Hostile take-overs — A review of defensive techniques currently used by target companies

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Take-overs of companies are being increasingly used as a means of business growth. Take-over candidates are decreasing and acquiring companies are becoming more aggressive in pursuing take-overs. The target companies have retaliated by using several new techniques to avoid hostile take-overs. Anti-take-over amendments to the company's Memorandum and Articles of association, 'golden parachute' arrangements, and the simultaneous bid for the acquiring company are being extensively used to defend hostile take-overs. The controversial nature of these new strategies has provoked heated academic debate as well as emotional arguments between business managers and shareholders.

The high cost of implementing the new strategies to defend take-overs has generated much adverse publicity in the United States. By contrast these new techniques have not found widespread use in South Africa. It can be expected that at some stage in the future these techniques will be implemented by the target companies in South Africa. The public policy implications of using these techniques are discussed in this article. The need to provide guide-lines on the use of new strategies to defend hostile take-overs is recommended. The listed companies in South Africa are instrumental in undertaking major take-overs resulting in increased business concentration. It is recommended that the Johannesburg Stock Exchange should provide guide-lines on acceptable methods to defend hostile take-overs.
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Oornames van maatskappye word toenemend gebruik as metode om groei te bewerkstellig. Maatskappye wat beskikbaar is vir oorname is besig om af te neem en oornemende maatskappye word meer aggressief in hulle oorname-aksies. Die 'doelwit'-maatskappye reageer hierop deur die benutting van verskeie nuwe tegnieke wat die voorkoming van vyandige oornames ten doel het. Anti-oorname-wysigings in die maatskappy se Akte en Statute van oprigting, sogenoemde 'golden parachute'-ooreenkomste, en die gelyktydige teenoorname-aanbod word op groot skaal getref as verdedigingsmeganisme teen vyandige oornames. Die kontroversiële aard van hierdie nuwe strategieë veroorsaak uitgerekte akademiese debattering en emosionele argumente tussen sakebestuurders en aandeelhouers.

Die hoë koste verbonde aan die implementering van die nuwe strategieë om oornames te verdedig het aanleiding gegee tot negatiewe beriggewing in die VSA. In kontras hiermee vind ons dat hierdie nuwe tegnieke/strategieë nog nie 'n wye gebruiksinslag in Suid-Afrika gevind het nie. Die verwagting is dat hierdie tegnieke vroeër of later wel deur die bogenoemde doelwit-maatskappye in Suid-Afrika ge-implementeer sal word. Die publieke beleidsgevolge van die benutting van hierdie tegnieke word in hierdie artikel bespreek. Die noodsaaklikheid om riglyne te verskaf vir die benutting van nuwe strategieë om vyandige oornames te verdedig word aanbeveel. Die genoteerde maatskappye in Suid-Afrika is instrumenteel in groot oorname-aksies wat toenemende besigheidkonsentrasie tot gevolg het. Daar word aanbeveel dat die Johannesburg Effektebeurs die riglyne moet verskaf ten opsigte van aanvaarbare metodes om vyandige oornames te verdedig.
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Introduction

In the past target companies have used several techniques to defend hostile take-overs. The target company could arrange that another company come to its rescue by effecting a 'friendly take-over'. The sale of valuable assets or divisions is used to make the take-over less attractive to a prospective acquiring company. The target company could also appeal to its shareholders to reject the take-over offer. This is achieved by disclosing several assets or projects that are likely to yield substantial profits in the future but are not fully reflected in the current market price and the take-over offer price.

