

Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities

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Abstract – “In recent years, the tender offer takeover has been praised and damned with a ferocity suggesting that the survival of capitalism is at stake. The truth, as in most disputes with substantial metaphysical content, is more prosaic.” F. M. Scherer, *Journal of Economic Perspectives*, winter 1988, pg, 69.

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INTRODUCTION

Merger, Acquisitions and Takeovers are the powerful ways to achieve corporate growth, but because of their complex nature, to protect the interest of all the parties, curb the malpractices and to facilitate orderly development these activities are regulated by a takeover code in most part of the world. Business combination, corporate restructuring and corporate reorganizations are terms which are used to cover mergers, acquisitions, amalgamations and takeovers.

As the paper is concern with hostile takeovers it is important to discuss first the concept of takeovers. Takeover refers to the process when one company acquires control over another company, usually a smaller company than the first company. A takeover may be defined as series of transactions whereby a person (individual or group of individual or company) acquires control over the assets of a company, either directly by becoming the owner of those assets or indirectly by obtaining control over the management of the company, which is generally achieved through acquisition of its securities. If the shares of the target company are closely held i.e. held by a small number of persons or groups, a takeover is generally effected by agreement with the holders of the majority of the equity share capital.

But where the shares are widely held and shareholding of the general public is substantial, the agreement between the acquirer and the controllers of the acquired company is not always necessary. In such cases, takeover may be achieved either by:

A Purchase of shares on the Stock Exchange; By means of a —takeover bid.

Hostile takeovers: Why do they occur?

Hostile takeovers, those opposed by the target's board of directors, became an —accepted part of the corporate control market in 1974 with Morgan Stanley and Company's representation of International Nickel Company of Canada in its hostile takeover of ESB Inc. In a hostile takeover, a bid is made directly to the shareholder of the target rather than the target's management. The acquirer obtains the needed votes, gains control, and replaces existing management. But what factors need be present in the target and the bidder firm for hostile takeovers to occur?

Conflicts of interest between the target firm's management and shareholders lie at the root of the hostile takeover phenomenon. These conflicts result from the separation of ownership (shareholders) form control (management). Conflicts arise from management's desire to use the firm's resources to achieve outcomes that do not coincide with shareholder's interest, which is maximizing the net present value of the firm's future profits.[2] When agency costs become high and internal controls, particularly the board of directors, have failed to protect the interests of shareholders from inefficient performance and non-value—maximizing behavior of management, the firm is likely to become the target of the hostile takeover bid.

Several factors can influence the level of agency costs. Often factors such as deregulation and increased competition create a need for valuation and restructuring of corporate assets in an effort to continue to maximize shareholder value. But sometimes current management fails to undertake the necessary steps to do so. New management without prior ties to employees or the community

may be more objective and better able to adapt the firm's productive assets to its changing environment. Hostile takeovers are one way of effecting the necessary changes. It is often argued that firms with managements and concentrate on long-term investments (e.g. research and development) at the expense of short-term earnings are susceptible to takeover targets. The premise to this explanation of hostile takeovers is that markets are short-sighted and poor current profits lead to stock under valuations which create favourable takeover conditions. Agency costs arise here as the market puts more emphasis on current cash flows and management places greater weight on future cash flows. However, evidence does not support this—myopic market hypothesis. Significant amounts of free cash flow also contribute to agency costs. Free cash flow is that cash flow in excess of the amount required funding all projects that have a positive net present value when discounted at the relevant cost of capital. With high levels of free cash flow, managers may seek to secure their own position by making inefficient low-return investments rather than paying out the free cash flow to shareholders in the form of dividends. Yet it may be difficult to distinguish this behavior from prudent investing that turn out to be less profitable than expected.

Agency costs may also explain why some companies choose to initiate hostile takeovers. Companies with significant free cash flow and unused borrowing power may engage in unwarranted acquisition activity—pay significant premiums for targets to fulfill objectives other than value maximization. Acquisitions aimed at diversification, geographic expansion, or increased firm size may be pursued in order to further management's goals of self – entrenchment of —empire-buildingll rather than enrich shareholders. Thus, unwarranted acquisition activity not only explains why firms may become targets, but is also one explanation of bidder behavior oftakeovers. This may also explain instances of negative returns to shareholders of acquiring firm's management benefits at the expense of shareholders.[3]

HOSTILE TAKEOVER TACTICS:

An initial step that is often pursued before using the various tactics of hostile takeover is accumulation of target's shares; this is called establishing a toe hold. One advantage of this is that if market is unaware of bidder's action, the bidder may avoid payment of premium. It also provides bidder with same rights as that of other shareholders, thus establishing a fiduciary duty which the board now have to the bidder. Toe holds result in lower tender offer premiums, and also increases probability of tender offer's success. Options for the hostile bidder are fewer as compared to that of targets. Bidders are typically left with three main tactics viz. bear hug, tender offer and proxy fight.

