Managers, Workers, and Corporate Control

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Abstract

If the private benefits of control are high and management owns a small equity stake, managers and workers are natural allies. There are two forces at play. First, managers effectively transform employees into a “poison pill” by signing generous long-term labor contracts and thereby reducing the firm’s attractiveness to a raider. Second, employees act as “white squires” for the incumbent managers, lobbying against hostile takeovers to protect the high wages enjoyed under incumbent management. Our model is consistent with available empirical findings, and yields new predictions as well.

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1 Introduction

Labor economists view industrial relations as being shaped by the conflict between workers and management. Financial economists view corporate governance as the outcome of the diverging interests of shareholders and management. In reality, these two conflicts of interest are present simultaneously, and interact with each other. We show that the conflict in corporate governance, when particularly acute, can soften the clash in industrial relations. In companies where control confers high private benefits and where management has a small equity stake, managers have the incentive to pay workers high wages, and to monitor them little. Non-controlling shareholders are those who bear most of the costs of this employment policy.¹

One would expect the market for corporate control to prevent such behavior, unless managers can entrench themselves via legal anti-takeover defenses. In fact, this is not the case. Incumbent managers have the incentive to pursue a generous employment policy precisely to defend themselves against hostile takeovers. There are two distinct but complementary reasons for this. First, by writing long-term contracts entitling workers to high wages, managers effectively transform employees into a “poison pill”: their high wages reduce the firm’s attractiveness to a raider. Second, to the extent that they are not protected by long-term contracts against the risk of a wage cut by the raider, employees will act as “white squires”: they will fight hostile takeovers to protect their high salaries by lobbying, demonstrating, threatening strikes against the raider, etc. Both these implicit anti-takeover defenses are available even when explicit defenses are forbidden or limited by the law.

The idea that workers and incumbent managers are natural allies against non-controlling shareholders and potential raiders (the shareholders’ own natural ally) was already put forward by Hellwig (2000). He argued that this “natural alliance” actually extends beyond manager-worker relations, pointing out that “Incumbent managers who try to buttress their positions will regularly find allies in the political system, labor, the media, the judiciary, and even the universities” (p. 122) against outside shareholders. In the same spirit, Pagano and Volpin (2001) analyze the circumstances in which an economy-wide political alliance between managers (or controlling shareholders) and workers can arise, and impose laws that give poor protection to non-controlling shareholders.

Here we show how such a labor-management “alliance” can arise at the level of individual firm, and explain why this alliance – or implicit contract – is “natural”,

¹Very few studies investigate the relationship between labor contracts and corporate control. Shleifer and Summers (1988) propose a view of hostile takeovers as breaching implicit contracts between incumbent managers and workers. Garvey and Gaston (1998) formalize this view of takeovers, but – as Shleifer and Summers themselves – do not explain why incumbents have the incentive to stick to labor contracts that raiders have the incentive to breach. More recently, Chemla (2000) investigates the impact of takeover threats affect long-term labor relations, and particularly stakeholders’ investment. Others have studied the connection between labor-management relation and corporate governance in particular contexts, such as German codetermination (Gorton and Schmid, 2000), Japanese lifetime employment practices (Gilson and Roe, 1999) or employee-owned corporations (Hansmann, 1996).
that is, fully incentive-compatible: why, in particular, managers do not wish to renege on their generous wage concessions once the takeover threat does not materialize, unlike in the implicit-contract setting of Shleifer and Summers (1988). In our model, a generous wage policy is the managers’ preferred policy also ex post, while wage-cutting is the raider’s preferred course of action.

This difference in the preferred policies of the incumbent and the raider is rooted in the different stake they hold in the company – a key assumption of the model. The incumbent management has a smaller stake in the company than the raider would have upon taking over the company. As a result, the incumbent manager prefers to rely more on generous wage settlements than on intensive monitoring to motivate employees. Most of the cost of the wage settlement is shifted onto other shareholders, while the monitoring cost is entirely borne by the manager himself. In contrast, a successful raider with a large stake in the company wants to go for a “hard-nosed” strategy: cut wages as far as legally possible, and increase monitoring to keep work incentives high. Therefore, workers prefer the incumbent manager to the raider, and can trust him, his pledged employment policies being in his best interest.

The model has a number of empirical predictions. First, in companies where private benefits are high and the managers’ equity stake is low, employees should be paid relatively high wages, and a large fraction of them should be hired under long-term employment contracts. By the same token, such companies should be unattractive to a raider or difficult to take over. As a result, the model predicts a negative correlation between the average employee compensation (or the fraction of long-term contracts) and the frequency of hostile takeovers, controlling for other factors (such as anti-takeover legislation).

A second prediction is that if a takeover succeeds, the new management will renegotiate lower salaries with the short-term employees and, as far as the law allows, also with employees on long-term contracts. It will also start monitoring workers more intensively. The company’s share price will increase in proportion to the share of employees with renegotiable contracts in the total wage bill.

A third prediction is that in companies where private benefits are high and managers’ equity stake is low, employees take industrial or political action to oppose hostile takeovers, as well as any change in corporate governance that reduce the current management’s control. In these circumstances, employees become political allies of managers or controlling shareholders.

In contrast with the previous predictions, the latter one requires a certain degree of workers’ coordination. While the “poison pill” mechanism does not require any collective action by workers (managers themselves offer to overcompensate them), to act as “white squires” workers must be able to coordinate themselves, presumably via trade unions. By the same token, employee stock ownership plans (ESOPs) have a potential role to play in this context. When workers act as “white squires”, giving them an equity stake in the company enables them to vote together with the incumbent manager in the fight against the raider.

Interestingly, the “poison pill” and the “white squires” mechanisms complement
each other, their respective effectiveness being determined by the degree of employment protection. If they enjoy high employment protection, workers on long-term contracts are effective as a “poison pill”, since a successful raider will be unable to renegotiate their salaries; but by the same token they have little incentive to behave as “white squires”, since they face little risk of a wage cut under the new management. Conversely, if the law affords them little protection under the new management, the “poison pill” mechanism becomes ineffective, but the “white squires” mechanism is strengthened, as employees know that the success of a hostile takeovers would threaten their wage levels. This is a further testable prediction of the model.

The paper is structured as follows. Section 2 lays out the structure of the model. In Section 3 we solve for the equilibrium, identify the circumstances in which labor contracts are used as “poison pills” and derive a set of testable predictions. In Section 4 we introduce the additional assumption that workers can affect the probability of a takeover, identify the circumstances in which workers act as “white squires”, and compare the resulting predictions with the available evidence. Section 5 concludes.

