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Legal Investor Protection and Takeovers

by

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Executive Summary

As prominently argued by Manne (1965), takeovers are a means to redeploy corporate assets more efficiently and to discipline incumbent management, thereby mitigating agency problems in large public corporations. Subsequent research shows that there are various impediments to an effectively operating market for corporate control, such as e.g., the free-rider problem. Financing constraints on part of the bidder are another potentially significant barrier which the existing theoretical takeover literature has – rather surprisingly – not yet taken into account.

In the paper, we analyse takeover outcomes when bidders are financially constrained and therefore have to raise funds from investors to finance their bids. To this end, we incorporate both financing constraints and legal investor protection into a standard takeover model à la Grossman and Hart (1980). In our model, legal investor protection limits the ease with which the bidder, once in control, can divert corporate resources as private benefits or gains. This has two main implications. First, it reduces the bidder's profit from the takeover, thus making it less likely that a value-improving takeover occurs. Second, better investor protection raises the post-takeover share value, thus increasing the bidder's pledgeable income and, by implication, her funding capacity. The increased funding capacity does, however, not relax the bidder's budget constraint when target shareholders free-ride, i.e., only tender when the bid price at least matches the post-takeover share value. As the bid price increases one-for-one with the post-takeover share value, the bidder's need for funds increases one-for-one with the pledgeable income, thereby offsetting any positive effect of better legal investor protection on her budget constraint.

Turning this result on its head, if the bid price were not to adjust in lockstep with the bidder's pledgeable income, then the positive effect of legal investor protection on the bidder's funding capacity might affect the takeover outcome. In the paper we focus on one factor that breaks the one-for-one relationship between the bid price and pledgeable income, namely bidding competition, where bidders are forced to offer a higher price than the post-takeover share value. Given that private benefits are not pledgeable, offers exceeding the post-takeover share value must be partly funded out of the bidders' own funds. Consequently, the takeover outcome does not only depend on bidders' willingness to pay - i.e., their valuations of the target - but also on their ability to pay. In particular, if the less efficient bidder - i.e., the one who creates less value - is wealthier, the takeover outcome may be inefficient. In this case, stronger legal investor protection may improve efficiency: By boosting bidders' ability to raise outside funds against the value which they create, stronger legal investor protection makes it less likely that more efficient but less wealthy bidders are outbid by less efficient but wealthier rivals.

We explore several implications of this argument, notably the optimality of the “one share – one vote” rule. The leading argument in support of this rule is that it minimizes the risk that more efficient bidders with low private benefits are outbid by less efficient rivals with high private benefits (Grossman and Hart, 1988; Harris and Raviv, 1988). Our analysis provides another and novel argument in support of the “one share – one vote” rule: Such a rule is optimal, because it minimizes the likelihood that more efficient but less wealthy bidders are outbid by less efficient but wealthier rivals. Furthermore, deviations from "one share--one vote" are more detrimental to efficient takeover outcomes when legal investor protection is weak.

References

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