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The effects of takeover defenses: Evidence from closed-end funds ☆

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ABSTRACT

I use a sample of closed-end funds to examine how takeover defenses impact shareholder value and promote managerial entrenchment. These funds use the same defenses as general corporations but provide an ideal, homogeneous environment for testing their effects. Defenses are associated with lower fund market values, weaker reactions to activist 13D filings, and higher compensation levels for both fund managers and directors. This study provides greater clarity on the unresolved impact of takeover defenses on firm value, while showing for the first time that directors, who are responsible for adopting takeover defenses, financially benefit from their use.

1. Introduction

This paper explores how takeover defenses impact firm value and promote managerial entrenchment. I use data hand-collected from closed-end fund charters and bylaws to test the effects of takeover defenses. Using an index that tracks fund defenses across a 15-year period, I first show that defenses are associated with larger closed-end fund discounts and weaker reactions to activist 13D filings. These results both indicate that defenses have a negative effect on market values. My unique data set allows me to confirm this finding in a time-series setting. I then show that fund managers and directors financially benefit from the use of defenses. Compensation levels are positively related to the defense index, and the adoption of additional defenses is associated with simultaneous increases in compensation for both managers and directors. Finally, I verify that defenses are effective impediments to shareholder action. The index of takeover defenses is negatively and significantly related to the likelihood of success in activist attempts. This study provides greater clarity on the relation between takeover defenses and firm value while producing new evidence of the entrenchment-promoting effects of defenses. In particular, the board of directors, in the unique position of setting their own compensation contracts while having power over defense adoptions, are shown to reap significant financial benefits from the use of defenses.

Like in general corporations, closed-end fund managers and directors are faced with the possibility of an activist investor gaining control of the company and replacing them. Managers often react to this possibility by adopting

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defense measures that may mitigate or eliminate the impact of effective activist oversight. The defenses adopted by these funds are a subset of the defenses commonly used by general corporations; there are no defense mechanisms that are specific to closed-end funds. Closed-end funds, however, present an ideal setting in which to test the effects of these defenses. First, we can use a fund's discount as a direct and accurate measure of the disparity between net asset value (NAV) and market value. While there are various explanations for the closed-end fund discount, impediments to shareholders' ability to realize net asset value should play a role. Second, closed-end funds provide a level of homogeneity in manager skill sets and contracts not found in general corporations. Managers and directors of general corporations are compensated in a variety of forms, including stock, options, cash, and bonuses, which makes compensation difficult to measure and presents risk-return tradeoffs that influence compensation levels. These management teams also undertake diverse tasks that require a wide range of talent levels and skill sets; certain positions may face varying supply and demand conditions for talent, further influencing compensation levels. Managers and directors of closed-end funds, on the other hand, undertake similar tasks and are always paid in cash. The fund manager is paid as a contractually stated percentage of the fund's net asset value, while directors are always paid in the form of a cash retainer fee. The standardized nature of the job tasks and compensation schemes allow for more effective tests of the impact of takeover defenses on compensation levels that generalize to a broad set of corporations.

Prior studies of the impact of takeover defenses on firm value have produced a wide range of results. One strain of the literature argues that takeover defenses result in higher firm value due to bargaining effects (Comment and Schwert, 1995; Lipton, 2002; Kadyrzhanova and Rhodes-Kropf, 2011). Contrasting studies suggest that shareholder rights improve firm value, as seen in Scharfstein (1988), Ryngaert (1988), Gompers, Ishii, and Metrick (2003), Bebchuk, Cohen, and Ferrell (2009), and Cuñat, Gine, and Guadalupe (2012). Empirical work on the topic has primarily relied on either *Q*-ratios or event studies to examine the effect of defenses on shareholder value. *Q*-ratios, used by Gompers, Ishii, and Metrick (2003) and Bebchuk, Cohen, and Ferrell (2009), only allow estimation annually and are inherently noisy due to inconsistent accounting, misstated liabilities, and varying opportunity sets. Event studies of the market returns following a change in a firm's defense structure, used in Ryngaert (1988), Comment and Schwert (1995), and Cuñat, Gine, and Guadalupe (2012), address some of these concerns but have produced inconsistent results and lack the scale of the *q*-ratio studies, generally focusing on a single defense, or in the case of Cuñat, Gine, and Guadalupe (2012), focusing only on narrowly passed shareholder-sponsored governance proposals. I employ both methodologies in this paper but instead of *Q*-ratios and market returns, I use the closed-end fund discount. This measure relies on asset valuation via the fund's NAV, which represents a more accurate accounting valuation of assets than is observed in general corporations. The use of the closed-end fund discount is therefore likely to be more informative than the *Q*-ratios often used by similar studies. Additionally, the NAV is observed at a much higher frequency than general corporation asset values, providing a unique opportunity for event studies that consider the interaction of both market values and asset values. Hence, this study offers an opportunity to provide greater clarity on the unresolved impact of takeover defenses on shareholder value.

The executive compensation literature has also disagreed on the role of takeover defenses. Linn and McConnell (1983) and Knoeber (1986) show that defenses can be used to optimize managerial contracts, providing protections that allow the manager to work in the best interest of the shareholder. DeAngelo and Rice (1983), Borokhovich, Brunarski, and Parrino (1997), and Core, Holthausen, and Larcker (1999) show that potential impediments to activism allow managers to make decisions that benefit themselves at the expense of shareholders. Each of these studies focuses on chief executive officer (CEO) contracts. This study contributes to the discussion by testing the effects in an environment of homogeneous compensation styles, but I also expand the discussion to include the board of directors. Directors have been largely ignored by the compensation literature, especially as they relate to takeover defenses. Ryan and Wiggins (2004) examine the level of director compensation and how it relates to board composition and CEO characteristics but do not address the role of takeover defenses. Since directors are primarily responsible for adopting defense measures, an analysis of their incentives seems prudent.

This is not the first study to use the closed-end fund discount as a tool to explore general discrepancies between market value and asset values. Prior literature using the discount has examined factors such as high trading costs for sophisticated investors (Pontiff, 1996), agency costs (Barclay, Holderness, and Pontiff, 1993; Berk and Stanton, 2007), and investor sentiment (Lee, Shleifer, and Thaler, 1991; Hwang, 2011) as explanations of mispricing. The findings of this study are consistent with and unaffected by these prior models. Discounts can occur due to a variety of rational or irrational causes, but this mispricing is reduced by the potential for activism. The likelihood of successful activism is related to how many impediments are in place.

Governance in the closed-end fund sector has been explored in previous work by Del Guercio, Dann, and Partch (2003) and Gemmill and Thomas (2006). Both of these studies rely on observations from a more limited data set, considering only a single year of governance data. The focus of these studies is primarily on board composition and how it relates to expense ratios. Del Guercio, Dann, and Partch use data from 1996 proxy statements to show that funds with low expense ratios have smaller boards and more independent directors. According to their study, staggered boards are positively related to closed-end fund premiums, counter to the findings in my study. Gemmill and Thomas (2006) use 1996 governance data for UK-listed funds to show that fees are higher when the board is large and when there are more outside directors. Relative to these studies, this paper focuses more on the