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Abstract

We investigate the monitoring effect of large outside blockholders by examining the market reaction to partial acquisitions. After removing partial acquisitions which lead to majority control blocks, we study a sample of initial outside block formations. We separate the sample into three groups based on the acquirer's intent: activist, strategic, and financial. The three-day cumulative abnormal returns (CAR) around activist and strategic block purchases are significant both economically and statistically (17.55% and 15.46%, respectively), suggesting that the monitoring and strategic benefits are economically meaningful and comparable in magnitude. In contrast, the CAR around financial block purchases is only marginally significant (1.42%), both economically and statistically. We document a positive wealth effect of block size, pressure insensitivity of the block and board representation and a negative wealth effect of the managerial ownership of the target firm. We also find that the market reaction to activist blocks is particularly large when there is no previous outside block. The observed variation in the wealth effect for three different types of blocks appears to reflect different ex-ante takeover expectations in part.

1. Introduction

Shareholders owning a small fraction of outstanding shares have little incentive to monitor management, since the benefits they receive from monitoring activities are unlikely to exceed the costs that they bear. Therefore, small shareholders have incentives to free-ride in monitoring management. There have been a number of papers taking the view that large outside blockholders can mitigate agency problems by behaving as monitors (e.g., Shleifer and Vishny, 1986; Huddart, 1993; Admati, Pfleiderer, and Zechner, 1994; Maug, 1998). There has also been considerable empirical support for this theory (e.g., Agrawal and Mandelker, 1990; Bertrand and Mullainathan, 2001; Chung, Firth and Kim, 2002; Hartzell and Starks, 2003).

The previous studies analyze the already existing large outside blockholders. By analyzing the formation of a new outside block, we are able to measure the market value of the monitoring of large outside blockholders. Therefore, our study is a dynamical extension of static studies on the monitoring role of large outside blocks just as the investigation of the market reaction to insiders' trading is a dynamical extension of studies that look at the static relationship between inside ownership and firm value.

Choi (1991) identifies three explanations for the positive market reaction to partial acquisitions; a monitoring effect, a takeover anticipation effect and an undervaluation signaling effect. However, anecdotal evidence suggests that partial acquirers often state that they intend takeovers along with many other monitoring activities such as obtaining a directorship on the target board and meeting with the target management. Therefore, it is possible to consider takeovers to be one of the many monitoring actions an acquirer might engage in.

Dyck and Zingales (2001) document that control blocks may expropriate minority shareholders. As a further refinement of the literature on outside block monitoring, we only consider partial acquisitions larger than or equal to 5% and less than 50%. Our criterion of 5% to 50% attempts to ensure that the blocks are significant outside investors but are unlikely to be de facto controlling blocks.[1]

We identify three reasons for partial acquisition: shareholder activism to enhance firm value, portfolio investment and strategic alliances. Using the stated reasons for partial acquisitions, we classify partial blocks as activist blocks, financial blocks or strategic blocks. We define activist block purchases as those made with the announced intention of influencing firm policies or those made by individuals known for activist policies in the past. Financial block purchases are those made by banks, pension funds, money managers, and passive individual investors who state expressly that acquisitions are made for investment purposes only. Strategic block purchases are those made by other companies that expressly state the strategic alliance as the principal consideration of the deal.

The three-day cumulative abnormal returns (CAR) on activist and strategic block purchases are significant both economically and statistically (17.55% and 15.46%, respectively) while that for financial block purchases is only marginally significant on both accounts (1.42%). The differences in the magnitude of CARs suggest that both activist and strategic blocks add value to the target. The value added with activist blocks is predominantly derived from monitoring, whereas the value added with strategic blocks

[1] In order to account for the possibility of minority de facto control blocks, we also consider the sample of partial acquisitions that lead to ownership between 5% and 20%.

mostly arises from synergy. It is interesting to note that monitoring and synergy effects are comparable in magnitude.

If we assume that undervaluation effects are comparable between activist, strategic, and financial block purchases, then the relative differences of 16.13% and 14.04% in the 3-day CARs should reflect primarily monitoring effects and synergy effects, respectively. Since a takeover is a potential vehicle of governance change an activist blockholder may institute, a part of 16.13% may reflect takeover anticipation effects. However, as we mentioned previously, we do not necessarily view a takeover to be separate from the rest of the monitoring activities. Furthermore, since a takeover does not materialize within a year in almost three quarters of activist block purchases (72.73%), the non-takeover related monitoring benefits must be clearly significant.[2]

We then examine whether the market reacts differently to a partial acquisition based on other characteristics of the acquisition and the acquirer, such as block size, pressure sensitivity, and board representation. We document that block size has a positive effect on the market reaction. The pressure insensitive partial acquirers (defined as those who do not have current or potential business ties with the target firm such as mutual funds and pensions funds) produce a larger positive market reaction. Board representation (defined as the acquirer having a seat on the target's board of directors) of partial acquirers leads to a larger positive market reaction, suggesting that a seat on the target board is helpful in monitoring management.

[2] Only 12 targets of partial acquisitions in our sample of 44 activist blocks (27.27%) were taken over by the partial acquirer or any other third party within a year. Only 25 targets of partial acquisitions in the combined sample of 264 target firms (9.47%) were taken over by the partial acquirer or any other third party within a year.

The wealth effect surrounding the formation of the new outside block may also depend on the governance mechanisms of the target firm already in place. Therefore, we examine the interaction between the new outside block and important governance mechanisms such as board independence of the target firm, managerial ownership, lender monitoring, institutional ownership of the target, the duality of the target firm shares and the existence of other outside blocks. While we do not find evidence that the wealth effect depends on the existing governance mechanisms in general, we find that the market reaction to the activist blocks is even larger when there is no previous outside block. This finding provides further evidence that activist blocks are viewed as efficient monitors.

The remainder of the paper is organized as follows. Section 2 presents hypotheses tested and related literature. Section 3 describes the sample and the data used. Section 4 presents the methodology and the empirical results. Section 5 concludes the paper.

2. Hypotheses

The quality of monitoring is likely to depend on block characteristics such as the size of the block and the purpose of the partial acquisition. In addition, there may be an interaction between governance characteristics of the target firm and the emergence of a new outside block. We develop a series of hypotheses which examine the effect of block characteristics and target governance characteristics on partial acquisitions. Our tests rely on the event study methodology in which we control for the undervaluation signaling effect.