2 The model

Consider a firm with dispersed outside shareownership and contestable control. The incumbent management owns a fraction \( \beta \) of the cash-flow rights of the firm, and its fraction of the voting rights is sufficiently low that a raider can take over the company. We represent two generic production cycles in the firm’s life. The sequence of events is illustrated in Figure 1.

At \( t = 0 \), the firm hires workers, whose number is standardized to 1 for simplicity. The workers can be hired with long-term contracts that span two production cycles or with short-term ones that cover only the first cycle. Let \( \lambda \) denote the fraction of workers who are hired with a long-term contract. The output of the first production cycle is produced and the corresponding wages are paid within period 0. For expositional simplicity, we do not model the first production cycle explicitly. However, the results are unaffected if it is modeled like the second production cycle, which unfolds between periods \( t = 2 \) and \( t = 4 \).

At \( t = 1 \), after the first production cycle is completed and before the second one starts, a raider can take over the firm. The probability of a takeover, \( p \), is a positive number \( \pi \) if the raider decides to attempt the takeover, and is 0 otherwise. Without modeling the takeover process, we assume that the raider’s net gain from a successful takeover is a fraction \( \tau \beta_R \) of the increase in shareholder value, where \( \beta_R \) is the fraction of equity acquired by the raider and \( \tau \) is a parameter that identifies the ability of the raider to extract this surplus from the shareholders (and it is affected by the structure of the market for corporate control, as will be discussed later).

At \( t = 2 \), new workers can be hired with short-term contracts, and the second production cycle starts. As in Calvo and Wellisz (1978), workers can be induced to invest in effort through wage incentives and/or through monitoring. Managers set both the wage \( w \) and the monitoring intensity, that is, the probability \( q \) with which
they can verify their employees’ effort level. This probability of detection depends on
the private cost borne by the manager to monitor employees, which for simplicity is
assumed to be linear in $q$: $c(q) = c_m q$, where $c_m$ is positive constant. If the takeover
succeeds, the raider replaces the former management and monitors workers directly
via the same monitoring technology.\footnote{So in our model the raider has no intrinsic advantage in monitoring workers. However, if he
were assumed to be a more effective monitor, our results would be reinforced.}

At $t=3$, workers choose their effort level. If they exert no effort, their productivity is $y$. If they exert effort, at a private cost $c_e$, their productivity rises to $y + \Delta$. After workers choose their effort level, management randomly verifies it for a fraction $q$ of employees, and can still replace those caught shirking with new (unskilled) workers, hired at the competitive wage $\bar{w}$.\footnote{The workers that leave the firm at this stage can themselves obtain the reservation wage $\bar{w}$ from other employers. Therefore, rather than firing the workers caught shirking, the manager may equivalently renegotiate their salary down to the competitive level $\bar{w}$.} The management cannot observe the individual productivity of workers that are not monitored at this stage.

Finally, at $t=4$, employees produce output $y$ or $y + \Delta$, depending on their effort level, and receive their salary. (Although this salary refers to the second production cycle, for brevity we shall refer to it as “the” wage.) Shareholders earn the firm’s profits, amounting to the difference between the firm’s production and its wage bill. If still in control, the initial manager receives a non-monetary benefit $B$.

In this setting, we will show that the incumbent manager can reduce the probability of a takeover by offering long-term labor contracts to the company’s employees, against the interests of the company’s shareholders. We assume that he has complete control over wage policy, since the company’s existing shareholders are dispersed.

We impose three restrictions on the parameter space:

1. $4c_e c_m / \Delta^2 < \beta < c_m / c_e$: the right-hand inequality ensures that the monitoring problem has an interior solution, while the left-hand inequality ensures that workers’ investment in effort is ex-post efficient.

2. $B - \sqrt{\beta c_e c_m} = \bar{B} > 0$: the private benefits of the incumbent manager, net of the monitoring costs, are positive. This is the source of the agency problem between shareholders and the company’s management.

3. $\beta R > [(1 + \tau)/\tau]^2 \beta$: this inequality ensures the contestability of control over the company. It requires the raider to obtain a positive expected net gain from the takeover at least in the scenario most favorable for him, that is, if he can renegotiate the labor contract with all the firm’s employees. If this condition is not met, nobody has the incentive to bid for the company.

This condition that the raider bids for a considerably larger stake than that owned by the incumbent management is a crucial assumption of the model. It is precisely his larger stake in the company that motivates the raider to monitor workers more and pay them less than the incumbent manager. We take $\beta_R$ and $\beta$ to be parameters
of the model, but they can be endogenized assuming that both the raider and the incumbent manager are wealth-constrained, with the incumbent manager being able to invest a smaller amount of personal wealth than the raider in the firm. This may result from the fact that incumbent managers are entrepreneurs able to identify and develop many investment opportunities, while raiders can only manage existing firms. As a result, even if initially they are endowed with the same wealth level, incumbents hold a smaller stake in each of their firms, compared to the stake that a raider can purchase in any one of them. The difference between $\beta_R$ and $\beta$ may also be affected by financial regulation: while control over the company can be had with a relatively small stake, the raider may be required to bid for a larger one by a mandatory takeover bid rule. Such rules are present in many jurisdictions, in Europe as well as in the US.\footnote{The London City Code and security laws in other European countries requires raiders to launch a tender offer to all minority shareholders, if they purchase more than 30 percent of the voting shares of a public company. Similarly, in Delaware, where a large percentage of US companies are incorporated, a bidder who buys more than 15 percent of a firm’s stock cannot legally complete the takeover unless he buys at least 85 percent of the target’s shares or gets the approval of two thirds of the shareholders.}

3 Workers as poison pills

Proceeding backwards, the first step to consider is the worker’s moral hazard problem at $t = 3$. Under the assumption that inducing workers to provide effort is always efficient (assumption 1), the monitoring level $q$ and the wage $w$ are chosen so as to satisfy the workers’ incentive compatibility constraint.

If a worker invests effort in his job, his utility is $w - c_e$: the wage minus the cost of effort. If the worker invests no effort, his utility is $q\overline{w} + (1-q)w$: with probability $q$ he is caught shirking and is replaced (or his wage is renegotiated down to the reservation level); with probability $1-q$, he obtains the wage $w$ because the manager cannot distinguish him from a high-productivity worker.

Hence, the incentive compatibility constraint is

$$q(w - \overline{w}) \geq c_e \quad (1)$$

So, workers provide effort either if the probability $q$ of being caught shirking is high or if the wage loss $w - \overline{w}$ from dismissal is high, compared to their cost $c_e$ of investing in human capital. How are the level of supervision, $q$, and the wage, $w$, chosen? They depend on two factors: (i) who controls the firm from period 2 onwards (the previous management or the raider) and (ii) whether workers are under a long-term or a short-term contract.

