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CONTROLLING THE CONFLICT OF INTEREST IN MANAGEMENT BUYOUTS

John C. Easterwood, Ronald F. Singer, Anju Seth, and Darla F. Lang*

Abstract—A controversial aspect of the management buyouts that were popular throughout the 1980s is the potential for a conflict of interest to arise when a manager bids to acquire the firm he manages. This study examines 184 management buyouts and reports three findings. First, returns to pre-buyout shareholders are greater when managers must bid against outside acquirers. Second, bid revisions in the face of competition exceed revisions due to shareholder litigation and negotiations with boards. Third, the incidence of competition is negatively related to the pre-buyout share holdings of managers.

THE decade of the 1980s witnessed a dramatic increase in the number of firms converting from public stock ownership to private ownership. These transactions received much attention, in part because management's participation in the offers raises the question of a conflict of interest. Management's fiduciary duty to shareholders requires that management seek the highest possible price from the buyout group. However, management's self interest suggests that managers could seek to minimize their bid. Recent empirical literature in this area concentrates on the sources of gains from buyouts.¹ In contrast, this study focuses on the role of institutional and market factors in controlling managerial conflicts of interest.

This study reports results for 184 firms involved in management buyout attempts initiated between the years 1978 and 1988. The evidence suggests that explicit competition for control of the firm induces large revisions of offer prices. This results in higher cumulative abnormal returns and higher bid revisions for firms that face competition compared to firms that do not face competition. The study also shows that the incidence of competition is a function of the firm's ownership structure. Buyout attempts are more

likely to face explicit competition when managerial holdings are small, while buyout groups that do not face competition typically have large insider holdings. However, the concentration of outsider holdings does not affect the incidence of competition.

The paper is organized as follows. Section I reviews the literature on the motivations for management buyouts (MBOs or buyouts).² Section II examines the bidding process in these transactions. This section highlights the role of alternative mechanisms in controlling management's ability to benefit, at the expense of outside shareholders, in management buyouts. Section II also describes the sample and data employed in this study. Section III analyzes the impact of these alternative mechanisms on pre-buyout stockholder returns, and on bid revisions. Section IV examines the impact of ownership structure on the bidding process. Finally, section V summarizes the results and conclusions.

I. Motivations for MBOs

Research on MBOs documents the large premiums, over pre-buyout market prices, associated with management buyouts.³ The literature examines four potential sources of these profits.

- (i) efficiency gains through improved operations and reductions in agency costs (Denis (1992), Kaplan (1989b), Lehn and Poulsen (1989), Muscarella and Vetsuypens (1990), and Smith (1990)).⁴

² The terms "management buyout" and "buyout" will be used interchangeably in this paper. The sample of firms included in this study were all targets of a group which included incumbent managers and offered to purchase all of the outstanding equity (or equity not already owned by members of that group). All of the offers called for the elimination of publicly traded equity upon completion of the offer. No divisional buyouts are included in this study. The sample includes both firms that were successfully taken private by management and firms which received buyout offers but were acquired by another party.

³ Kaplan (1989b), for example, reports an average premium of 42.3%.

⁴ See, however, Long and Ravenscraft (1989) for a critical analysis of these and other LBO performance studies.

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¹ For a review of the literature on the motivations for buyouts, see Amihud (1989) and the more recent studies referenced in section I of this paper.

- (ii) savings from reduced corporate income tax liabilities (Kaplan (1989a) and Lehn and Poulsen).
- (iii) wealth transfers from pre-buyout bondholders (Asquith and Wizman (1990), Cook, Easterwood and Martin (1992), Marais, Shipper and Smith (1989), and Warga and Welch (1991)).
- (iv) wealth transfers from employees (Shleifer and Summers (1988), Kaplan (1989b), Lichtenberg and Siegel (1990), Muscarella and Vetsuypens).

In a competitive market for control, all of the gains from a buyout will be captured by the target's pre-buyout shareholders. However, with informational asymmetry, managers might be able to exploit their informational advantage to the detriment of the pre-buyout stockholders. Furthermore, managers, by virtue of their position and influence in the firm, might be able to forestall competitive bidding thereby distorting the division of gains in their favor. The actual distribution of gains from buyouts is an unsettled issue. Kaplan (1989b) argues that competition for control leads to pre-buyout target shareholders capturing most of the gains from a buyout. On the other hand, Lowenstein (1985) concludes that managers exploit their position or informational advantage.⁵ The remainder of this paper addresses that issue.

