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Tender Offers, Takeovers and Corporate Governance

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TECHNICAL REPORT

I.- INTRODUCTION

The system of Corporate Governance establishes the rules and regulations that guide the behavior of controlling shareholders, members of the board, and managers of companies in an economy. It further defines the obligations and responsibilities of these individuals vis-à-vis foreign investors (non-controlling shareholders and creditors). As such, the long-term strength and dynamism of a country depends, to a large extent, on the system of corporate governance[1] used and the protection it provides to foreign investors. Evidence suggests that the countries that best safeguard these investors' rights enjoy deeper, more developed capital markets which, in turn, leads to lower costs of financing for local companies.[2]

For these reasons, there has been a trend toward enhancing systems for corporate governance around the world in recent years. Over 25 codes of "*corporate good practices*" have been drafted in 14 countries in the last two years. These include the "Admission Rules" of the European Association of Securities Dealers Automatic Quotation (October 1996), the "Principles of Good Practice for Boards of Directors" of the Commonwealth Association for Corporate Governance (April 1998), the "Draft of Corporate Governance Standards and Guidelines" of the Organization for Economic Cooperation and Development (October 1998), the "Brazilian Code of Best Practices" of the Brazilian Institute of Corporate Directors (April 1997) and the "New Corporate Governance Guide on Formation of Audit Committees" of the Hong Kong Society of Accountants (January 1998), among others.

For Chile it is essential to tackle this problem now. The effectiveness of corporate governance has increasingly captured the interest of international investors in the wake of the Asian financial crisis. Clearly, these investors' perception of the relative efficiency of the corporate governance systems in place in different countries is decisive as they reevaluate their investments around the world. For this reason, the time is nigh to improve regulations on the management of corporations engaging in tender offers to bring them into line with both international trends and local conditions. Such changes must be based on a comparative analysis of legislation and international experience.

II.- THEORETICAL FRAMEWORK

There are essential two objectives of a sound system of corporate governance:

1. To provide an efficient structure for management incentives (in an effort to maximize corporate value.)

2. To establish responsibilities and other safeguards that keep *insiders*[3] from using their control over the company to extract value from it at the expense of *outsiders*[4].

The former can be called "*business prosperity,*" while the latter refers to the "*fair distribution of profits*" among corporate managers, shareholders and creditors.

Most developing countries suffer from shortcomings in both aspects of corporate governance. In

[1] In our legal system, "corporate governance" refers to the responsibilities, rights and obligations of the directors of listed corporations.
[2] See La Porta, R., Lopez de-Salines, F., Shleifer, A. y R.W. Vishney, "Law and Finance", *Journal of Political Economy*, 1998.
[3] *Insiders* are majority shareholders, board members elected by majority shareholders and corporate management.
[4] *Outsiders* are voting minority shareholders, non-voting minority shareholders and creditors.

many nations, managers react to incorrect incentives and thus fail to place an accent on maximizing corporate value.

In Chile, however, the issues associated with corporate governance are mostly found in the second category, that is, in terms of the "*fair distribution of profits.*" It appears that the incentives for Chilean managers to maximize profits are appropriate. Chilean companies are profitable, actively growing and developing, and are competitive both domestically and in international markets. However, the practices of some companies over the last two years have raised questions about the effectiveness of existing safeguards in keeping *insiders* from obtaining disproportionately high profits and value in the company as compared to the *outsiders,* to the detriment of the latter's equity stake.

The issues associated with responsibility and monitoring of activities by management and controlling shareholders have been a focal point of attention in developed nations over the past two decades. In general, the discussion has concentrated, especially in the U.S. and U.K., on the conflicts between the interests of a company's management and those of its shareholders, since ownership of corporations is widely distributed in those nations. As such, no single shareholder or group of shareholders holds a big enough stake in the company to effectively control management. Thus, the conflict is between those who exercise day-to-day control over the companies (management) and shareholders (owners).