If a worker is hired under a long-term contract, his wage in the second production cycle is already set by the labor contract signed at $t = 0$. (Its level, $w_L$, will be determined when analyzing the initial stage of the game.) At $t = 2$ the manager can
only choose the probability of detection \( q \). The incentive compatibility constraint requires this probability to be \( q_L = c_e / (w_L - \bar{w}) \). In this case, the level of supervision is independent of the identity of the management, the wage being preset.

If instead the worker’s contract can be renegotiated at \( t = 2 \) (as happens if the employee was hired under a short-term contract at \( t = 0 \)), the level of monitoring and the wage, \( (q, w) \), are chosen so as to maximize the utility of the party in control subject to the workers’ incentive compatibility constraint: \( w \geq \bar{w} + c_e / q \). The amount of monitoring \( q \) will differ depending on whether the takeover succeeds. If the incumbent manager remains in charge, \( q \) is chosen to maximize his utility \( u_I \):

\[
\max_{q \in [0,1]} \quad u_I = \beta (y + \Delta - w) - qc_m
\]

subject to the worker’s participation constraint (1) and to the manager’s own participation constraint:

\[
u_I \geq \beta (y - \bar{w})
\]

where the right-hand side is the manager’s utility if workers are given no incentive to exert effort.

From the first-order condition \( (\beta c_e / q^2 = c_m) \), which is necessary and sufficient for a maximum, one obtains the level of monitoring chosen by the incumbent:

\[
q_I = \sqrt{\beta c_e / c_m}
\]

which is strictly positive. It is smaller than 1 by assumption 1, and it is smaller than the optimal level of supervision, which would prevail under sole ownership of the firm \( (\beta = 1) \). Hence, the separation of ownership and control induces under-monitoring of workers.

The wage that the incumbent pays to workers therefore is:

\[
w_I = \bar{w} + \sqrt{c_e c_m / \beta}
\]

It is decreasing in \( \beta \) and increasing in \( c_m \), because a lower stake and more expensive monitoring lower the probability of detection and therefore increase the wage premium necessary to motivate workers (wage incentives and monitoring being substitutes). It is increasing in \( c_m \), because the wage premium must compensate workers for their investment in human capital. When \( q \) and \( w \) are set according to equations (3) and (4), the manager’s participation constraint is met if \( \beta (\Delta - \sqrt{c_e c_m / \beta}) > \sqrt{\beta c_e c_m} \). This holds by assumption 1, being equivalent to the condition \( \beta > 4 c_e c_m / \Delta^2 \).

Similarly, if the raider acquires control of the firm, he will choose a level of monitoring \( q = \sqrt{\beta_R c_e / c_m} = q_R \) and a wage \( w = \bar{w} + c_e / q_R = w_R \). Since \( \beta_R > \beta \) by assumption 3, the incumbent manager monitors workers less than a successful raider:

\[
q_I < q_R
\]

and pays them higher wages:
\[ w_I - w_R = \sqrt{c_e c_m / \beta} - \sqrt{c_e c_m / \beta_R} \equiv \delta > 0 \]  

(5)

where the difference \( \delta \) is increasing in \( c_e, c_m \) and \( \beta_R \), and decreasing in \( \beta \). The incumbent manager monitors less and pays higher wages because he internalizes to a smaller extent the costs of his wage policy, since he owns a smaller fraction of the firm.

At \( t = 1 \), the probability of a takeover depends on the gain that a raider expects from the takeover. A successful takeover creates shareholder value because it reduces the firm’s wage bill: it increases the firm’s profit by \((1 - \lambda)\delta\), that is, by the lower wages for all workers who were hired at \( t = 0 \) under a short-term contract. The raider’s gain from a successful takeover is equal to a fraction \( \tau \beta_R \) of the increase in shareholder value, where \( \tau \) depends on the functioning of the security market. The decision faced by the potential raider is whether to attempt a takeover or not. If he does, the net change in his expected utility is given by the expected gain from the takeover \((\pi \tau \beta_R (1 - \lambda)\delta)\), net of the raider’s expected monitoring cost. In case of success, the raider will monitor the workers hired under short-term contracts at a cost \((1 - \lambda)q_R c_m\), and those hired under long-term contracts at a cost \(\lambda q_L c_m\). Therefore, a takeover attempt is worthwhile if and only if

\[ \pi \left\{ \tau \beta_R (1 - \lambda)\delta - [(1 - \lambda)q_R + \lambda q_L] c_m \right\} > 0 \]

or

\[ (1 - \lambda)[\tau \beta_R \delta - (q_R - q_L)c_m] - q_L c_m > 0 \]  

(6)

Condition (6) implies that the initial manager can reduce the probability of a takeover by setting up long-term contracts, that is, by raising \( \lambda \). Specifically, let us denote by \( \hat{\lambda} \) the value of \( \lambda \) such that the expression on the left-hand side of (6) is zero:

\[ \hat{\lambda} = \frac{\tau \beta_R \delta - q_R c_m}{\tau \beta_R \delta - q_R c_m + q_L c_m} \]  

(7)

For any \( \lambda \geq \hat{\lambda} \), the raider will not attempt a takeover. Notice that \( \hat{\lambda} \) is bound between zero and one if and only if \( \tau \beta_R \delta > q_R c_m \), which, upon substituting for \( \delta \) and \( q_R \), is seen to be equivalent to \( \tau \sqrt{\beta_R} > (1 + \tau)\sqrt{\beta} \). The latter condition is guaranteed by assumption 3.

At \( t = 0 \), the manager chooses the fraction of workers to hire with a long-term contract, \( \lambda \), and their wage, \( w_L \).

Let us first consider the wage. The maximization problem faced by the manager is identical to the problem (2) that he will face at \( t = 2 \) with a short-term worker, except that now \( w_L \) is the only choice variable. As we have seen above, the level of monitoring to be chosen at \( t = 2 \) is dictated by the incentive compatibility constraint \( q_L = c_e / (w_L - \bar{w}) \). Hence, \( w_L = w_I \) and \( q_L = q_I \). The incumbent manager pays the same wage to workers hired under short- or long-term contracts, and monitors them with the same intensity.