II. The Bidding Process for Buyouts and Sample Selection

A. The Bidding Process

This study examines three mechanisms that restrict potential wealth transfers from pre-buyout shareholders to the buyout group. The mechanisms are: (1) the role of outside directors as agents of the pre-buyout stockholders, (2) shareholders' access to legal resource, and (3) potential and actual competition for control.⁶

⁵ See, e.g., Hite and Vetsuypens (1989) for an analysis of some of these issues in the context of divisional buyouts.

⁶ The opportunity to block most buyout offers by voting against the proposal (or by not tendering shares) provides public shareholders direct control over management abuse (DeAngelo, DeAngelo and Rice (1984)). This study abstracts from this issue, examining only non-voting controls over MBOs.

(1) Outside Board members: The directors of an MBO target are required to project the interests of existing stockholders. In the face of attempted underbidding, outside directors can take three steps to protect public stockholders' interests. First, the directors can act as bargaining agents for outside shareholders. Second the directors can recommend that shareholders vote against a buyout proposal or refrain from tendering their shares. Third, directors can actively seek rival bidders.⁷ Nevertheless in several cases, the Delaware courts found that several boards failed to act independently in management buyouts. A key factor in the court's opinions is the boards' failure to actively pursue competing offers.⁸

(2) Shareholders' access to legal recourse: Outside shareholders can seek legal protection from inadequate bids. During the period examined in this study shareholders could file litigation on three bases. First, they could attempt to prevent the transaction from occurring on the grounds that it lacks a "proper business purpose." Second, shareholders could seek appraisal remedies in the courts as a device to force buyout participants to pay higher prices.⁹ Third, shareholders could allege that the MBO involves conflicts of interest without arms-length negotiation.

(3) Competition for control: Both actual and potential competing offers could limit the ability of managers to underbid. An important determinant of the success of competition in preventing managerial underbidding is the ownership structure of the firm. Large inside holdings might effectively prevent outsiders from competing against the buyout group's bids.¹⁰ On the other hand, a high degree of concentration of outside ownership may increase the likelihood of potential or actual outside bids. Large outside shareholders might represent potential allies for an outside bidder competing with managers.

⁷ For a detailed discussion of the role and responsibility of the Board of Directors in the current legal environment see Simpson (1988).

⁸ Allen (1990). See Macey (1990) for a critique of these rulings.

⁹ For further discussion of appraisal remedies and SEC Rule 13e-3 that requires a management statement on the fairness of the offer, see Herzel and Colling (1984) and DeAngelo and DeAngelo (1987).

¹⁰ See Morck, Shleifer and Vishny (1988a, b), and Stulz (1988) for discussions of the impact of ownership concentration on competing bids.

B. Sample Selection

This study examines 184 buyout proposals initiated between 1978 and 1988. Buyout targets were initially identified from the *Wall Street Journal Index (WSJ)*, W. T. Grimm's *Mergerstat Review*, *Mergers & Acquisitions*, and Lehn and Poulsen's (1989) list of firms that converted to private ownership between 1980 and 1987. Data requirements dictated the following screens for inclusion in the sample.

- (i) press coverage, proxies, or one of the above sources identified management as participants in the buyout.
- (ii) *The Wall Street Journal* reported an offer price.
- (iii) The CRSP Daily Returns File reports the firm's stock returns.
- (iv) a control transaction was consummated.

The final sample includes 149 successful MBOs and 35 unsuccessful MBOs that lost to an outside bidder.

III. The Impact of Alternative Control Mechanisms

Management's unique role as a bidder could protect them from exposure to the rigors of competitive bidding (Brudney and Chirelstein (1978), Chazen (1981), Brudney (1983), Lowenstein (1985), and Lowenstein (1986)). On the other hand, competition in the market for corporate control could force managers to offer competitive bids (Kaplan (1986b)). This section examines this issue by using stock return data and offer prices. The analysis of stock return data uses an event study methodology to analyze the impact of an MBO on stock returns.¹¹ Cumulative abnormal returns are calculated from 20 days prior to the announcement date of the first clear indication of takeover activity. The accumulation period ends on the date of resolution of the offer price uncertainty.¹² The computation of standardized cumu-

¹¹ For a discussion of the meaning of the cumulative abnormal return and event study methodology, see DeAngelo, DeAngelo and Rice (1984).

