On Missing the Point: The "Hollowing-out" Debate

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[*Caveat*: *This brief is submitted to the Competition Review Panel as a personal statement and does not necessarily reflect the opinions of the Institute or of its board of directors]*

The strength and size of the latest wave of foreign takeovers of Canadian corporations has spurred a sharp debate about their costs and benefits to Canadian society.

For some, this latest wave is but a passing phenomenon, largely offset by Canadian firms taking over foreign firms. On that side of the argument, people wax euphoric about "global" financial markets, an irresistible force for good, dispensing benefits to every society it touches. They marshal all fragments of past evidence to persuade one and all that there are few problems, and many gains, arising from foreign takeovers.

Canada, they claim, should learn from, and imitate, its big brother to the south, "a country with a significantly more liberalised [takeover] regime than Canada's." Foreign takeovers are not the issue; Canadians are. They are sentimental, emotional and uninformed about foreign takeovers. Unbeknownst, they suffer from residual bouts of "economic nationalism", "mercantilism", "statism" and "commercial xenophobia".

All of the above have found their way into the Conference Board's recent term paper "*Hollowing out"–Myths and Reality*" (February 2008). Not surprisingly, people of sound mind and sober disposition tend to run for cover and from the issue.

The other side, to which we belong, rejects this narrow definition of the issue. We agree that markets are good. They are indeed the citizens' best friends…when properly regulated. Unregulated markets, the financial ones in particular, may well be harmful to society's welfare and the citizens' pocketbook.

Located in a broader frame of reference, the current wave of foreign takeovers becomes a mere symptom, a harbinger of what is to come. First, we must share a historical reminder.

A reminder

In April 1990, Senate Bill 1310 of the Pennsylvania legislature, the strongest anti-takeover bill passed by any state, became law. The prime purpose of that bill was to block the **Canadian** Belzberg family's attempted take-over of Armstrong World Industries, a

Pennsylvania company.

The wave of hostile takeovers in the 1980s, fuelled by junk bonds, leveraged buy-outs, raiders of all sorts and “green-mailers”, triggered legislative action in some thirty states in the Land of Free Markets. These anti-takeover legislations vary from state to state but *they all aim at shifting the balance of power to the board of directors.* Even in the investor-friendly United States, governments acted to control “hostile” takeovers.

The nationality of these raiders or hostile bidders was of little consequence as most were American outfits trying to takeover American companies. The governments of Pennsylvania, Indiana, Delaware, Ohio and many other states, believed, and were strongly supported by their population, that these hostile takeovers were not in the best interest of companies nor of society at large. It is certainly not a case of Americans suffering from “economic nationalism” or “commercial xenophobia”, unless of course the residents of the state of New York are considered *foreigners* in the state of Pennsylvania.

Ever since American states enacted these laws, the financial community and various economists have lamented the “discount” in share value that results from such protection from takeovers.

Yet, these laws are still very much on the books. They empower a company’s board of directors to reject an offer to buy the company if they deem that it is not in the long-run interest of the company. In some states, they may (in two states, they have to) consider the impact of the proposed takeover on all stakeholders (employees, creditors, suppliers, the community).

At this very moment, Microsoft is keen on buying Yahoo, a company incorporated under Delaware laws and without a staggered board. In the United States, that is the most propitious circumstance for a would-be acquirer. Yet, the board of Yahoo has rejected the Microsoft bid (which offers a 62% premium over the share price before the announcement), declaring that it “substantially undervalues” Yahoo (*The Wall Street Journal*, February 11, 2008).

That may be a negotiating stance but the fact that the board of directors can reject the bid gives them some leverage in extracting a better price. That is in the interest of all shareholders. The alternative to negotiation is unappealing for Microsoft. It would have to engage in a proxy fight to get its nominees elected to the board of Yahoo. Imagine if Yahoo had chosen to stagger the election to its board of directors over three years!

Compare this to the Canadian situation, in the Alcan-Alcoa case for instance. Alcan’s board of directors could not have rejected outright Alcoa’s hostile bid. It had to let the bidder make its offer directly to its shareholders, who may well have accepted the offer, in spite of the board recommending against it.
Alcoa is incorporated in Pennsylvania. Here is what an American legal scholar writes on

the subject of the Alcan-Alcoa battle: "*The effect of all this* [the Pennsylvania anti-takeover statutes] *would be to permit Alcoa to effectively undertake a "just say no" defense to any Alcan pacman bid* [i.e. a counter-offer by Alcan to buy Alcoa]*... Compare this to Quebec* [i.e. Canadian] *law, which permits Alcan to keep its poison pill for only a short period of time and has similar time limitations on other explicit anti-takeover maneuvers.*" (Steven M. Davidoff, May 16th, 2007)

In addition, Alcoa, typical in that respect of some 60% of companies in the Standard and Poor's 500, has a staggered board, which means only a third of directors are up for election every year. That is a very effective measure against unwanted takeovers, a measure much decried by institutional investors.