1. **Bear hug:** This is done by contacting board of director of target with an expression of interest in target and showing intention of going directly to shareholders if these overtures are not favorably received. This puts pressure on board because it must be considered as it is overly generous lest board may be violating its fiduciary duties. When bear hug becomes public arbitragers start accumulating targets stock, taking the firm in play. Bear hug is less expensive and less time consuming but if the target strongly opposes the acquisition it may be unsuccessful, leaving the bidder to pursue expensive tactics as tender offer.

2. **Tender offers:** Publicly announced intention of buying a firm followed by rapid accumulation of target's stocks at a premium is considered as tender offer. Tender offers are more expensive takeover tactics due to legal filing fees and publication costs associated with it. A tender offer puts the company in play with means that will eventually be taken over, not necessarily by the firm that initiated the process. The targets that were not acquired by the bidder either went to white knights or remained independent. White knights accounted for most of the instances when target fought off initial bidder.

The bidder may go with an all cash tender offer or may use securities as part or all of the consideration used for tender offer. Securities may be more attractive to some stockholders as in some cases it may be considered tax free. Sometimes the target shareholders are given an option to receive cash or securities in exchange of their shares. This makes the offer more flexible.

3. **Proxy fight:** Proxy fight is an attempt by a single shareholder or group of shareholders to take control or bring about changes in a company through use of proxy mechanism of corporate voting. In a proxy fight the insurgent may use his votes and garner support from other shareholders to oust the incumbent board or management.

DEFENSES AGAINST HOSTILE TAKEOVERS:

Takeover defenses include all actions by managers to resist having their firms acquired. Attempts by target managers to defeat outstanding takeover proposals are overt forms of takeover defenses. Resistance also includes actions that occur before

a takeover offer is made which make the firm more difficult to acquire.[4]

The intensity of the defenses can range from mild to severe. Mild resistance forces bidders to restructure their offers, but does not prevent an acquisition or raise the takeover price substantially. Severe resistance can block takeover bids, thereby giving the incumbent managers of the target firm veto power over acquisition proposals.

A natural place to begin the analysis of takeover defenses is with the wealth effects of takeovers. There is broad agreement that being a takeover target substantially increases the wealth of shareholders. At first glance, the large gains for target stockholders in takeovers seems to imply that all takeover resistance is bad.

Resistance makes the firm more difficult to acquire. If the defense works, it lowers the probability of a takeover and stockholders are thus less likely to receive takeover premiums.

Even for an economist, it is hard to argue that shareholders benefit by reducing their chance to sell shares at a premium. But the issue is not that simple. Takeover resistance can benefit shareholders. Stockholders are concerned about the market value of the firm. The market value of any firm is the sum of two components: the value of the firm conditional on retaining the same management team; and the expected change in value of the firm from a corporate control change, which equals the probability of a takeover times the change in value from a takeover.[5]

Market value of firm= Value of firms with current managers + probability of a control change x change in value of a control change

Stockholders are concerned about how takeover defenses affect all three components of value: the value of the firm under current managers, the probability of an acquisition, and the offer price if a takeover bid occurs.

PRE-BID DEFENSES:

According to Clarke and Brennan (1990) the best pre-bid defense is a management that maximizes shareholder value. By maximizing the shareholder value the shareholders are satisfied and therefore the incentive for any change in control of the company is reduced. In addition to a strong corporate strategy to keep the shareholders pleased, a company can as a pre-bid defense tactic concentrate on the share structure to reduce the attractiveness of the company.

1. Blowfish

A defense tactic referred to the name Blowfish can be used from a company facing a hostile bid. It involves strategies of buying new assets with an underlying purpose of forcing the company to grow; this leads to that the value of the company increases at the same time as the liquid assets decreases. The reason behind this defense tactic is that the higher value will intimidate the acquiring companies with limited financial resources to place a bid. The reduced financial resources of the target company acts as a secondary effect, reducing the acquiring companies' incentives even more for a takeover. (Arnold, 2005).

