Are Antitakeover Charter Amendments Good News or Bad News For Managers and Shareholders?

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Abstract

In recent years many firms adopted antitakeover amendments to their corporate charters. The amendments have come under criticism from those who believe that they are harmful, and little sentiment in favor of the amendments seems to exist. This article discusses issues related to antitakeover amendments, and presents an overview of available empirical evidence about the amendments. The evidence demonstrates that the amendments are not always harmful and indeed suggests that the amendments, at least in some cases, are beneficial.

I. Introduction

During the 1980s, many corporations became, or anticipated becoming, targets of unfriendly takeover bids. In response to the increased likelihood of becoming the target of a hostile takeover attempt, the top officers of these firms frequently sought shareholder approval of what we commonly refer to as "antitakeover" charter amendments. These amendments take a number of forms, but all ostensibly make takeover of a target firm more difficult without the cooperation of target management. Even though the takeover activity of the '80s has slowed considerably, firms continue to adopt the amendments and researchers continue to try to explain the effects of the amendments.(1)

The amendments, and managers who seek their adoption, have come under criticism from those who believe that the amendments are harmful because they affect the efficiency of the market for corporate control by reducing the likelihood that poorly managed firms will be taken over. In addition, it appears that very little sentiment exists in favor of the amendments. The purpose of this article is to discuss issues related to antitakeover amendments, and to present an overview of the empirical evidence that we have about the amendments, in order to demonstrate that they are not always harmful.(2) Indeed, the evidence suggests that the amendments, at least in some cases, are beneficial.

The remainder of the paper is organized as follows. Section II describes the most frequently observed antitakeover amendments. Section III discusses the

debate surrounding antitakeover amendment adoption. Section IV presents the empirical evidence, and Section V contains implications and conclusions.

II. Types of Antitakeover Amendments

Firms frequently propose several types of antitakeover amendments to their corporate charters. The *staggered board* amendment generally requires that the board of directors be divided into three classes of equal size. The members of each class serve a three-year term, with the terms of office staggered so that shareholders elect only one-third of the directors annually, increasing the time required to elect a majority of the board.

The *supermajority vote* amendment generally requires more than a simple majority of voting shares to approve a merger or other business combination. The required approval ranges from 66 2/3 to 95 percent. This amendment can include a *board out clause*, which allows the board of directors of the target firm to override the supermajority vote requirement under certain conditions, such as approval of the business combination by a majority of the directors unaffiliated with the bidder.

The *fair price* amendment generally requires that each shareholder receive a "fair" price in the takeover bid, generally defined as a price equivalent to the highest price received by a single shareholder during a specified period prior to the tender date. The requirements typically become effective when a shareholder of the

firm acquires a minimum of between five and twenty percent of the firm's outstanding shares. If the bidder fails to meet the fair price requirements, then the amendment requires supermajority approval as high as 90 to 95 percent of a merger or business combination. As with supermajority vote amendments, fair price amendments can include a "board out" clause.

Other amendments exist that are viewed as anti-takeover in nature. These amendments prevent shareholders from taking action by written consent rather than at a meeting, prevent the removal of board members without establishing cause and/or require a supermajority vote for removal, or authorize management to issue classes of common or preferred stock that may carry special voting or dividend rights. Most amendments include a *lock-in* provision, which requires a supermajority vote to repeal any of the antitakeover amendments after adoption.

III. The Debate about the Amendments

A considerable debate exists regarding the amendments' effects. Proponents of the amendments suggest that the amendments increase incumbent management's bargaining power in a takeover bid, which helps managers prevent a bidder from gaining control of the target firm's assets at an unreasonably low price. The amendments raise the probability that the bidder will adequately compensate target shareholders for control of the target firm's assets. In this situation, the amendments are beneficial to shareholders.

Another argument suggests a benefit associated with the amendments beyond the increased bargaining power that they provide. According to Knoeber (1986), optimal managerial contracts involve deferred compensation based on the availability of better information regarding managerial performance. Hostile takeovers may lead to managerial firing or new contracts that eliminate deferred compensation owed to incumbent managers. In this case, managers who perform well and are entitled to deferred claims lose while the bidding firm gains at their expense. Antitakeover amendments may be one way to protect managerial claims to long-term deferred compensation, since the amendments can result in incentives for the bidding firm to initiate a friendly takeover rather than a hostile takeover. In this case, the amendments allow for more effective contracting between shareholders and managers. That is, managers will be willing to accept deferred compensation that will more accurately reflect performance, rather than immediate compensation, which, by definition, is based on less information.