Given this result, we can substitute for \( q_R, q_L \) and \( \delta \) into the expression for \( \hat{\lambda} \) in (7), and express this threshold in terms of parameters alone:
\[
\hat{\lambda} = \frac{\tau \beta_R - (1 + \tau) \sqrt{\beta \beta_R}}{\beta + \tau \beta_R - (1 + \tau) \sqrt{\beta \beta_R}}
\]  

The manager then chooses \( \lambda \) in order to maximize his expected utility:

\[
\max_{\lambda \in [0,1]} u_I = \beta[(y + \Delta - w_I) + p(1-\lambda)\delta] + (1 - p)(B - \sqrt{\beta c_e c_m})
\]  

where \( p \) is equal to 0 if \( \lambda \geq \hat{\lambda} \), and to \( \pi \) otherwise. The first term is the manager’s fraction of the verifiable profits produced by the company. This is the sum of the company’s profits under the incumbent manager, \( y + \Delta - w_I \), plus the savings in the wage bill if the raider is successful, \((1 - \lambda)\delta\), weighed by the probability of success, \( p \).

The second term is the net private benefit of control: the private benefit of staying in control, \( B \), minus the supervision cost, \( \sqrt{\beta c_e c_m} \), weighed by the probability that the takeover fails, \( 1 - p \). The net private benefits of control \( \tilde{B} \equiv B - \sqrt{\beta c_e c_m} \) are positive by assumption 2, and they are decreasing in \( \beta \), \( c_e \) and \( c_m \) and increasing in \( B \).

It is immediate that the choice of the optimal \( \lambda \) is restricted to the following alternatives: either \( \lambda = 0 \) or some \( \lambda \geq \hat{\lambda} \). The manager’s utility in (9) is strictly decreasing in \( \lambda \) for given \( p \), and for \( \lambda \in [0, \hat{\lambda}] \). At \( \lambda = 0 \) the security benefits are maximized, at \( \lambda \geq \hat{\lambda} \) the private benefits are maximized. The manager’s utility for \( \lambda = 0 \) is:

\[
u_I(0) = \beta[(y + \Delta - w_I) + \pi \delta] + (1 - \pi)\tilde{B}
\]

while his utility for \( \lambda \geq \hat{\lambda} \) is:

\[
u_I(\hat{\lambda}) = \beta[(y + \Delta - w_I)] + \tilde{B}.
\]

The comparison between the two depends on the sign of the following expression:

\[
u(0) - u(\hat{\lambda}) = \pi(\beta \delta - \tilde{B}).
\]

If the expression (12) is positive, all labor contracts should be short-term. Otherwise, a fraction \( \lambda \geq \hat{\lambda} > 0 \) should be long term. The trade-off in (12) turns on the difference between the incumbent’s security benefits \( \beta \delta \) and his private benefits \( \tilde{B} \). On the one hand, signing long-term contracts is costly for the manager because it reduces his security benefits: by discouraging a takeover, he will himself miss the opportunity of earning a fraction \( \beta \) of the value enhancement produced by the raider. On the other hand, the same reduction in the contestability of control also protects his private benefits of control. In this sense, management uses long-term labor contracts strategically, as a “poison pill” against raiders. It is immediate to see that the net cost of signing long-term contracts, (12), is increasing in his stake \( \beta \) and decreasing in his gross private benefits \( B \). Hence, for \( \beta \) small enough and/or \( B \) large enough, the incumbent manager will choose a fraction \( \lambda \geq \hat{\lambda} \) of long-term contracts. Equating expression (12) to zero, one obtains the locus of the combinations \((\beta, B)\) for which
the incumbent manager is indifferent between using short-term labor contracts alone and relying on a mix of short- and long-term contracts (the latter designed to act as a “poison pill” against potential takeovers):

\[
\bar{B}(\beta) = \sqrt{c_{ecm}} \left( 2\sqrt{\beta - \frac{\beta}{\sqrt{\beta_R}}} \right)
\]  

(13)

The function \(\bar{B}(\beta)\) is increasing and concave, and reaches a maximum for \(\beta = \beta_R\), as shown in Figure 2. Recall that for control to be contestable, we must be in the region where \(\beta < \left[\frac{\tau^2}{(1 + \tau)^2}\right] \beta_R\), as stated by assumption 3, which implies \(\beta < \beta_R\). (For values of the region where \(\beta > \left[\frac{\tau^2}{(1 + \tau)^2}\right] \beta_R\), there is no threat of takeover and therefore the incumbent manager is indifferent between offering short- and long-term contracts.) Therefore, in Figure 2 the region where long-term labor contracts are used as a poison pill is formed by the points above the \(\bar{B}(\beta)\) locus and to the left of the value \(\left[\frac{\tau^2}{(1 + \tau)^2}\right] \beta_R\) on the horizontal axis. Proposition 1 characterizes the manager’s optimal labor policy:

**Proposition 1** For any value of the incumbent manager’s stake \(\beta\), there is a threshold \(\bar{B}\) such that (i) if private benefits \(B > \bar{B}\), the manager signs long-term labor contracts with a fraction \(\lambda \geq \bar{\lambda}\) of its employees; (i) if instead \(B < \bar{B}\), the manager signs only short-term labor contracts. The threshold \(\bar{B}\) is an increasing and concave function of \(\beta\), in the parameter region where control is contestable.

Intuitively, the larger the private benefits of control, the stronger is the incumbent’s incentive to seek protection from a raider by committing to long-term contracts. This incentive is tempered if the manager owns a large stake in the company, since in this case a large fraction of the extra wages paid to workers comes from his pocket.

Proposition 1 can be rephrased in terms of predictions about the expected wage paid to workers.

**Corollary 1.** If control is contestable, the average wage is increasing in the private benefits \(B\) of the incumbent manager, and is decreasing in his stake \(\beta\). Specifically, the average wage equals \(w_I\) if \(B < \bar{B}(\beta)\), and \(w_I - \pi \delta\) otherwise.

Since the value of the company, which consists of its security benefits, is inversely related to the wages paid, Corollary 1 immediately implies that the firm value is increasing in \(\beta\) and decreasing in \(B\). These results also translate into predictions about the probability of a takeover:

**Corollary 2.** If control is contestable, the probability \(p\) of a hostile takeover is decreasing in the private benefits \(B\) of the incumbent manager, and is increasing in his stake \(\beta\). Specifically, \(p = 0\) if \(B < \bar{B}(\beta)\), and \(p = \pi > 0\) otherwise.

One may object that these predictions are hard to test empirically, because it is difficult to measure managers’ private benefits \(B\). However, the two corollaries – taken together – also predict an inverse correlation between two endogenous variables.
of the model: the average wage and the probability of a hostile takeover. Both these variables are measurable at the company level. To the best of our knowledge, so far there is no evidence on their correlation. We plan to analyze it using data for US corporations.