Where again does one find the more permissive, "liberalized", takeover regime? In Canada or in the U.S.?

In Canada, once a company is "in play" [i.e. an offer to buy the company has been received from a credible entity], the board's role is limited. It must organize a proper auction for the company and, in the end, recommend that shareholders accept or reject the best offer. Shareholders may disregard this recommendation. If they hand in their shares in sufficient number, the deal is done.

Anytime a company is put "in play", by decision time, a large percentage of the shares will be in the hands of arbitrageurs and other hedge funds. They will play a significant role in deciding the fate of the company; but their motivations are simple and well known: make sure the buyer likely to offer the most money in cash is lined up and go for it. That has happened in the case of Falconbridge and Inco. It is the way it will work for years to come.

The Canadian debate should not be focused narrowly on foreign takeovers but more broadly on who should decide the fate of a company and through what process. Canada does not need to imitate the actions taken some twenty years ago by these American states, though we should draw lessons from them. We need to define the proper legal framework for our own circumstances and for our own time.

That debate should take into account two important aspects missing from the current discussion:

The transformation of global financial markets over the last twenty years.

The role of stable ownership in developing internationally competitive companies.

1. The world of finance is flat!

Thomas Freedman's conceit of an industrial world that is "flat" has generated deserved skepticism. However, the world of modern finance is indeed largely "flat", global, borderless. It is made-up of regulated and publicly accountable institutions. More and more, it is also populated by unregulated, opaque players implementing tricky, even hazardous, financial strategies.

The transformation of financial markets over the last 20 years has changed the nature of share ownership. A lot more "shareholders" are transient seekers of quick upsides through sophisticated strategies that have little to do with the conventional notion of ownership. A lot more "investors" are of the impatient, short-term kind.

In the process, company shares become traded commodities churning at an increasingly fast pace. The average period of stock holding is now down to some six months. It was seven years in 1960.

The combination of transient shareholders, institutional pressures for quick results and specialized funds circling companies with all sorts of game plans tend to bring about a short-term mind-set in the management of publicly traded companies. For instance:

- Some types of hedge funds take a significant stake in publicly traded companies to get their management to undertake whatever action will quickly push up the stock price. Selling the company or merging it is the fastest way to trigger a one-time boost in share price. A study of demands made by these so-called hedge funds as shareholders in a large sample of American companies (Bratton, 2006) found the following:
  Selling the company (33% of cases);
  Unbundling (32% of cases); *Disgorging cash* (number of cases unspecified);
  Management and board changes (number of cases unspecified).

Pressures exerted by these hedge funds instill a short-term orientation in the management of any company they target or are likely to target. This is very real stuff. The Compton Petroleum company from Calgary, for instance, is presently under "assault" from a hedge fund that is demanding that the company puts itself for sale so as maximize value for shareholders. "You need to put the company up for sale now", declares the imperious hedge fund manager. The Abu Dhabi National Energy Co. is reportedly standing by as a prospective buyer (John Partridge, *Globe and Mail*, January 29th, 2008).

- Private equity funds, flush from their latest round of fund raising, are now in a lull because of the poor credit conditions. As they are committed to invest this new capital within five years, they will have to get back in the game and start again taking over companies in some fashion or another. These funds accounted for 25% of all acquisitions worldwide in 2006! Their familiar game plan, when successful, produces value for their investors but it is a game plan with a short-time horizon of some five years.

- Sovereign Wealth Funds have trillions to invest and, in some cases, manifest a voracious appetite for natural resources of the kind found in abundance in Canada.

- A survey of 400 financial executives of U.S. companies found that they would "*give up positive NPV* [i.e. profitable] *projects to meet short-term earnings benchmarks… In the end, many of our results are disturbing.*

The majority of CFO's admit to sacrificing long-term economic value to hit a target or smooth short-term earnings" (Graham, Harvey and Rajgopal, 2005)

American and European policy makers are also concerned, indeed worried, about the impact of this new world of finance on their economy and industrial structure.

The issue here is not one of "foreign" takeovers. The fact that many of these new financial players happen to be foreign to Canada and mostly American is rather irrelevant. The issue is the role played by these new financial actors in shaping the nature and character of industrial firms.

Porter's epiphany

There is a book likely to be found on the bookshelves of every policy maker and politician concerned with national competitiveness, Michael Porter's ***The Competitive Advantage of Nations*** published in 1990**.** By 1992, Porter realized that an important piece was missing from his model: the role of financial markets.

That year, he wrote two articles on how the American financial markets were producing short-term management of companies, the stifling of innovation and under-investment in strategic assets. He made a set of recommendations that were quite radical in the American context.

Porter's timing was unfortunate. The next years witnessed the Internet boom and surging stock markets. Porter was ridiculed in the financial press for his lack of "foresight". He dropped the subject. But he was right, even more so in the financial context of 2008.

