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The Regulation of Takeovers in New Zealand

and

Returns to Shareholders

A thesis presented in partial fulfilment of the requirements for a Master of Business Studies

at

Massey University

Andrew Gordon Kittle
2001

ABSTRACT

Between 1 January 1996 and 30 June 2001 takeovers in New Zealand were governed by a set of regulations that formed part of New Zealand Stock Exchange ("NZSE") listing rules. The NZSE rules were relatively light in their approach to governing takeovers and received much criticism throughout their tenure. Prior to 1 January 1996 takeovers had been regulated by the Companies Amendment Act 1963.

We examine the returns to targets and bidders between 1 January 1990 and 30 June 2000 to determine how effective the rules were in promoting shareholder wealth. The change in regulations between 1995 and 1996 also presents an opportunity to examine the impact on returns from moving from a lightly regulated regime to one which is more regulated with a greater amount of required disclosure.

We find that returns to both targets and bidders were lower under the NZSE regime than under the Companies Amendment Act 1963. This result is attributed to several specific aspects of the Companies Amendment Act 1963 such as the ability of the target to recover defense costs from bidder and a set period for which the offer must remain open.

ACKNOWLEDGMENTS

I would like to thank my supervisor, Associate Professor Fayez Elayan of the Department of Finance for his invaluable guidance and advice throughout my research. Professor Lawrence Rose, Head of the Department of Finance and Dr Denny Meyer were also extremely supportive and helpful with their comments on drafting and statistical analysis respectively.

I would like to thank my wife Susan Lowe for her support and patience throughout the long period that this research took. Lastly, I would also like to thank UDC Finance Limited for their support.

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1 INTRODUCTION

Takeovers are, and will continue to be, emotive and controversial events. They provoke a wide range of emotions from parties such as the general public, aggrieved shareholders, embattled management, the media, and politicians. This is understandable given the sums of money at stake are usually in the millions of dollars, and people's livelihoods are at stake since takeovers frequently lead to redundancies. Management can be aggrieved due to the belief that the takeover bid undervalues their company, or that projects that enhance shareholder value have not yet reached fruition. Alternatively they may simply be trying to retain their perquisites. Shareholders may be upset that they were not able to participate in the premium for control, or that they are effectively locked into the company at a discount after a partial takeover. Politicians view takeovers as causing large scale redundancies, or see valuable "national" assets being sold to foreign companies.

The takeovers debate in New Zealand has been raging for over a decade, and has been centered on the adequacy of the regulations controlling the process. There are two sides to the debate. One side argues that strategic parcels of shares are inherently more valuable, and thus should command a premium for control that other shareholders should not necessarily receive. This side argues that takeovers are economically important for any economy since they remove entrenched/inefficient management and re-deploy resources to higher valued uses. As such takeover regulation should promote, not restrict, takeovers. The other side of the debate argues that all shareholders own the assets of the company, thus all shareholders should have the opportunity to participate in takeovers. This side also argues that large shareholders often have an unfair advantage in being able to sell their shares in a takeover situation.

The debate has been sparked (periodically) by controversial takeovers. Arguably the two that have received the most attention were the takeover of Lion Nathan Limited by Kirin Breweries in 1997, and the takeover of Montana Group Limited by Lion Nathan Limited in 2001. Both were partial takeovers and in both cases minority shareholders felt aggrieved that they were not able to share in the premium for control. The result of the pressure has been for the current Labour Government to announce the enactment of a takeovers code, which took effect from 1 July 2001. This replaced rules governing

takeovers that were part of the New Zealand Stock Exchange listing rules. These rules were in effect from 1 January 1996.

There was a substantial amount of debate leading up to the announcement of the new takeovers code. One of the criticisms prior to its announcement was that there was no substantial evidence on the performance of the previous set of rules. The aim of this research is to fill that gap (albeit belatedly).

