

Advanced Corporate Finance

Takeover Defenses: Poison or Placebo?

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Agency view of Takeovers

- “Takeovers, like bankruptcy, represent one of Nature’s methods of eliminating deadwood”
 - Nobel laureate Paul Samuelson
- “Competition among managerial teams limits divergence from shareholder wealth maximization”
 - Manne (1965)

Key judicial role of shareholders: Sell to highest bidder!

“Arbitrageurs and takeover specialists facilitate [takeover] transactions by acting as intermediaries to value offers by competing management teams, including incumbent managers...Stockholders have no loyalty to incumbent managers; they simply choose the highest dollar value offer from those presented to them in a well-functioning market for corporate control, including sale at the market price to anonymous arbitrageurs and takeover specialists.”
Jensen and Ruback (1983)

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Agency view of hostility

- Successful hostile takeovers resolve a costly agency conflict between corporate officers and shareholders
- They respond to a breakdown of the company's internal governance system
- As such, they benefit investors but threaten incumbent, inefficient management

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Takeover Impediments

- Regulatory/legal/political roadblocks
- Strong managerial resistance
- Private benefits of control may cause inefficient managers to win
- Sophisticated expropriation methods
- Imperfect contracts and enforcement

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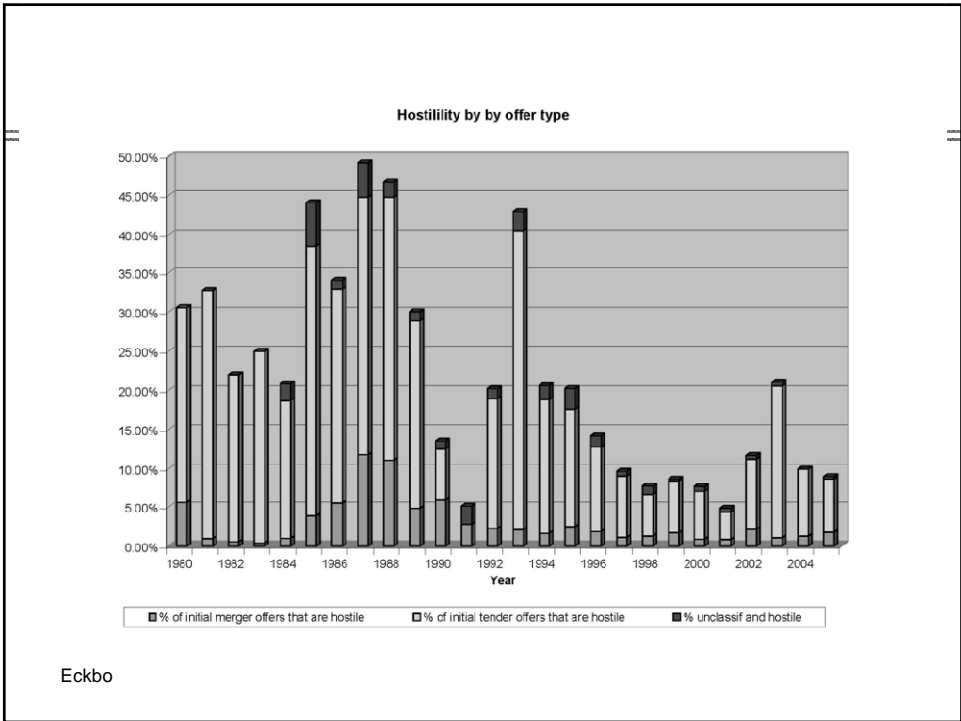
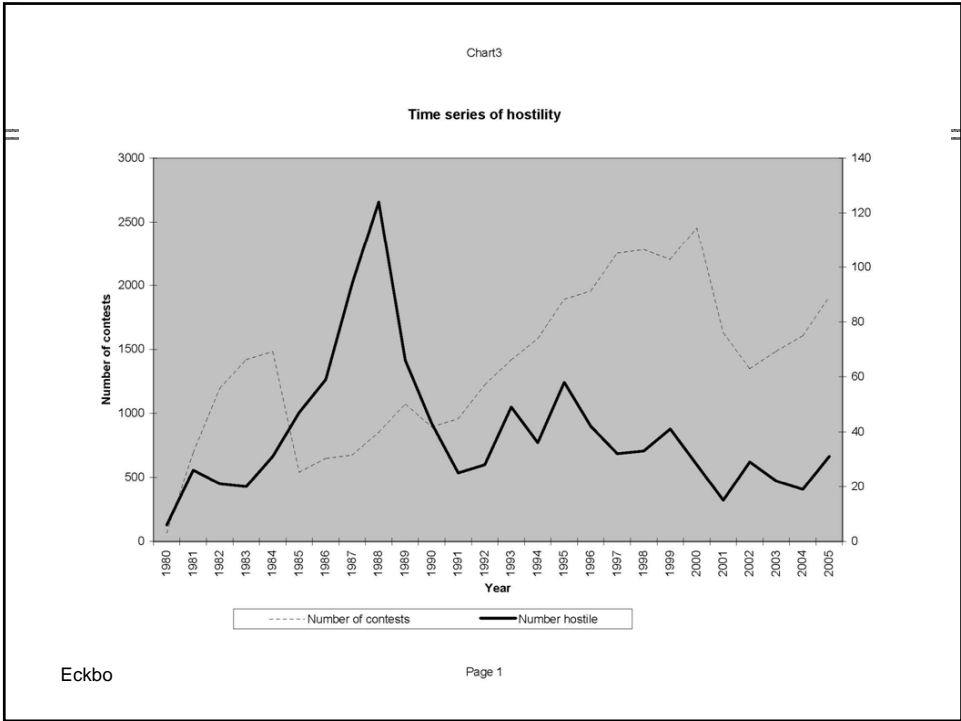
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1975-85: Downsizing following industry excess capacity

