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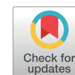
How directors trade and learn during takeovers



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1. Introduction

A change in corporate control such as a takeover represents a significant event in the life of a firm, having short and long-term implications on firm value and shareholder wealth. Corporate insiders such as target and acquirer directors have knowledge of, and influence over imminent bids because they participate in takeover negotiations. Such foreknowledge of takeovers and involvement in the negotiations create a potential conflict of interest where these directors have opportunities to increase personal wealth or to further their careers and reputation. Agrawal and Nasser (2012) show such behaviour in U.S firms where target directors increase their net purchases in the lead up to takeover announcements. On the other hand, target director trading can signal to investors the information on takeover type and terms, because their trading is connected to the realised takeover premium. As previous studies indicate differences in realised premium based on deal characteristics,[1] it is plausible that target directors modify their trading decisions based on the foreknowledge acquired about these deal characteristics. Acquiring directors have also been shown engaging in informed trading around takeover announcements with small increases in purchases and decreases in sales (Seyhun, 1990). More recently, Shams et al. (2016) report opportunistic trading by Australian acquiring directors where preannouncement trading value is positively associated with abnormal return at announcement. Although insiders have information advantage over outside investors, in some cases, the information is insufficient or the market may disagree with management's decision to engage in takeovers. In these cases, learning or acquiring additional information occurs during the takeover process. Luo (2005) and Kau et al. (2008) demonstrate acquirer learning from the market where the market reaction to a takeover announcement predicts the likely outcome of the deal.

In this study we document the pattern and level of prebid announcement trading by target and acquirer directors in Australian firms to determine if directors on either side of the deal use their private information about its upcoming announcement. Prior studies have examined trading by either target directors (Agrawal and Nasser, 2012) or acquirer directors (Shams et al., 2016). We use a different approach and focus on the contemporaneous trading by directors on both sides of the takeover negotiation. The benefits from such an approach are that aspects of the deal such as type (scheme of arrangement or off market bid) and consideration offered (cash only or non-cash only) are controlled for, and trading signals the likely outcome and valuation aspects[2] of the takeover bid from the perspective of the target and acquiring firms. However, as regulation prohibits directors from trading on undisclosed or private information, the trade signals may not be clear or easy for the market to interpret. We differentiate between schemes of arrangement and bids because lately, schemes of arrangement have become the vehicle of choice to effect changes in corporate control, amidst concern that shareholders in the former receive lower offer prices. Considering potentially reduced shareholder protection, it is important to understand whether directors trade differently in bids and schemes, to the possibly (further) detriment of these shareholders.

The second objective is to study director learning during the takeover process, when outside investors disagree with management

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[1] Previous studies have shown that realised premium is higher in deals initiated by bidders (Masulis and Simsir, 2015), in cash deals (Huang and Walkling, 1987), in strategic deals (Dittmar et al., 2012) and in bids compared to schemes of arrangement (Bugeja et al., 2015).

[2] Previous studies have shown acquiring insiders signalling valuation aspects of the deal. For example, Song (2007) showed that acquirers with pure insider selling underperform after acquisition while Akbulut et al., (2015) linked net sellers to overpaid deals.

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about the benefits of proposed mergers or acquisitions. Anecdotal evidence indicates they communicate their disagreement by decreasing their shareholdings and Edmans and Manso (2010) refer to such investor reaction as disciplining managers through trading. We address the issue of whether in such cases, acquirer directors 'listen' to the market and withdraw the offer, or alternatively, disregard the market and finalise the deal. Specifically, we consider whether management uses information from the capital market to improve the investment decisions they make. In this study, we define "learning" as acquiring directors extracting information during the takeover process and using this information to make the final decision about the acquisition. In addition, we test whether learning extends to the trades of target directors, particularly in circumstances where there are more incentives to learn. These include takeovers where because of the nature of the deal, information asymmetry is high such as in resources or high tech deals, or other cases when there is more uncertainty surrounding the completion of the deal, such as in off-market takeover bids.