Finally, the model produces some predictions concerning the effects of a successful takeover:

**Corollary 3.** If a hostile takeover succeeds, the new management negotiates lower wages with the employees holding short-term contracts, and monitors them more intensively. In addition, the company’s value rises in proportion with the share of short-term employees in the total wage bill, \( \lambda \).

The existing evidence on the wage reaction to successful hostile takeovers is consistent with the first prediction of Corollary 3. Bhagat, Shleifer and Vishny (1990) document a small decrease in the average compensation of the target companies’ employees. Rosett (1990) reports that a wealth transfer from workers to shareholders accounts for 10 percent of the hostile takeover premium within 18 years after the takeover, and Becker (1995) finds that hostile takeovers are associated with a significant reduction of union wage premia.

There is also considerable anecdotal evidence on drastic wage-cutting after takeovers, especially in the US airline industry. In 1981 Frank Lorenzo, owner of Texas International Airlines, took over Continental Airlines, just as the company’s labor contracts were about to expire and, rather than negotiating with the airline’s labor unions, he filed for bankruptcy. This move allowed him to fire union employees, restart the company with non-union staff, cut wages by half and force employees to accept longer working hours, shorter breaks, and no guaranteed time off.\(^5\) Similarly, months after winning a contest to take control of TWA in 1985, Carl Icahn persuaded union pilots and mechanics to take a wage cut in return for a 15 percent stake in the company, and a year later he fired 5,000 striking flight attendants after they refused to accept wage cuts and increased hours.

### 3.1 The role of employment protection

So far we have assumed that the long-term labor contracts signed at \( t = 0 \) are legally binding also at \( t = 2 \). The management in charge at \( t = 2 \) (whether it is the same who signed the contract or not) can neither fire existing workers nor renegotiate their wage. That is, we assume that the law grants complete employment protection to long-term employees.

Suppose instead that at \( t = 2 \), the incumbent manager can layoff (at most) a fraction \( f \) of the employees hired with a long-term labor contract. This is intended

\(^5\)Later Lorenzo tried to apply the same strategy to Eastern Airlines, but this time he failed because of the fiercer resistance of the unions. Upon taking over the company in 1986, he asked its machinists to take a pay cut, but these went on strike, and labor unrest eventually brought the company down.
to capture the fact that employment protection can be less than complete, at least for some workers. The degree of employment protection is then measured by $1 - f$, the fraction of “protected” workers. We will see that the smaller is this fraction, the lower is the effectiveness of long-term employment contracts as a poison pill.

At $t = 2$ the raider, but not the incumbent manager, will find it optimal to renegotiate with the workers that can be laid off, by making a “take-it-or-leave-it” wage offer at the optimal wage for the raider $w_R$. As a result, if the takeover is successful, the firm’s profit increases by $(1 - \lambda)\delta + \lambda f\delta$, that is, by the lower wage bill for the $1 - \lambda$ workers who were hired at $t = 0$ under a short-term contract and for the $\lambda f$ workers hired with a long-term contract but can be fired.

Hence, the decision faced by the potential raider whether to increase the probability of success in the takeover attempt is modified simply replacing $(1 - \lambda)$ with $(1 - \lambda) + \lambda f$ in the reasoning developed in the previous section. Therefore, a takeover attempt is worthwhile if and only if

$$\pi \left\{ \tau \beta R [1 - \lambda(1 - f)] \delta - [(1 - \lambda(1 - f)) q_R + \lambda(1 - f)q_L] c_m \right\} > 0$$

or

$$[1 - \lambda(1 - f)] [\tau \beta R \delta - (q_R - q_L)c_m] - q_Lc_m > 0$$

Correspondingly, the critical fraction of long-term contracts $\tilde{\lambda}$ above which the raider will not attempt a takeover is

$$\tilde{\lambda} = \frac{1}{1 - f} \cdot \frac{\tau \beta R \delta - q_Rc_m}{\tau \beta R \delta - q_Rc_m + q_Lc_m}$$

that is, is decreasing in $1 - f$, the degree of employment protection. The intuition is that the lower is the employment protection, the less effective is this “poison pill” to fend off hostile takeovers, and accordingly a large dosage of the pill is needed, that is, a larger fraction of long-term contracts is signed. However, this fraction cannot exceed one. If employment protection $1 - f$ falls below a threshold level $1 - \tilde{f}$ such that $\tilde{\lambda} = 1$ in expression (15), the “poison pill” cannot prevent a takeover even if all workers are given long-term contracts. Therefore, in this scenario the incumbent management switches back to a policy of issuing only short-term labor contracts ($\lambda = 0$).

Hence, Proposition 2 follows immediately:

**Proposition 2** If control is contestable and $B > \hat{B}$, the fraction $\tilde{\lambda}$ of long-term contracts is decreasing in the degree of employment protection offered to long-term employees. If the degree of employment protection falls below a critical value $1 - \tilde{f}$, the firm issues no long-term contracts ($\lambda = 0$).

The results in Proposition 2 can be rephrased in terms of predictions about the average wage paid to workers.

**Corollary 4.** If control is contestable, the average wage is increasing in the degree of employment protection, $1 - f$. Specifically, the average wage equals $w_1$ if $1 - f$ exceeds a critical value $1 - \tilde{f}$ and if $B > \hat{B}$. Otherwise, it equals $w_1 - \pi \delta$. 

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These results also translate into predictions about the probability of a takeover. A low degree of employment protection thwarts the use of long-term labor contracts as a “poison pill”:

**Corollary 5.** If control is contestable, the probability $p$ of a hostile takeover is decreasing in the degree of employment protection, $1 - f$. Specifically, $p = 0$ if $1 - f$ exceeds a critical value $1 - \hat{f}$ and if $B > \hat{B}$. Otherwise, $p = \pi > 0$.

Finally, the model produces some predictions concerning how the effects of a successful takeover relate to the degree of employment protection:

**Corollary 6.** If a hostile takeover succeeds, the fraction of employees with whom the new management negotiates lower wages and the increase in the company’s value are decreasing functions of the degree of employment protection, $1 - f$.