We examine control transactions between 1 January 1990 and 30 June 2000. Our principal finding is that the stock exchange rules ("the rules") did not appear to enhance shareholder wealth from takeovers. Post-announcement returns were found to be lower for both targets and bidders under the rules than prior to 1996. This is at least partially in contrast to our expectations. We predicted that returns would improve for targets but deteriorate for bidders due to the increased cost of making a bid. When the rules are examined in isolation it is found that stricter rules (Minority Veto) provide better returns than lighter rules (Insider Only). We also examine returns for full versus partial bids. Full takeovers are found to provide higher returns for both targets and bidders than partial acquisitions.

Several structural influences are also examined, namely toeholds, managerial and institutional shareholdings following research suggesting that they play a role in determining the selection of the takeover rule. These factors may then influence takeover returns. Toeholds are not found to provide substantially lower (higher) returns to targets (bidders), although returns are found to be higher for both bidders and targets when the bidder has a controlling stake than when it had no toehold or a toehold of less than 50%. Managerial and institutional shareholdings are found positively influence returns to targets and bidders, although the extent to which is mixed.

Given that our primary findings are
(1) the rules did not appear to enhance shareholder wealth in the event of a takeover;
(2) that tighter regulations seem to increase shareholder wealth; and
(3) full takeovers are preferable to partial takeovers in terms of returns:
the new takeovers code may provide benefits to shareholders of targets and bidders.

The remainder of this study is structured as follows: Section 2 outlines the rationale for this study and how it contributes to the existing literature on takeovers, both in a New Zealand and an international context. Section 3 provides an overview of takeover regulations in New Zealand. This section also covers the arguments for and against a mandatory bid rule. Section 4 reviews the existing literature on takeovers including various theories and empirical evidence. Previous New Zealand studies of takeovers are reviewed in Section 5. Section 6 then outlines the hypotheses tested by this paper. In section 7 we turn to the empirical methodologies used to test our theories. Sections 8 and 9 provide the results of the event studies and the cross-sectional regressions respectively. Section 10 analyses the results and the implications from a regulatory context and Section 11 outlines ideas for further research. Section 12 concludes.

2 CONTRIBUTION TO THE LITERATURE

Previous research on takeovers in New Zealand has concentrated on two areas. Firstly older literature examined returns generated by the takeover process and confirmed international evidence. Secondly, more recent papers have looked at factors that may have influenced the choice of the takeover regime under the rules.

This research will make a contribution to the existing literature on takeovers in New Zealand in the following ways:

2.1 The Impact of the NZSE Regulations

The main aim of this research is to examine the effect of the rules on returns to targets and bidders complementing several recent studies.[1] Takeover returns post-1996 will be compared to pre-1996 in order to determine the impact, if any, that the rules had on returns. The returns post-1996 will then be broken down according to the takeover rule that applied to the transaction. A previous study by Linklater (1998) looks at returns post-1996 versus returns pre-1996. However her research suffers from an excessively small sample, and she does not consider the impact of partial acquisitions. Linklater (1998) also does not consider each of the three stock exchange rules in isolation.

In recent years the NZSE rules have been subject to some intense criticism. The outcome of the debate has been the enactment of a new takeovers code, which came into force from July 1, 2001. However, whether or not the criticism of the NZSE rules was justified is unknown as there has been no research on the impact of the NZSE rules. This study hopes to shed some light on the relative performance of the now redundant stock exchange regulations that have governed takeovers in New Zealand to determine if there was substance behind the criticism.

This research is also important in the wider context with the recent introduction of a whole new set of rules for governing takeovers. We analyse the impact of the introduction of regulations on takeover returns (i.e. New Zealand went from a relatively unregulated takeover environment pre-1996 to a more regulated environment post-1996). Additionally, the three options within the NZSE rules allows us to compare the

effects on returns of relatively restrictive regulations versus liberal regulations in the same business environment and economic conditions.

2.2 Partial and Full Acquisitions

This study takes a broader look at takeovers than previous studies. It examines all change in control transactions (including increases) between 1 January 1990 and 30 June 2000. For the purposes of this study a change in control transaction has been defined in two ways:

1. An acquisition of stock that takes the acquirer above a total holding of 20%; and
2. The acquisition of five percent or more of shares in any given year if the acquirer already holds in excess of 20% shares outstanding.