2. Poison pill

The usage of Poison pills can be seen as a tactic best suited for an implementation before a hostile bid is placed on the company. The Poison pills represent a creation of securities carrying specific rights and are executed by a triggering event, such as a hostile takeover. The securities are often owned by the board or the management in a target company and allow them to fight back and ward off a hostile attempt. One example of Poison pills is convertible securities in combination with options or warrants. To prevent being turned down by a friendly bidder, the Poison pills can be terminated by the holders and in that way make the company attractive to a friendly takeover. (Weston et al, 2004) The most frequently used Poison pill is the implementation of *call-plans* in the target company. A call-plan is associated with an option to buy shares in the targeted company, often to a large discount, and is often designed so the holder will execute the option when a hostile takeover bid is placed. This results in that the hostile bidder is, after the execution of the call options, diluted and the control of the target company can remain among the board and the management. The above explanation is known as a *flip-in poison plan*, when call options are placed in the target company. A flip-over poison plan is when call options are placed in the acquiring company by the target company. The basic idea is to defend the target by acquiring a large block of shares in the hostile bidder through the call options. The options are exercised after the takeover is completed which result in a large ownership by the target company in the new established company.

This will make the target company less attractive for a hostile takeover and can eliminate potential hostile bids. (Weston et al, 2004) A *put-plan* is also a designed to eliminate potential hostile bids.

Shark repellent

The Shark repellent strategy is synonymous for pre-defense tactics made by the company in order to be less attractive to a future hostile takeover. The Shark repellents are build-in defense mechanisms that make the company more difficult

to take over. Golden parachutes, dual-class stock and a staggered board are some of the tactics known as Shark repellents. The golden parachute is provision to the management if they are forced to leave the company or if the company is acquired. The provision will give the management team a large bonus in cash or stocks and will be very expensive for the hostile takeover, which result in a costly acquisition. (DePamphilis, 2005) The staggered board will prevent a hostile takeover by preventing the entire board from being replaced at the same time. For example some of the members of the board can be elected every two years and/or some every fourth year. An acquirer does not want to wait four years to replace the board and a hostile takeover can be avoided. (DePamphilis, 2005).

Post bid Defenses

As described in above section, post-bid defenses are measures executed after a hostile bid is placed. The defense tactics can be described as specific financial responses to the terms of the bid, lobbying and public relations activities, appeals to regulatory and political bodies and searching for potential friendly bidders. (Schoenberg & Thornton, 2006)

Corporate Restructuring and Reorganization

A corporate restructuring might be necessary and may involve taking a company private, dispose of attractive assets, implement an acquisition or as a final action liquidate the company. Taking the company private involves buying back the majority of the company's shares, and this process is seen as a win-win situation for both shareholders who receive a premium and the management regains control of the company. To keep in mind here is that the premium paid needs to represent a substantial to current market price, in order to avoid unnecessary lawsuits. Another way of making the company less attractive is to divest the most attractive assets (Crown jewel defense), and the cash proceeds can be used to finance other defenses such as special stockholder divide.

A so-called defensive acquisition is another defense that might be undertaken with the intent to lower excess cash balances and to weaken current borrowing ability. The last and final restructuring possibilities are company liquidation and pay off the creditors and pay a so-called liquidation premium to shareholders. However this action only makes sense if the liquidation premium is larger than the premium offered by a bidder. (DePamphilis, 2005)

Crown jewel defense

When an acquirer decides to attempt a hostile takeover the company has analyzed the target and sees value in the target's assets or the operations. To fight back in a hostile takeover the target can then sell some of the most valuable assets, called crown

jewels; to a third party to reduce the value of the company to force the hostile bidder to draw back the bid. The target can also sell the crown jewels to a White knight with a restriction to buy back the assets after the hostile bidder has drawn back the bid for a pre-agreed price, a so called sale and lease-back agreement is also. This strategy can however create some difficulties for the target company. If the assets are sold the company will end up with large amounts of cash and can become more attractive for a hostile takeover by other company. (Fällman, 1990)