When the size of the block is large enough to provide monitoring incentives but not large enough to provide expropriation incentives, block investors are likely to

contribute to firm value by monitoring management and the market is likely to anticipate the monitoring benefit. We expect a positive market reaction to the formation of a new block.

The monitoring effectiveness may also depend on the nature of outside blockholders. Outside block investors who state expressly their intention to influence management in order to increase firm value or are known to be activist shareholders are likely to provide more effective monitoring than purely financially motivated block investors. We expect that the wealth effect of activist blocks is larger than that of financial blocks. In a related work, Barclay and Holderness (1991) find that abnormal returns associated with negotiated block trades are positive (5.6%) and stock price increases are larger when management does not resist the blockholder's effort to influence corporate policy.

Outside block investors who are strategic partners of the target firm are likely to provide synergy benefits which purely financially motivated block investors would not be able to provide. We expect that the wealth effect of strategic blocks is larger than that of financial blocks. In a related work, Chan et al. (1997) show a positive market response to announcements of strategic alliances even when the alliance does not involve equity participation.

Whether blockholders exercise their power by disciplining management is likely to depend on the size of their shareholdings. If their shareholdings are high, it is more difficult to sell shares whenever they wish. This liquidity problem can cause blockholders to hold shares for longer periods, collect information and monitor management actions (Maug, 1998). In addition to lack of liquidity, the greater is the proportion of block

ownership, the larger is the likelihood that the benefit of monitoring will exceed the cost. Therefore, we expect a positive relationship between block size and market reaction.

Another distinction that is made is whether acquiring blockholders are pressure sensitive or insensitive (Brickley, Lease and Smith, 1988). Pressure sensitive blockholders are defined as those who might have current or potential business relations with the firm (commercial banks, insurance companies, etc.). These blockholders might not be as effective in monitoring the firm as the pressure insensitive ones since they would be less likely to object to questionable practices for fear of losing the company's business. If this theory is indeed valid, we would expect a stronger market reaction to a partial acquisition announcement if the acquiring blocks are pressure insensitive. Payne, Millar and Glezen (1996) provide support for this theory by examining banks as institutional investors. They find that officers of banks that have business relations with the firm rarely vote against the management if they happen to hold directorships with the company. However, faced with increasing public scrutiny, pressure sensitive firms may object to questionable practices as a way to maintaining their reputation throughout the market. The reputational concern argument would predict a positive relationship between pressure sensitivity and market reaction, contrary to the conflict of interest argument presented previously.

If the partial acquirer is able to obtain board representation on the target firm, then it is more likely to be an effective monitor. Therefore, we expect a positive relationship between the market reaction and the board representation of the partial acquirer.

The corporate governance literature has established both empirically and theoretically that monitoring of firms can be done by a variety of different entities with

different goals and different mechanisms. It follows that the market reaction to these different types of monitoring should vary based on the perceived efficacy of the method chosen. Furthermore, this would depend on the existing governance characteristics of the firm. Specifically, the market reaction to the formation of a new monitoring device would depend on how this new device will interact with the sources of monitoring already in place. Based on this intuition, we develop related sub-hypotheses.

An important internal monitoring mechanism is the board of directors. The separation of ownership and control can lead to agency problems. If a large percentage of directors are also managers of the company or are otherwise affiliated with the firm (insider directors), these agency problems could be more serious in nature. Earlier studies show that the presence of unaffiliated directors (outsider directors) on the board enhances firm performance. For example, Weisbach (1988) shows that firms with low levels of inside directorship perform better than those with high levels of inside directorship. The traditional board independence hypothesis, which is in part based on this type of empirical evidence, would hold that firm value increases monotonically with the proportion of outside directors on the board. However, Bhagat and Black (2001) suggest that there is an optimal number of outside directors and more outside directors are not necessarily better for shareholders. According to the interior optimal board independence hypothesis (Bhagat and Black, 2001), we would expect the market reaction to outside block formation to be unrelated to the proportion of outside directors on the board; while according to the traditional board independence argument, we would predict that the market reaction to outside block formation would be negatively related to the proportion of outside directors on the board.

Another important governance mechanism is the percentage of managerial ownership. It is generally believed that managers start acting in the best interest of shareholders if they own a significant percentage of the firm's outstanding shares (Jensen and Meckling, 1976). Based on this theory, we could potentially view high managerial ownership as a substitute governance mechanism to the formation of an outside block.

One of the external monitoring mechanisms we consider is financial leverage. According to Jensen (1986), agency problems such as overinvesting can be mitigated by disbursing the free cash flow to investors. Financial leverage is a viable candidate for curbing overinvestment since the manager would have to pay out interest expense on a regular basis. Furthermore, banks are viewed as effective monitors of corporations due to their ability to access firm information (Fama, 1985). If financial leverage and partial acquisition are viewed as substitute monitoring mechanisms, we would expect to see a greater market reaction for targets with low leverage ratios than those with high leverage ratios. Therefore, we would expect a negative correlation between the market reaction to the announcement of partial acquisitions and the financial leverage of the target firm.

However, in partial acquisitions which take place via private placement as opposed to block transfer or open market purchases, the target firm experiences cash infusion from the partial acquirer by receiving cash from the partial acquirer in exchange for new equity. Therefore, partial acquisitions which take place via a private placement can lead to a resolution of financial distress where the target firms are highly leveraged. If the financial distress resolution effect dominates the substitution effect, we would expect the market reaction to be positively correlated with financial leverage.

Another important external monitoring mechanism is the presence of institutional investors. In United States, institutional ownership grew from 6.1% in 1950 to more than 50% in 2002 (Gillan and Starks, 2003). Institutional investors can mitigate agency problems by behaving as monitors. There has also been considerable empirical support for this theory (e.g., Chung, Firth and Kim, 2002; Hartzell and Starks, 2003). If institutional investors and outside blocks are viewed as substitute monitoring mechanisms, then we would expect to see a greater market reaction for targets with low institutional holdings than those with high institutional holdings. However, Duggal and Millar (1999) do not find that institutional investors play an active role in the takeover market. If institutional shareholders are passive, then we would expect the market reaction to the formation of an outside block to be unrelated to institutional holdings.

Dual class common stock where one class of common stock has more voting rights than the other(s) is often associated with managerial entrenchment (Jarrell and Poulsen, 1988). If management is entrenched using dual class common stock, the partial acquirer is less likely to influence the management. As a result, it is less likely to be an effective monitor than otherwise. Therefore, we expect a negative relationship between dual class common stock and the market reaction to the formation of a new outside block.

