Hostile Takeovers as an external mechanism of corporate governance: advantages and disadvantages.

أنشطة الإستحواذ العدائية كآلية خارجية لحوكمة الشركات: المزايا والعيوب.

Djellaba Ali, PhD Student at FSESG, Laboratory of LFIEGE, Badji Mokhtar University, Annaba - Algeria, ali.djellaba@univ-annaba.org.
Benamara Mansour, Professor at FSESG, Laboratory of LFIEGE, Badji Mokhtar University, Annaba - Algeria, mansour_benamara@yahoo.fr.

Received:28/10/2019 Accepted: 03/01/2020 Published:31/01/2020

Abstract:

This study aims at highlighting the significance of hostile takeovers activities as an alternative external mechanism whereby shareholders can replace underperforming or opportunistic managers.

The study found that hostile takeovers offer several advantages to protect shareholders when internal controls are ineffective but at the same time, it has got disadvantages and hides a dark side for shareholders.

Keyword: CG; takeover; hostile takeover; advantages; disadvantages.
JEL classification code : G30, G34.

ملخص:

تهدف هذه الدراسة إلى تسليط الضوء على أهمية أنشطة الإستحواذ العدائية كآلية خارجية بديلة تمكن المساهمين من مراقبة وإستبدال المسيرين الإنتهازيين وذوي الأداء الضعيف.

توصلت الدراسة إلى أن أنشطة الإستحواذ العدائية تقدم العديد من المزايا لحماية المساهمين عندما تكون الضوابط الداخلية للمؤسسة غير فعالة، لكن في نفس الوقت لها مجموعة من العيوب وتخفي جانبا مظلما للمساهمين .

الكلمات المفتاحية : حوكمة الشركات؛ الإستحواذ؛ الإستحواذ العدائي؛ المزايا؛ العيوب.
تصنيف JEL: G30، G34.

Corresponding author: Djellaba Ali, e-mail: ali.djellaba@univ-annaba.org

1. Introduction :

It is well know that the separation of ownership and control brings about agency problems, which need to be dealt with via corporate governance mechanisms. According to this line, internal governance mechanisms are often ineffective if managers put their interests ahead of the interests of the shareholders. Therefore, the remaining independent reduces shareholder returns when compared to takeover offers. This governance role of takeovers is grounded in Manne's (1965) argument that the stock market represents an objective evaluation of managerial performance. When the opportunity to create new value via the redeployment of assets or the displacement of existing managers becomes apparent, the company becomes an attractive target in the market for corporate control.

Based on this, this study attempts to answer the following main question:

What are the advantages and disadvantages of hostile takeover activities as an external mechanism of corporate governance?

In order to cover the various aspects of the subject, the study was divided into the following axes:

- Key concepts of corporate governance;
- Takeover (concept and motives);
- The governance role of hostile takeover;
- The effects of a hostile takeover activity.

2. Key concepts of corporate governance

2.1. Definition:

There is a wide variation in the definitions of CG, which reflects the different approaches of academic disciplines and the changing attitudes over time. Therefore, in the economic field, the OECD definition is often cited as an authoritative, intentionally agreed definition. It states:

"Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (OECD, 2015, p 17).

2.2. Pillars of Corporate Governance:

The pillars of corporate governance can be summarized as follows (Kaushik Sharma, 2015, p 18):

- **Transparency:** Ensuring timely, adequate, and accurate disclosure of all material information. These disclosures must be over and above the statutory provisions given under rules and regulations.
- **Accountability:** The board of directors is accountable not only to shareholders but to stakeholders and executives of the company are accountable to the board for the performance of the tasks assigned to them.
- **Fairness:** Fair and equitable treatment to all shareowners, including minorities, and to all participants in the corporate governance structure.
- **Responsibility:** The board of directors and management are responsible for their behaviour and there must exist a means for penalizing mismanagement.