### 3.2 The role of stock market transparency

The raider’s incentive to launch a takeover depends on his expected gain. We assumed that the raider receives a fraction $\tau$ of the shareholder value created by the takeover. This parameter is affected by the degree of market transparency. If trading motives are not easily recognized in the stock market and regulation does not force rapid disclosure of large stake holdings, the raider can accumulate a considerable toehold in the company before the shares start appreciating as a result of his trades. In this case, $\tau$ is large and he will pay a modest control premium to the market. Conversely, in the extreme case where the stock market appropriates entirely the value enhancement potentially generated by the raider ($\tau = 0$), the latter’s incentive to bid vanishes altogether, as in Grossman and Hart (1980). Our model, however, imposes a tighter lower bound on $\tau$ for the incentive to bid not to vanish: the probability of a takeover is zero unless $\tau > \sqrt{\beta}/(\sqrt{\beta R} - \sqrt{\beta}) > 0$, which is yet another restatement of assumption 3. Notice that nothing prevents $\tau$ from exceeding 1, if the raider expects to draw some private benefits of control from the company, on top of his fraction of the company’s value enhancement.

Provided it satisfies this lower bound, the result in Proposition 1 and Corollaries 1 and 2 hold irrespective of the size of $\tau$. However, the size of $\tau$ has a positive impact on $\hat{\lambda}$: a higher $\tau$ – that is, a less transparent stock market – induces management to issue long-term contracts to a larger fraction of employees. Intuitively, the larger the fraction of the company’s enhancement that the raider expects to retain, the greater his inducement to launch a takeover bid, and the “dosage” of the poison pill to be administered to deter the takeover is correspondingly larger. Being control otherwise more contestable, the firm will have to sign more long-term employment contracts as anti-takeover defense.

### 3.3 The role of takeover legislation

The success of a hostile takeover hinges crucially upon existing takeover legislation. In some countries incumbent managers have large discretion in fighting raiders. In
others, they need shareholders’ approval to implement any defensive strategy. Ultimately, these differences across countries reflect the balance of power between different interest groups, as well as cultural and historical differences. The clash between different approaches to takeover legislation has caused the recent failure by European countries to introduce a common takeover legislation: while hostile takeovers are allowed in the UK, they are traditionally discouraged by the law in Germany – an outcome strenuously supported by powerful management lobbies in that country.

In our model, the role of the takeover legislation can be represented by the probability $\pi$ that the raider is successful – $\pi$ being lower in countries (and states) where legislation is less favorable to hostile takeovers. According to the model, a stricter anti-takeover legislation increases the average wage. The intuition for this result is that incumbent managers are more likely to stay in control, and therefore will pay higher wages than a raider would. This is consistent with evidence by Bertrand and Mullainathan (2001), who show that across US states the introduction of state-level anti-takeover legislation in the 1980s has been associated with an increase in the average wages at firm level.

4 Workers as white squires

So far, we have assumed that employees do not play an active role in fighting against corporate raiders: it is the incumbent management who designs their employment contract so as to make the company a less desirable takeover target. However, in reality employees can take a more active role: they may lobby against hostile takeovers, coming to the rescue of incumbent management as “white squires”. Naturally, this assumption is appropriate only if workers are already an organized pressure group: trade unions are likely to play an important role in organizing such a collective action.

To capture this possibility, we make a single amendment to the model’s assumptions laid out in Section 2. We assume that at $t = 1$, the workers can lobby to reduce the probability of success of a raider by a fraction $\varepsilon$ at a cost $l(\varepsilon)$. The lobbying cost is assumed to be an increasing, differentiable and convex function of the proportional reduction in probability $\varepsilon$.

Within the setting of this model, workers with short-term contracts prefer dealing with the incumbent manager than with a raider because the latter is tougher in his monitoring policy and cuts their wages from $w_I$ to $w_I - \delta$. This is the case because the incumbent manager has a low equity stake in the company, and therefore prefers to pay them an efficiency wage rather than monitoring them intensively. In contrast, a raider will want to monitor workers intensively, since to carry out the takeover he accumulates a large stake in the company.

Naturally, short-term workers will not engage in a costly lobbying activity if the structure of long-term contracts set up by the manager at $t = 0$ is already sufficient to deter a takeover. In other terms, if the “poison pill” is operational, there is no need for workers to act as “white squires”.

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Suppose that instead the structure of labor contracts is such that a successful takeover can occur so that we are in the shaded area of Figure 2, where $B < \bar{B}$. In this case, workers are all under short-term contracts, and therefore they would all face a wage cut if a takeover succeeds. Therefore, they have the incentive to reduce the probability of a takeover: their expected wage $w_I - \pi(1 - \varepsilon)\delta$ is increasing in $\varepsilon$. Hence, their decision problem is:

$$\max_{\varepsilon} w_I - \delta\pi(1 - \varepsilon) - l(\varepsilon)$$

From the first order condition $l'(\varepsilon^*) = \delta\pi$, the solution $\varepsilon^*$ is strictly increasing in the baseline probability of a successful takeover $\pi$ and in the prospective wage cut $\delta$. Workers will fight more intensively if a takeover would be very likely otherwise ($\pi$ high). This suggests that their activism and other anti-takeover defenses are substitutes: in countries where regulation discourages hostile takeovers ($\pi$ high), workers need to exert less pressure to block them.

Recalling the comparative statics of $\delta$ from (5), one can also immediately establish that the reduction in the probability of the takeover’s success $\varepsilon^*$ is decreasing in the incumbent manager’s equity stake $\beta$ and increasing in the raider’s prospective stake $\beta_R$. Intuitively, workers fight the takeover more intensively the softer is their current manager (due to his low stake) and the tougher the prospective raider (due to his high stake).

The following proposition summarizes these results:

**Proposition 3** If $B > \bar{B}$ and control is contestable, employees do not lobby against takeovers, because these are deterred by long-term wage contracts. If $B < \bar{B}$ and control is contestable, employees lobby against takeovers, and reduce its probability of success by an amount that is increasing in the baseline probability of a takeover $\pi$ and in the raider’s prospective stake $\beta_R$, and is decreasing in the incumbent’s stake $\beta$.

The equilibrium choices of the incumbent management, and particularly the choice of the fraction of long-term contracts $\lambda$, are instead unaffected, since the probability of takeover does not affect the sign of (12) but only its scale. By the same token, Proposition 1 and its three corollaries are unchanged. The results about the role of employment protection, instead, are quite different, as shown in the next subsection.

### 4.1 The role of employment protection

Consider a reform that reduces the degree of employment protection, $1 - f$. Other things equal, this would increase the attractiveness of a takeover for a raider. From the analysis of Section 3 we know that the incumbent management will offset this increased attractiveness by raising the fraction of workers hired with long-term contracts, $\lambda$, but can do so only up to a point. If the degree of employment protection $1 - f$ falls below the threshold level $1 - \hat{f}$ such that $\hat{\lambda} = 1$ in expression (15), the
“poison pill” mechanism becomes ineffective even if all workers are given long-term contracts.

