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The Wrong Prescription? Revisiting the Justification for Poison Pills

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One of the fundamental tenets of market capitalism is the freedom of willing buyers and willing sellers to transact business. Ironically, this basic rule does not apply in the world of corporate mergers and acquisitions. Because of so-called "poison pills," deals effectively require the support of the target company's board of directors. Here we consider how "poison pills" evolved, allowing directors to prevent shareholders from selling their property to third parties offering premium prices. Based on massive value losses from withdrawn tender offers in the last few years, however, we suggest that it is time to revisit the broad judicial deference that has allowed directors to use poison pills to stand between bidders and stockholders indefinitely.

Poison pills emerged as a solution to a significant problem facing corporations and shareholders. In the early 1980s, corporate raiders used "two-tiered" tender offers to coerce shareholders into tendering their shares for unfair prices. In short, the bidder offered cash for enough shares to acquire majority control, but offered junk bonds or other securities of questionable value to the remaining shareholders to "squeeze out" those who did not tender. This offer structure created an artificial rush to tender because shareholders wanted to get cash on the front end rather than risky securities in the second transaction.

Martin Lipton, perhaps history's most successful corporate takeover advisor, created the "poison pill" to solve this problem. Triggered when a bidder unapproved by the board acquires more than a preset percentage of the company's stock, a poison pill lets all shareholders except the hostile bidder buy shares at a fraction of their market value. These new share issuances drastically dilute the bidder's position, making it prohibitively expensive to acquire the company. Since directors do not need shareholder approval to adopt poison pills and can be redeemed by the target's board, directors control whether a bidder can actually close its tender offer.

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POISON PILLS

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In *Moran v. Household Int'l Inc.,* the Delaware Supreme Court upheld directors' power to use this powerful defensive device, but with conditions. The Court seemingly tied its validation of the poison pill on two points: (1) a board's decision to keep a pill in place is always subject to fiduciary duties (and therefore open to judicial review) and (2) if shareholders do not like how a board is using the pill, the shareholders preserve their ability to remove the directors from their jobs by running a proxy fight.

The validation of the poison pill in *Moran* coincided (and arguably caused) the decline of the coercive hostile takeover bids that marked the 1980s. Once poison pills were held to be lawful, however, boards used these devices to prevent shareholders from accepting all-cash for all-shares tender offers. In *City Capital Associates v. Interco,* the Delaware Court of Chancery upheld a board's power to employ the pill to give itself time to develop an alternative transaction or provide previously undisclosed information to stockholders, presumably to persuade against accepting the tender offer. However, the Court held that once those purposes were achieved, the stockholders should have the right to decide for themselves whether to accept a non-coercive offer. The Court recognized that corporate directors — even those acting in subjective good faith — could seriously harm shareholder interests by using a pill to preclude a legitimate alternative to the board's preferred course.

The conventional wisdom often presented by corporate advisors is that besides protecting against coercive offers, poison pills cause bidders to pay higher prices to gain director support than the price shareholders would otherwise demand for their shares. Whatever intuitive appeal this argument may have, we have not found empirical proof that poison pills actually create this positive effect.

The balanced rule of *Interco* was short-lived. Soon after Lipton's law firm publicly advised clients to reincorporate outside of Delaware if *Interco* remained good law, the Delaware Supreme Court issued its landmark decision in *Paramount Communications, Inc. v. Time, Inc. ("Time-Warner")*. The *Time-Warner* opinion suggested (but did not expressly rule) that directors can use a poison pill to reject indefinitely any bid, so long as the directors believe their long-term strategy will eventually generate greater wealth for stockholders. Thus, boards seemingly could "just say no" to a premium bid that a majority of a company's shareholders prefer over staking their future on the current board's managerial skill.