- Hostile takeovers and subsequent divestitures
- Forced downsizing through LBOs
- Renewed focus on shareholder rights
- Growing institutional shareholder activism
- Development of high-powered financing instruments, such as high-yield (“junk”) bonds, facilitating massive acquisitions

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1985-95: Managerial counter-revolt

- Managers regained position through strong takeover defenses
 - Poison pills
 - Staggered boards
 - Insider-dominated boards
 - State antitakeover laws
- Institutional investors respond by becoming increasingly active

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Often-heard management response

- “Hostile takeovers are disruptive, unproductive, and ultimately value-reducing”
- “Current management should not be replaced by the Raider”
- “The Raider is not serious about the future of this company – we are”
- “Shareholder rights must be curtailed so they cannot accept bid”
- “We need more time”

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Professions of a “Short-termer”

“It is questionable how much more long term planning shareholders can stand. What many managements seem to be demanding is more time to make the same mistakes”

T. Boon Pickens (HBS-1986)

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The populist view

From Barbarians at the Gate:

“RJR-Nabisco is the deal people regard as most symptomatic of the excesses of Wall Street....RJR-Nabisco was not a departure, it was the culmination of a process that had gone badly out of control.”

Evidence: This deal created value of \$15+ billion!

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Attack on the junk bond market

“junk bonds are..the currency of “casino economics”...they’ve been used not to create new plants or jobs or products but to do the opposite: to dismantle existing companies so the players can make their profit...This isn’t the Seventh Cavalry coming to the rescue. It’s a scalping party”

J. Richard Munro, Chairman and CEO, Time Inc.
(1989)

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Demise of junk bond market

- 1986: The Federal Reserve issues new margin rules that restricts the use of debt in takeovers to 50% of the purchase price. This re-introduced size as a deterrent to takeovers
- The S&L crisis choked junk bond demand
- Michael Milken and the collapse of Drexel Burnham Lambert
- 1990: Junk bond market collapses