Finally, the marginal effect of the formation of an outside block can depend on whether other outside blocks already exist. If the marginal effect of the formation of an outside block is larger when there is no existing outside block (case of decreasing marginal benefit), then we expect the market reaction to be negatively correlated with the existence of previous outside blocks.

3. Data

The sample of initial non-control block acquisitions is selected from the SDC database for the years from 1997 to 2000.[3] The following sample selection criteria are used: (1) the initial common stock holding of the target by the acquirer is less than 2%; (2) the stock ownership after the acquisition is 5% or more, but does not exceed 50% of the target firm's outstanding shares; (3) targets are not financial services firms; (4) the stock price data of the target firms is available in the CRSP daily returns files over a one year period prior to the filing; (5) there is a summary of 13D or 13G filings of the partial acquisition in the Factiva database; (6) accounting data are available in the Compustat database; (7) proxies are available in the LexisNexis or the EDGAR database; (8) institutional ownership information is available in the quarter prior to the announcement date either in the Factiva database or in the Compact Disclosure database; (9) the partial acquisition reported in the SDC database is confirmed by searching the Factiva database; (10) the announcement of the partial acquisition is not preceded by other partial acquisition announcements during the 2-month period prior to the disclosure; (11) the announcement of the partial acquisition does not take place in the middle of a tender offer process; (12) no announcement of other material events such as surprise earnings, earnings restatements and major investment or divestiture decisions occurs within a week before and after the announcement of partial acquisitions.

The first two criteria are used to identify partial acquisitions that lead to outside blocks. The third criterion is to ensure that all the accounting data are comparable across

[3] Other studies use similar lengths of study period; Mikkelson and Ruback (1985) use a sample of 337 SEC 13D filings during the period 1978-1980. The study by Choi (1991) is also based on a 4 year period from 1982 to 1985. Note also that our 4-year period is homogenous in the sense that it largely coincides with the latest bull market in the U.S.

the targets. Criteria (4) through (8) are to ensure the completeness of the data required to test various hypotheses.

Using criterion (1), we require that the initial ownership of the bidder does not exceed two percent because we are only interested in those partial acquisitions which give rise to the formation of a new monitor of the firm.[4] Furthermore, because we only consider those partial acquisitions which give the partial bidder a monitoring incentive and clout, but are unlikely to confer the partial bidder de facto control of the firm, we impose criterion (2) to exclude those partial bids which result in ownerships of greater than or equal to 50%.[5] The announcement effect of partial acquisitions screened using criterion (2) is likely to reflect the monitoring benefit of the partial bidder, and not the costs associated with the private benefits of control.

In connection with the selection criterion (5), we use summaries of 13D or 13G filings reported by Dow Jones Select Filings Newswires to examine the nature and the purpose of the partial acquisition.[6] Under the William's Act as amended in 1970, a buyer must file with the Securities Exchange Commission (SEC) a disclosure known as 13D or 13G within ten calendar days after the five percent threshold is exceeded where the identity of the investor(s), the number of shares acquired in the transaction, the total number of accumulated shares (and the fractional ownership) and the stated purpose of ownership (e.g., arbitrage, investment, influence, or control among others) are disclosed.

[4] Because of this restriction, the resulting sample is a subset of all the 13D and 13G filings for the period. If we use 0% or 1% as the lower limit of the beginning holding, the sample size becomes lower (258 and 189, respectively). However, the results are qualitatively the same. Considering change in block size without regard for the initial holding is an interesting issue, which we do not explore in this study.

[5] In most jurisdictions, 20% stock ownership is considered to give the block-holder de facto control of the firm. When we restrict the sample using the 20% ownership as maximum, the result is qualitatively similar.

[6] Institutional investors file 13G while all others file 13D.

Criterion (8) is to ensure that the events reported by the SDC are indeed accurate. Because the SDC database is a secondary source of information, we use all articles surrounding the partial acquisition reported in the Factiva database to confirm whether a genuine partial acquisition occurs and whether the announcement data is accurate. If the announcement date inferred from the Factiva database is unambiguously more reliable than the date reported in the SDC database, we use the Factiva date for the event study.

The definition of a partial acquisition varies across the literature. For example, Amoako-Adu and Smith (1993) define partial acquisition as the event where the acquirer seeks less than full control of the target firm, that is, less than 90% of the target firm's shares. Choi (1991) uses 50% as the threshold for the partial acquisition, leaving out those partial acquisitions which represent majority control blocks. Following Choi (1991) we define outside blocks as investors who acquire less than 50% but more than 5% of the target firm's stock. We assume that partial bids larger than or equal to 50% and less than 90% lead to majority control blocks. We exclude all de facto control blocks, which comprise majority control blocks, so that the minority shareholder expropriation and private benefits of control are mitigated.

Panel A of Table 1 shows the actual sample selection process. Of acquisitions reported in the SDC database for the 1997-2000 period, 723 events satisfy the criteria 1 and 2. Once the targets whose business is financial services are excluded (requirement 3), the sample is reduced to 616 events. The requirements (4) through (12) reduce the sample size to 264.

[Table 1 about here]

Bethel et al. (1998) distinguish three types of block share purchases where they consider all blocks with 5% ownership or more; these are activist blocks, financial blocks and strategic blocks. They define activist block purchases as those made with the announced intention of influencing firm policies or those made by individuals known for activist policies in the past. Financial block share purchases are those made by banks, pension funds, money managers, and passive individual investors. Strategic block purchases are those made by other companies that are unopposed by management. In order to isolate the synergy effect of partial acquisitions, we improve on their definition of strategic block by employing a finer selection criterion. According to our definition, for an acquisition to be considered strategic, the target firm's management and the partial acquirer need to expressly state the strategic alliance as part of the deal.[7] Entities or individuals filing 13D would have to expressly state that they do not intend to influence the management nor do they have extraordinary plans for the firm to be considered as financial blocks. As for entities or individuals filing 13G, it is assumed that they do not intend to influence the management nor do they have extraordinary plans for the firm. On the other hand, for a block to be considered activist, it would have to expressly state that it will attempt to influence the management of the firm in order to enhance the firm value in its 13D filing. However, individuals such as Carl Icahn who are known for activist policies in the past are considered as activists even if there is no explicit mention of influencing the management either in 13D or press releases.