Therefore, if employment protection falls below the threshold level, the incumbent management will rely only on short-term labor contracts in the whole region in which control is contestable. Graphically, the shaded area in Figure 2 will extend to the whole region to the left of the point $\left( \frac{\tau^2}{(1+\tau)^2} \right) \beta R$ on the horizontal axis, and so will the region in which workers have the incentive to fight a takeover threat. In other words, a reduction of employment protection that makes the “poison pill” mechanism ineffective raises the willingness of workers to act as “white squires”:

**Proposition 4** If control is contestable and the degree of employment protection falls below the critical value $1 - f$, then workers lobby against takeovers, irrespective of the value of $B$.

### 4.2 Evidence

The model expounded so far is consistent with a considerable body of evidence. First, there are several cases in which workers tried to block hostile takeovers, sometimes openly solicited by the incumbent management of the target company. Their lobbying was successful where it struck a sympathetic chord in local media and politicians, and unsuccessful otherwise. In this section, we briefly describe four cases – in three different countries – in which the employees of the target firm tried to block a hostile takeover.

We also report evidence on two institutional mechanisms that the managers of a potential target can set up in order to increase the ability of their employees to act as “white squires”: employee stock ownership plans (ESOPs) and non-shareholder constituency statutes. The first mechanism acts by giving shares to employees and the second by giving them consideration in corporate objectives. Both schemes are particularly widespread in US corporations, and both have been motivated mainly by the incumbent managers’ desire to protect their control against hostile takeovers.

#### 4.2.1 Successful “white squires” : the case of Thyssen

The ability of workers to avert an attempted takeover is exemplified by the Krupp-Thyssen case reported by Hellwig (2000). In mid-March 1997, the German steel producer Krupp-Hoesch announced plans for a hostile takeover of its main competitor, Thyssen AG. It offered DM 15 million, well-above the DM 12 million current market value of the target firm. The management of Thyssen said it would fight a takeover, which threatened the jobs of tens of thousands of its 111,000 remaining workers and that it would seek partners to fight off a hostile takeover bid.

Meanwhile, in a statement signed by Thyssen’s management, board chairman Dieter Vogel, supervisory board chairman Heinz Kriwet and works council head Georg Bongen, said that in order to assure investors of an adequate return on a takeover
bid, a buyer would have to consume all of Thyssen’s capital reserves and make deep rationalization cuts. They stated “This has nothing to do with a planned, responsible management strategy that is equally oriented toward the workers’ interests as well as capital. These are Wild West methods that are incomprehensible in view of the current problems in Germany and in North Rhine-Westphalia”. These words were echoed by the Minister of Labor, Norbert Blüm, who declared that hostile takeovers are not part of the “language of a social market economy but of the language of the Wild West”.

This argument was very successful. In the following two weeks, politicians, union leaders and the media all joined a campaign of protest against Krupp’s attempted hostile takeover and persuaded Krupp to delay its hostile takeover bid. Executives from both companies were summoned by state premier Rau, and chancellor Kohl recommended them find a “reasonable solution” to their dispute, in the interests of all Germans. Meanwhile, protests by the employees at both companies continued. More than 10,000 workers at Thyssen gathered in Duisburg to discuss measures to be taken against the takeover. According to the employees’ factory committee, workers at Krupp-Hoesch also laid down their work and stopped production.

On March 24, the Krupp-Hoesch concern retracted their hostile takeover bid. Together with Thyssen’s managements, they issued a joint public statement in Düsseldorf, assuring that there would be no further hostile takeover attempts and that discussions on merging their steel production were in progress. Despite the retraction of the takeover bid, on March 25 the Union for Metal, Engineering and Electronics still went ahead as planned with a demonstration of more than 30,000 workers in the banking centre in Frankfurt, marching in front of the headquarters of Deutsche Bank. The demonstration was meant to be against Deutsche Bank, which had been prepared to approve a large loan to enable Krupp-Hoesch in its attempted takeover bid of Thyssen.

As Hellwig notes, Thyssen’s shareholders were the only losers from Krupp’s failed takeover bid: “The stock market capitalization of Thyssen returned to the level of DM 12 billion, where it had been before the tempest started,” depriving the target’s shareholders of DM 3 billion (p. 211).

4.2.2 Unsuccessful “white squires”: the case of Mannesmann

In other cases, the employees of a hostile takeover bid have been equally vocal but less successful. On 11 March 2000, the British company Vodafone Airtouch succeeded in taking control of Mannesmann, one of the largest German companies, sealing a $183 deal, the largest one in history to that time. The deal brought to an end months of rancorous negotiations, in a bitter battle that once again mixed lobbying by big business, politics and unions’ uproar.

The financial press hailed the deal as a signal of a climate more favorable to hostile takeovers in continental Europe, where they had been traditionally discouraged, as shown by Thyssen’s case. Clearly, the changed political climate was one of the key reasons why the protests of Mannesmann’s employees were not as successful
as those of Thyssen’s: though reluctantly and after initially criticizing it, German Chancellor Gerhard Schroeder eventually lauded the deal – an attitude that contrasts with Helmut Kohl’s active involvement in barring the Krupp’s bid.

Unsurprisingly, this time the target’s shareholders were the winners. Mannesmann’s shareholders were given 58.964 shares in the merged company Vodafone Airtouch for each share they held in Mannesmann, a 10 percent improvement on the original offer of 53.7 shares.

4.2.3 Two ongoing cases

Germany is not the only country where workers have played an important role in trying to block hostile takeovers. The cases of Daewoo in Korea and Willamette in the US illustrate this point. In both cases the outcome of the takeover is not known to this date.

Daewoo Motor  In May 2001 General Motors offered to buy the ailing company Daewoo Motor, one of the largest corporations in Korea, on the condition that Daewoo layoff some 5,000 employees. Interestingly, this follows a large-scale restructuring of labor contracts within the company: on February 16, the bankrupt Daewoo Motor had already eliminated 1,750 jobs and replaced permanent positions with temporary workers that can be terminated at any time. This clearly has increased the scope for further layoffs or wage cuts by General Motors, once it buys Daewoo.

The layoffs at Daewoo have led to nationwide mass strikes protesting the loss of jobs and working conditions (Koreans work six days a week, with an average of 50 hours at $ 4.33 an hour, and have no social security in case of layoff). On June 2, 10,000 workers marched through the capital of South Korea and a detachment of 1,000 workers demonstrated at General Motors’ Korean offices. The demonstrations met with violent repression by the police.

