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)

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
### 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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### 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
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

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”
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)

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!
### 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)

### 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
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

Allied Signal’s bid for AMP 1998

- 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
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”

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
**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”

**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
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?

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
Coercive tender offer?

- Unconditional bid for $\alpha = 0.5$ of the shares at $P_O = $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

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<td>Tender Shares</td>
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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

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
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

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
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)

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
### 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
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

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
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 implement a poison pill

- Stakeholder clause
  - Charter language that allows directors to consider the effects of their decisions on constituents other than shareholders

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
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

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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