These were known under the NZSE rules as a "restricted transaction". For the purposes of this research I define a partial acquisition as any acquisition of less than 100% that was a restricted transaction. By defining takeovers in these ways this research is able to take a broader examination of takeovers to include transactions where control of a company is passed, or strengthened.

Previous research in New Zealand has generally examined only takeovers for 100% of a company.[2] However when the purpose of the research is to examine the impact of regulations on returns to shareholders all change in control transactions should be considered in order to improve our understanding of the relationship between regulations and economic returns. In this study we are seeking to determine how takeover regulations affected shareholder returns, and control over the company's assets does not always change due to the purchase of 100% of the company's shares. If partial acquisitions are not considered then a vital piece of the jigsaw is missing.

Additionally, one of the criticisms of the rules leading up to the enactment of the takeovers code was that small shareholders tended to miss out on participating in changes in control. In New Zealand partial regulations historically have been governed by the same set of rules as full takeovers. Therefore any difference in returns between partial and full is due to factors other than regulations. Other countries such as Australia and Britain have rules that deal specifically with partial acquisitions. If returns from partial

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[1] Tapping et al (1998) and Berkman and Navissi (2000).

acquisitions are substantially lower than from full acquisitions then separate rules governing partial takeovers become necessary.

2.3 Structural Influences and Takeover Regulations

The third contribution of this research is the examination several structural influences on returns to shareholders over the period 1 January 1990 to 30 June 2000. These are toeholds, managerial and institutional shareholdings. Whilst these factors are not new, previous New Zealand studies on takeover returns have not considered all of these influences within the same model. Several previous studies touch on one or the other[3]. The link between these factors and the regulatory aspect of this study are two previous studies[4] in New Zealand which show that shareholder structure influences the choice of rule. These factors could affect returns in the takeover situation, and as such it is considered to be important that we cross-sectionally control for them.

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[2] Firth (1997) briefly touches on partial takeovers but does not examine the differences between partial and full takeovers.
[3] For instance Mandelbaum (1993b) examines toeholds only, Firth (1997) examines institutional and managerial shareholdings as part of his research.
[4] Tapping et al (1998) and Berkman and Navissi (2000).

3 TAKEOVER LEGISLATION AND THE NEW ZEALAND ENVIRONMENT

In 2000 the Labour Government announced the implementation of a takeover code from 1 July 2001. This section seeks to give an overview of some of the current takeover rules that applied in New Zealand, and the new legislation.

3.1 Takeover Legislation

Why regulate the takeover process at all? It has been recognized that shareholders are vulnerable under a takeover situation. They may have incomplete or inadequate information as to the offer, pressure may be placed on the target shareholders to sell their shares, or shareholders may be subject to the prisoner's dilemma.[5] On the other side, management may take measures to frustrate the takeover purely to retain their position in the company and defeat what would have otherwise been an economically rational takeover from a shareholder's point of view.[6]

Internationally the approaches to takeover regulation differ sharply. For instance, in the United States the tender offer process is highly regulated by legislation. There are few restrictions on placing a bid, but management has a wide range of defensive devices to frustrate a potential raider. In the UK on the other hand, the takeover process is not regulated by legislation. Takeovers are governed by the City Panel on Takeovers and Mergers, which is an unincorporated body. Although the panel's takeover code carries no legislative weight, it is supported by the courts. There are many restrictions on takeovers and partial takeovers are virtually prohibited. Defensive tactics are also heavily regulated.[7]

3.2 The Regulation of Takeovers in New Zealand

The takeovers debate has raged in New Zealand since the late 1980s. Arguments have surrounded the premium for control and the rights of the minority shareholder. In October 2000 the Labour Government announced that it would implement a formal

[5] As noted by Bradley (1980). Two suspects of the same crime are placed in separate rooms. Neither knows if the other will confess to receive a lighter punishment.

[6] Ogowewo (1996).