The hostility of Daewoo workers may partly reflect their recollection of the tough employment policies and work conditions that GM had imposed from 1978 to 1982 when it had formerly owned the Korean motor company. In 1991 the employees of Daewoo worked an average of 73 hours a week, and on average six workers were killed and 443 injured each day.

Nevertheless, a portion of Daewoo employees still supports the takeover – about 7,000 auto workers and almost all the 3,800 unionized employees, as of June 2001. Moreover, General Motors enjoys the backing of the South Korean government. These factors make it likely that the deal will eventually go through. In all cases, employees are playing an important role in the outcome of the deal. “GM’s takeover of Daewoo Motor will entirely depend on the company workers’ attitude towards restructuring,” GM Asia-Pacific President Rudy Shlais told a press conference in Bangkok in April 2001.
**Willamette Industries**  In 2000 the Weyerhaeuser company made a hostile bid for its competitor Willamette Industries, an Oregon-based wood and paper company employing 3,500 workers. Since then, a number of bids and counterbids have been made, and the management of Willamette has called for support from its employees as well as by the local media, especially by calling their attention to the mill closures, output curbs and job losses that the bidding company would implement in case of success. Willamette’s employees have responded to this call by the incumbent management: on April and June, they staged demonstrations in Portland, denouncing Weyerhaeuser’s attempt to fill three Willamette board seats to win control of the target company.

4.2.4 **Employee Stock Ownership Plans**

Survey evidence reveals that about 20 percent of US adults own shares in the company for which they work. This is largely due to employee stock ownership plans (ESOPs). An ESOP provides a vehicle whereby a corporate employer can make tax-deductible social security contributions of cash or stock into a trust. Participants are not taxed on the contributions they receive until they withdraw them from the plan, and are required to invest in the employer’s stock. ESOPs have grown dramatically in the US, from 1,601 in 1974 to 11,090 in 1997 (Gaugham, 1996).

Their popularity has not been due only to their tax benefits, but also to their use as anti-takeover device in the mid-1990s. Incumbent managers realized that employees were stable shareholders and would not be likely to sell out in the context of a hostile takeover, largely to protect their jobs. In addition, they would vote against a proposed merger, especially considering that the ESOP voting rights are held by a trustee appointed by the board of directors. In Gaugham’s (1996) words, “a target corporation may use the ESOP as a white squire by placing stock in the plan” (p. 376).

The anti-takeover potential of ESOPs was greatly enhanced by a 1984 Delaware anti-takeover statute, stating that bidders holding more than 15 percent of a company’s stock must wait three years to complete the takeover unless they buy at least 85 percent of the target’s shares (or two-thirds of the shareholders approve the acquisition). As a result, a company incorporated in Delaware can prevent a hostile takeover simply by putting more than 15 percent of its stock in an ESOP. This strategy was first used by Polaroid to successfully counter a hostile takeover by Shamrock Holdings, and then imitated by a large number of other companies.

A large body of evidence shows that companies with ESOPs have more stable management, and are less likely to be taken over by a bidder. Both Chaplinsky and Niehans (1994) and Beatty (1995) find that ESOPs reduce the likelihood of takeover attempts. The former authors also document that they are more effective anti-takeover devices than poison pills. In fact, Park and Song (1995) report that companies that adopted or expanded ESOPs relied less frequently on other anti-takeover defenses.

ESOPs tend to damage the original shareholders. They suffer a dilution of equity,
although in some cases this effect is offset by a repurchase of the newly issued shares by the company at a later date. Moreover, they effectively pay for a transfer of wealth to employees, if these receive shares at a price below their current market value. Chaplisky and Niehaus (1994) report that in 48.2 percent of the firms the ESOPs led to an increase in employees’ compensation. Finally, ESOPs damage original shareholders by lowering the contestability of the firm, as suggested by their effect on stock prices (Park and Song, 1995, and Chang, 1990).

Though primarily used by US corporations, the use employee stock ownership as anti-takeover device is not unknown in Europe. In 1999, the fashion company Gucci faced a hostile takeover bid by a French competitor LVMH. Gucci’s management created a stock ownership plan, with the intent of diluting LVMH stock and get employees to support it counter the bid. The workers accepted to invest their severance payment fund into Gucci stock, and the takeover bid was defeated, although later an Amsterdam court declared it void. To compensate its employees for their loyalty, the company’s management chose to award them a prize, which was paid in cash to non-Italian residents and in shares sold below market price to Italian residents. In exchange for this financial benefit, the company asked that the shares would not be sold for three years and that workers formed an association of Gucci owner-employees.

4.2.5 Non-Stockholder Constituency Statutes

Yet another way of reinforcing employees’ role as white squires is to permit – or even require – the board of directors of a corporation to consider also groups other than shareholders in conducting their company, and especially in considering takeover offers and other proposals concerning changes in corporate control. Such statutes can thereby give non-stockholder groups – such as employees – rights against directors, which can compete against those of shareholders and possibly override them.

Hanks (1989) reports that this is a widespread, though little-known, legal development in the US. In at least 24 states, non stockholder statutes have been introduced at the end of the 1980s, with the clear purpose of adding to the arsenal of anti-takeover tools available to incumbent managers: “Opponents of hostile takeovers apparently felt that by giving directors a wider range of factors upon which to base a rejection of a takeover offer, they would help protect the directors from liability and thus encourage them to resist takeover offers” (Hanks, p. 20).

5 Conclusions

In this paper we have shown that if the private benefits of control are high and management owns a small equity stake, managers and workers are natural allies. Managers pay high salaries to workers to protect control from raiders and workers are willing to fight hostile takeovers to protect their high wages.

There are two forces at play. First, managers effectively transform employees into a “poison pill” by signing generous long-term labor contracts and thereby reducing
the firm’s attractiveness to a raider. Second, employees act as “white squires” for the incumbent managers, lobbying against hostile takeovers to protect the high wages enjoyed under incumbent management. Unlike in existing models of implicit contracts, the convergence of interests of workers and incumbent managers has a rational basis.

The model we present offers a number of testable predictions. First, the average employee compensation (or the fraction of long-term contracts) is predicted to be negatively correlated with the frequency of hostile takeovers, controlling for other factors. A second prediction is that if a takeover succeeds, the new managers will cut the salaries with the short-term employees and, as far as the law allows, those of long-term employees, and will increase the level of workers’ monitoring, while the company’s share price will increase in proportion to the share of employees with renegotiable contracts. A third prediction is that in companies where private benefits are high and managers’ equity stake is low, employees take industrial or political action to oppose hostile takeovers. For some of these predictions, existing studies already provide evidence, and this is consistent with the model. Other predictions still await empirical testing.
References