Opponents argue that the amendments decrease the probability that takeover will occur. The probability decrease occurs because managers' motivation is to

protect their own jobs by preventing takeovers, even when the takeover would benefit shareholders. The amendments enhance managerial entrenchment in this situation. If the market expects managers to use the amendments to increase their job security, thereby reducing the probability that inefficient managers will be replaced, and to defeat potentially beneficial takeovers, then the amendments will be harmful to shareholders.

IV. The Evidence

The empirical evidence discussed below deals with two issues: the stock price effects associated with amendment proposal, and the consequences of amendment adoption.

A. Stock Price Effects

The debate surrounding the use of antitakeover amendments has led to several studies of the effect of amendment proposals on the shareholders of the proposing firms. Results are inconclusive, disagreeing with respect to both the direction and significance of the effect. DeAngelo and Rice (1983) find insignificant negative effects on shareholders of proposing firms, while Linn and McConnell (1983) find significant positive effects. More recently, Jarrell and Poulsen (1987) find insignificant negative effects of amendment proposals on shareholders of exchange and non-exchange listed firms. However, they report a significant negative effect for the combined group of exchange and non-exchange listed firms. In addition, McWilliams (1990) finds that the amendments have an insignificant positive effect on shareholders of proposing firms.(3)

A possible explanation of these conflicting results may be the two offsetting effects of the amendments. On the one hand, the amendments potentially increase managerial bargaining power for some firms in takeover bids, but at the same time they also appear to decrease the probability that takeover will occur for some firms. Studies that seek to measure the effect tend to look at average responses across all firms in their sample. This may lead to the mixed results that we observe. Therefore, subsequent studies have tried to refine the analyses to better capture and understand the effect of the amendments on the firm's shareholders. I discuss below the specific issues that these studies address, and then present an overview of the empirical evidence.

Type of amendment

Specific types of amendments may allow managers to increase bargaining power more effectively or to entrench themselves more effectively. The market will view those amendments that increase bargaining power as beneficial. It will view those amendments that allow managers to entrench themselves more effectively and to

thwart value-increasing takeovers as harmful. Both arguments exist for most types of antitakeover amendments.

Jarrell and Poulsen (1987) and IRRC (1984) suggest that fair price amendments are beneficial because they discourage two-tier tender offers and encourage bidders to negotiate directly with the target firm's managers for control of the target firm. The benefit associated with managers acting as central negotiators comes about because diffuse and non-cooperating target shareholders are not in a position to negotiate the best price for control of their firm. The provisions of the fair price amendment appoint managers as the central negotiators for target shareholders only in those cases when the bidder is making a two-tier offer considered to be unfair to the target shareholders. If the benefit associated with the increased bargaining power of the fair price amendment is the predominant effect of the amendment, then we should observe a positive stock price reaction to the amendment proposal.

A potentially negative aspect of fair price amendments relates to the nature of the supermajority vote provision, which requires supermajority vote approval for takeover unless the bidder pays all shareholders a fair price for their shares. Since avoidance of the supermajority vote clause is possible, the fair price amendment may be the least restrictive type of amendment. If the more restrictive nature of the *other* types of amendments most effectively enhances managers' bargaining power, then shareholders will benefit more from non-fair price amendments. Additionally, the fair price amendment also could discourage some offers that would be favorable to shareholders. This can occur because the fair price provision will increase the cost of the offer to the bidder if the bidder is unable to use a two-tier tender offer to gain control of the target firm. In this case, the amendment is viewed as harmful to shareholders, leading to a negative stock price reaction to amendment proposal.