[7] See De Mott (1988) and Ogowewo (1996) for further details on the similarities and differences of the two systems. A full analysis of the differences and similarities of the two systems is beyond the scope of this paper.

takeovers code to be supported by the Takeovers Act 1993.[8] This code is intended to give minority shareholders a better deal in a takeover. Prior to the new regulation takeovers in New Zealand were principally governed by the following pieces of legislation and rules[9]:

3.2.1 The Companies Amendment Act 1963 ("the act")

Prior to the takeovers code becoming operational, this was the only piece of legislation that directly applied to takeovers in New Zealand.[10] It covered both listed and unlisted companies and applied to written offers to purchase shares where the bidder will control more than 20% of the voting rights. The legislation did not cover verbal offers or stands in the market.

The major provisions of the legislation were[11]:

1. Prior notice to target: a takeover offer shall not be made unless the bidder has sent the target a notice in writing of the offer including terms of the bid.
2. Pause Period: the bidder must pause for at least 14 days between the date of the notice and the acceptance of shares.
3. Obligation of the target: the target company must ensure that all of its shareholders are notified of the bid.
4. Minimum acceptance period: the offer by the bidder to purchase shares must remain open for at least one month.
5. Defence can be financed by bidder: the target may recover the costs of its defence from the bidder.

The most common criticism of the act was that its provisions were very easily avoided as it does not cover stands in the market, oral offers, or offers to less than six shareholders. Watson (1996) notes that the Takeovers Panel described 39 listed companies in which control changed between February 1993 and April 1995, all of which avoided the act. Another criticism of the act relates to the provision that allows the costs of the targets'

[8] Interested readers are referred to Fitzsimons (1996) and Watson (1996) for an excellent background to the development of takeover law in New Zealand.
[9] Please note that the sections on regulations are descriptive in nature and are not intended to be a complete analysis.
[10] Ibid Watson (1996)

defence to be recovered from the bidder.[12] This provision makes the takeover process more costly from the bidders' perspective and potentially lowers the probability of a takeover. The provision also increases the agency problem since it effectively aids the entrenchment of management. Finally, this provision also creates an incentive for target management to make the takeover as long and costly as possible as the costs will ultimately be borne by the bidder no matter what the outcome of the takeover contest.

3.2.2 Section 4 of the New Zealand Stock Exchange ("NZSE") Listing Rules

Section 4 (hereinafter referred to as "the rules") of the NZSE listing rules took effect from 1 January 1996 and were made obsolete on 1 July 2001 by the Takeovers Code. Companies listed on the NZSE were required to adopt one of three options available to govern the takeover process in their constitution. The underlying theme of the rules is that a company's shareholders have the choice of how corporate control is transferred. Shareholders can choose from an option that allows control to be passed easily with the controlling shareholder able to receive the full premium for control, an option that takes the middle ground, or an egalitarian option that requires the premium for control to be shared amongst all shareholders.

The rules governing takeovers were triggered either by:

1. an acquisition of greater than 20%, or
2. by a bidder who already has a stake greater than 20% and is increasing its shareholding by five percent or more in any one year.

The three options were:

(1) Notice and Pause: This was the standard provision governing a takeover. Bidders must give notice of their intention to bid and wait a set length of time before proceeding with the takeover. The bidder must give three days notice for a private bid, one-day notice for an on-market bid, and fifteen days for a bid by a company insider.

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[11] Mandlebaum (1993c)
[12] Mandlebaum (1993c)

(2) Insider Only: This was the least restrictive of the rules and it was only applicable to takeovers made by company insiders. It is essentially a modification of the Notice and Pause regime. The only notice requirement under this rule is fifteen days in the case of a bid by company insiders.

(3) Minority Veto: This regime is the most restrictive of the rules. The name is misleading in that the minority can not veto the bid, instead this rule operates as an equal price clause. All bidders must give a fifteen-day notice period. Any partial offers must be on a pro-rata basis.

The Minority Veto regime is closest to the tender offers under the US system and to takeover rules in Australia, UK, and Canada. It should not come as a surprise that very few listed companies chose the Minority Veto option. Most stakeholders would wish to dispose of their stake at the highest premium achievable in the event of a bid. This set of rules could prevent large shareholders from receiving a larger control premium since any premium would have to be shared amongst all shareholders.