In Chile, however, as in many countries in Western Europe and in Canada, most corporations are controlled by a single shareholder, family or economic group. Under these conditions, the conflict of interest emerges most sharply between controlling shareholders (who may in fact own less than the majority of shares) and the investors outside that controlling group, minority shareholders and creditors.

There are essentially two types of situations in which a conflict emerges between the allocation of corporate value by management and controlling shareholders on the one hand, and minority shareholders (also called non-controlling shareholders for these purposes) and other investors on the other:

1. *Transfer Prices and Use of Corporate Opportunities*: These cases involve the extraction of company value at the administrative level.

2. *Major Corporate Events:* These cases involve the extraction of corporate value at the ownership level, particularly through the receipt of *"Control Premiums."*

1. Transfer Prices and Corporate Opportunity: Value Extraction at the Management Level

A. The Agency Problem

Given that control and ownership of a company do not always like in the hands of the same agent, management's interests can diverge from shareholder interests. This is known as the "*Agent Problem*." Investors need the specialized human capital managers have to offer to create returns on their financial capital. Furthermore, managers need the resources provided by investors to carry their business projects forth. However, how can shareholders be certain that –once they have provided the resources and the investment has been made– they receive a reasonable return in exchange?

The simplest solution to this conflict is to establish contracts between investors and managers that clearly spell out management's responsibilities, what will be done with the money invested in the company and how earnings will be divided between the two groups. Despite its potential, this solution poses one very serious problem: it is technologically impossible to structure "complete" [5]

[5] Economic-financial doctrine refers to "complete" or "incomplete" contracts although the legal sciences do

contracts that consider the countless situations management may confront or that regulate how management should react in each and every case.[6]. Thus, what we have are fundamentally "incomplete" contracts that leave management with a wide range of decision-making leeway with regard to situations that are not specified in the written contracts.

The contracts between investors and management also suffer from other drawbacks. To be efficient, they must be very clear and precise –which in itself is not an easy thing to attain –so as not to require excessive interpretation when enforced by the courts or specially appointed arbitrators. Furthermore, when corporate ownership is dispersed among many investors who own a very small slice of the corporate pie, there is little incentive for them to stay abreast of the activities undertaken by management and thus adequately exercise their control. This issue is known as the "F*ree Rider Problem.*"

Because of the incomplete contracts, subject to interpretation and with limited incentives for investor monitoring, corporate managers have enormous discretional power in making decisions about the company's future. This discretionary power can be used to help meet the owners' goals or to attain their own personal objectives. In the latter case, managers extract value from the company to the detriment of the shareholders. This extraction can take two forms:

1. Performing transactions with affiliates at non-market rates. This is known in economic theory as the problem of "*Transfer Prices" or;*

2. Diverting attractive business opportunities toward themselves or toward an affiliate (a related person or company.)

Managers can use their control over the contracts signed for certain goods and/or services to extract value from the company by means of transactions conducted at non-market values. The most obvious cases are when managers inflate their salaries or when they enter into "self-contracts," that is, when they sign contracts on behalf of the company with counterparts in which they have a sizable personal investment or some other type of economic interest. For this very reason, it is not unusual for corporate legislation or statutes to require partial shareholder approval before all or a substantial part of the company's assets can be sold.

Managers can also divert benefits toward themselves at the expense of the company via the *Extraction of Business Opportunities*. The most typical cases are those in which a potentially profitable business opportunity is proposed to the company and the managers redirect it to other firms in which they have a greater economic stake. These cases are clear violations of the managers' responsibility to act on behalf of the company's interest and are usually referred to as the *"oath of loyalty"* or *"fair play."* Such shady deals can result in sizable losses for the company and shareholders alike.

The study, analysis and subsequent penalizing of diversions of corporate opportunity are important because of the direct negative effect these practices can have on the company. Nonetheless, the use of corporate information by managers to their own personal benefit in other contexts should not be considered a topic of public policy interest. Managers cannot help acquiring valuable information in the course of their work. As such, they cannot be expected to forget that information when engaging in personal business or when working for other firms. So long as none of the benefits obtained by their side-businesses creates a direct loss for the company or harms the stock market, public policy decision-makers should essentially ignore such activities.