As shown in Panel B the sample consists of 44 activist blocks (16.7% of the sample), 123 financial blocks (46.6% of the sample) and 97 strategic blocks (36.7% of the sample). Panel B also shows the distribution of the formation of all outside blocks as

[7] Relevant articles in the Factiva database are used for the purpose.

well as activist, financial and strategic blocks by year. The number of outside block formations peaks in 1997 and then levels off in subsequent years.[8] In all years, there are more financial blocks and strategic blocks than activist blocks. The proportion of activist blocks ranges from 11.4% in 1999 to 22.8% in 1998. We also note that the proportion of strategic blocks jumps from 27.9% in 1997 to 38. 6% in 1998 and stays high coincident with the accelerating technology stock bubble.[9]

4. Empirical Tests

We choose to concentrate on the formation of a partial acquisition as our event of interest because it leads to the creation of a new monitoring mechanism and its economic effect can be measured by the event study methodology. The marginal effect of the formation of outside blocks (via partial acquisition) is approximated by the cumulative abnormal returns and we test the interaction of outside blocks with a wide range of internal and external governance mechanisms using regression analysis.

Daily stock returns over -30 to 30 trading days are used to estimate the abnormal returns associated with the announcement of formation of monitoring blocks. The returns from -150 to -31 days (120 observations) are used to estimate the market model specified below and abnormal returns are estimated over [-1,0], [-1,1], [-5,5], [-10,10] and [-30,30] event windows. However, we report univariate analysis and regression results based on

[8] The partial acquisition activity drops off considerably after 1997. While we are unaware of the reasons, we control for this by including year dummies in the regressions reported.

[9] The distribution of the target firms by industry is shown in the Appendix 2. Since the study period coincides with the "new economy" era, the industries of the target firms are heavily represented by chemical and allied products (SIC Code 28) which encompass many of the bio-technology firms; industrial machinery (SIC Code 35), electronic/electric equipments (SIC Code 36), instruments and related products (SIC Code 38), communications (SIC Code 48), which comprise many of the high-technology firms; and non-financial services (SIC Code 71-87), which comprise a large number of dot.com firms. We control for the industry concentration by including industry dummies in the regressions reported.

the three day CAR over [-1,1] only. The market model is modified following Scholes and Williams (1977) to include lags and leads to correct for the possible problems with thin trading on the target firms which tend to be small in size.

$$R_{jt} = \alpha_j + \sum_{k=-2}^{+2} \beta_{jk} R_{m,t+k} + e_{jk},$$

where

R_{jt} = the daily holding period return of stock j,

$R_{m,t+k}$ = the daily holding period return of the value weighted index of all stocks for the lagged, contemporaneous and lead periods,

β_{jk} = the beta coefficient.

Returns up to 30 days preceding the announcement are used to capture the market anticipatory effect and returns up to 30 days post-announcement are used to examine any lagged response. The daily stock residuals are cumulated over the event window and the cumulative abnormal returns are averaged cross-sectionally to arrive at the mean cumulative abnormal returns (CAR).

Table 2 shows the announcement effect of the formation of monitoring blocks. The three-day announcement CAR for all blocks is 9.27%. Using the standardized abnormal return test, which is also known as the Patel test, the abnormal return is highly significant (p-value<1%). This result is consistent with the large outside blockholders monitoring hypothesis. Two-day [-1,0], five-day [-2,2], 11-day [-5,5] and 21-day [-10,10] and 61-day [-30,30] event windows show positive and significant cumulative average abnormal returns as well.

The cross-sectional return variance at the time of block purchases is likely to be significantly different from the pre-event window return variance. We take care of this problem by carrying out the cross-sectional test (Brown and Warner, 1985), the standardized cross-sectional test (Boemer, Musumeci, and Poulsen, 1991), and the generalized sign test (Cowan, 1992). Both the cross-sectional and the standardized cross-sectional test compensate for a possible return variance increase on an event date by incorporating a simple empirical cross-sectional variance adjustment. Brown and Warner (1985) report that the cross sectional test is well-specified for event date variance increases. Boemer, Musumeci, and Poulsen (1991) report that the standardized cross-sectional test is well specified and more powerful than the cross-sectional test. Cowan (1992) reports that the generalized sign test is well specified and is also more powerful than the cross-sectional test. These computations are shown in the last three columns of Panel A of Table 2. The results of the paper remain essentially the same.

[Table 2 about here]

Cumulative abnormal returns for activist, financial and strategic blocks are shown separately in Panel B of Table 2. The three-day cumulative abnormal returns (CAR) on activist, financial and strategic block purchases are 17.55%, 1.42% and 15.46%, respectively. The three-day cumulative abnormal return (CAR) on activist block purchases is significant both economically and statistically (17.55%) while that for financial block purchases is only marginal both economically and statistically (1.42%) suggesting that monitoring benefit is economically meaningful only for activist blocks.

If we assume that undervaluation effects are comparable between activist block purchases and financial block purchases then the difference of 16.13% in the 3-day CAR should reflect primarily monitoring effects. Since a takeover is a potential vehicle of governance change an activist may institute, a part of 16.13% may reflect takeover anticipation effects, which we view to be one of the entire spectrum of monitoring actions. It is interesting to note that a takeover does not materialize within a year in 72.73% of activist block purchases, therefore the non-takeover related monitoring benefits must be clearly significant in the case of activist block purchases.

Furthermore, the mean 3-day CARs for the targets of activist partial acquirers taken over in a year (N=12) and those not taken over in a year (N=32) are 16.47% and 18.22%, respectively. The difference of -1.75% is not significant (p-value=0.981). Given that the market has the ability to distinguish future targets from non-targets (Palepu, 1986 and Song and Walkling, 2000), an insignificant difference between the takeovers and the non-takeovers appears to be due to the small sample size used for comparison (N=12 vs. N=32).

The relative frequencies of ex-post takeover activity are 27.27%, 1.63% and 11.34% for firms with activist blocks, financial blocks and strategic blocks, respectively. The differences across types are statistically significant. Furthermore, the CAR is positively correlated with the relative frequency of ex-post takeovers for three different types of blocks. This result suggests that the variation in the market reaction for different types of block purchases may reflect different takeover expectations in part.[10]

[10] Because there is anecdotal evidence that activist blocks often facilitate third party takeovers, we keep both takeovers by the blocks themselves and third party takeovers when we count ex-post takeovers for different types of block purchases. When third party takeovers are removed from the count, the result is essentially the same.