¹² In most cases, the accumulation period's ending date was the date of shareholders' approval of the going private proposal, or the announcement date of the results of a successful bid or tender offer. If the *Wall Street Journal* did not provide a satisfactory announcement date, the ending date was the last trading day of the firm's common stock. Board approval was never used as the ending date because in some of the buyouts outside bids or bid revisions occurred after board approval. The market model estimates are calculated over the 400 trading days before the start of the accumulation period.

TABLE 1.—THE PRESENCE AND TYPE OF OTHER TAKEOVER ACTIVITY

Category	No. firms
No other takeover activity	83
Other takeover activity	101
Types of Other Takeover Activity	
(1) Unsuccessful outside offer, targeted share repurchases, or published rumors of an impending bid	11
(2) Announcement of a large stake acquisition, an intention to acquire, or an impending proxy fight	19 ^a
(3) Outside offer preceded buyout offer	25
(4) Outside offer followed buyout offer	46 ^b

^a A large stake acquisition is an acquisition of 5% or more of the firm's outstanding stock in the previous year.

^b Fifteen of these firms were the objects of one of the types of takeover activity included in categories (1) and (2) prior to the management buyout proposal.

lative abnormal returns followed the procedures in Mikkelsen and Partch (1988) to allow for varying lengths of the accumulation periods.¹³

A. The Impact of Takeover Activity on Stockholder Returns

This section studies the association of outsider attempts at control with pre-buyout stockholder abnormal returns. Table 1 characterizes the types and incidence of takeover activity experienced by firms in the sample. The 83 firms that were not the targets of any outside takeover activity are called the *non-takeover* sample. The 101 firms that were the targets of other takeover activity are called the *takeover* sample.

Takeover activity in the takeover sample includes:

- (1) Unsuccessful outside offers, targeted share repurchases from a large stakeholder, and published rumors that the firm was the target of takeover activity prior to the announcement of the management buyout offer.
- (2) An announcement of a large stake acquisition by an outsider prior to the announcement of the buyout proposal, an intention to acquire, or an impending proxy fight.

¹³ All statistical tests of stock returns used standardized CARs.

TABLE 2.—THE IMPACT OF COMPETITION ON AVERAGE CUMULATIVE ABNORMAL RETURNS TO PRE-BUYOUT SHAREHOLDERS

Competitive partition of the sample	<i>N</i>	Mean	Median
Panel A: Non-takeover versus Takeover			
Firms in the non-takeover sample	83	25.9% ^a	25.8% ^b
Firms in the takeover sample	101	38.6 ^a	37.0 ^a
Panel B: Single versus Multiple Bidder			
Firms with one bidder	113	26.1 ^a	24.1 ^b
Firms with multiple bidders	71	43.7 ^a	41.3 ^b
Panel C: Non-takeover versus Implicit Competition			
Firms in the non-takeover sample	83	25.9	25.8
Firms facing implicit competition	30	26.7	19.5
Panel D: Implicit Competition versus Multiple Bidder			
Firms facing implicit competition	30	26.7 ^a	19.5 ^b
Firms with multiple bidders	71	43.7 ^a	41.3 ^b

^a The two means in the panel are significantly different from each other at the 0.01 level.

^b The Wilcoxon two-sample test based on sums of ranks shows that the distributions are different at the 0.01 level.

- (3) Tender offers or outside buyout proposals announced prior to the management buyout proposal.
- (4) Outside offers announced after the management offer.¹⁴

Thus competition can involve explicit competing bids (categories (3) and (4) above) or other takeover activity (as described in categories (1) and (2)).

Table 1 shows that 71 of the 184 buyout proposals (39%) faced explicit competition. Of the remaining 113 firms, 16% (30 firms) experienced other forms of competitive takeover activity but did not receive a formal outside offer. We describe these firms as facing implicit competition. Finally, 45% (83 firms) of the entire sample experienced neither explicit nor implicit competition around the time of the buyout proposal.

Table 2 provides average cumulative abnormal returns for firms stratified by the presence and type of competition accompanying the buyout offers. The mean cumulative abnormal returns for each group in the sample range from 25.9% to 43.7%. All means are significantly different from zero at the 1% level.