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not recognize this distinction.

[6] There are three reasons complete contracts cannot be established: a) because it is impossible to predict every situation that may occur in the future, b) because it is technologically impossible to draft or put in writing all the numerous and complex situations that may occur in the future and, lastly, c) such a complete contract, even if it were possible to draft, would be entirely too expensive to create.

There is a natural way of checking to see if abuses have occurred through *Price Transfers* or *Diversion of Corporation Opportunities* in the case of a listed corporation: over time, non-market condition trades and lost business opportunities are expressed in less than optimum corporate performance. At the end of the day, this is reflected in lower share prices and higher financial costs.

B. Possible Solutions to the Agent Problem

Essentially three approaches have historically been used to resolve the *Agent Problem*: one is a market solution while the other is based on legislation. The former is a matter of reputation. Since managers must protect their good name and be recognized by the market as honest individuals so that they can secure funding from investors in order to carry out their future projects, they tend to seek to fill the objectives set forth by the owners of the companies they manage.

However, although reputation is an important component in ensuring sound behavior by managers and executives, evidence suggests that this alone does not solve the *Agent Problem*.

The second mechanism of protection operates via legislation. This essentially means that investors are given the right to control management in exchange for the resources they supply to the company. If management fails to comply with these requirements, the investors are entitled to sue and see that the corresponding legal penalties are enforced.

One of the investors most important means of applying control is through their right to vote at general meetings of shareholders. Their vote can influence such key matters as mergers, acquisitions, renewal of the Board, etc. Other legal sources of protection include restrictions on some actions by management, such as “self contracts” which eliminate the possibility of executives’ participating in the determination of their own salaries and in any decisions made regarding business conducted with companies in which they hold an economic stake.

In countries where the legal protection afforded to shareholders’ interests has been weak, the market reaction to the *Agent Problem* has been to concentrate corporate ownership in the hands of just a few investors. The concentration of ownership is the third mechanism for resolving the issue, since it ensures an adequate level of monitoring of management’s decisions by the shareholders (who now have an incentive to do so[7]) through the board members they appoint for that purpose.

The empiric evidence in this regard is clear. The highest concentration of ownership is seen in those countries whose legislation is of French origin (such as Chile) that provide the least legal protection for investors (e.g. Italy) and where, on average, some 54% of the ownership of the 10 largest private companies is in the hands of the three biggest shareholders[8].

In practice, the solution given at the bill submitted to the Congress, named " Ley OPA " in Chile, was to recognize that certain mayor corporate events concentrated the eventual extraction of value between insiders and outsiders, and therefore called for its regulation.
Thus, the case for transaction among affiliates was a key concern. The main features here is to set up a procedure for transactions with affiliates that unabled the Directors with conflict of interests to vote on the transaction ; information disclose in a timely manner so the market is duly informed about the said transaction. Moreover, there still a shareholder's right to call for a shareholder's meeting, before the Board of Directors voting, if more than 5% of the votes do not agree with the price and terms of the deal.

[7] Since a greater percentage of their stake is at risk.
[8] See La Porta, R., Lopez de-Salines, F., Shleifer, A. y R.W. Vishney, “Law and Finance”, Working Paper 5661, *National Bureau of Economic Research*, 1996.

The latter procedure will not encourage transactions that at its root, do not consider a fair and attractive market price for the company. In fact, the minimum time framework of 20 working days, between the disclose of information to the market regarding the asset or business or liability to be bought or sold, is enough time for the market test. Meaning, competition and other agents could enter the transaction scenario and make competitive offerings to the company.
Therefore, controllers will have to duly appraise the risk of giving away the asset or liability sold or bought to their competitors. That's a clear incentive for them to propose only transactions at their best known market price.

C. The Cost of Having Major Investors

The problem that emerges from the large investor solution is that they can, in turn, use their control over the company via their board members to expropriate value from the minority shareholders (who lack control) and those who own non-voting shares. This problem is accentuated when the controlling group exercises its power over the company by means of a very limited participation in ownership. The mechanisms most frequently used in this process are issuing shares with different voting rights, while retaining those with preferential voting rights or controlling the company through a pyramid structure. Using these techniques, the controlling shareholders extract value from the company, either through transactions with companies in which they hold an economic interest (related person or company) or through some other mechanism designed for this express purpose.