Anti-take-over amendments

Several researchers have studied the growth of the take-over phenomenon in the Western World. Salter and Weinhold (1982: 66 – 69) have shown that as the take-over candidates decrease acquiring companies are becoming more aggressive in pursuing take-overs. Cary (1970: 839 – 844) has provided a list of new techniques developed by the target companies to protect themselves against hostile take-overs which they consider not to be in the best interest of their shareholders. Hochman and Folger (1979: 537 – 573) have observed that several target companies have made themselves less vulnerable to take-overs by adopting several anti-take-over amendments to the company's Memorandum and Articles of Association. De Angelo and Rice (1981) have shown that anti-take-over amendments impede take-overs by:

(a) inhibiting a bidder's ability to take control of the target company's board of directors after the take-over, or
(b) inhibiting a bidder from implementing changes in the target firm's operating activities, including sale of major assets.

There are two opposing views on the use of anti-take-over amendments to impede take-overs. Those opposed to anti-take-over amendments contend that take-overs play an important role in removing inefficient managers from office. Anti-take-over amendments therefore impede the allocation of company resources to the most efficient managers. According to this view, anti-take-over amendments are contrary to the best interests of the shareholders of the firms that adopt them. A contrary view is held by the proponents of the anti-take-over amendments. According to their advocates, anti-take-over amendments have at least two salutory effects. Firstly, they strengthen the hand of incumbent management in dealing with acquirors whose primary objective is to acquire the assets of the target company at an unreasonably low price. Secondly, they provide for greater continuity in the management and thus

a greater stability in the firm's long-term planning, profitability and growth.

The arguments of the two sides of the debate surrounding the use of anti-take-over amendments lead to opposite predictions on the impact of such amendments on the share price of the target company. According to the opponents of such amendments, the introduction of anti-take-over amendments will have a negative impact on the company's share price because it reduces the probability that inefficient managers will be removed from office. According to the advocates of anti-take-over amendments the introduction of such amendments will have a positive impact on the company's share price because it reduces the probability that the acquiror will gain control of the firm's assets without adequately compensating the target company's shareholders.

A recent study by Linn and McConnell (1982) investigated the impact of anti-take-over amendments on the share prices of the firms that have adopted them. It was found that the introduction and adoption of anti-take-over amendments are associated with the increase in share prices and that the removal of anti-take-over amendments are associated with a decline in share prices. Grossman and Hart (1980:42 – 64) have observed that the net effect of anti-take-over amendments is to raise the price of the acquired company when a take-over bid is made. De Angelo and Rice (1981) developed a 'shareholder interest hypothesis' as an explanation for the increase in share prices associated with the adoption of anti-take-over amendments. A key assumption of the shareholder interest hypothesis is that monopolistic gains are to be expected from a successful merger of two firms. The monopolistic gains arise because the acquiring company is assumed to have monopolistic information concerning the profitable use of the acquired company's resources. The objective of the shareholders of the target company is to devise means to obtain a maximum possible share of these gains. One possible method of accomplishing this goal is the introduction of anti-take-over amendments.

The market valuation of a firm plays an important role in the probability of a take-over of the firm. Marris (1966) has presented a theory of take-overs in relation to the market valuation of a firm's equity shares. According to this theory, if the market value of a firm's share price fall relative to the book value of the firm's net assets, the valuation ratio is lowered, and the probability of a firm being subjected to a take-over is increased. This theory is based on the market's disciplinary role in the economy and on the supposition that firms that are not profitable will be given a lower rating by the share market in the form of declining share prices. The lower share price causes the valuation ratio to drop.

In view of the importance of a firm's valuation ratio in defending take-overs it can be expected that the timing of anti-take-over amendments is likely to influence the valuation of a firm's equity shares. Anti-take-over amendments imply undervalued equity prices and therefore there is an upward adjustment in market valuation following the announcement of such amendments. Similarly, a removal of anti-take-over amendments implies equal or excess valuation of a firm's shares and therefore a downward movement in market valuation can be expected.