2.3. OECD Principles of Corporate Governance

Although the OECD principles of corporate governance are non-binding, their value has been recognized as key elements of good corporate governance, and they have been incorporated into codes in many different countries. For example, the Committee on Corporate Governance in Greece produced its Principles on Corporate Governance in Greece, which reflected the OECD Principles, whilst the China Securities Regulatory Commission published its Code of Corporate Governance for Listed Companies in China, which also drew substantially on the OECD Principles (Mallin, 2013, p 42).These principles can be explained in accordance with the following table:

Table 1. OECD Principles of CG

Principle	Narrative
Ensuring the basis for an effective corporate governance framework	The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly articulate the division of responsibilities among different supervisory, regulatory, and enforcement authorities.
The rights of shareholders and key ownership functions	The corporate governance framework should protect and facilitate the exercise of shareholders' rights.

The equitable treatment of shareholders	The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.
The role of stakeholders in corporate governance	The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.
Disclosure and transparency	The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.
The responsibilities of the board	The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Source: Prepared by researchers based on, OECD Principles of Corporate Governance, 2004, PP 29-58, detailed site: http://www.oecd.org/corporate/ca/corporategovernanceprinciples/31557724.pdf (consulted on: 12/05/2019).

2.4. Benefits of Good Governance

Good corporate governance leads to various benefits. These are (Kaushik Sharma, 2015, p 17):

- **Stability and long-term sustainability for investors:** Good corporate governance practice builds confidence amongst stakeholders, which promotes stability and long-term sustenance of the stakeholders' relationship.
- **Stability and growth for the enterprises:** Good corporate governance practices provide constancy and growth for the enterprise.

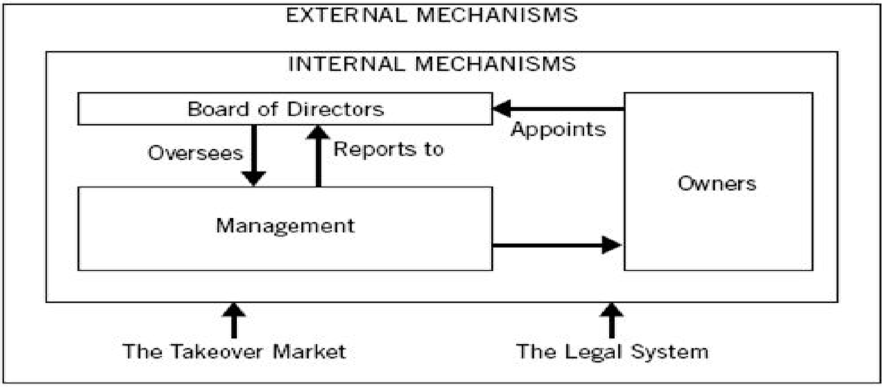
- **Acquisition and retention of talent:** Well-governed companies attract and retain well-qualified, hardworking, honest, ambitious, and competent people.
- **Reduce risks, mismanagement, and corruption:** Effective governance can reduce the amount of risk. Well governed companies follow the fundamental principles of corporate governance, such as transparency, accountability, and equitable treatment to all shareholders; this will reduce the overall incidence of corruption, fraud, and mismanagement.
- **Reputation and recognition:** A well governed company helps to improve its goodwill and reputation.

Higher firm valuation: Good corporate governance has a positive impact on the share price of the company. Studies in India and abroad show that markets and investors take notice of well managed companies, respond positively to them, and reward them with higher valuations.

2.5. Corporate Governance Mechanisms

Mechanisms of corporate governance are often distinguished as either internal or external. Internal corporate governance concerns the relationships and balance of powers within a corporation within a corporation, primarily among the board, managers and shareholders but also other internal stakeholders such as employees. External corporate governance refers to outside forces that exercise a disciplining influence on managers, such as takeover markets, financial markets and regulatory intervention (Klettner, 2017, p 6). These mechanisms can be illustrated in the following figure:

Fig 1. Corporate Governance Mechanisms



Source: Slide Player (2016), Corporate Governance and control of global Operations, P 22, detailed site: https://slideplayer.com/slide/4809593/ (consulted on: 05/06/2019).

3. Takeover (concept and motives):

3.1. Concept of takeover:

Takeover is a general and imprecise term referring to the transfer of control of a firm from one group of shareholders to another. A firm that has decided to take over another firm is usually referred to as the bidder. The bidder offers to pay cash or securities to obtain the stock or assets of another company. If the offer is accepted, the target firm will give up control over its stock or assets to the bidder in exchange for consideration (i.e., its stock, its debt, or cash) (Ross, Westerfield and Jaffe, 2002, P 823).