In addition, the NZSE rules made it difficult for this option to be chosen. In order to adopt the Minority Veto regime the provisions have to be approved by special resolution by two separate groups of shareholders with at least a 75% majority. The two groups are all shareholders with holdings of greater than ten percent and those with holdings of less than ten percent.

In addition to establishing regulations that lightly govern takeovers, the NZSE established a set of rules that tightly governs the means by which takeovers may be contested. These rules prevent defenses such as poison pills and poison puts.

In general, the rules are biased towards increasing the occurrence of takeovers by removing barriers to takeovers and reducing the costs of mounting a bid. Given that defensive tactics are prohibited as well, the playing field is tipped significantly in favour of the bidder. This is in contrast to the United States where there is little regulation governing bids, but targets, as stated earlier, have a wide range of methods with which to defend a bid. The United Kingdom on the other hand has laws to restrict how bids take place, but also restricts defensive activity.

Therefore it would appear that takeover legislation should take a stance on whether bids are restricted or not and whether defensive tactics can be employed or not. The two sides are mutually exclusive. Bids should not be heavily restricted and not defensive tactics, or visa versa (as is the case with the previous New Zealand rules).

3.2.3 The Takeovers Act 1993

Until 2001 this act had no legislative value in New Zealand since the takeovers code that accompanied it was deferred as a result of political pressure. The principle purpose of the act is to formulate a code to govern takeovers. The Act has five objectives, which are:

1) "to establish a Takeovers Panel to formulate a code for takeovers for specified companies";
2) "to empower the Panel to define the transactions where the Code applies and nature and content of the rules applying to those transactions";
3) "to empower the Minister of Justice to decide whether to advise the Governor-General to approve the Code or alternatively defer the decision";
4) "to provide the Code will have force of law if approved by the Governor-General";
5) "to provide for the administration and enforcement of any operative Code".[13]

3.3 The Takeovers Code ("the Code")

The Code was submitted by the Takeovers Panel in October 2000, and came into force on 1 July 2001. The Code applies to companies listed on the New Zealand Stock Exchange, and companies that have 50 or more shareholders and greater than $20 million of assets.

The Code has stirred up a large amount of controversy.[14] Proponents claim that it will enhance the rights of minority shareholders, strengthen the reputation of the New Zealand Stock Exchange and increase local investment in the New Zealand Stock Exchange. Proponents also blame the rather lack-lustre performance of the NZSE compared to its international counterparts on the lack of protection for minority

[13] Ibid Watson (1996) pp 319 – 320

shareholders arising from having no takeovers legislation. This is a very strong statement to make and it would be extremely difficult, if not impossible, to prove or refute conclusively. However there has been some circumstantial evidence. A survey of institutional investors by Merrill Lynch suggested that a higher risk premium was placed on New Zealand stocks because there was no formal takeovers legislation in place.[15]

The key provision of the Code requires a mandatory bid be made to all shareholders when any party increases their shareholding above 20% of outstanding shares. The bid may be a full bid or a partial bid for at least 50% of the shares and the price offered must be the same for all shareholders. An equal offer must be made to all company shareholders on a pro-rata basis in the event of a partial bid. The Code also continues the prohibition on defensive activities by management of the target-company.

The Code is based on the code in force in Australia in an effort to align the takeover legislation of the two countries, and also to give minority shareholders a "better deal". The Code is also similar to that applying in the United Kingdom and various other EC countries such as Germany and Switzerland. The overriding principle of the Code is equal treatment. The principal of equal treatment is based on the premise that all shareholders own the company's assets and as such all shareholders should share in the premium for control. The Code also aims to increase the participation of shareholders in control transactions. In the letter to the Minister of Justice dated 8 June 1995 the Takeover Panel stated:

"As its principal thrust, the Code seeks to promote the contestability of corporate control through workable and effective takeover activity and, at the same time, provide an increased measure of participation and equal treatment for shareholders."[16]

A mandatory bid to all shareholders, whether on a pro-rata basis or a full basis, ensures that minority shareholders are able to participate in a change of control transaction. It is noted that bids below the 50% threshold are allowed if a shareholder vote approves the transaction. Additionally, an acquirer can purchase a block of shares that will take it into

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[14] There have been numerous articles in several newspapers citing these arguments. See for example The Dominion September 6, 2000 and The Dominion October 18, 2000.