Panel A of table 2 compares the 83 non-takeover offers with the 101 takeover offers. The *t*-test rejects the hypothesis that the mean returns to pre-buyout shareholders are equal for

¹⁴ Classification into these categories is based on the last type of takeover activity to occur other than the buyout announcement. The activity had to have taken place within a year of the buyout announcement.

the takeover and non-takeover samples. The Wilcoxon two-sample test rejects the hypothesis of equality of the two the distributions. Panel A shows that stockholders achieve higher abnormal returns from buyouts with explicit competing bids and/or implicit outside competition. Panel B rejects the hypothesis that the means and the distributions of the cumulative abnormal returns for the single bidder (that is the buyout offer alone) versus the multiple bidder (the buyout offer plus at least one outside bidder) samples are equal. Panel C stratifies the sample into the 83 firms facing no outside competition and the 30 firms facing implicit competition. There is no significant difference in mean or median abnormal returns to stockholders in these two groups.

In summary, the table documents an association between competition via explicit outside bids and higher abnormal returns to stockholders. In contrast, implicit outside competition is not associated with higher abnormal returns compared to the returns experienced by stockholders of buyouts involving no competition whatsoever.

This difference between stockholder's abnormal returns in MBOs subject to explicit outside competition versus those subject to implicit outside competition is verified in panel D of the table. The panel compares abnormal returns for the group of buyouts subject to explicit competition with those subject to implicit competition alone. The data shows that the mean and median abnormal return to the former group are significantly greater than the mean and median return to the latter group.

These results imply that the higher returns to the takeover sample can be explained by the 71 multiple bid contests, rather than takeover activity per se.^{15,16} At this point there are two possible explanations for the above empirical regularities. First, competing bids could limit management's ability to pay prices unfavorable to the pre-buyout stockholders. Second, the total gains arising from a buyout might determine the degree of explicit bidding competition. That is, competing bids are more likely to occur when the potential gains from a buyout are high. This induces a positive association between the existence of competing bids and abnormal returns to pre-buyout stockholders.

In short, the direction of causality is not clear. The essential question is does competitive bidding result in higher returns to pre-buyout shareholders because it increases the share of the total gains to the stockholders, or is it simply that high potential gains are associated with explicit competition.¹⁷ The following analysis considers this issue.

B. The Impact of Pre- and Post-MBO Controls on Stockholder Returns

This section examines the role of pre-MBO activity, as well as post-MBO activity to control management buyouts. The issue raised here is important in that it provides information on the effectiveness of outside stockholders' attempts to protect themselves from adverse managerial decisions. The sample of 184 MBOs is divided into

¹⁵ These results are consistent with the those in Lowenstein (1985), despite several important methodological differences and a much larger sample size (184 versus 28). On the other hand, the findings differ from Kaplan (1989b) who used a similar methodology on a smaller sample of firms, over a shorter time frame.

¹⁶ The apparent differences in returns could be the consequence of including 35 management buyout proposals that lost to competing bidders. In order to check this, table 4 was reproduced using only the 149 successful buyout proposals. The results are virtually identical to those in table 4 using the full sample. Furthermore, in November, 1985 the Delaware courts mandated active participation by outside directors in obtaining competitive bids. This may have altered the relative returns received by stockholders of targets after this decision. In order to check this, table 4 was constructed for pre- and post November, 1985 proposals. The incidence of competition increased after the Revlon decision. However, there was no substantial difference in the return comparisons over these two time periods.

¹⁷ The authors are indebted to an anonymous referee for pointing out the dual interpretation.

groups on the basis of the type and timing of takeover activity (pre-MBO hostile bids, post-MBO competing bids, implicit takeover activity), internal controls (post-MBO negotiation and shareholder litigation), and no other activity.

Table 3 presents a three-by-three contingency table that permits the simultaneous evaluation of the association of these factors with returns earned by pre-buyout shareholders. The rows of table 3 describe events preceding the announcement date of the buyout group's offer. These rows partition the firms into three categories of takeover activity. The first row contains the 114 firms that experienced *no takeover activity* prior to the MBO bid. The second row contains the 45 firms that experienced some form of *implicit takeover activity* prior to the MBO. This classification includes failed takeover bids, rumors of pending outside bids, large stake acquisitions or other events described in categories (1) and (2) of table 1. Finally, the third row contains the 25 firms that received a pre-MBO *hostile bid*. The columns of table 3 partition the firms based on events following the initial MBO announcement. The first column contains the 67 firms facing no activity after the initial buyout bid. The second column contains the 60 firms that experienced shareholder litigation or bid revisions resulting from negotiation with the board. These firms did not receive a post-MBO competing outside bid. The final column contains the 57 firms that received a *competing bid* following the initial buyout offer.¹⁸

Each cell in the table presents the mean cumulative abnormal return (CAR) and population size. As expected, the mean CAR in each cell is significantly different from zero. Of more interest, however, is a comparison of the mean CARs across cells. The *F*-statistics testing for equality of all cell means and those testing for equality of row means reject the hypotheses of equality at the 1% level of significance. The *F*-statistic testing for equality of column means rejects the hypothesis at the 5% level of significance. Thus the

¹⁸ The third column of table 3 includes 22 firms that negotiated bids upwards or were objects of shareholder lawsuits and received a competing outside offer after the initial buyout offer. This classification scheme seems reasonable in light of the results in table 2. In all but one of these 22 cases, the litigation or efforts to raise the bid preceded the arrival of the competing offer.