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Recent hostile bids

- Biggest hostile takeover attempt in 1998 was AlliedSignal's \$10 billion bid for AMP (defeated)
- Canadian Airlines' bid for Air Canada (defeated, 01/00)
- Vodafone's (UK) \$134 billion bid for Mannesmann (succeeded, 02/00)
- Pfizer's \$92 billion bid for Warner Lambert (succeeded, 02/00, but had to pay \$1.8 billion breakup fee to Am. Home Products)
- Oracle v. Peoplesoft
- Microsoft v. Yahoo

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Allied Signal's bid for AMP 1998

- AMP: World's largest producer of electronic connectors, with 1997 sales of \$6 bill.
- AlliedSignal offers 50% premium, conditional on removal of AMP's poison pill and a commitment by AMP not to sue under Pennsylvania's state antitakeover laws
- The poison pill contains a "dead-hand" provision giving sitting, continuing board members exclusive right to vote a merger

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Robert Ripp, AMP's CEO & Chair

- “I am focused on growing this company, not selling it.....I am going to do what it takes to achieve the results our shareholders expect, but we need time” (1998)
- AMP Institutional Owner: “AMP is asking us to walk away from a 50% premium and trust a guy with no operating experience”

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Emotions run high....

“You have dissipated your assets, mortgaged your future and disenfranchised your shareholders and placed in jeopardy the financial security of your employees...To prevent a merger with Limited at a premium of more than 50%...you appear to have lost any sense of responsible corporate behavior”

Limited's letter to CHH board after defeat of bid

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Myth: Firm needs “long-term owners”

- What is “long-term”?
- The current stock price is always “long-term”
- Company needs active shareholders, willing to vote at shareholder meetings or sell stock
- “Long-term” is often used synonymously with “passive”

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Myth: Takeovers cause short-termism

- What is “short-termism”?
- Evidence show that it is the low R&D companies that are most likely to become takeover targets
- High R&D tend to imply high stock price which is the best defense against takeover

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Why resist an unsolicited bid?

- To increase the winning bid?
- To retain management/director position?
- Problem: How do you infer entrenchment?
 - Look at the nature of the defense: Does it eliminate bids or simply raise them?

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Worst defense: Bidder elimination

- Involves making it too costly to launch a bid, or to make it too advantageous to drop an existing offer
 - The latter is achieved by a greenmail payment in return for a standstill agreement
 - The former is achieved using breakup fees, reverse greenmail or a poison pill security
- These tactics are widespread, and significantly harm stockholders

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Coercive tender offer?

- Unconditional bid for $\alpha=.5$ of the shares at $P_0=\$20$
- Successful bid will be followed by merger of minority shares at 10
- Another merger bid for \$18 per share ($\alpha=1$) is expected after the expiration of this offer
- Would you tender?

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Prisoner's dilemma

<u>Decision</u>	<u>Offer Succeeds</u>	<u>Offer Fails</u>
Keep Shares	\$10	18
Tender Shares	15	20

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Solutions to the dilemma

- Delay expiration of the first bid in order to give the second bid time to materialize
- Fair price provisions raise the average price in the first bid, by raising the \$20 back-end minority buyout price
- Competing repurchase offer
- Empirically, little evidence of coercive offers

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Greenmail and Standstills

- A “raider” with a reputation for successfully acquiring firms purchases 10% of your firm’s voting stock in the open market
- Your management repurchases the 10% at a substantial premium over the market price. The value of the targeted repurchase premium is the greenmail payment
- The “raider” responds by signing a standstill agreement not to purchase your stock again

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Effects of Greenmail and Standstills

- The greenmail payment is a dividend paid to a single shareholder
- The standstill agreement eliminates the potential takeover, and therefore any takeover premium already incorporated in the target stock price
- The loss to shareholders typically in the several hundred million dollar range

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Mesa Petroleum bid for Unocal