In addition, Jarrell and Poulsen (1987) suggest that supermajority vote amendments most effectively help managers entrench themselves. The supermajority vote amendment is potentially more harmful to shareholders than, for example, the fair price amendment since a bidder will face the supermajority vote provision unless the amendment contains a "board out" clause. However, the primary provision generally found in the "board out" clause states that at least a majority of board members not affiliated with the bidder must approve the business combination to avoid the supermajority vote requirement. In the event of a hostile takeover attempt, the bidder will not receive this approval because the incumbent board opposes the takeover, so the supermajority vote provision remains in effect. If this amendment has little or no effect on the premium paid in successful

takeovers, but primarily results in fewer successful takeovers, then target shareholders lose the takeover premium that they would otherwise receive. Therefore, the supermajority vote amendment is harmful, leading to a negative stock price reaction at proposal. On the other hand, the amendment may encourage bidders to negotiate with managers of the target firm who are potentially able to elicit a higher takeover premium for target shareholders. If the market perceives increased bargaining power as the predominant effect of the amendment rather than deterrence of successful takeover bids, then the market should react positively to the supermajority vote amendment.

Staggered board amendments are potentially harmful, as well. If a firm has a three-year staggered board, a hostile bidder will have to wait for at least two elections in order to gain majority representation on the board because shareholders elect only one-third of the board members annually. The bidder may forego trying to take over the firm with the staggered board in favor of a target firm with no staggered board. In this case, target shareholders of the staggered board firm lose the takeover premium, which leads to a negative reaction to the amendment proposal. The argument in favor of staggered board amendments again deals with the way managers use the amendment. IRRC (1984) indicates that corporations justify a staggered board as a way to provide continuity on the board. It is also possible that a bidder will negotiate takeover terms with managers that are more favorable to target shareholders if the bidder is unable to gain majority representation on the board quickly. In this case, shareholders benefit from having the amendment in place, which should lead to a positive stock price reaction at proposal.

Amendments that restrict shareholders to taking action only at meetings, that prevent the removal of directors without establishing cause and/or require a supermajority vote for removal, or that authorize issuance of additional common or preferred shares could also lead to several possible shareholder wealth effects. If shareholders cannot act by written consent, then any bidder wishing to gain control of the firm by a merger can do so only at a formal meeting at which shareholders can vote on the proposed merger. In addition, if only the board of directors has the right to call special meetings, a bidder may have to wait until the annual meeting for a vote on the proposed merger. It also will be more difficult for a hostile bidder to gain majority representation on the board if there is a provision that directors be removed only for cause and/or by a supermajority vote. Both the director removal and shareholder action amendments limit shareholders' actions and can protract the takeover process. In both cases managers of the target firm will have more time to organize resistance to a hostile bidder. Therefore, under these conditions, these amendments are harmful to shareholders.

ers leading to a negative stock price reaction at proposal.

On the other hand, the amendments may be beneficial to shareholders. Requiring shareholders to take action at a meeting may enhance shareholder participation in the control decision, which will potentially lead to an increase in the negotiated takeover premium. Also, the predominant effect of these amendments may be to enhance manager's bargaining power during takeover, which will benefit target shareholders. For example, if shareholders cannot remove directors from the board easily (e.g., without establishing cause), then a bidder may decide to negotiate takeover terms with managers that are more favorable to target shareholders.

Finally, by authorizing the issuance of additional shares of common or preferred stock, shareholders provide managers the flexibility to make rights offerings commonly referred to as poison pill defenses. A variety of forms exist that these securities can take, but all give the shareholder rights and privileges if the issuing firm becomes a takeover target. These privileges generally result in the takeover becoming extremely expensive to the bidding firm. In addition, Malatesta and Walkling (1988) report that on average poison pill defenses significantly reduce shareholder wealth, which is similar to the result reported by Ryngaert (1988) for the most prohibitive types of poison pill adoptions. This evidence suggests that an amendment that authorizes issuance of shares that can be used as poison pill defenses could be viewed as potentially harmful to shareholders, leading to a negative stock price reaction at amendment proposal. On the other hand, if increasing managers' flexibility in the face of a takeover is beneficial to shareholders, then we should observe a positive stock price reaction to the amendment proposals. The benefit in this case is the bidder's willingness to negotiate more favorable takeover terms for target shareholders with managers if the management of the target firm is in a position to make the takeover very expensive for the bidding firm. It is also possible that managers will not use the authorized shares as poison pill securities, in which case the market may view the amendment as neither harmful nor beneficial.

