Two corporate governance mechanisms: activism and hostile takeovers

Hostile takeovers have long been considered the quintessential disciplinary governance mechanism. A similarly confrontational strategy has lately come to prominence by way of **activist hedge funds** that buy into poorly run firms and use the threat of hostile tactics to pressure management into accepting specific proposals to improve shareholder value.

Our paper compares these two governance mechanisms within a unified framework where any outside investor — bidder or activist — faces a dual free-rider problem since target shareholders neither contribute to the cost of intervention nor sell their shares unless the price fully reflects the anticipated value improvement.

As bidders acquire control, dispersed shareholders free-ride by selling their shares only if the **takeover premium** incorporates the expected post-takeover gains. Acquiring those shares increases bidders' incentives to improve share value afterwards, but paying the premium prevents them from recouping the costs of doing so. These unrecompensed costs are their costs of gaining control.

Activism does not build on majority control. On the contrary, the point of the campaign is to compensate for the lack of it. The activist hence optimally limits her share purchase, balancing the benefit of gaining influence from additional voting rights against the cost of unrecompensed effort. The downside is that the endogenous limit on her equity stake caps her effort incentives, and when the value she creates under these incentives is too small, activism does not materialise.

Our key insight is that the profits from the two strategies exhibit opposite comparative statics with respect to the potential value improvement. In particular, a larger scope for value improvement in the target firm raises the takeover premium more than net surplus, but at the same time, makes an activist campaign more rewarding relative to its costs. Thus, activism turns more profitable as takeovers become too "expensive." This entails distinct return patterns. Tender offers with larger surpluses yield smaller bidder returns, while more valuable campaigns also are more profitable.

In the second part of the paper, we analyse how activism and tender offers interact with the board's prerogative to negotiate mergers that are binding for all shareholders. Ideally, boards overcome free-riding, but coordination problems among shareholders reappear when boards resist control changes out of self-interest. Yet, the prerogative remains relevant insofar as outside investors can seize control of boards.

Bidders can acquire just enough shares to gain control and absorb the remaining shares afterwards through a so-called freeze-out merger (when all remaining minority shareholders are forced to sell their shares). Activists can wage campaigns that aim at brokering mergers with bidders, which has been referred to as takeover activism. Since the power to force ownership changes can be abused, there is legal recourse: mergers are contestable in court and can be amended, if deemed to be in breach of fiduciary duty or unfair to dissenting shareholders.

As we show, the legal risk of a subsequent price revision amounts to stochastic free-riding and has opposite effects on the two governance mechanisms. In tender offers, the option to freeze out minority shareholders harms bidders ex ante. To minimise unrecompensed costs, a bidder buys just enough shares to reach majority. Absent freeze-outs, the price paid equals the value she generates owning half the shares. The freeze-out option introduces the commitment problem that, at this price, the bidder will exercise a freeze-out. Anticipating this, and in view of the possible benefits of a legal challenge to the freeze-out, shareholders then hold out in the initial offer. In equilibrium, the bidder still buys as few shares as needed, but at a premium at which a subsequent freeze-out is unattractive. This premium decreases with legal risk, as the temptation of a freeze-out (i.e., commitment problem) weakens.

In takeover activism, where the merger allows no ex ante free-riding, the legal risk merely reinforces ex post free-riding, and this effect is aggravated by higher legal risk. In addition, takeover activists limit ex ante free-riding during the campaign stage, but by using the merger prerogative, do not let their own stakes constrain incentives to create value—that is, they also limit ex post free-riding, if not during, at least after the campaign. Thus, if possible, activists are better off acting as control brokers, rather than using control to implement value improvements on their own.

In the final part of the paper, we no longer examine takeovers and activism in isolation but consider (parameter) constellations in which both are simultaneously feasible. The co-existence as feasible alternatives affects tender offers and activism asymmetrically. Optimal tender offers are pinned down by the majority requirement and the ex ante free-rider condition, whereas the bidder's outside option is irrelevant for the offer terms.

By contrast, the potential of a tender offer erodes activists' already limited incentives and so reduces campaign profitability. In the case of a single "active" outside investor who can make a bid if regular activism fails, this reduction in campaign incentives is efficient, since the takeover is socially preferable. This is not true in the presence of a separate bidder. In this case, the activist can free-ride on a bid, so activism only emerges if its profitability exceeds the expected forgone takeover premium (rather than bidder profit). We show that regular activism cannot clear this hurdle, making takeover activism the only relevant alternative. Furthermore, revealed-preference arguments imply that takeover activism is Pareto-improving. Hence, in the case of activist-bidder pairs, the dis-incentivising effect of a potential tender offer on activism is welfare-decreasing.

Our theoretical analysis has implications for returns across different types of activism and the co-evolution of activism and M&A. First, takeover activism should exhibit higher returns than other forms of activism. Second, takeover activism generates efficiency gains at the extensive and intensive margin: it enables takeovers that otherwise would not occur and replaces some tender offers with more efficient mergers. Hence, institutional changes that facilitate activism should not cause a decrease in M&A. Rather, it should lead to a concurrent (1) increase in campaigns, (2) increase in total M&A activity, and (3) decline in hostile bids. This broadly matches patterns observed since the 1990s.

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Notes:

- *This blog post appeared originally on the site of the Harvard Law School Forum on Corporate Governance and Financial Regulation, and has been slightly edited here. It is based on the authors' paper Activism and Takeovers, CEPR Discussion Paper No. DP12616.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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