If we assume that undervaluation effects are comparable between strategic block purchases and financial block purchases, then the difference of 14.04% in the 3-day CAR should reflect primarily the synergy effects of strategic block purchases. It is also interesting to note that the magnitude of the synergy effect (14.04%) is comparable to that of the overall monitoring effect (16.13%).

Appendix 1 shows the definitions of the variables used in both the univariate and the regression analysis. Activist block is a dummy variable taking the value of one when the acquirer expressly states its intention to influence the management of the firm to improve the firm value or the acquirer is known for shareholder activism in the past and zero otherwise. Strategic block is a dummy variable taking the value of one when the acquirer is a partner in a strategic alliance and zero otherwise. Block size is measured as the proportion of the common stock of the target acquired. Pressure insensitive block is a dummy variable taking the value of one when the acquirer is pressure insensitive and zero otherwise. Pressure insensitive acquirers are those who have no current or potential business or ownership ties with the target firm. Board representation is a dummy variable taking the value of one if the acquirer has a seat on the target's board of directors.

Board independence is measured as the ratio of outside directors to the total number of directors. Following prior studies of boards, we define inside directors as those directors who are employees of the firm, gray directors as those directors who are family members of controlling shareholders or officers, or those who have business dealings with the firm other than directorship and outside directors as those who are neither inside nor gray directors. We exclude gray directors from outside directors.[11] Managerial

[11] However, the inclusion of gray directors in outside directors does not change our results.

ownership is measured as the fraction of common stock held by the firm's officers and directors.[12] Debt ratio is measured as the ratio of the book value of the total assets minus the book value of equity to the book value of total assets.[13] Proportion of institutional ownership is measured as the proportion of common stock of the target firm held by institutions. Dual class common stock is a dummy variable taking the value of one if the target firm has dual class common stock.[14] No previous outside block is a dummy variable taking the value of one if there is no outside block prior to the partial acquirer.

Q ratio is measured as the ratio of the book value of total assets minus the book value of equity plus the market value of equity to the book value of total assets. Market-to-book ratio is the market value of equity divided by the book value of equity. Sales is measured in millions of dollars. Total assets is measured in millions of dollars. Takeover intention is a dummy variable taking the value of one if the partial acquirer expressly states its takeover intention. Private placement is a dummy variable taking the value of one if the method of acquisition is private placement.

[Table 3 about here]

Table 3 shows the descriptive statistics of the variables used in both the univariate and the regression analysis. Panel A shows the proportions of dummy variables. Financial blocks outnumber activist blocks by about three to one; strategic blocks comprise 36.7% of the sample. Only 14 out of 264 sample events have pressure sensitive partial acquirers (4.9%). This result suggests that outside blocks formed during the period

[12] We further disaggregate the ownership of outside directors and the ownership of managers. Using managerial ownership which excludes the ownership of outside directors, we obtain qualitatively the same results.

[13] Debt ratio is also calculated as the ratio of the book value of debt to the sum of the market value of equity and the book value of debt. The results reported in the paper remain essentially the same.

[14] For dual firms, voting rights have been used for the ownership variables. We obtain qualitatively identical results when we use cash flow rights for the ownership variables.

tended not to have potential or actual business ties with the targets. In 23.5% of all cases partial acquirers obtain a seat or more on the board of the target firm.[15] Only 7.2% of the target firms have dual class common stock. In about three in every ten block formations the partial block is the first outside block of the target firm. In only 3.8% of the all cases acquirers express the intention to takeover the target firm. In 34.5% of all cases, the block acquisition involves a private placement, that is, the target firm issues to the partial acquirer a new common stock or other forms of securities which can be converted to the common stock of the target firm.

Panel B of Table 3 shows the descriptive statistics of continuous variables. The mean and the median block sizes are 13.7% and 9.4%, respectively.

Next, we report the governance characteristics of target firms. The fraction of outside directors (BI), which measures board independence, has a median value of 0.50 indicating that there are as many target firms with insider-dominated boards as those with outsider-dominated boards. Mean and median managerial ownerships are 26.0% and 21.9%, respectively, indicating that target firms have significant managerial ownership. We proxy lender monitoring by the debt ratio; the mean and median debt ratios are 54.1% and 47.4%, respectively. The institutional ownership of the median target firm is 26.9%.

The mean q ratio is 2.729. The high mean q ratio suggests that the targets tend to be concentrated in growth industries. Not surprisingly, the average market-to-book ratio of equity of target firms is also very high (5.255). Half of the firms have sales between $0.1 and $69 million and total assets between $1 and $92 million, indicating the presence of a large number of small firms, unlike the sample used in Bethel, Liebeskind and Opler (1998).

[15] It is worthwhile to note that the block purchase always precedes acquirer representation on the target board.

We carry out a regression analysis of the wealth effect on the block attributes as well as target governance characteristics. We use the following regression model:

$$CAR = \alpha_0 + \beta \text{ Acquirer Characteristics} + \gamma \text{ Target Governance Characteristics} + \delta \text{ Controls} + \varepsilon,$$

where acquirer characteristics comprise activist and strategic blockholder dummies, block size, a pressure insensitive block dummy and a board representation dummy. The target governance characteristics comprise the fraction of outside directors on the board, managerial ownership, debt ratio, institutional ownership, a dual class common stock dummy and a new outside block dummy. Control variables are the q ratio, the log of sales, a dummy for takeover intention, and a private placement dummy. Finally, β, γ and δ are vectors of coefficients which correspond to Acquirer Characteristics, Target Governance Characteristics and Controls.

In order to isolate the monitoring effect, we control for the takeover anticipation effect and the undervaluation signaling effect[16]. We control for the takeover bid anticipation effect by identifying those partial acquisitions which are explicitly takeover motivated. We use the takeover intention variable which identifies partial acquirers that expressly state their intention to takeover the target.[17] Since the q ratio has been associated with overvaluation (Shleifer and Vishny, 1988; Stulz and Walkling, 1989;

[16] The takeover anticipation effect is controlled for more as a point of interest, rather than a separate effect from that of monitoring. We contend that a takeover is one of many monitoring actions an activist may engage in.

[17] We find some acquirers take over the targets themselves or arrange a takeover of the targets without making an explicit statement of their takeover intension. In this sense, board representation, which is closely related to actual takeover outcomes, is a better proxy for takeover anticipation effects.