The preceding discussion indicates that, in theory, uncertainty exists regarding the directions and relative magnitudes of the expected stock price effects of various types of antitakeover amendments. Empirically, Jarrell and Poulsen (1987) find that fair price amendments have very little effect on the stock price of proposing firms, while staggered board, supermajority vote, and the authorization of preferred stock have a significantly negative effect on shareholder wealth for their full sample. When Jarrell and Poulsen categorize firms according to where they are listed (i.e., exchange versus non-exchange listed firms), they find no significant

effects for the exchange listed firms. In addition, McWilliams (1988) finds no significant effects associated with the proposal of any of the antitakeover amendments for her sample composed solely of exchange listed firms. If a stock price reaction to antitakeover amendment proposals exists, the empirical evidence suggests that amendment type alone is not able to help us identify that effect.

Ownership structure

The effect of the amendments may depend on managerial share ownership. Stulz (1988) demonstrates that, as the percentage of shares controlled by managers increases from zero, an increasingly high percentage of outside shareholders must tender their shares in order for a bid to be successful. This requires the successful bidder to offer a higher premium than is required if managers held none of the firm's shares. Shareholders benefit and the value of the firm increases as the result of the expectation of a higher premium in the event of a successful takeover. On the negative side, as managers control larger proportions of the firm's shares, the probability of successful takeover decreases, approaching zero in the extreme case when managers own 50 percent of the firm's shares and can block the takeover. The reduction in the assessed probability of a successful takeover harms shareholders.

According to Stulz's theory, antitakeover amendment proposals have an ambiguous effect on firm value. A negative stock price effect may occur due to a reduction in the probability of a successful takeover. Antitakeover amendments ostensibly decrease this probability unless incumbent management is in favor of the takeover. However, the introduction of antitakeover amendments may simultaneously increase managerial bargaining power leading to an increase in the expected takeover premium which in turn leads, *ceteris paribus*, to an increase in firm value. The net impact of the amendment proposal on firm value depends, of course, on which factor is dominant, and may vary according to the value of managerial share ownership.

For firms with low managerial share ownership, the amendments' positive effect that results from the increase in managerial bargaining power should outweigh the negative effect that results from the decrease in the probability of takeover. We expect the opposite to occur for firms with high managerial share ownership because, as managerial share ownership increases, the probability of a successful hostile takeover decreases.

Consistent with the arguments put forward by Stulz, McWilliams (1990) finds a significant positive stock price effect for amendment proposals made by firms having low levels of managerial share ownership (ten percent or less), which is significantly larger than negative effects

found at higher levels of share ownership. McWilliams also uses regression analysis to confirm the significant negative relation between the announcement stock price effect of amendment proposal and managerial shareholdings. Jarrell and Poulsen (1987) and Agrawal and Mandelker (1990) also test for a significant relation between the stock price reaction to antitakeover amendment proposals and managerial share ownership. Using regression analysis, both studies find that their managerial share ownership coefficient estimate is insignificant, leading them to conclude that managerial shareholdings are unrelated to the amendment announcement effect.⁽⁴⁾ Conversely, Bhagat and Jefferis (1991) find a negative relation between the likelihood of an antitakeover amendment proposal and the chief executive's ownership stake and the voting power of employee stock ownership plans.

Another factor that may affect whether a firm is likely to propose antitakeover amendments is the level of institutional share ownership. Jarrell and Poulsen (1987) suggest that institutional investors are well informed regarding their investments relative to small unsophisticated external shareholders. Therefore, the institutional shareholders vote in favor of amendments that are value increasing and against amendments that are value decreasing. This suggests that we should observe firms with high institutional share ownership proposing amendments that do not have a significant negative effect on shareholder wealth. Jarrell and Poulsen find that, in general, a positive relation exists between the stock price effect of antitakeover amendments and institutional shareholdings. Agrawal and Mandelker (1990) also report this finding. In addition, Brickley, Lease, and Smith (1988) report that institutional investors opposed the amendments more strongly in cases where the proposals resulted in a negative stock price reaction. Collectively, the results presented above suggest that ownership structure is an important variable for understanding the nature of the impact of antitakeover amendments.