Large share price run-ups in target firms has been documented by many studies (Schwert, 1996; Betton et al., 2014) together with positive reactions to takeover announcements (da Silva Rosa., 2000). In acquiring firms, negative reactions are observed when the acquirer pays in shares or has a high Tobin's q because the market believes that the acquirer's shares are overvalued (Myers and Majluf, 1984). However, when private equity-backed firms are acquired, announcement returns are positive (Masulis and Nahata, 2009). As Cumming and Li (2011) suggest, trading in acquirers in the preannouncement period is more likely to be insider trading when price changes in this period match expected post-announcement returns. Models developed by Shleifer and Vishny (2003) and Rhodes-Kropf and Viswanathan (2004) predict that overvalued firms are more likely to acquire other firms using stock. Akbulut (2013) uses insider trades to estimate misvaluation and finds that acquirer insiders who sell more of their shares are more likely to make stock acquisitions in the next quarter. He also shows that subsequent acquisitions are associated with negative and lower announcement and long run returns. In later work, Akbulut et al., (2015) show that abnormal insider sales signal overpayment for acquisitions. These studies demonstrate that acquirer trading in the preannouncement period predicts the reaction to takeover announcements and even longer term returns in acquirers.

We study director trading in Australian Securities Exchange (ASX) listed target and acquirer firms over the period 2006 to 2016 where alternative methods of effecting a change in corporate control are available, in the form of schemes of arrangement and off market takeover bids.[3] With schemes characterised by a lower level of shareholder approval and non-application of the Eggleston principles, there are concerns that they fail to provide adequate protection for target shareholders. Indeed Bugeja et al. (2015) report lower premiums in schemes relative to bids. Director trading is investigated in schemes and bids separately to determine whether directors trade to exploit knowledge of the type of takeover or to signal to outside investors the terms of the takeover, and whether director learning is different when information asymmetry is higher.

Learning during takeovers is an issue from both theoretical and empirical perspectives. The Efficient Market Hypothesis (EMH) tells us of the capital market's superiority over individuals in processing public information. The market's informational efficiency influences the investment decisions in firms, in terms of economic efficiency. However, when making substantial investment decisions, firms sometimes overlook the negative market reactions to takeover announcements and complete the deal anyway. Director learning during the takeover process can be better understood in light of the competing views of Dye and Sridhar (2000) and Roll's (1986) hubris hypothesis of corporate takeovers. Dye and Sridhar (2000) claim that the current literature overlooks the flow of information from the capital market to the firm but fixates on the information flow in the other direction. On the other hand, Roll (1986) contends that managers ignore the signals from the market due to hubris. Other studies on learning during takeovers have examined learning gains from repetitive acquisitions (Aktas et al., 2009), and serial acquirer bidding (Aktas et al., 2011).

This study contributes to the literature in several ways. First, we consider the trading activity of target and acquiring directors on either side of the deal. To the best of our knowledge, this is the first study on trading by insiders around takeovers that examines both target and acquirer director trading where the deal characteristics are kept constant. Second, we show differences in director trading because of takeover type and consideration offered. That is, schemes and bids reflect the uncertainty around the outcome of the bid and the underlying information asymmetry while cash only or a combination of cash and scrip indicate beliefs about firm valuation. While bids represent the most common method of effecting change in corporate control in Australia, these deals can be friendly or hostile while schemes being only friendly deals are designed to be 100% effective in producing a change. We also investigate the competing effects of takeover type and consideration offered on target and acquirer director trading. Third, we study whether the stock market feedback loop operates in Australia where management of the acquiring firm learns from the market about the takeover bid, a phenomenon observed in the US and French markets (Luo, 2005; Kau et al., 2008). Finally, we extend the learning concept by considering the information flow from target director trading. Trading by insiders signals their beliefs about firm value and target insiders increase their holdings by engaging in passive trading in the year before takeover bids are announced (Agrawal and Nasser, 2012).

Our results show target directors reducing both their purchases and sales, relative to normal times, in the runup to takeover announcements. The reduction in sales was generally more than decreases in purchases, resulting in net selling. This behaviour was stronger in bids and non cash deals. When the type of takeover and consideration offer terms were combined, the former had a stronger effect on target director trading. In acquiring firms, there is strong evidence of reduced director selling especially in bids and cash only deals. The type of takeover has a stronger effect on acquirer trading when linked to consideration offered. Acquiring directors appear to learn from the market and target director trading during the takeover process where the market's reaction and director trading in the preannouncement period affect the likelihood of deal withdrawal. Acquirer directors also learn more from the

[3] The Corporations Act (2001) deals with takeovers in Australia with Chapter 6 containing the main takeover provisions while Part 5.1 covers schemes of arrangement.

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