Why should a board of directors have this significant power? Does a pill create shareholder benefits that justify its use to override majority rule? The conventional wisdom often presented by corporate advisors is that besides protecting against coercive offers, poison pills cause bidders to pay higher prices to gain director support than the price shareholders would otherwise demand for their shares. In other words, in the absence of any pill, bidders can pay price "X," which is the amount needed to get a majority of shareholders to sell their shares in a takeover bid. In theory, a pill allows boards to elicit a price higher than "X." Whatever intuitive appeal this argument may have, we have not found empirical proof that poison pills actually create this positive effect. There is little reason to conclude that shareholders would accept materially lower premiums than boards are able to elicit, suggesting that any higher premium the poison pills elicit is marginal, at best. Also, poison pills may be no more effective in eliciting higher premiums than other less aggressive defenses.

Conversely, by looking at the past three years alone, we find ample empirical evidence of poison pills contributing to massive destruction of shareholder and firm value. The chart above lists recent cases where a board rejected an unsolicited takeover bid and refused to redeem the company's poison pill, and the bidder withdrew its bid rather than wait for whatever time it would take to replace the board through a proxy fight. The chart shows the loss in value following withdrawal of the bid.

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Shareholder Value Lost Due to Poison Pills: Recent Examples

Target	Acquirer	Offer amount above target's stock price	Subsequent target stock price decline (%)*		
			1-Day	30-Days	90-Days
Asyst Technologies Inc.	Aquest Systems Corp	66%	(82)	(93)	(94)
Atmel Corp	Microchip Technology Inc.	52%	(30)	(39)	(29)
Axcelis Technologies Inc.	Investor Group	29%	(26)	(76)	(91)
Charlotte Russe Holding Inc.	Charlotte Russe Hldg Inc SPV	31-38%	(53)	(35)	(47)
Diebold Inc	United Technologies Corp.	66%	(29)	(29)	(29)
Emulex Corp.	Broadcom Corp.	40%	(19)	(18)	(N/A)
International Rectifier Corp.	Vishay Intertechnology	13%	(44)	(50)	(41)
Mentor Graphics	Cadence Design Systems Inc.	30%	(34)	(33)	(64)
PeopleSupport Inc	Investor Group[1]	18%	(31)	(54)	(46)
Rentech Inc	Sherwood Invest Overseas Ltd.	30%	(35)	(44)	(42)
Republic Services Inc	Waste Management Inc.	22%	(36)	(34)	(34)
SanDisk Corp	Samsung	80%	(65)	(78)	(56)
Take-Two Interactive	Electronic Arts	64%	(36)	(48)	(56)
WCI Communities	Investor Group	16%	(64)	(67)	(81)
Yahoo!	Microsoft	62%	(21)	(15)	(36)

*** (% Difference between final offer price and post-withdrawal target stock price)**

The data illustrate that tens if not hundreds of billions of dollars of potential shareholder gains have been lost when bidders withdrew offers in the face of boards refusing to redeem their poison pills. Whether or not the target boards acted for improper entrenchment or out of a good faith belief in their own long-term strategies is irrelevant to the shareholders who were denied the chance to tender shares and saw the stock price then plummet. Notably, these examples do not even address the billions of dollars of firm value that shareholders never knew they could have enjoyed from offers that were never made public because the target CEO deters a bid by making clear that the board will leave the pill in place and actively oppose any takeover efforts. This empirical evidence is particularly salient given that numerous scholars, such as Harvard Law School's Lucian Bebchuk and Allen Ferrell, have shown that poison pills are among the anti-takeover provisions contributing most to managerial entrenchment and the reduction of firm valuation.

Given the above data, we believe the arguments favoring the use of poison pills may make more sense in theory than in reality. Even assuming that pills allow boards to elicit marginally higher takeover premia in the normal course, it only takes a few boards who overplay their hand to wipe out any gains attributed to poison pills, and to turn the effect of pills into massive shareholder and societal losses. While we are not advocating the invalidation of poison pills in all instances, we believe the standard under which Delaware courts examine fiduciaries' use of poison pills should be reexamined. At the least, we believe that Delaware courts should return to the standard articulated in *Interco*, and require that in order to maintain a poison pill in the face of a significant premium offer, a board demonstrate a legitimate need for more time to adequately inform its shareholders about the company's standalone prospects or to pursue a realistic and imminent alternative transaction. The first step in changing the status quo is for shareholders to just say no to "Just Say No."

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