Combinations of amendment type and ownership structure

The relation between ownership structure and the effect of amendments on shareholders also should depend on the type of amendment proposed. A specific type of amendment may have a stronger effect on the probability of takeover than others since some amendments may change existing voting rules in a way that reduces the voting power of outside shareholders more effectively than others. Supermajority vote and fair price amendments change the percentage of votes required to approve a business combination, and staggered board amendments change the voting rules for electing the board of directors. Therefore, the relations between ownership structure and effect of the amend-

ment proposals on shareholder wealth presented above may vary depending on type of amendment proposed.

Jarrell and Poulsen (1987) report that adoption of fair price amendments is more likely when institutional investment in the firm is high. They also report that the probability of proposing fair price amendments is lower the higher is the level of managerial shareholdings, but the relation is insignificantly different from zero. Agrawal and Mandelker (1990) report a positive linear relation between the stock price reaction to amendment proposals and institutional share ownership for fair price and supermajority vote amendment proposals. McWilliams (1990) finds that all amendments, except fair price amendments, appear to be beneficial for firms whose managers have low share ownership and lead to increasingly negative effects on shareholders for high managerial share ownership firms.

In summary, the empirical evidence regarding the stock price effect of antitakeover amendment proposals indicates that the ownership structure of the firm and the type of amendment proposed play an important role in the resulting effect of the amendments on shareholder wealth. Specifically, the amendments are beneficial when proposed by firms with low managerial and high institutional shareholdings, especially if the amendment type is other than fair price.

B. Consequences of Amendment Adoption

As stated in Section III, one of the criticisms of antitakeover amendments is that they ostensibly decrease the probability that takeovers will occur, allowing inefficient managers to entrench themselves and continue to mismanage their firms. Pound (1987) reports that the amendments do appear to reduce the frequency of takeover bids; however, they do not appear to increase the expected value of the takeover bid to target shareholders when takeovers do occur. These results lead Pound to conclude that the amendments are detrimental.

Meulbroek, Mitchell, Mulherin, Netter, and Poulsen (1990) and Pugh, Page, and Jahera (1992) also study subsequent activity by firms that adopt antitakeover amendments. The basis for these studies is the theory presented by Stein (1988) who suggests that the existence of potential takeover threats makes managers focus on less profitable short-term projects to increase current profitability at the expense of profitable long-term projects. If antitakeover amendments provide takeover protection, then they should provide managers the opportunity to focus on more profitable long-term projects. Meulbroek, Mitchell, Mulherin, Netter, and Poulsen report that investment in R&D expenditures decreases after adoption of the amendments. However, Pugh, Page, and Jahera conclude that firms that adopt

antitakeover amendments increase both capital expenditures and R&D following amendment adoption. Pugh, Page, and Jahera unsuccessfully try to replicate the Meulbroek et al. negative results, even though they reconstruct the Meulbroek et al. sample. The Pugh, Page, and Jahera results suggest that the amendments allow managers to adopt a more long-term focus regarding investment decisions.

McWilliams (1992) further examines the hypothesis that antitakeover amendments allow managers to entrench themselves and take subsequent action that is detrimental to shareholders by examining Tobin's q for amendment and non-amendment firms. Tobin's q is a proxy for how well the firm is being managed, and is defined as the ratio of a firm's market value to the replacement value of its assets. McWilliams determines that firms that propose the amendments do not have q ratios that are significantly less than non-amendment firms; that firms proposing the amendments experience an increase in q ratios after amendment proposals, but the increase is not significantly less than the corresponding increase for non-amendment firms; and that, after controlling for factors that affect q , there is no significant difference in q ratios for amendment and non-amendment firms. These results suggest that amendment firms are managed at least as well as non-amendment firms.

V. Implications and Conclusions

The collective body of evidence regarding antitakeover amendments provides an ambiguous picture of their effects on shareholder wealth. In general, no systematically positive or negative effect on shareholder wealth seems to exist when firms propose the amendments. When researchers attempt to identify more clearly the amendments' effects, we observe that fair price amendments have very little effect on shareholder wealth, while other non-fair price amendment proposals are associated with negative effects. However, when we observe the stock price reaction for exchange listed firms only, we fail to identify significant effects associated with the proposal of any type of antitakeover amendment.

