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## Impact of SOX on the returns to targets and acquirers in corporate tender offers

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### ABSTRACT

We argue that, following the sweeping reforms introduced by the Sarbanes-Oxley Act (SOX), managers of bidding firms have become more strategic in choosing acquisition targets in inter-firm tender offers. Using a large sample of tender offers between 1996 and 2009, we report that the proportion of synergy-driven value-maximizing acquisitions increased following the passage of SOX. Targets experience lower pre-bid share price run-up, receive larger deal premiums, and have larger announcement period abnormal returns after SOX. Acquiring firm shareholders also experience significant wealth gains around the announcement in the post-SOX period. Employing industry and matched firm portfolios, we also document that both the operating performance and buy-and-hold abnormal returns over the three- and five-year post-acquisition period improved significantly after SOX. Overall, our evidence shows that SOX had a positive influence in the market for inter-firm tender offers.

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## 1. Introduction

In this paper we examine the impact of the Sarbanes-Oxley Act (SOX) of 2002 on inter-firm tender offers. Publicly traded firms in the United States today are subject to substantially higher levels of scrutiny of their activities than in the past. We argue that, following the reforms introduced by SOX, managers have become more strategic when selecting targets in their acquisition decisions and are more likely to engage in acquisitions that create synergy and enhance shareholder value. Using a sample of tender offers from 1996 to 2009, we find evidence consistent with our hypothesis. Post-SOX acquisitions via tender offers enhance value significantly more than those in the pre-SOX period, despite the fact that targets generate higher announcement period abnormal returns and receive larger deal premiums.

SOX introduced sweeping reforms in corporate governance standards, enhanced transparency in corporate disclosure, created a timelier reporting regime for insider trades, instituted stiffer penalties for corporate wrongdoing, and increased legal liabilities for corporate officers. For example, insider transactions must now be reported within two trading days, compared to a potential delay of as many as 40 calendar days prior to SOX. Brochet (2010) and Bhabra and Hossain (2015) reported that the information content of insider trades increased significantly after SOX. Similarly, Chhaochharia and Grinstein (2007) found that firms with corporate governance standards below those mandated by SOX saw an improvement in their value once they complied with the new standards. Barger, Lehn, and Zutter (2010) found that managerial

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risk-taking has decreased after SOX, which is consistent with the increased personal liabilities for corporate officers associated with the new requirement to certify financial statements.

We chose a sample of tender offers to analyze managerial acquisition motives. Specifically, we investigated the returns to both targets and acquirers in the short term and the returns to acquirers in the long term in the pre- and post-SOX periods, controlling for firm- and deal-specific characteristics that affect these returns. Bradley, Desai, and Kim (1983) showed that acquirers exploit potential synergies in tender offer acquisitions by acquiring special resources of the target firm and implementing a revised operating strategy. The authors argued that the “revised operating strategy may involve more efficient management, economies of scale, improved production techniques, the combination of complementary resources, increased market power, redeployment of assets to more profitable uses, or any number of value creating mechanisms that fall under the general rubric of corporate synergy” (pp. 183–184). We argue that the combination of better oversight from higher corporate governance standards and increased penalties and liabilities for corporate officers, among other things, probably have positively impacted shareholder-manager incentive alignment and, in turn, the types of acquisition made via tender offers, after the passage of SOX. Given the evidence that management has a reduced affinity for risk-taking since SOX (Barger et al., 2010), we hypothesize that the targets management seeks in the post-SOX period will be those that allow for greater exploitation of potential synergies. In other words, we expect the proportion of value-maximizing tender offers to be higher in the post-SOX period.