McConnell and Servaes, 1990; Stulz and Walking, 1991), we control for undervaluation effects using the q ratio as well as the market to book ratio of equity (MBR).

Table 4 shows the results of the regression analysis. Using Model 1, we test the influence of block characteristics on the market reaction. The coefficient of the activist dummy is positive and significant, suggesting that activist blocks provide more effective monitoring than purely financial monitors. We find that the coefficient of the acquired block size is positive and significant showing that larger blocks produce greater positive wealth effects than smaller blocks, consistent with the monitoring incentive hypothesis. We find that the coefficient of pressure insensitive blockholders is positive and significant showing that pressure insensitive blockholders produce a much greater wealth effect than pressure sensitive blockholders. Board representation is positively correlated with the market reaction, which also implies that monitoring effectiveness increases when the acquirer sits on the target board.

[Table 4 about here]

In Model 2 we examine the effect of the existing governance characteristics of the target firm on the market reaction to the formation of new outside blocks by adding to Model 1 a series of governance variables discussed in the hypothesis section. The coefficient of board independence is not statistically significant. The result is consistent with the interior optimal board independence hypothesis which states that "more is not necessarily better" (Bhagat and Black, 2001). We then measure board independence less strictly by counting gray directors as outside directors. The coefficient of the board independence variable, which is the sum of gray and outside directors divided by the total number of directors, is not statistically significant either.

The market reaction to the formation of new outside blocks is significantly and negatively correlated with managerial ownership.[18] That is, in a firm characterized by low managerial ownership, the formation of an outside block is met with a more positive market reaction. The finance literature has long held that managerial ownership is an important governance mechanism which reduces the agency costs that arise from the separation of ownership and control. This result is consistent with the interpretation that an outside block is a *substitute* of managerial ownership. An alternative interpretation is that if the managerial ownership is very high, then the ability of the outside blocks to influence management is limited. Therefore the wealth effect of a partial acquisition would be small.

The coefficients of other governance variables, namely, debt ratio, institutional ownership, dual class common stock, no existing outside block are not statistically significant. Of the control variables, the q ratio, firm size, the dummy variable for takeover intention, and the dummy variable for private placement are not significant either.

We consider the question whether partial acquirers buy a board seat with large acquired blocks. We examine the relationship between board representation and block size. We find that block size is positively correlated with board representation. Since financial acquirers rarely take a board seat, we infer that activist and strategic partial acquirers tend "to buy a board seat by acquiring larger blocks."[19]

[18] To determine the non-linear effect of target managerial ownership on the market reaction to the formation of an outside block, we conduct a piece-wise regression as per Morck, Shleifer and Vishny (1988). None of these variables is shown to be significant.

[19] We do not make a separate table. The results will be available upon request.

As a robustness check, we add the number of the existing outside blocks in addition to the "no existing outside block" dummy. Since the variable is not significant, we do not report the regression result separately in a table. Similarly, we add the percentage ownership of the existing outside blocks in addition to the "no existing outside block" dummy. Neither variable is significant. In order to mitigate the impact of potential outliers in q ratio, we use the inverse of q ratio. The results are not affected by the alternative measure.

It is possible to gain effective control of the firm with equity ownership less than 50%. This is a concern because large outside shareholders may be beneficial to other outside shareholders by monitoring management while de facto control blocks may expropriate minority shareholders. In order to single out the monitoring effect without the contamination of a possible wealth expropriation by a large outside shareholder, we remove the blocks which are larger than 20% from the original sample. While not reported as a table, we find that the results are qualitatively similar indicating that the expropriation effect of de facto minority controlling blocks is limited in our original sample.[20]

We test formally whether there is any difference in the interaction between the governance variables and the formation of an outside block depending on whether the block is activist by introducing interaction dummies between the activist block dummy and the governance variables. The results are shown in Table 5.

We confirm the significance of block size, business relationship between the block and the target and board representation. In addition, we also find that managerial ownership has a more negative effect on shareholder wealth when the block is an activist.

[20] We will provide the results upon request.

This may reflect the fact that even an activist block is unlikely to influence management if managers are very entrenched. Similarly, we find that a target firm with no previous outside block enjoys a greater wealth effect when the block is an activist. This is consistent with the monitoring hypothesis that the wealth impact of an activist block would be correspondingly greater in a target firm where monitoring is particularly weak.

[Table 5 about here.]

5. Summary and Conclusions

The finance literature has long held that large outside blockholders serve as monitors of management. While there has been considerable support for the benefit of monitoring by large outside blockholders, existing studies on the monitoring role of large outside blockholders examine the static relationship between outside block ownership and firm value. Our study looks at the formation of a new outside block and the corresponding market reaction allowing us to measure the wealth effect of large outside shareholders *dynamically*. After removing partial acquisitions which lead to majority control blocks, we study a sample of outside block formations.

The three-day cumulative abnormal return (CAR) on activist block purchases is significant both economically and statistically (17.55%) while that for financial block purchases is only marginal both economically and statistically (1.42%) suggesting that monitoring is economically meaningful only for activist blocks. If we assume that undervaluation effects are comparable between activist block purchases and financial block purchases, then the difference of 16.13% in the 3-day CAR should reflect primarily monitoring effects. Since a takeover is a potential vehicle of governance change an

activist may institute, a part of 16.13% may reflect takeover anticipation effects. Contrary to Choi, we view takeovers as a subset of the entire spectrum of monitoring actions. However, since a takeover does not materialize within a year in a 72.73% of activist block purchases, the non-takeover related monitoring benefits must be clearly significant in the case of activist block purchases.

The three-day cumulative abnormal return (CAR) on strategic block purchases is significant both economically and statistically (15.46%). If we assume that undervaluation effects are comparable between strategic alliance block purchases and financial block purchases, then the difference of 14.04% in the 3-day CAR should reflect primarily synergy effects. We also note that the magnitude of the overall monitoring effect (16.13%) is comparable to that of the synergy effect (14.04%) observed in partial acquisitions motivated by strategic alliances.

We document that block size, pressure insensitivity of the acquirer, and board representation by the acquirer all have positive effects on the magnitude of the market reaction. These findings suggest that acquirers purchasing larger quantities, pressure insensitive acquirers, and acquirers who hold target directorships are all viewed as being more effective in monitoring management.