Accounting for the firm's ownership structure is more helpful in allowing us to isolate the amendments' effects. There appears to be some benefit for firms that propose the amendments when managerial share ownership is low, and potential harm to shareholders for firms with relatively high levels of managerial share ownership that propose the amendments. These results suggest that, for low managerial share ownership firms, the potential increase in incumbent management's bargaining power in a takeover bid outweighs the decrease in the probability that takeover will occur. In addition, allowing for institutional investment in the firm, we observe that firms with high institutional shareholdings tend to

propose the amendments that are primarily value enhancing.

The interaction of amendment type and ownership structure provides additional insight. It appears that all amendments, except fair price amendments, provide some benefit for firms whose managers have low share ownership, but result in increasingly negative effects on shareholder wealth for high managerial share ownership firms. One possible explanation of the fair price amendment results is that the market views fair price amendments as making takeover more costly to potential bidders than other amendments. This occurs because the bidder must pay a uniform price to all shareholders under the fair price amendment to avoid the supermajority vote provision. The increased cost may have the effect of reducing the probability of takeover, leading to a negative stock price reaction that outweighs any potential benefit associated with management's increased bargaining power. Another possible explanation is that the more restrictive nature of the other types of amendments more effectively enhances management's bargaining power than does the fair price amendment. In this case, shareholders benefit more from non-fair price amendments.

The final evidence presented deals with whether the amendments do in fact affect takeover frequency and managerial entrenchment subsequent to adoption. The evidence indicates that the amendments do appear to reduce the probability that the adopting firm will become a takeover target; however, it does not appear that the amendments enhance entrenchment allowing managers to take subsequent action that is detrimental to shareholders.

The evidence taken as a whole suggests that the criticism leveled against antitakeover amendments *in general* is inappropriate. Under some circumstances most of the amendments appear to positively affect shareholder wealth, and under no circumstances do the amendments *systematically* harm shareholders. The evidence does suggest that managers have information available that will help them assess whether the amendments are potentially beneficial or harmful to their firm. Managers can determine whether the type of amendment they plan to propose and the ownership structure of their firm are such that the amendment would be potentially beneficial. Managers should choose to forego proposing the amendments to their corporate charter under those circumstances that suggest that the amendments will be harmful. However, giving in to public criticism and foregoing all antitakeover amendments appears to be contrary to taking action that is in shareholders' best interests. On the basis of the evidence that we have, it appears that some firms will benefit by adopting antitakeover amendments to their corporate charters.

VI. Suggestions For Future Research

One important area for future research will address the long-term effects of the amendments. For example, the amendments may increase the importance of the internal governance structure of the firm by potentially lessening the effect of the external governance of the market. In time, we may also discover that firm-specific characteristics, such as managerial share ownership and board composition, lead some types of amendments to be more effective than others. In addition, the amendments may affect the strategic management of the firm by allowing managers to adopt a more long-term focus in their strategic decision making. Additional information about these and other issues will allow us to gain further insight into antitakeover charter amendments.

Footnotes

1. Section IV describes antitakeover amendment studies.
2. This article differs from Jensen and Ruback (1983) and Jarrell, Brickley, and Netter (1988) in that it focuses exclusively on some of the most frequently observed antitakeover charter amendments, and it includes an overview of more recent manuscripts that did not exist at the time of the earlier surveys.
3. Samples for DeAngelo and Rice (1983), Linn and McConnell (1983), and McWilliams (1990) include exchange listed firms only.
4. Differences between the Jarrell and Poulsen (1987), Agrawal and Mandelker (1990), and the McWilliams (1990) studies may explain the inconsistency in conclusions. Agrawal and Mandelker use the same sample as Jarrell and Poulsen. Seventy-five percent of the Jarrell and Poulsen sample represents fair price amendment proposals, while only 30 percent are fair price proposals in McWilliams' sample. The latter part of Section IV. A discusses the interaction between stock price reaction, ownership structure, and amendment type.

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