In other words, takeover may be defined as a “transaction or series of transactions whereby a person (individual, group of individuals or company) acquires control over the assets of a company, either directly becoming the owner of those assets or indirectly by obtaining the control of the management of the company.” Oesterle instead defines a takeover as a “stock purchase offer in which the acquiring firm buys a controlling block of stock in a target, most often a majority of the outstanding voting stock. The controlling block of stocks enables the purchasing firm to elect the target’s board of directors and to effect statutory mergers.” This latter definition seems to limit the meaning of the word “takeover” to a simple stock purchase offer (Enrico Colcera, 2007, P 7).

Friendly takeover and hostile takeover should be distinguished, because it usually starts the process by the presentation of a bid from the acquirer to the target company’s management. At this point the takeover offer is friendly and is viewed as a form of invitation to join merge the two companies addressed to the target company’s board of directors. It is then up to the target company’s board of directors to decide whether to accept or decline the invitation and thus the takeover offer. If it is rejected, the acquirer can turn to the target company’s shareholders. By directly approaching the shareholders, the acquirer transforms the friendly offer into a hostile one. In more detail, the two concepts are defined as follows:

- **Hostile Takeover:** is a type of takeover that one company attempts to gain power over another without creating an agreement. In this strategy, the aggressor company purchases a high enough percentage of the company’s shares to gain a controlling interest in it. After acquiring enough shares, the aggressor company will start to displace former board members and slowly push all former company members out of their positions (Sanjay Anand, 2008, P 20).
- **Friendly takeover:** is a type of takeover that the management of the acquired company as well as management of the target company agrees to the terms and conditions of the takeover and takeover is done without any difficulty, arguments, and fights. An acquirer doesn’t have to do any plotting or make any strategies against the target company in order to acquire the same.

3.2. Motives for takeover:

The rationale for takeover activity has been discussed for many years. Unfortunately, no single hypothesis is sufficient to cover all takeovers and it is because the motives for takeovers are very complicated that it is useful to develop some framework to explain this activity. Of the numerous explanations available, the following are the most common in the literature, which has prompted the development of some hypotheses to explain takeover activities. Of these, eight broad reasons for takeover have emerged (Piesse, Few Lee, Lin and Chang Kuo, 2013, p 542):

- Efficiency Theory
- Agency Theory
- Free Cash Flow Hypothesis
- Market Power Hypothesis
- Diversification Hypothesis
- Information Hypothesis
- Bankruptcy Avoidance hypothesis
- Accounting and Tax Effects

4. The Governance role of hostile takeover:

In his seminal article, Manne (1965) emphasizes the role of the takeover market as an external control mechanism over incumbent managers, when he said: "the market price of shares does more than measure the price at which the normal compensation of executives can be "sold" to new individuals. Share price, or that part reflecting managerial efficiency, also measures the potential capital gain inherent in the corporate stock. The lower the stock price, relative to what it could be with more efficient management, the more attractive the take-over becomes to those who believe that they can manage the company more efficiently" (Manne, 1965, p 113).

In the same vein, Jensen & Ruback propose a precise definition of the takeover market. It is as "an arena in which alternative management teams compete for the rights to manage corporate resources" (Jensen and Ruback, 1983, p 42). According to this line, Rappaport argue that takeover represents the most effective check on management autonomy ever devised (Rappaport, 1990). By posing a constant threat of displacement or facilitating t e transfer of corporate assets to alternative management teams, takeovers deter managers from promoting their own interests at the expense of shareholders.

Similarly, Denis et al (2003) explains the takeover as an external mechanism of CG, based on when internal control mechanisms fail to a large enough degree – i.e. when the gap between the actual value of a firm and its potential value is sufficiently negative - there is incentive for outside parties to seek control of the firm. The market for corporate control in the US has been very active, as have researchers interested in this market. Changes in the control of firms virtually always occur at a premium, thereby creating value for the target firm's shareholders. Furthermore, the mere threat of a change in control can provide management with incentives to keep firm value high, so that the value gap is not large enough to warrant an attack from the outside (

Denis & McConnell, 2003, p 4). This is also explained by O'Sullivan and Wong (1998) where "the greater is management's departure from value - maximisation, the larger the potential gain for any acquirer and consequently the more vulnerable the incumbent management team is to takeover bid" (O'Sullivan and Wong, 1998, p 19).