[15] Refer Guardian Trust's submission to the Takeovers Panel.

[16] Letter to the Minister of Justice, 8 June 1995, page 5.

a majority position without making a formal offer to all shareholders if this transaction is approved by a majority of disinterested shareholders. This legislation allows all shareholders the ability to participate in change of control transactions.

3.4 Arguments for and against the Code

One of the main arguments against the Code is that it will increase the costs of a takeover both in terms of actual costs and the amount of the investment required since not all control transactions would have taken the acquirer to a holding at least 50%. Opponents argue that the Code will stifle takeover activity in New Zealand[17], protect inefficient management from the threat of removal posed by takeovers, and result in resources being applied to less efficient uses. Opponents of the Code also argue that large shareholdings are worth more commercially, that large shareholders take greater risks, expend greater resources in researching the target, and make a proportionately larger contribution to the company. As such they should be entitled to greater returns.

There is little doubt that larger shareholdings are worth more commercially given that they frequently represent control over assets. However risk is defined as variance in returns, and thus all shareholders in a company are exposed to the same risk[18]. It could also be argued that the large shareholders' monitoring is also in their own best interests. This is because monitoring reduces their portfolio risk, and large shareholders are better informed as to when to make an investment or exit decision. One could also argue that small shareholders are more exposed to loss than institutional shareholders. This is because a) they could have a higher proportion of their wealth tied up in the shares, b) they lack the knowledge and sophistication of the institutional shareholders, and c) they could be inadequately diversified. It is noted that the above arguments do not fit into the economic model of rationality, however they are commonly observed in real life.

The opponents of the Code also argue that the US market does not have the mandatory bid provisions and takeovers work perfectly well without the provisions. However, as pointed out by the Takeovers Panel, the dispersion of ownership is higher in the US than in New Zealand. The NZSE in its submission to the Takeovers Panel stated that at least 75% of companies have one owner of greater than 20%, and 50% of listed companies

[17] This point will be examined in greater detail in section 3.6

[18] Of course unsystematic risk can be diversified away to some extent, but systematic risk cannot.

have one owner of greater than 40%. Therefore in the NZ context it is easier for control to pass without minority shareholders becoming involved. The Takeovers Panel also points out that controlling shareholders in the US have fiduciary duties to minority shareholders, and these are support by courts. Equally important, and not seemingly recognized by the opponents of the Code, is the US markets enable target management to undertake a wide range of defensive actions to frustrate the bid. Thus the US market also has legislation which could be seen to restrain takeover activity, or raise the costs of a takeover.

The center of the arguments is the premium for control. Should the premium for control be received by large investors or should it be spread amongst all shareholders in the company? This is one argument that is unlikely to be resolved in the near future as the two sides are polarized. Opponents of the Code claim that large parcels of shares are worth more, whilst proponents argue that all shareholders have claims to the assets of the company. One significant problem is that it has been observed in New Zealand that institutions with holdings that are not strategic in nature are often able to jump the queue. This was the case with the Lion Nathan / Montana takeover[19] this year where institutions were able to sell at higher prices and ahead of many small shareholders. Critics are not able to justify this behaviour with the argument that larger shareholdings are worth more.

The mandatory bid provision could also have the effect of encouraging free-riding behaviour by minority shareholders to a greater extent than already exists. This is because the minority shareholders know in the event of a takeover occurring they will obtain a share of the returns. Therefore no incentive exists to undertake monitoring when these costs will be borne by larger shareholders. Previously they would probably have only participated in a takeover in the event of a full bid and even then they would not have been guaranteed receipt of the same price for their holding as the large shareholder(s)[20]. One perceived problem with the mandatory bid rule is that if large shareholders are not able to exit at a premium it could encourage those shareholders

[19] Section 11 provides some background on this controversial takeover.