By introducing other governance mechanisms as explanatory variables, we study how a new large outside block interacts with the existing governance mechanisms. The existing governance mechanisms we examine are board independence, managerial ownership, financial leverage, ownership held by institutions, dual class common stock and the existence of other outside blocks. The market reaction to the formation of a new block is negatively correlated with managerial ownership suggesting that even an activist

block is unlikely to succeed faced with an entrenched management. While we do not find evidence that the wealth effect depends on the existing governance mechanisms in general, we find that the market reaction to the activist blocks is even larger when there is no previous outside block, which provides further support for the monitoring explanation.

Overall, our results suggest that activist blockholders are effective monitors, the monitoring benefit is economically significant and the magnitude of the monitoring benefit is comparable to that of the synergy benefit in strategic partial acquisitions. The extent of monitoring depends on some of the characteristics of the acquirer and the target: block size, pressure sensitivity of the block, the existence of any previous outside block, and managerial ownership.

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Table 1
Sample Description

Panel A. Sample selection

	Number	Percent
Screened after selection criteria 1 and 2	723	1.95%
Screened after selection criteria 3	616	1.66%
Screened after selection criteria 4 through 12	264	0.71%

The sample selection criteria are: (1) the initial common stock holding of the target by the acquirer is less than 2%; (2) the stock ownership after the acquisition is 5% or more, but does not exceed 50% of the target firm's outstanding shares; (3) targets are not financial services firms; (4) the stock price data of the target firms is available in the CRSP daily returns files over a one year period prior to the filing; (5) there is a summary of 13D or 13G filings of the partial acquisition in the Factiva database; (6) accounting data are available in the Compustat database; (7) proxies are available in the LexisNexis or EDGAR database; (8) institutional ownership information is available in the quarter prior to the announcement date; (9) the partial acquisition reported in the SDC database is confirmed by searching the Factiva database; (10) the announcement of the partial acquisition is not preceded by other partial acquisition announcements during the 2-month period prior to the disclosure; (11) the announcement of the partial acquisition does not take place in the middle of a tender offer process; (12) no announcement of other material events such as surprise earnings, earnings restatements and major investment or divestiture decisions occurs within a week before and after the announcement of partial acquisitions.

Panel B. Distribution of the formation of monitoring blocks by type and year

	Activist blocks		Financial blocks		Strategic blocks		All blocks	
Year	N	Percentage	N	Percentage	N	Percentage	N	Percentage
1997	17	13.9%	71	58.2%	34	27.9%	122	100.0%
1998	13	22.8%	22	38.6%	22	38.6%	57	100.0%
1999	5	11.4%	15	34.1%	24	54.5%	44	100.0%
2000	9	22.0%	15	36.6%	17	41.5%	41	100.0%
1997-2000	44	16.7%	123	46.6%	97	36.7%	264	100.0%

Table 2
Market reaction to the formation of new outside blocks

Panel A. Cumulative abnormal returns for all blocks

Event time period	CAR (%)	Cross-sectional test (t-statistics)	Standardized cross-sectional test (z-statistics)	Generalized sign test (z-statistics)
[-1, 0]	7.73	8.11***	6.09***	7.01***
[-1, 1]	9.27	8.23***	6.17***	8.00***
[-2, 2]	9.86	8.45***	6.70***	7.63***
[-5, 5]	9.63	7.18***	6.28***	6.39***
[-10, 10]	9.77	5.22***	5.31***	6.76***
[-30, 30]	8.36	2.62***	3.97***	4.05***

Panel B. Cumulative abnormal returns for three types of blocks

Event time period	Activist blocks (N=44)	Financial blocks (N=123)	Strategic blocks (N=97)	Activist blocks - Financial blocks	Strategic blocks - Financial blocks
[-1, 0]	13.84***	1.33*	13.07***	12.51***	11.74***
[-1, 1]	17.55***	1.42***	15.46***	16.13***	14.04***
[-2, 2]	18.18***	2.29*	15.70***	15.89***	13.41***
[-5, 5]	19.60***	2.83	13.74***	16.77***	10.91***
[-10, 10]	21.12***	4.55***	11.24***	16.57***	6.69***
[-30, 30]	23.29***	3.49	7.76**	19.80*	4.27*

CARs (mean cumulative abnormal returns) are reported in percentages. The level of significance is one-tailed. In panel B the level of significance is based on the generalized signed test.
*** indicates 1% level of significance.
** indicates 5% level of significance.
* indicates 10% level of significance.

Table 3
Descriptive statistics

Panel A. Descriptive statistics of dummy variables

	Proportion
Block characteristics	
Activist blocks	0.167
Financial blocks	0.466
Strategic blocks	0.367
Pressure insensitive blocks	0.951
Board representation	0.235
Target governance characteristics	
Dual class common stock	0.072
No previous outside block	0.292
Control variables	
Takeover intention	0.038
Private placement	0.345

Panel B. Descriptive statistics of continuous variables

	Mean	Median	Minimum	Maximum
Block characteristics				
Block size	0.137	0.094	0.034	0.500
Number of the existing blocks	1.849	2.000	0.000	8.000
Percentage ownership of the existing blocks	0.190	0.151	0.000	0.855
Target governance characteristics				
Board independence	0.512	0.500	0.000	0.941
Managerial ownership	0.260	0.219	0.000	0.884
Debt ratio	0.541	0.474	0.000	0.123
Institutional ownership	0.269	0.211	0.000	0.923
Control variables				
Q ratio	2.729	1.650	0.423	27.911
Market to book ratio of equity	5.255	2.143	0.193	115.93
Sales ($ million)	601	69	0.1	27973
Total assets ($ million)	760	92	1	27278

Table 4
Regression analysis of the wealth effect of the formation of new outside blocks as a function of outside block and target firm characteristics

		Model 1	Model 2
	Constant	-0.158(-2.78)***	-0.119(-1.86)*
Block characteristics			
	Activist block	0.103(3.07)***	0.096(2.77)***
	Strategic partner block	0.094(3.71)***	0.087 (3.37)***
	Block size	0.002(1.71)*	0.002(1.92)*
	Pressure insensitive block	0.142(2.98)***	0.150(3.10)***
	Board representation	0.078(2.75)***	0.074(2.55)**
Target governance characteristics			
	Board independence		-0.018(-0.37)
	Managerial ownership		-0.001(-2.00)**
	Debt ratio		-0.010(-0.71)
	Institutional ownership		-0.028(-0.54)
	Dual class common stock		0.027(0.64)
	No previous outside block		0.030(1.18)
Control variables			
	Q ratio	-0.001(-0.17)	-0.001(-0.33)
	Log of sales	0.006(1.13)	0.005(0.82)
	Takeover intention	-0.060(-0.99)	-0.054(-0.89)
	Private placement	0.022(0.87)	0.025(1.00)
N		264	264
Adjusted R^2		0.19	0.19

The dependent variable is the cumulative abnormal return. Year dummies and industry dummies are not shown in the table. Coefficients are White heteroskedasticity consistent estimates. The t-statistics are shown in parenthesis and the level of significance is two-tailed.
*** indicates 1% level of significance.
** indicates 5% level of significance.
* indicates 10% level of significance.