Scorched earth

A strategy associated with the Crown jewel defense tactic is the Scorched earth strategy. Similar to the Crown jewel strategy, the primary objective is to make the target less attractive when a hostile takeover is in motion. The target sells all the valuable assets in an attempt to fight back a hostile bidder, but the strategy is not the best way of preventing a hostile takeover. If important and valuable assets are sold, shareholder value will decrease and if succeeded leave the shareholder with an almost worthless share in the target company. (Gilson & Bernard, 1995)

Share repurchase

Share repurchases has for a long time been used as a defense for takeovers. A high share value intimidates hostile bidders, and a reduction in the quantity of issued shares on the stock market can affect the stock value to increase (Gaughan, 1996). The takeover threat is today not isolated only to the local market; the raider can appear from any place on the global market place. There are two ways for the target company to go about with share repurchasing. First they can offer the shareholders to buy back shares with an underlying goal to regain control of the company. Secondly, they can buy outstanding shares on the stock market. Share repurchase is not entirely used as a takeover defense. If the value of out-standing shares is low (in bear market), the corporate treasury usually buys back shares with the intention to rise the value. Also the other way around, if the demand is high (bull market), the quotations is high and the company's response is to issue more shares (Weston et al, 2004). Share repurchase is often a sign that the company's management is optimistic about the future and believes that the current share price is undervalued. Reasons for conducting buy backs is raising earnings per share, increasing internal control of the company and obtaining stock for employee. (DePamphilis, 2005)

Management buyout

A Management buyout (MBO) is an action where the operating management increases their owner position in the company, often with the help of

external investors and finances the purchase through leverage buyouts (Frankel, 2005).

MBOs can be referred to as a two edged sword. On one side it can be an effective defense tactic against hostile bidders, but on the other side it can trigger a reaction and attract new competitive bids. The reason behind conducting a MBO is often the result of incumbent management, and the effect will often result in a large debt for the company. So the next goal is to get the company back on track so the debts can be amortized according to plans (Weston et al, 2004). Along with the White knight, MBO's in UK are the substantive and effective takeover defense (Schoenberg & Thornton, 2006).

Pac-man defense

The Pac-man defense tactic is seen as an aggressive defensive tactic and the name comes from the famous videogame with the same name. Using this strategy, the target company fights fire with fire and starts buying shares in the company that has placed the hostile takeover bid. The strategy is in most cases a hard and complicated way to go and is best suited for targets that are larger than the hostile bidder. The Pac-man tactic is extremely costly and can be devastating for both companies involved in the battle. To afford to buy the shares, both companies may make use of debt and the succeeding company will be tainted with a huge debt stake from both companies. One incentive to use this strategy is that the target company finds the idea of a combined organization attractive but wants to control the final outcome, and therefore tries to buy the hostile bidder. (DePamphilis, 2005)

Positive public information

The board announces positive public information with the intent to increase the stock price which will lead to a takeover that will be more costly. Through alternations in the balance sheet, where undervalued assets are revalued to market value, will create an reaction where the market value of the company will increase and therefore more costly to acquire (Cooke, 1988). A secondary effect with the increased stock price is that it will create incentives for shareholders to remain as owners (Weston et al, 2004).[6]

REFERENCE

1. In a public company or a private company, which is a subsidiary of a public company, this is achieved through acquiring effective control over equity shares as preference shares generally do not carry voting rights in such companies. See section 87 of the Companies Act, 1956, which reads as follows:

Voting rights

- 1.1 Subject to the provisions of section 89 and sub-section (2) of section 92-
- 1.a every member of a company limited by shares and holding any equity share capital therein shall have a right to vote, in respect of such capital, on every resolution placed before the company; and
- 1.b his voting right on a poll shall be in proportion to his share of the paid-up equity capital of the company.
- 1.2 (a) Subject as aforesaid and save as provided in clause (b) of this sub-section, every member of a company limited by shares and holding any preference share capital therein shall, in respect of such capital, have a right to vote only on resolutions placed before the company which directly affect the rights attached to his preference shares.

Explanation.- Any resolution for winding up the company or for the repayment or reduction of its share capital shall be deemed directly to affect the rights attached to preference shares within the meaning of this clause.

2. Diana L. Fortier Hostile Takeovers and the Market for Corporate control
3. ibid
4. Richard S. Raback An overview of Takeover Defenses p/49
5. ibid
6. Markus Johansson, Martin Torstensson, **Hostile Takeovers** The Power of the Prey P/17

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Research Paper

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