TABLE 3.—CONTINGENCY TABLE FOR PRESENCE OF PRE-MBO TAKEOVER ACTIVITY AND POST-MBO CONTROLS ON UNDERBIDDING USING CUMULATIVE ABNORMAL RETURNS^a

		Post-MBO Controls on Underbidding			Row total
		No Activity	Negotiations or Shareholder Litigation	Competing Bid	
Pre-MBO Takeover Activity	No activity	24.6% 42	27.3% 41	50.8% 31	32.7% 114
	Implicit takeover activity	27.2% 13	26.3% 17	25.5% 15	26.3% 45
	Hostile bid	51.2% 12	33.0% 2	42.3% 11	45.8% 25
	Column total	29.9% 67	27.2% 60	42.5% 57	32.9% 184

Note: The first number in each cell is the cell mean, and the second number is the number of observations in each cell. $R^2 = 0.289$.

Test for equality of all cell means: $F = 8.88$ (0.0001).

Test for equality of all row means: $F = 8.66$ (0.0001).

Test for equality of all column means: $F = 3.19$ (0.0435).

^aAll significance tests are based on standardized abnormal returns, cumulated from the first announcement through the date on which the final price was known. The F -values that are reported are based on partial or Type III sums of squares. P -values are reported in parentheses next to each F -statistic.

returns to pre-buyout public shareholders differ according to the type of pre- and post-buyout activity.

Notice that on average, returns on firms experiencing some form of explicit pre- or post-MBO bidding (hostile or competing bids) contain larger cumulative abnormal returns than those experiencing no explicit bidding competition (row 3 and column 3 versus all other rows and columns). Furthermore, the largest returns are received by stockholders in buyouts in which there were bids prior to or bids following the buyout announcement, but were accompanied by no other takeover activity. Finally, buyouts that experienced no control on managerial behavior (no activity pre- and post-MBO) have the lowest average cumulative abnormal returns.

Table 4 presents the results of pair-wise t -tests and p -values for differences in mean return between each pair of cells from table 3. Of the 36 comparisons, 10 are significantly different at the 1% level, 5 are significant at the 5% level, and 1 is significant at the 10% level. The remaining 20 comparisons are not significant (NS).

These tests reveal a distinctive pattern associated with the type of competition facing the buyout group. Pair-wise comparisons of the mean abnormal return in each cell containing buyout

firms with no explicit competition (cells 11, 12, 21, 22), shows no significant differences across these cells. A comparison of each cell involving competing bids (cells 13, 23, 31, 32, 33), reveals no differences across cells for 7 of the 10 comparisons in the group. The remaining 3 comparisons all involve the cell containing firms that experienced pre-MBO implicit takeover activity and post-MBO competitive bids (cell 23). The mean abnormal returns for the firms in cell 23 is significantly lower than the other cells involving competition except for the firms experiencing pre-MBO bids followed by post-MBO negotiation and litigation (cell 32). Finally, the table gives comparisons between cells that experienced no explicit competition versus those that experienced either pre-MBO hostile bids and/or post-MBO competing bids (cells 11, 12, 21, or 22 versus 13, 32, 31, 32, or 33). Of the 20 comparisons, 14 indicate that the firms experiencing no explicit competition have significantly lower abnormal returns than those experiencing either pre- or post-MBO competition. The 6 comparisons revealing no significant difference in abnormal return all involve either hostile bids followed by negotiation or shareholder litigation (cell 32) or implicit takeover activity followed by competing bids (cell 23).