In the same vein, Hitt et al (2016) argue that the market for corporate control is an external governance mechanism that is active when a firm's internal governance mechanisms fail. They also see that the market for corporate control is composed of individuals and firms that buy ownership positions in or purchase all of potentially undervalued corporations typically for the purpose of forming new divisions in established companies or merging two previously separate firms. Because the top-level managers are assumed to be responsible for the undervalued firm's poor performance, they are usually replaced (Hitt, Ireland and Hoskisson, 2016, p 325).

5. The effects of hostile takeover activities:

In term of the implications of hostile takeover activities as an external mechanism for corporate governance, it is important to note that they have advantages and disadvantages, which can be analyzed as follows:

5.1. Advantages of hostile takeover:

Hart (1995) explains that hostile takeover is a powerful mechanism in disciplining the management due to the large rewards available to those parties who are able to identify underperforming companies (Hart, 1995, p 684). In addition to the rewards, takeover is also motivated by several other factors comprising recovery of agency costs, market power, economies of scale and scope, underpriced resources and potential costs of takeovers (Gibbs, 1993, p 55).

In the context of the above, Fan and Goyal (2006) state that corporate takeovers are a way of creating wealth for target companies as well as for acquiring companies (Fan and Goyal, 2006, p 877). According to this line, several studies find evidence of the relationship between takeover activities and shareholder returns. The results indicate a positive effect of takeover for the acquired firms' shareholders as well as for the acquiring companies' managers. This should however not come as a surprise , as the takeover market work as any other market, that is, if the demand for a company increases, the price for that company increases as well.

In contrast, the results show a negative effect of takeover on the acquiring companies' shareholders, this is due to motives of the takeover activity which is to maximise management utility instead of maximising shareholder wealth.

5.2. The disadvantages of hostile takeover

A number of criticisms of the role of the hostile take-over in the corporate governance process have been identified in the literature, which can be summarized as follows:

- The threat of take-over may encourage managers to focus on short-term gains to the detriment of long-term investments decisions (Short, Keasey, Hull and Wright, 1998, p 157);
- The take-over mechanism may be used by managers of the bidding firm to further their own objectives, and may represent the strategic objectives of the bidder rather than managerial failure on the part of the target. Furthermore, the well-documented positive relationship between firm size and directors' remuneration fuels the accusation that directors may perceive take-overs as a relatively easy method of increasing firm size and hence their own remuneration, regardless of the economic merits of such actions (Denis & McConnell, 2003, p 4);
- The take-over mechanism may allow new shareholders to renege on implicit claims between the firm and other stakeholders and appropriate rents from other stakeholders (Short, Keasey, Hull and Wright, 1998, p 158).
- Target company's management team can initialize various poison pills such as; publicly condemn the offer or divest vital assets that are deemed to be of importance to the acquirer. The purpose of these measures is to make the target company less attractive to the acquiring party.

In addition, once the takeover bid is launched there is no guarantee it will be successful. Takeover bids fail for a variety of reasons including (Keasey, Thompson and Wright, 2005, p 156):

- Successful defense by target management. We point out that from a governance perspective, the decision of target companies to resist certain takeovers is especially interesting as it provides an opportunity to try to understand whether such resistance is motivated by a desire to maximise shareholder wealth or to protect incumbent managers from market discipline.

- Intervention by the regulatory authorities;
- Voluntary withdrawal on the bidder's part or rejection of the bid by target shareholders.

6. Conclusion :

In light of the above, it is still hard to say whether hostile takeover activities are beneficial as an external mechanism of corporate governance, and the only thing that is certain is that their advantages and disadvantages are highly dependent on from whose angle one is viewing from. Despite the respectable rationale hostile Takeovers of seeking to correct for inadequate company performance and occur primarily to reconcile the interests of shareholders and managers by improving the performance of target companies. On the other hand, managers interested in maximizing the size of their business empires can waste corporate resources by overpaying for takeover activities rather than returning cash to the shareholders. In addition, the target company's management team can initialize various poison pills such as; publicly condemn the offer or divest vital assets that are deemed to be of importance to the acquirer. The purpose of these measures is to make the target company less attractive to the acquiring party.