- T. Boone Pickens Jr. and his Mesa Partners II made an \$8.1 billion bid to acquire Unocal
 - Group already owned 13.6% of company
 - Offered \$54/share cash for 37% of Unocal's stock and \$54 a share in junior securities for the rest
 - Unocal's board responded by offering to exchange \$72/share in senior securities for 50.1% of the Company's total shares.
 - Unocal barred the Mesa group from participating in the stock repurchase

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Reverse Greenmail

- Instead of repurchasing the raider's shareholding, you repurchase a certain percentage of every other shareholder's stock ownership, excluding the raider
- The targeted dividend is now being financed out of the pocket of the raider
- In 1985, the Delaware Supreme Court labeled this action no worse than greenmail (Unocal v. Mesa Petroleum)

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Unocal Precedent – 1985

- Delaware Supreme Court ruled that Unocal had sufficient legal basis to exclude Mesa from the repurchase plan
 - Any defensive measure the board adopts must be reasonable in relation to the threat posed
 - Board adopted the strategy "with the good-faith belief" that is must protect its shareholders from "grossly inadequate and coercive two-tier" tender offer
 - Business Judgment Rule – if a corporate board has acted in good faith, without conflict of interest, and "with enhanced scrutiny", then the court will not second-guess the directors on issues related to defenses

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The Poison Pill (“shareholder rights plan”)

- A right to receive an extraordinary payout in the case of a takeover attempt, to the exclusion (and detriment) of the raider
- A permanent threat of reverse greenmail
- The pill is effective even without a standstill agreement
- The pill effectively deters bids also in jurisdictions where discriminating between shareholders is illegal (e.g., Canada)

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Breakup Fees

- Suppose you think you are going to be the target of a hostile bid.
- Find a friendly bidder (“white knight”) and make a breakup fee agreement
- A second bidder must now pay the fee to the first (white knight) if its rival bid succeeds
- Pfizer paid American Home Product \$1.8 billion for breaking up AHP’s negotiations with Warner Lambert

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Breakup fees are probably efficient

- Fee reduces expected bidding costs
 - for first bidder only (“stalking horse”)
 - Target commits ex ante to a breakup fee only if target initiates takeover (otherwise, adverse selection)
- Fee protects initial bidder against opportunistic behavior by target

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Misc. takeover defenses - 1

- Supermajority vote requirement
 - Often 75 or 85% for merger decisions. Also used to lock-in existing charter provisions
- Classified (staggered) board
 - Directors classified into separate classes and elected to overlapping terms. Deters proxy contests since only one class up for election each year

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Misc. takeover defenses - 2

- Blank check preferred stock
 - Authorized preferred for which the board has broad discretion to set voting, dividend, conversion, and other rights. Used to used as a vehicle to implement a poison pill
- Stakeholder clause
 - Charter language that allows directors to consider the effects of their decisions on constituents other than shareholders

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Other takeover defenses - 3

- Unequal voting rights (dual class)
 - Grants superior voting rights to one class of equity
- Shareholder meeting requirements
 - Restrictions on right to call special shareholder meetings, and restrictions on right to act by written consent (so that you have to wait for the next meeting)
- Eliminating cumulative voting and right to alter board size

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State Anti-takeover Laws - 1

- Several states have adopted laws which make it more difficult (costly) to perform hostile takeovers
- Pennsylvania have among the most detrimental set of legal rules
- “Race to the bottom” by firms to incorporate in such “protective” states

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State Anti-takeover Laws - 2

- Freeze-out law
 - Prohibits large shareholder from engaging in any business combination with the covered firm for a specified number of years (3 years in Delaware) unless target firm’s directors approve before the bidder acquires more than a specified number of target shares
- Control share acquisition law
 - Requires shareholder approval before a large shareholder may vote shares obtained in a control share acquisition

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State Anti-takeover Laws - 3

- Fair price law
 - Similar to fair price charter amendments adopted by firms
- Cash-out law
 - Mandatory bid rule following the purchase of a certain stake in the firm (e.g. 20%)
- Poison pill law
 - Grants firms the right to adopt poison pills