TABLE 4.—SIGNIFICANCE LEVELS FOR PAIR-WISE *T*-TESTS FOR DIFFERENCES IN MEAN CUMULATIVE ABNORMAL RETURNS ACROSS PRE- AND POST-MBO ACTIVITY

Pre-MBO activity	Pre-MBO activity	No Activity (cells 11, 12 and 13)			Implicit Takeover Activity (cells 21, 22 and 23)			Hostile Bid (cells 31, 32 and 33)		
		No Activity	Negotiation or Litigation	Competing Bids	No Activity	Negotiation or Litigation	Competing Bids	No Activity	Negotiation or Litigation	Competing Bids
No Activity (cells 11, 12 and 13)	No activity		NS	0.01	NS	NS	NS	0.01	NS	0.04
	Negotiation or litigation			0.01	NS	NS	NS	0.01	NS	0.04
	Competing bids				0.01	0.01	0.01	NS	NS	NS
Implicit Takeover Activity (cells 21, 22 and 23)	No activity					NS	NS	0.01	0.05	0.03
	Negotiation or litigation						NS	0.01	NS	0.05
	Competing bids							0.01	NS	0.06
Hostile Bid (cells 31, 32 and 33)	No activity								NS	NS
	Negotiation or litigation									NS
	Competing bids									NS

^a NS denotes differences in means that are not significant. All significance levels are rounded to two digits.

The findings in tables 3 and 4 are amenable to a straightforward interpretation. Row and column comparisons indicate that firms experiencing pre- and/or post-MBO bidding earn significantly higher returns compared to firms experiencing other forms of control mechanisms. Furthermore, firms experiencing no control activity other than the buyout offer (cell 11) had the lowest abnormal returns compared to all other groupings.

Further examination of tables 3 and 4 provide additional insight into the direction of causality. Those MBOs experiencing neither explicit nor implicit competition (cell 11) experienced the lowest average abnormal return of all cells. These cell returns, in general, are significantly lower than those containing some explicit bidding competition, but not significantly lower than cell returns containing non-bidding forms of competition. These results provide evidence that MBO offers are, in general, not preemptive, and that non-bidding attempts at control are ineffective in improving returns to stockholders over no control activity.¹⁹

Those MBOs experiencing *only* pre- or post-announcement bidding, (cells 13 and 31) had the

two highest abnormal returns. These returns are significantly greater than both the returns in the absence of any control activity, and those when non-bidding activity was present. This implies that the alternative control mechanisms are not successful in providing additional time for potential bidders to contest the management offer or to induce higher bids from the buyout group. Indeed it appears that competing bids alone suffice to raise shareholders' value.

C. *The Impact of Alternative Control Mechanisms on MBO Bidding*

The above analysis provides substantial information on the impact of competition and alternative control mechanisms on pre-offer stockholder abnormal returns. This section examines the impact of these alternative mechanisms on offer revisions following the initial buyout offer. The analysis throws additional light on the effectiveness of these mechanisms in controlling underbidding. Three common control mechanisms are considered. These are: (1) outside directors as agents for stockholders, (2) stockholder litigation, and (3) competing outside bids.

Within the total sample, the *WSJ* reported that 109 firms experienced buyout bid revisions after an initial offer. Twenty-six of these revisions fol-

¹⁹ See Fishman (1988) for a model of preemptive bidding under conditions of asymmetric information. In that model Fishman shows that bids designed to foreclose on the arrival of competing bids result in higher returns to targets than initial bids that lead to competing bids.

TABLE 5.—THE IMPACT OF NEGOTIATION, LITIGATION AND COMPETITION ON BUYOUT BID REVISIONS

Reason for Revision of Buyout Bid	N	Mean	Min	25%	Median	75%	Max
Negotiations with Outside Directors ^a	26	8.1%	0.8%	3.3%	7.5%	10.9%	33.3%
Shareholder Litigation ^a	27	6.5	0.3	1.5	5.0	10.0	26.7%
Competing Bids ^b	56	17.3	2.1	8.4	13.3	21.4	59.3%

^a Revisions are calculated as the revised offer price minus the initial offer price divided by the initial offer price. Revisions for the two firms (one in each row) who initiated offers prior to the 1987 market break, changed their bids immediately following the break, and then changed again following negotiation or lawsuits, are computed using the first post crash price as the initial price.