'Golden parachute' arrangements

Another arrangement intended to curb hostile take-overs is to provide some financial protection to key members of the management team in the event of a possible take-over. A contract between the company and key executives is created whereby the latter receive a lump sum payment in the event of a hostile take-over. The so-called 'golden parachute' has become the most controversial topic in the current take-over scene in the United States. McLaughlin (1982:47 – 49) has shown that virtually all major take-overs in the United States during 1982 had included some form of protection to senior management in the event of change in control. Morrison (1982:82 – 87) has highlighted the main benefits accruing to the key executives protected by the 'golden parachute'. Firstly, a 'golden parachute' provides financial independence which in turn enables the target company executives to evaluate the take-over prospect objectively. Secondly, this arrangement is intended to compensate the executives for any possible loss in earning capacity, pride, prestige, and power. Furthermore, the contingency compensation to senior executives is a form of bribery by the company providing such protection. The executives concerned are likely to display greater loyalty to their company following the introduction of 'golden parachute' arrangements.

'Golden parachutes' also provide protection to the shareholders. Such arrangements make it possible for companies to have and to retain the services of key executives. Without a parachute arrangement certain companies that are 'ripe' for take-overs would not be able to attract senior executives. These arrangements increase the price of a take-over and may deter certain acquiring companies from continuing with their original plan. 'Golden parachute' arrangements have not come into use in South Africa. However, as the number of take-overs increase it can be expected that such arrangements will become popular in South Africa.

In the United States there have been several cases where large lump sum payments have been made to senior management after a change in control following a take-over. Several shareholder groups have voiced strong disapproval for the use of company funds to protect senior managers in take-over situations. It is argued that the large salaries commanded by the management team include a compensation for the risk of dismissal in the event of a take-over. It is further argued that it is inconsistent for a company to give financial protection to one group of employees and to exclude similar protection to the vast majority of the company's work force. Both sides are presenting a strong case in support of their views and at this stage no finality has been reached. However, increased shareholder resistance will have to be considered in future contracts protecting managers in take-over situations.

Simultaneous bid for the acquiring company

The high incidence of take-overs has also led to the development of more aggressive methods to defend take-overs by the target companies. Reier (1982:164 – 168) has shown that many target companies opposed to a take-over are adopting the technique of a simultaneous take-over bid for the acquiring company. By maintaining a counter-attack on the acquiring company the target company can stall and ultimately defeat the take-over bid. Both the acquiring and the target company can be financially crippled by spending huge sums in purchasing each others shares. Adkins (1982:59) has shown that in the much publicized take-over involving Bendix Corporation and Martin Marietta Corporation both these companies were so financially weakened that they were both subjected to a take-over by a larger company, United Technologies Corporation. There is no justification for this type of take-over defence. The financial resources tied up by using this technique results in no increase in productivity or in social benefit to society.

The waste of Corporate resources in a simultaneous take-over bid has generated adverse reaction to all take-overs. Opponents of take-overs have used the Bendix-Martin Marietta case to advocate banning all take-overs. Gilpin (1983:2) reports that the SEC has set up a special committee to investigate existing practices and regulations governing take-overs. In particular the SEC is concerned about the dubious methods employed in recent take-overs. Prohibiting all take-overs can be counter-productive. Certain take-overs can be beneficial to the shareholders and to the economy. Nevertheless, there is a need to discourage those take-overs which are likely to waste the shareholders' funds in costly take-over battles. Lazere (1982:19 – 20) has suggested that financial institutions should only finance those take-overs where both parties to the take-over are in agreement and where productive business assets are involved in the transaction. It is suggested that such a provision will distinguish between empire building and genuine resource allocating take-overs.

Hostile take-overs in South Africa

The new strategies to defend hostile take-overs have been given extensive publicity in the more advanced countries such as the United States and the United Kingdom. However, very little attention has been devoted to these new techniques in South Africa. The market for take-overs is small and therefore fewer hostile take-overs are encountered in the local business scene. As a result of this the regulatory authorities have not taken the initiative to regulate certain techniques to defend hostile take-overs which are not in the interest of the shareholders nor the economy.