Table 5
Regression analysis of the wealth effect of the formation of new outside blocks as a function of outside block and target firm characteristics using interaction dummies

Variables	Coefficients
Constant	-0.131(-2.04)**
Block characteristics	
Activist block	0.237(2.13)**
Strategic partner block	0.089(3.53)***
Block size	0.002(2.30)**
Pressure insensitive block	0.151(3.22)***
Board representation	0.062(2.17)**
Target governance characteristics	
Board independence	-0.012(-0.23)
Activist block x Board independence	-0.063(-0.48)
Managerial ownership	-0.001(-1.13)
Activist block x Managerial ownership	-0.005(-2.76)***
Debt ratio	-0.014(-1.10)
Activist block x Debt ratio	-0.104(-1.15)
Institutional ownership	-0.068(-1.22)
Activist block x Institutional ownership	-0.047(-0.29)
Dual class common stock	0.031(0.74)
Activist block x Dual class common stock	-0.073(-0.43)
No previous outside block	0.029(0.93)
Activist block x No previous outside block	0.364(4.44)***
Control variables	
Q ratio	-0.001(-0.32)
Log of sales	0.006(1.12)
Takeover intention	-0.095(-1.50)
Private placement	0.029(1.21)
N	264
Adjusted R^2	0.24

The dependent variable is the cumulative abnormal return. Year dummies and industry dummies are not shown in the table. Coefficients are White heteroskedasticity consistent estimates. The t-statistics are shown in parenthesis and the level of significance is two-tailed.
* indicates 10% level of significance.
** indicates 5% level of significance.
*** indicates 1% level of significance.

Appendix 1
Variable Definitions

Variable name	Definition	Sources
Activist block	a dummy variable taking the value of one if the acquirer is a partner in strategic alliance	13d and 13g filings
Strategic block	a dummy variable taking the value of one if the acquirer is a partner in strategic alliance	13d and 13g filings; Factiva database
Block size	the proportion of the common stock of the target acquired	SDC database; Factiva database
Pressure insensitive block	a dummy variable taking the value of one if the acquirer is pressure insensitive (Pressure insensitive acquirers are those who have no current or potential business or ownership ties with the target firm.)	13d and 13 g filings; Proxy statements
Board representation	a dummy variable taking the value of one if the acquirer has a board representation	13d and 13g filings; Factiva database
Board independence	a proxy for board independence measured as the ratio of outside directors to the total number of directors	Proxy statements
Managerial ownership	the managerial ownership variable measured as fraction of the common stock of the firm held by the firm's officers and directors	Proxy statements
Debt ratio	debt ratio measured as the ratio of the book value of the total assets minus the book value of equity to the book value of total assets	Compustat
Proportion of institutional ownership	an institutional ownership variable measured as the proportion of the common stock of the target firm held by institutions	Compact Disclosure database; Factiva database
Dual class common stock	a dummy variable taking the value of one if the target firm has dual class common stock	Proxy statements
No previous outside block	a dummy variable taking the value of one if there is no outside block prior to the partial acquirer	Proxy statements
Q ratio	the q ratio measured as the ratio of the book value of the total assets minus the book value of the equity plus the market value of the equity to the book value of the total assets	Compustat database; CRSP database
Market-to-book ratio	the market to book ratio of equity.	Compustat database; CRSP database
Log of sales	log of the total net sales of the target firm in millions of dollars	Compustat database
Total assets	the total assets in millions of dollars	Compustat database
Takeover intention	a dummy variable taking the value of one if the partial acquirer expressly states its takeover intention	13d and 13g filings
Private placement	a dummy variable taking the value of one if the method of acquisition is private placement	13d and 13g filings

Appendix 2
Distribution of the target firms by industry

Industry	SIC Codes	Activist	Financial blocks	Strategic blocks	Total blocks	Percent of sample
Crops	1	0	0	0	0	0.0
Natural resource extraction	10, 12, 13, 14	3	2	2	7	2.7
Real Estate Development	15	0	2	0	2	0.8
Food products	20	1	0	3	4	1.5
Tobacco	21	0	0	0	0	0.0
Apparel and textile mill products	22, 23	0	3	1	4	1.5
Prefab buildings	24	0	0	0	0	0.0
Furniture and fixtures	25	0	0	0	0	0.0
Paper and allied products	26	0	0	2	0	0.8
Printing and publishing	27	0	1	2	3	1.1
Chemicals and allied products	28	4	22	9	35	13.3
Petroleum and coal products	29	0	0	0	0	0.0
Rubber and plastics	30	0	2	1	3	1.1
Leather and footwear	31	0	1	0	1	0.4
Stone, clay and glass products	32	1	1	0	2	0.8
Primary products and metals	33,34	0	6	3	9	3.4
Industrial machinery	35	1	5	4	10	3.8
Electronic/electric equipment	36	2	3	14	19	7.2
Transportation equipment	37	0	3	2	5	1.9
Instruments and related products	38	1	4	5	10	3.8
Miscellaneous manufacturing	39	2	0	0	2	0.8
Railroad transportation	40	0	0	0	0	0.0
Trucking and warehousing	42	0	2	0	2	0.8
Air transportation	45	1	0	0	1	0.4
Miscellaneous transport	47	0	1	0	1	0.4
Communications	48	2	10	9	21	8.0
Utilities and waste management	49	3	1	0	4	1.5
Wholesale	50, 51	3	3	0	6	2.3
Retail	52-59	5	15	2	22	8.3
Non-financial services	71-87	15	32	39	86	32.6
Other		0	2	1	3	1.1
Total		44	123	97	264	100.0