^b Revisions are calculated as the ending offer price minus the buyout group's first offer price divided by its first offer. Outside offers prior to the buyout group's first offer are ignored. The revision for one of the two firms whose bidding contest spanned the 1987 market break is computed using the first post crash price as the initial price. No revision figure is reported for the other firm because the crash occurred just prior to the last bid.

lowed recommendations of outside directors.^{20,21} Twenty-seven revisions followed shareholder litigation, and 56 followed explicit competing bids. Table 5 reports summary statistics for these revisions.²² The median and mean revisions due to negotiation are about 8%. In these cases, revisions range from less than 1% up to 33%. The median and mean revisions due to shareholder litigation are 5% and 7%, respectively. The results reported in the first two rows of table 5 demonstrate that bargaining by outside directors and shareholder litigation provide some protection against underbidding by the buyout group. However, the revisions in many of these cases are small. In fact, 6 of the 53 revisions are less than 1% and can be regarded as token revisions.²³

The third row of table 5 presents revisions following competing bids. The median and mean

revisions relative to the buyout group's first offer are about 13% and 17%, respectively. These figures are roughly twice the comparable values for revisions following non-bidding controls on buyout offers. Furthermore, none of the revisions in the contested bids are less than 2%. The average revision due to competing bids is significantly different from the average revisions due to negotiation and litigation at the 1% level.²⁴

The relative magnitudes of the revisions suggest that direct competition has a greater impact on buyout offer revisions than the other control mechanisms. This implies that competing bids are effective in improving on initial buyout offers, whereas other forms of control are less effective. This is direct evidence that explicit competition contributes to higher returns to stockholders compared with other forms of control. It is also inconsistent with the argument that high potential gains attract competition rather than vice versa. The other control mechanisms should be no less effective in settings where the potential gains are large enough to attract competing bids.

IV. Ownership Structure and the Incidence of Competition

Up to this point the paper examines the role of alternative means of control over MBOs in improving the benefit to pre-buyout stockholders. The evidence suggests that stockholders of buyouts involving explicit controls over the buyout price, in general, fare well compared to those

²⁴ Revisions following negotiation are not significantly different from revisions following stockholder litigation.

²⁰ *Wall Street Journal* information understates the incidence of this control because the initial announcement is occasionally coincident with board approval following negotiation with the board of directors. There is no reason to suspect that this problem biases our estimate of the average revision of the offer price due to the use of this control.

²¹ In 2 cases, the public announcement stated that the investment banker/advisor found the initial offer unfair. In 18 cases, the *WSJ* indicated that bargaining with outside directors and their advisors was the reason for the revision. In the remaining 6, the reason for revision was not specified. However, in each of these cases, other motivations for offer revision (litigation and competition) were absent.

²² Offers that included both cash and securities were valued using an investment banker's estimate of the securities' worth if the *Wall Street Journal* provided one. If not, then face value of the securities was used to compute the offer price. For this reason, results using offer prices may reflect some upward bias. The valuation of securities included in the offer was treated consistently for all three rows in table 3.

²³ Five of these followed stockholder litigation.

TABLE 6.—TWO ASPECTS OF OWNERSHIP STRUCTURE AS DETERMINANTS OF THE TYPE OF COMPETITION

Competitive Partition of Sample	N	Holdings of Large Outsiders		Holdings of Managers	
		Mean	Median	Mean	Median
Panel A: Non-takeover versus Takeover					
Firms in the non-takeover sample	83	10.0%	5.1%	30.6% ^a	29.5% ^b
Firms in the takeover sample	101	9.2	6.1	10.0 ^a	5.5 ^b
Panel B: Single versus Multiple Bidder					
Firms with one bidder	113	9.9	5.6	25.3 ^a	20.8 ^b
Firms with multiple bidders	71	9.0	6.1	9.7 ^a	5.2 ^b
Panel C: Non-takeover versus Implicit Competition					
Firms in the non-takeover sample	83	10.0	5.1	30.6 ^a	29.5 ^b
Firms facing implicit competition	30	9.6	6.9	10.8 ^a	7.0 ^b
Panel D: Implicit Competition Versus Multiple Bidder					
Firms facing implicit competition	30	9.6	6.9	10.8	7.0
Firms with multiple bidders	71	9.0	6.1	9.7	5.2

^a The two means in the panel are significantly different from each other at the 0.01 level.

^b The Wilcoxon two-sample test based on sums of ranks shows that the distributions are different at the 0.01 level.

stockholders of MBOs facing no controls. Furthermore, outside activity is more effective than internal mechanisms in exacting higher takeover bids. Finally, explicit competition from outside bidders is more effective than implicit outside competition. This section examines the impact of the firm's ownership structure on the incidence and effectiveness of competition for buyouts.

Ownership structure includes both the concentration of holdings of large outside stockholders, as well as insider (manager) holdings. It is likely that the concentration and distribution of these holdings have an important impact on buyout bidding strategies and the returns to pre-buyout stockholders.

