board of Directors. To justify its defensive measures under the *Unocal* standard, the target's board must show that (1) it had a reasonable basis to believe that a legitimate threat to the corporation existed, and (2) its response is reasonable in relation to the threat posed. Thus, the *Unocal* ruling enhanced the level of scrutiny placed on defensive measures beyond the protections afforded by the business judgment rule to also include the potential for a judicial review. In the second case, *Moran v. Household International Inc.*, the Delaware Supreme Court validated the use of a poison pill plan as a legitimate response to a takeover bid under the *Unocal* standard. This triggered a surge in adoptions of poison pill plans and permanently altered the takeover landscape. For example, Ryngaert (1989) reports an 850% increase in poison pill plans between the court ruling and the end of 1986.

Since the *Moran v. Household* ruling, courts applying Delaware law have validated numerous other poison pills under the *Unocal* standard. The two cases that have attracted the most attention among finance researchers were both concluded in 1995, namely *Unitrin, Inc. v. American General Corp.* and *Moore Corp. v. Wallace Computer Services, Inc.* (hereafter, the "1995 Delaware rulings"). Indeed, in the search for a solution to the pervasive endogeneity problem in research on governance, a growing body of literature

* Corresponding author. Tel.: +1 317 274 4984.
E-mail addresses: rheron@iupui.edu (R.A. Heron), erik-lie@uiowa.edu (E. Lie).
[1] Tel.: +1 319 335 0846.

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singles out the 1995 Delaware rulings as an exogenous shock that unexpectedly and effectively insulated managers of Delaware-incorporated firms from the market for corporate control. As such, the rulings have been used as an instrument to study the effect of managerial entrenchment on corporate behavior. For example, empirical studies report that, after 1995, Delaware firms exhibit decreases in employee ownership within defined contribution plans (Rauh, 2006), risk (Low, 2009), and credit lines (Yun, 2009), and increases in cash holdings (Yun, 2009) and executive compensation (Bereskin and Cicero, 2013), all of which have been attributed to enhanced managerial entrenchment.

In this study, we dispute the use of the 1995 Delaware rulings as an exogenous entrenchment shock for several reasons. We outline the reasons here and discuss them in detail in the next section. First, the *Moran v. Household* and other rulings had already paved the way for the use of poison pills. Second, any effect of the 1995 Delaware rulings likely extend beyond the state of Delaware, rendering difference-in-difference tests based on Delaware and non-Delaware firms invalid. In this regard, it is also relevant that one of the 1995 Delaware rulings was actually a Federal court ruling on Delaware law, and it would not be binding for later Delaware court cases. Third, there is no extant evidence that Delaware firms became more entrenched after 1995. Fourth, there is no convincing evidence that the poison pills that the 1995 rulings validated are associated with entrenchment.

Our study directly tests whether the 1995 Delaware rulings had any significant and lasting effect. To do so, we examine hostile takeover attempts from 1985 to 2009, with a particular emphasis on the use of poison pills among the targets. Comment and Schwert's (1995) sample ends in 1991, so the lack of a deterrent effect from poison pills that they demonstrate might not extend to the post-1995 environment. Heron and Lie's (2006) sample covers the period from 1985 to 1998, thus primarily before the 1995 rulings, and they do not examine whether the results vary across time. We are interested in examining whether targets of hostile takeovers are more likely to adopt poison pills after the 1995 Delaware rulings, whether the rulings generally altered the outcomes of the hostile takeover attempts, and whether poison pills adopted after the rulings were more effective in thwarting takeovers or extracting higher premiums from the bidders.

As noted earlier, it is unclear whether any effect from the 1995 Delaware rulings pertains to only Delaware firms or all US firms. But what is clear is that studies using the rulings as an exogenous shock presume that there is an effect *and* that the effect is significantly stronger for Delaware firms. Thus, we design our tests primarily to gauge whether the rulings affected Delaware firms. However, our research design also allows us to examine whether the rulings had a broader effect, with the important caveat that tests for a broader effect from the rulings might be influenced by unrelated time-variant effects.

In our initial test, we document that, relative to non-Delaware firms, Delaware firms were no less likely to be targeted in hostile takeover attempts after than before 1995. Thus, there is no evidence to suggest that the 1995 Delaware rulings contributed to keeping hostile suitors at bay.

Next, we examine the determinants of poison pill adoptions among target firms. Consistent with Heron and Lie (2006), the most important determinant is insider ownership. In particular, firms that have low insider ownership, and, thus, presumably are more vulnerable to hostile takeover attempts, are more likely to adopt poison pills. More importantly for the purposes of our study, we find no evidence that target firms are more likely to employ poison pills after the 1995 Delaware rulings, regardless of whether the firms are incorporated in Delaware. Thus, the rulings did not spur an increase in the use of poison pills to cope with potential hostile bidders.

Even if the 1995 Delaware rulings had no effect on the frequency with which targets use pills, the rulings could alter the effectiveness of those pills or have a broader effect irrespective of whether pills are used. Thus, we carefully examine the outcome of the takeover attempts. We find that a takeover attempt is more likely to succeed if the bidder increases the bid beyond the initial bid, such that the final bid is comparatively high. We also find that a bidder is less likely to succeed when there are competing bidders, but that the probability that the target will be acquired is higher when there are multiple bidders. However, regardless of whether the takeover attempts occur after 1995, the target is incorporated in Delaware, or both, the outcome is similar, and poison pills do not significantly affect the probability of success for a bidder or the probability that the target is acquired by any bidder.

We further find that multiple bidders are associated with greater bid increases during the contest, which in turn result in higher final premiums. Also, consistent with Heron and Lie (2006), poison pills induce greater final takeover premiums, mostly as a result of bid increases after the initial bid. But the 1995 Delaware rulings have no general effect on the takeover premiums (although there is a slight decline in premiums after 1995 that is hard to attribute to the rulings), nor do they alter the effect that poison pills have on the takeover premiums.

Overall, we find no evidence that the 1995 Delaware rulings had any effect on hostile takeover activity or outcomes, either via the poison pills that the rulings address, or more generally. On this basis, we argue that the rulings had a trivial effect on firm entrenchment and cannot be used as an exogenous entrenchment shock to infer the consequences of entrenchment on corporate behavior. In this regard, our study joins an emerging literature (e.g., Atanasov and Black, forthcoming; Atanasov and Black, 2015b) that questions some of the causal inferences from the use of exogenous shocks to examine corporate governance issues. Nonetheless, we remain guarded in interpreting the published evidence on the effect of the 1995 Delaware rulings other than to say that there is no evidence that any observed changes in behavior among Delaware firms around 1995 are attributable to increased entrenchment.[2]

[2] While we are interested primarily in whether or not the collective evidence supports the interpretation that the 1995 Delaware Court rulings were truly watershed events that effectively insulated managers from unwanted takeovers and we are not proposing alternative explanations at this point, it is worth noting that overall economic conditions improved substantially from 1994 to 1995. For instance, throughout 1994 the economy was beginning to improve rapidly, prompting the Federal Reserve to double the Federal Funds Rate from 3% at the start of 1994 to 6% by early 1995. The return on the S&P 500 (including dividends) rose from 1.32% in 1994 to 37.58% in 1995 and continued to exceed 20% every year through 1999. Variations in economic factors across states and time inevitably affect corporate decisions and behavior in systematic manners.

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