The form and contents of the Memorandum and Articles of Association of companies in South Africa is regulated by the Companies Act of 1973, as amended. The current Act makes no provision for the inclusion or exclusion of anti-take-over amendments. The basic philosophy of the Companies Act is that shareholders are best able to decide on matters pertaining to the domestic issues of the company. Shareholders in South Africa are at liberty to make anti-take-over amendments to the Articles of Association if they consider it to be in the best interests of the company. The adoption of anti-take-over amendments will create a more efficient market for securities in South Africa. Therefore, there is no justification for prohibiting target companies from adopting anti-take-over amendments to their Memorandum and Articles of Association.

The Maintenance and Promotion of Competition Act of 1979, as amended has provided the machinery under which all take-overs in South Africa are to be investigated. The Act has made provision for a Competition Board which has powers to investigate take-overs and make recommendations to the Minister of Economic Affairs to terminate those take-overs which are not in the public interest. A further task of the Competition Board is to conduct research on various aspects of economic concentration in South Africa. Therefore, it is submitted that the Competition Board is ideally placed to undertake an in-depth investigation on the public policy implications of new defences against take-overs. In particular the Competition Board should investigate the 'golden parachute' arrangements and the simultaneous take-over bid for the acquiring company in terms of the public interest criterion. Based on such an investigation and its past experience the Competition Board should provide guide-lines on acceptable methods to defend hostile take-overs applicable to all companies in South Africa.

The Johannesburg Stock Exchange (JSE) has provided several rules, requirements, and procedures to be followed by all listed companies in South Africa (Feb. 1976). Furthermore, the JSE has also provided a list of requirements applicable to take-overs by all listed companies and their subsidiaries (April 1976). None of the defences against hostile take-overs fall within the ambit of the JSE control over the listed companies. The listed companies in South Africa and in particular the conglomerate companies are predominant in the local take-over scene. As candidates for take-overs decrease the acquiring companies can be expected to be more aggressive in pursuing take-overs. The target companies can be expected to retaliate by making use of several techniques to defend hostile take-overs outlined in this paper. Therefore, it can be expected that several listed companies in South Africa will be making use of 'golden parachute' contracts and also implement the simultaneous bid for the acquiring company as a means to defend hostile take-overs. The protection of shareholders interests is an important function of a stock exchange. Therefore, it is necessary for the JSE to set up a special committee to investigate the several new techniques to defend hostile take-overs. Based on such an investigation as well as the guide-lines of the Competition Board, appropriate rules, requirements, and procedures to be followed by all listed companies should be implemented.

Conclusions

This paper has presented new strategies used to defend take-overs in the United States. At some stage in the future it can be expected that South African target companies will be making use of these strategies to defend hostile take-overs. These new take-over defences are controversial and will generate much public debate when they are used in South Africa. In particular the simultaneous take-over bid for the acquiring company, and 'golden parachute' contracts will have widespread public policy repercussions. Acquiring companies will have to be more circumspect in their take-over activity. A detailed investigation of the probable outcome of a prospective take-over candidate will be necessary to avoid costly take-over battles. Target companies can be expected to be more aggressive in defending take-overs considered not to be in the shareholder's interest. Both the acquiring and the target companies will have to devote vast resources in implementing and defending future take-overs.

The regulatory authorities in South Africa will have to respond to the new developments in defending hostile take-overs. The new strategies to defend hostile take-overs have far-reaching public policy implications. It is therefore necessary for the Competition Board to undertake research on the possible harm to the economy caused by hostile methods to defend take-overs. Based on such investigation the Competition Board should provide guide-lines on acceptable methods to defend hostile take-overs applicable to all companies in South Africa. Furthermore, there is also a need for the JSE to provide rules, regulations, and procedures for defending hostile take-overs involving listed companies in South Africa. Failure to provide such guide-lines and regulations could result in a misallocation of corporate funds in futile take-over battles which are neither in the interest of the shareholders nor of the economy.

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