Given the potential danger of oppression of minority stakeholders at the hands of other shareholders, a variety of safeguards have been established to protect them from the interests of the *insiders*. These include:

1. Shareholder rights will be better protected when access to cash flow is intimately linked to voting rights. That is, when companies operate under a one share-one vote framework. This means that shareholders or board members cannot take control of cash flow with just a small fraction of the shares.

2. As it becomes easier for shareholders to exercise their right to vote at regular and extraordinary meetings, they can do so more expediently. This is the case in countries that allow shareholders to vote via e-mail.

3. In some countries –including Chile– shareholders are not required to deposit their securities at the company or at the corresponding broker several days prior to regular and extraordinary meetings. This practice permits shareholders to sell their stake just before the meeting and thus form strategic alliances among minority shareholders.

4. In some cases, accumulated voting is permitted. This gives greater power to minorities to increase their representation on the Board.

5. Low percentages are required to call an extraordinary shareholders meeting. The higher this percentage, the harder it is for minority shareholders to organize a meeting to effect changes in management.

6. Safeguards against being expropriated by controllers via the issue of preferential price shares. To avoid this, minority shareholders are given the preferential right to acquire these new share issues.

7. In some countries minority shareholders enjoy legal means of dealing with cases of oppression by directors or controlling shareholders. These mechanisms include the oppressed minority’s right to withdraw from the company, among others.

2. Major Corporate Events: Extraction of Value at the Controlling Shareholder Level

A. Buyouts and Takeovers

In the early 1960s, U.S. companies began formulating offers to acquire shares in other companies and invited shareholders –via advertisements or general announcements– to sell their shares at a price considerably above market value.[9]

Prior to the 1980s, corporate acquisitions were primarily financed via bank loans and the in-house resources provided by the purchaser. With the development of new financial instruments, such as "j*unk bonds,"* buyers secured access to a new financing mechanisms that covered up to 80% or 90% of the total value of the operation, thereby spurring the acquisition of shares via public tender.

At the end of the 1980s, both the number of attractive companies and the possibilities for funding those share acquisitions fell off sharply. As a result, the number of buyouts and takeovers, particularly the hostile variety, dropped substantially during the first five years of the 1990s.

Buyers looking to acquire a company via tender offer sought to do so quickly, using different means to pressure shareholders into selling as soon as possible. This pressure often led shareholders to make mistakes, due to a lack of information and a dearth of equal treatment among all the shareholders.

This situation led the U.S. Congress to pass the Williams Act in 1968. This legislation modified the Securities Exchange Act of 1934 and required that the market be informed of any shareholder owning over 5% (whether or not they had the intention of taking over the company). The Williams Act also regulated offers to purchase shares and established general rules for responsibilities and penalties for agents involved in takeover operations.

B. Types of Buyouts

Buyouts can be hostile or friendly. A hostile takeover occurs when neither the management nor the Board of the company being purchased support the action.

There are two types of friendly takeovers: "*Leveraged Buyouts*" and "*Management Buyouts.*"

Leveraged Buyouts consist of acquisitions of companies by other corporations, usually a group of individuals or institutional investors, who finance a large portion of the operation with debt and a small amount of capital. The debt is usually backed by the assets of the company the investors are seeking to acquire.

Management Buyouts, are different from leveraged buyouts in that the capital contributed to funding the trade is provided by the managers of the target company itself. As such, they become the owners of the firm they previously managed.

C. Economic Implications of Buyouts

The specialized corporate literature does not present a clear position on whether buyouts are good or bad. The arguments in favor suggest that:

Buyouts are an effective weapon against ineffective management, especially in the case of hostile takeovers. This is because the controlling shareholder can reduce the *Agent Problem*, since he or she

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[9] The movement of "*Tender-Offers*" in the United States has been highly cyclical. In any case, in the 1980s the number of *Tender-Offers* rose sharply and logged prices up to 50% over going market rates for some shares.

will have created incentives to monitor management and remove those who fail to maximize the economic value of the company.