7. References :

- **Books :**

- Alice Klettner (2017), Corporate Governance Regulation: the Changing Roles and Responsibilities of Boards of Directors, first publication, Routledge Taylor & Francis Group, Abingdon-United Kingdom.
- Christine A. Mallin (2013), Corporate Governance, fourth edition, Printed by Ashford Colour Press Ltd, Gosport, Hampshire, Oxford University Press, United Kingdom.
- Enrico colcera (2007): the market for corporate control in Japan, Springer Berlin Heidelberg, New York- USA.
- Michael A. Hitt, R. Duane Ireland, Robert E. Hoskisson (2016), Strategic Management: Competitiveness & Globalization, Concepts and Cases, 12th edition, Cengage Learning®, Canada.
- Kevin Keasey, Steve Thompson, Michael Wright (2005), Corporate Governance - Accountability, Enterprise and

International Comparisons, John Wiley & sons Ltd, Chichester - England.

- Priyanka Kaushik Sharma (2015), Corporate Governance Practices in India- A Synthesis of Theories, Practices, and Cases, first edition, Palgrave Macmillan, Basingstoke-United Kingdom.
- Sanjay Anand (2008), Essentials of Corporate Governance, Published by John Wiley & Sons Inc, Hoboken, New Jersey-USA
- Stephen A. Ross, Randolph W. Westerfield, Jeffrey F. Jaffe (2002), Corporate Finance, Sixth Edition, The McGraw-Hill companies, Inc. New York - USA.

- **Journal article :**

- Denis K. Denis, John J. McConnell (2003), International Corporate Governance, The Journal of Financial and Quantitative Analysis, Vol 38, N° 1, pp 1-36, Published by Cambridge University Press on behalf of the University of Washington school of Business Administration.
- Henry G. Manne (1965), Mergers and the Market for Corporate Control, the Journal of Political Economy, Vol 73, N° 2, pp 110-120, Published by The University of Chicago Press.
- H. Short, K. Keasey, A. Hull and M. Wright (1998), Corporate Governance, Accountability and Enterprise, Corporate Governance an International Review, Vol 6, N° 3, pp 151-165, Blackwell Publishers, United Kingdom.
- Joseph P.H. Fan, Vidhan K. Goyal (2006), On the Patterns and Wealth Effects of Vertical Mergers, The Journal of Business, Vol 79, N° 2, pp 877-902, Published by The University of Chicago Press.
- Michael C. Jensen, Richard S. Ruback (1983), The market for corporate control, Journal of financial Economics 11, pp 5-50, North -Holland Publishing Company.
- Noel O’sllivan, Pauline Wong (1998), Internal versus External control: an analysis of board composition and ownership in UK takeovers, Journal of management and governance 2, pp 17-35, Kluwer Academic Publishers, Netherlands.

- Oliver Hart (1995), Corporate Governance: Some Theory and Implications, The Economic Journal, Vol 105, N° 430, May 1995, pp 678-689, Published by Wiley on behalf of the Royal Economic Society.
- Philip A.GIBBS (2003), Determinants of corporate restructuring: the relative importance of corporate governance, takeover threat, and free cash flow, Strategic Management Journal, Vol 14, Special Issue, pp 51-68, Published by Wiley.

• **Internet websites:**

- Alfred Rappaport (1990), The Staying Power of the Public Corporation, detailed website: https://hbr.org/1990/01/the-staying-power-of-the-public-corporation (consulted on: 02/09/2019).
- Jenifer Piesse, Cheng Few Lee, Lin Lin, Hsien Chang Kuo (2013), Merger and Acquisition : definitions, Motives, and Market Responses, detailed website: https://www.researchgate.net/publication/290095164_Merger_and_Acquisition_Definitions_Motives_and_Market_Responses (consulted on: 15/09/2019).
- OECD (2015), G20/OECD Principles of corporate governance, OECD Report to G20 Finance Ministers and Central Bank Governors, P 9, detailed site: https://www.oecd.org/daf/ca/Corporate-Governance-Principles-ENG.pdf (consulted on: 12/09/2019).