[20] All shareholders would have definitely received the same price only if the target had the Minority Veto rule in place.

with effective control to undertake dilution[21] to increase their own returns and thus reducing the value of the minority.

One of the key costs of the new Code will be that it will reduce the marketability of large blockholdings. Shareholders with holdings in excess of 20% will find it more difficult to sell those holdings since any purchaser will inevitably be forced to make a bid for the whole company. Even if the potential acquirer was to make a pro-rata bid for in excess of 50% it is unlikely that the existing major shareholder would be able to completely exit their investment. The last alternative is to have the transaction subjected to a vote of disinterested shareholders. It is conceivable that the transaction could go ahead in this event given shareholder apathy, or that the minority shareholders could see benefits associated with the new shareholder such as market power, economies of scale, expertise etc.

Another argument frequently advanced against the new Code is that it provides no shareholder choice. The NZSE rules give shareholders the choice of three regimes as outlined earlier. There is no choice under the Code, nor is there an opt-out provision. However to include an opt-out provision would be inconsistent with the very notion under-pinning the Code – fairness to all shareholders. Majority shareholders would be able to use their position to force an opt-out. In addition, the author is not aware of many places in the world[22] where shareholders can choose their takeovers code. In general since "one size fits all" in other countries around the world with much larger companies, sharemarkets, and economies, why should New Zealand be an exception? It could be argued that New Zealand is a unique environment, however this equally applies to every country and most do not allow opt-out. In addition, one could also ask: just because I don't like the speed limit because it is too slow, does that mean if enough other people also object should we be allowed to opt-out of that law?

[21] In the sense of Grossman and Hart (1980).
[22] It is noted that the Pennsylvania Senate Bill 1310 permits an opt-out decision. However it appears that the motivation behind the legislation was not so much as to promote fairness amongst shareholders, but to allow management to concentrate on long-term financial performance instead of short-term performance, and to protect shareholders, workers, and communities from the effects of hostile takeovers.

3.5 Arguments behind a mandatory bid regime.

Luttman (1992) notes four arguments in favour of a mandatory bid rule. These are (1) to prevent a "stampede" in the event of a partial takeover bid, (2) equal opportunity to receive the takeover premium, (3) to provide an exit option, and (4) the possibility of future dilution activities by new majority holder.

The first argument in favour of a mandatory bid proposed by Luttman (1992) is that partial bids can be highly coercive, especially when they are front-end loaded or two-tier bids, and when they are on a first come first served basis.[23] However this pressure can be removed simply by regulating the structure of partial bids, for instance prohibiting proportional partial takeovers and increasing disclosure requirements. Thus this argument does not create a necessary condition for the mandatory bid rule.

The second argument in favour of the mandatory bid rule is philosophical in nature. The argument rests on the principal that the company's assets are owned by all shareholders. Thus all shareholders should be entitled equal opportunity to participate in any premium received for those assets. The other side is the argument based on Grossman and Hart (1980), minority shareholders free-ride off the monitoring of the large shareholder, thus they incur none of the costs of monitoring but share in the gains. The equality principle is where the underlying philosophy of the regime in the US and UK depart.[24] Both jurisdictions have equal price provisions in place to ensure all tendering shareholders receive any increase in price. However the regime in place in the UK goes further by ensuring that all shareholders have equal opportunity to participate in the takeover premium, there is no such compulsion in the US.

The third argument in favour of the mandatory bid rule is that the new controlling shareholder may make changes to the company such as the line of business that the company operates in[25]. The remaining minority shareholders may not necessarily agree to the structural change and wish to use their funds for another purpose. However after

[23] The coercive effects of a partial takeover bid will be further discussed in Section 4.5.5 of this paper.
[24] Refer to Ogowewo (1996).
[25] This has been a frequent occurrence in New Zealand. A recent example was the reverse takeover of New Zealand Petroleum Ltd ("NZP) by Blue Cross Elder Care Ltd. The business of NZP was subsequently changed after the takeover from petroleum to operating retirement homes.

the takeover of the company has taken place their exit options may be severely limited due to lower share prices or reduced liquidity of the company's stock. This is especially relevant in the New Zealand market, which does not have the depth of most overseas markets, and where many stocks are only thinly traded. As a result dissenting shareholders may not be able to exit after a major change in corporate strategy. Luttman (1992) points out that an alternative solution of allowing shareholders to vote on the transaction could have the effect of blocking transactions that are economically rational. However she is referring to German corporate law which requires unanimous voting procedures. The alternative to this is to have non-interested parties vote with a majority rule decision. This argument creates strong grounds for participation of all shareholders in a change in control transaction.