Large outside holdings may be an effective means of monitoring the terms of the buyout offer, thereby discouraging underbidding. On the other hand, the role of large outside stockholders as monitors of the firm's real operations could make buyouts less profitable. Finally, large outside stockholders could affect the intensity and form of outside takeover activity, thereby affecting the distribution of gains. The level of managerial holdings could also effect the distribution of gains arising from a buyout. In particular, large managerial holdings could serve to discourage outside competition, at the expense of the pre-buyout stockholders.

Table 6 presents the ownership structure of each sub-sample described in table 2. The second

and third columns present the mean and median percentage total holdings of large stockholders in each subsample.²⁵ The mean and median holdings of large outside shareholders range from 9% to 10% and from 5.1% to 6.9%, respectively. There are no significant differences in the mean or median across subsamples.

The fourth and fifth columns present the mean and median holdings of managers.²⁶ These holdings range from 9.7% to 30.6% and from 5.2% to 29.5%, respectively. A pair-wise comparison of insider holdings for firms that faced competition and those that did not (panels A and B) reveals a significant difference in managerial ownership across these categories. Panel C and D demonstrate that low managerial holdings characterize buyout targets that face either implicit or explicit competition while buyouts that face no competition typically have large managerial holdings.

Table 6 shows that the incidence of competition, either explicit or implicit, depends critically on the size of managerial holdings. Insider hold-

²⁵ The holdings of large stockholders is defined as the sum of the holdings of all non-manager stockholders that own at least a 5% stake in the firm. The share ownership information was obtained from the proxy closest to the beginning of the accumulation period.

²⁶ The managerial holdings figure reported here is the sum of all holdings by officers and directors. The figure reported also includes the holdings of family members and foundations controlled by managers. This total managerial holdings was utilized because it provides a reasonable assessment of managers' ability to block outside acquirers.

ings are, on average, significantly higher when the firm's buyout faces little or no control of the offer, compared to the alternatives (panels A, B, and C). However, the level of managers' holdings does not influence the form of competition. Furthermore, the concentration of outside ownership is not associated with either the form or incidence of competitive behavior in buyout offers. Thus large insider holdings appear to deter explicit and implicit control activity accompanying an MBO, while outside ownership structure has little if any impact.

The ability of managers with a high level of ownership in the firm to deter control over the buyout may or may not affect the actual returns experienced by the pre-buyout stockholders. This question is studied directly by examining differences in the CARs of MBOs with a high degree of ownership concentration compared to those with a low degree of ownership concentration. In order to do this, the sample is divided into the 92 firms with the highest degree of manager ownership concentration versus the 92 with the lowest.²⁷ The data indicate that, in general, stockholders of MBOs with a high level of managerial holdings experience lower CARs than firms with low managerial holdings. However, after controlling for single versus multiple bid contests, the level of managerial ownership has no significant impact on the average CARs. That is, a high degree of managerial holdings results in lower CARs to pre-buyout stockholders. However, this difference is explained by the lower incidence of explicit competition rather than the existence of large managerial holdings per se.

V. Conclusions

This study examines alternative mechanisms intended to control the price at which management buyouts are consummated. An examination of abnormal returns associated with management buyouts reveals that pre-buyout stockholders earn larger abnormal returns in contested buyouts compared to buyouts facing no competing or hostile bids. In contrast, buyouts accompanied by non-bidding forms of competition earn abnormal

returns which are no greater than those facing no attempts to control management buyouts.

An examination of bid revisions accompanying buyouts reveals that revisions are significantly larger after explicit competitive bids are announced compared to those revisions associated with negotiations or shareholder litigation. Furthermore, large managerial holdings tend to reduce the incidence of explicit completion. This reduction in explicit competition reduces the overall return to pre-buyout stockholders. As a result, pre-buyout stockholders earn significantly lower abnormal returns when managerial holdings are large compared to the abnormal returns in buyouts where managerial holdings are small.

The overall conclusion of this study is that explicit bidding competition in management buyouts leads to higher stockholder returns, higher offer revisions and may be an effective means of controlling buyout offer prices. In contrast, alternative control mechanisms, such as litigation, negotiation, and threat of competition has little effect on stockholder returns. Furthermore, stockholder returns in buyouts with this implicit competition fare no better than do stockholders of buyouts without any explicit or implicit competition.

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²⁷ The sample was also split by the concentration of outside ownership. There was no difference in CARs experienced by the firms on the basis of this stratification.

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