Second, the buyers pay a price for the shares that is above market value in an effort to foster the sale of shares. This enriches shareholders.

Third, hostile takeovers provide an incentive for management to seek out an alternative bidder,[10] which increases competition, guarantees and shareholder value.

Nonetheless, buyouts do have pitfalls. On the one hand, purchases can lead to an excessive concentration of ownership. This makes the controlling group more exposed to the company's specific risk. As a result, some profitable projects may not be implemented, depending on the degree of risk aversion of the controlling interests.

Second, empirical evidence suggests that in countries where corporate ownership is concentrated in the hands of just a few investors, the financial markets suffer from low liquidity. In practice this means that if an investor wants to leave the company the limited liquidity will depress stock prices.

Thirdly, changes in ownership control can lead to a redistribution of wealth in favor of the controllers –to the detriment of the minority shareholders– through the payment of "*Control Premiums.*" The *Control Premium* [11] is the result of the added private benefits the new controllers expect to receive, over and above the payment of dividends, by taking advantage of the synergies of the acquired company and those under its control, for example, or using the company's resources for their own benefit.

The "Ley OPA" treatment to this mayor event, is in sum to recognize the three main pitfalls of the actual regulation at the respect, and upgrade them to a better international and accepted standards.
First, set an adequate framework for information disclosure. Since any intention of taking control of a company and its formal close or the change of control,that means information from the buyer and the actual controller should be promptly disclose to the market. Stakeholders with more than 15% should disclose the intentions of additional shares buying.
Second, there should be a tender offer procedure, clear, specific and objective, enabling any investor or new mayor shareholders to know the takeover rules before entering this market. Mandatory bids should be the rule, but distributing a % of the whole control premium as a more realistic solution given present ownership concentrations. On the other hand, a reasonable period of transition to enable full enforcement of the mandatory bid could be advisable.
And lastly, increase the fiduciary role of Directors and management as well, making them responsible with a formal opinion when a takeover occurs.

D. Principles to Consider in Drafting Regulations

Undoubtedly, buyouts can bring benefits to shareholders. However, the cost of a takeover can supercede those benefits. Because of this, regulations must place a special accent on minimizing costs without creating disincentives to the use of tender offers.

The nations with Anglo-Saxon inspired legislation firmly protect shareholder interests from takeovers, mergers and other major corporate events. The regulations in those countries focus primarily on protecting the interests of savers, transparency in the information available, equal treatment of shareholders and the allocation of responsibilities and penalties.

The idea behind the equal treatment of shareholders is to avoid possible discrimination –among those who have certain features in common– through the payment of different prices in a public tender process that would result in a redistribution of wealth in favor a given group of shareholders.

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[10] Operation known as a "*White Knight*".

[11] *Control Premiums* are primarily paid to shareholders who own the shares with the greatest voting power, even when they are entitled to a lower flow of dividends.

Similarly, this legislation requires that the purchase offer be open to all shareholders of the series for which the offer is valid.

In Chile, the only regulation that addresses the topic of buyouts is Article 54 of the Securities Market Law. As such, tender offers are not effectively regulated in current Chilean legislation.

The practical cases of takeovers in Chilean companies have made it clear that the existing framework is insufficient to safeguard the interests of the *outsiders*. Similarly, a series of tender offers have made the regulatory shortcomings in the system all the more apparent, especially in the areas of information transparency, equal treatment of shareholders and the responsibilities of board members and controllers.
Tender Offer and Corporate Governance Law (Ley OPA), bill already submitted to the Congress and waiting for its final approval is the road taking by the Regulator to solve this market inefficiencies.
The expected output of this bill is unambiguously to foster institutional and private investor to channel investment flows to the Chilean securities market. Investor's protection will drive the process to close the discount gap between our markets and the global financial centers, increasing market liquidity.