The last argument proposed by Luttman (1992) in favour of the mandatory bid rule is based on the possibility that a new controlling shareholder may extract value from the company through activities such as selling assets to themselves at lower than market cost, or selling product to himself at favourable rates. Grossman and Hart term this as "dilution". The mandatory bid rule enables shareholders to exit if they think that the future value of the firm could be reduced as a result of the change in control.

3.6 Could the mandatory bid rule stifle takeover activity?

As mentioned in section 3.4, one of the arguments frequently advanced against the mandatory bid rule is that the market for corporate control provides a threat to management to perform or risk losing their position after the company is taken over. Any legislation that increases the costs of a takeover or makes it more difficult for a takeover to occur could lower the amount of takeover activity and reduce the effectiveness of the takeover as a means of corporate governance. This section provides arguments against that view.

3.6.1 Nothing New

The first counter argument is that the mandatory bid rule is nothing new. It is operational in the UK, Australia, Germany, Hong Kong and Singapore as well as other countries. This author is not aware of empirical evidence that the mandatory bid rule has reduced takeover activity in these countries. Indeed DeMott (1988) reports the observation that takeover activity had not decreased under the takeovers code operating in the UK.

3.6.2 Disciplining Inefficient Management

It is has been proven that takeovers do provide a means of disciplining poorly performing managers and reallocating resources to higher value uses. Although there is mixed evidence, Agrawal and Jaffe (1999) reach the conclusion that the inefficient management hypothesis[26] holds where the takeover is likely to be disciplining management. However, takeovers are frequently a last resort: shutting the gate after the horse has bolted. There have been many instances in New Zealand corporate history (and probably worldwide) of value being destroyed without companies being taken over such as Brierley Investments Limited and Fletcher Challenge. Although Fletcher Challenge is currently in the process of selling off divisions and returning funds to shareholders, this is being done voluntarily and not as the result of a hostile bid.[27] In addition, New Zealand is a much smaller market and has not witnessed takeover waves such as have occurred in the US.

3.6.3 Does Increased Costs Necessarily Mean Less Takeovers?

The other part of the argument against the mandatory bid rule, that it will increase costs of a takeover and reduce the number of takeovers occurring, can also be argued against. There is some empirical evidence in the matter of anti-takeover legislation and its impact on the frequency of takeovers, although it is all in the US setting. Pound (1987) provides evidence that the adoption of anti-takeover amendments adversely impacted on the frequency of takeovers. Pound (1987) examines a sample of 100 NYSE listed companies that adopted supermajority and classified board amendments between

[26] Agrawal and Jaffe (1999) have an excellent review of the literature on this topic in Appendix A of their paper.
[27] There has been a rather harsh criticism in the media that Fletcher Challenge is liquidating its assets because it is unable to provide its shareholders with an adequate rate of return.

1973 and 1979. He compares this to a control sample of firms in the same period and finds a significant difference in frequency of takeovers between the two groups.

However, in a more comprehensive study Comment and Schwert (1995) argue that antitakeover measures were not directly responsible for the decline in takeovers during the late 1980s, despite the widespread adoption of antitakeover devices.[28] Comment and Schwert (1995) estimate a probit model of takeover probability for a period from January 1977 to January 1991, and including 21,887 firm years. Their model yields positive coefficients for control share laws and business combination laws indicating that antitakeover laws do not deter takeovers.

[28] Comment and Schwert (1995) review the evidence of prior studies of takeover deterrence and find that the only consistent explanation of deterrence has been size. Other variables such as leverage, Tobin's Q etc have yielded mixed results.