2. Ownership matters.

The report of the Conference Board presents as "evidence" that "hollowing-out" should not be a concern the fact that some 43 Canadian companies in 2005 were "industrial champions" with a significant position in their respective international markets and revenues in excess of $1 billion.

The ownership structure of these “champions” has provoked little curiosity.

Of these 43 companies, three have already passed under foreign control. Of the forty remaining “champions”, half either are privately owned (6) or are controlled by a single (or related) shareholder (14). Of these fourteen companies, nine (9) are controlled through a superior voting class of shares.

Even among the twenty “champions” without a controlling shareholder, several companies were built up and became successful under a very stable form of ownership. Finally, the list, drawn mainly from publicly traded companies, misses very significant “champions”, such as Cirque du Soleil, Kruger and Maax, who are entirely private companies.

It seems that world-class industrial champions are typically built under a patient and stable ownership, relatively immune from unsolicited attempts to takeover the company.

The goings-on in the world of modern finance make this sort of business context very unusual for a publicly traded company with a dispersed share ownership and no limit on the percentage of shares that any one shareholder may acquire.

Conclusion and suggestions

The debate as to whether Canada is being hollowed out by foreign takeovers is poorly framed, misses the point. The issue that deserves a serious policy debate is whether Canada’s investment context, legal system and securities regulations are adequate to the current world of finance.

Do we want boards of directors to have some power to “just say no” to hostile takeovers? How and under what conditions? Should latecomer “investors” drive decisions on mergers and acquisitions?

Should shareholders be the only party to decide on the fate of a company? Do we want to better define which stakeholders should have a say in decisions about the future of a company?

Under what conditions would the sale of a company *not be* in the national interest, even if agreed to by its shareholders and its board of directors?

What policy changes would favor the stable ownership structure so important for the development of industrial champions?

Again it must be pointed out that some thirty U.S. states have taken measures to empower board of directors, in some cases perhaps too sweepingly; but the measures were not aimed (principally) at foreign takeovers but at all hostile takeovers.

The following suggestions are offered as a means to begin the discussion of the issues that really counts for Canadians:

- The Canadian securities commissions should review their position on defenses against takeovers (or should be asked by their respective government to do so). Is it socially acceptable to grant the absolute power to decide the fate of a company solely and exclusively to shareholders as if they were the loyal, long-term investors of yesteryears?

  The decision to sell a company should not rest entirely with very recent holders of shares who may be less informed than the board of directors about the company's prospects. The interest of these "shareholders" may not coincide with the long-term interest of the company. The Canadian securities commissions should provide that boards be empowered to take into account the interests of stakeholders, including shareholders, creditors, customers, employees, and the communities in which the company operates, when evaluating a bid to buy their company.

- The Canadian government should examine methods of applying the widely-held rule that applies to Canada's major banks to certain sensitive sectors of our economy (natural resources, for example); that rule limits to 20% the percentage of total shares held by a single shareholder.

- Institutional investors who are significant capital providers to growing private companies should seek means of providing liquidity to owners and others without having to list the company's shares on a stock exchange. In the current context, as soon as a company becomes public, pressures for short-term performance as well as a host of distracting governance and regulatory obligations may well hinder its performance.

- Institutional investors should tone down their hostility to superior voting shares. We should rather propose a framework to make this type of share structure benefit all parties. It would also make "going public" more attractive to growing companies, tomorrow's "industrial champions". The Institute for governance of public and private organizations (IGOPP) has proposed a reasonable framework. As noted above, many Canadian "champions" are products of this form of ownership; so are Google, Yahoo and Berkshire Hathaway!

- Institutional investors should review their policies on shareholding period. They should be prepared to hold positions for the long term and even engage in the governance of companies in which they have invested. Investors cannot declare themselves the "owners" of companies but leave whenever they wish. They should perhaps reflect upon Warren Buffett's view on this matter. When asked about his favorite stock holding period, he answered "Forever!" How long is he prepared to wait for performance? "Indefinitely!" The notion that shareholders receive a "loyalty" dividend (i.e. a 10% premium on dividends) after holding shares for more than two years may have merit in this context.

- The concept of corporate citizenship, though somewhat tricky to implement, may also have merit. As with national citizenship, a shareholder would acquire the right to vote only after a one-year holding period. Combined with a stipulation that a takeover proposal be submitted to a vote by shareholders, it would at least put the fate of a company in the hands of shareholders of some duration. The Institute for governance of public and private organizations (IGOPP) has taken position in favor of some form of corporate citizenship in Canada.

- Boards of directors should ensure that change-of-control clauses in the management contract of senior executives do not trigger huge windfalls if their company is taken over. In some cases, these arrangements work too well in making what would be a "hostile" bid into a friendly, management-supported transaction.