There are additional reasons why bidders stand to realize higher returns in tender offers after SOX. Bidders in tender offers incur a significant cost in the price run-up in target shares that precedes the announcement. This increases the acquisition cost for the bidder (Schwert, 1996). Brigida and Madura (2012) have also suggested that target share price run-up increases acquisition cost and reported that it is higher in the case of friendly transactions, in cross-border acquisitions, where the bidder is not a private equity firm, and where the bidder has not established a toehold in the target. The run-up in target share price can be the result of several factors, including rumors and speculation (Pound & Zeckhauser, 1990) and trading by insiders (Keown & Pinkerton, 1981).<sup>1</sup> Keown and Pinkerton argued that insiders profit from the time of their transactions until the information becomes publicly available. In a more recent study, Agrawal and Nasser (2012) reported that net purchases by officers and directors of takeover targets increased by about 50% in dollar value relative to their normal level in the six-month period leading up to the takeover announcement. The increase in net purchases was more pronounced for deals with less uncertainty, friendly deals, with single bidders, domestic acquirers, and less regulated targets. The stricter disclosure requirements for security transactions by insiders after SOX are likely to negatively affect the incentive for insiders to trade on private information. Therefore, we expect the run-up in target share price to be lower after SOX. The greater scrutiny to which publicly traded firms have been subject after SOX has also meant that higher quality firm-specific information is available to market participants. As a result, bidders today are in a better position to conduct the due diligence of their potential targets, thereby mitigating their risks of either buying the wrong assets or overpaying for the acquisition. Cheng, Li, and Tong (2016) found that targets with higher levels of information asymmetry receive larger bid premiums. Likewise, Skaife and Wangerin (2013) reported that targets with lower quality financial reporting (i.e., less reliable, less relevant, less precise) are offered higher takeover premiums by bidders. The improved information environment after SOX should mitigate target information asymmetry and negatively affect takeover premiums. By making competitive bids because of an improved process of due diligence, acquirers also reduce the likelihood of losing to potential rival bidders.<sup>2</sup>

Some recent studies have examined issues related to those addressed in this paper. Chelikani & D'Souza, 2011 found evidence of improved efficiency in firm valuation after SOX and observed that acquiring firms hold more cash and make more cash acquisitions after SOX. Yang (2014) examined whether managerial acquisition behavior changed after SOX because of the corporate governance reforms and found a positive relation between the restricted stock held by the acquirer firm CEO and the abnormal returns around the acquisition announcement. The author suggested that executive compensation packages with fewer options contracts and more restricted stock can align managerial incentives and value-maximizing decisions more effectively.<sup>3</sup> Chen, Lai, and Chen (2015) reported that while over boarded outside directors had a negative impact on wealth creation in mergers and acquisitions in the pre-SOX period, the relation is not significant after SOX; they attribute this to the mitigating effect of the governance reforms introduced in SOX. Krolkowski (2016) studied the influence of pay for performance on the acquisition decisions before and after SOX and found that it is more positively related to acquirer abnormal returns after SOX. The author also observed that bidders pay a lower acquisition premium for public targets after SOX. Cosset and Meknassi (2013), however, found that U.S. cross-listed targets that are SOX-compliant receive higher deal premiums. Similarly, Bhabra and Hossain (2017) report higher abnormal returns for acquirers, in both the short and long term, after SOX. The authors include both mergers and tender offers in their sample, with mergers constituting more than 90% of the sample. Mergers are usually friendly negotiated transactions; they allow for a more transparent process of due diligence. In this paper we focus on tender offers that present the management of the acquiring firms with greater challenges in evaluating the target. Also, Bhabra and Hossain (2017) do not examine the returns to target shareholders. Here, we investigate the announcement abnormal returns to target shareholders and the net insider trading activity that has been shown to affect pre-bid target share price run-up. To investigate whether managerial acquisition motives changed after SOX, we adopt the framework described in

<sup>1</sup> Sanders and Zdanowicz (1992) also find that the pre-bid price run-up in the targets cannot be attributed to insider trading alone.

<sup>2</sup> Bradley et al. (1983) show that unsuccessful acquirers incur significant costs if they lose out to rival bidders.

<sup>3</sup> For a sample of Canadian mergers and acquisitions (M&As), Dutta, Kenneth, and Saadi (2011) find that powerful CEOs are not necessarily associated with value-destroying acquisitions.

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