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To Our Clients

The Investment Manager Attack on Shareholder Rights Plans

Several institutional investors are joining with corporate raiders to attempt to eliminate defenses against takeover abuses. The Wall Street Journal today reports that the $38 billion College Retirement Equities Fund and the $58 billion California Retirement System will attack the shareholder rights plans ("poison pills") adopted by some 50 companies.

In evaluating these attacks, the self-interest of the managers of these institutions should be noted. They are not investors. They are speculators. They are compensated on the basis of how much quick profit they produce each quarter. They do not invest. They buy and sell. They do not have any long-term interest in the companies whose securities they trade in. As speculators they have no legitimate claim to the "mantle of champion of shareholder rights". They are self-interested promoters of takeovers for their own benefit. They are fueling the takeover frenzy. They encourage raiders, buy billions of dollars of junk bonds to finance bust-up takeovers and act in concert to defeat efforts to protect against takeover abuses.

The power of the institutional investment managers is enormous. A mere handful have the ability to control almost every major American corporation. They are using their power to force corporations to focus on short-term profits rather than long-term growth. They are forcing massive reductions in research and development and capital investment. They are forcing corporations to gamble on abnormally high levels of debt. They are destroying our ability to compete in world markets.

The concentration of power in institutional investment managers is ungoverned and unregulated. There is no statute or government agency that restrains these institutions from enabling raiders to bust up companies, destroy jobs and bankrupt whole communities. The public welfare demands that these investors be prohibited from undermining American business and our economy by their desire for short-term stock market profits. The need for legislation is clear. However, it is not likely that Congress will act. Therefore it is essential that the poison pill -- which is the only effective brake on the takeover frenzy -- be sustained.

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The SEC, the Poison Pill and Takeover Policy

Martin Lipton

The SEC's Chief Economist has issued still another study purporting to show that share purchase rights plans ("poison pills") are detrimental to shareholders. It doesn't require a sophisticated economic study to demonstrate that when a target rejects a takeover bid or evidences that, despite rumors to the contrary, it isn't likely to be taken over, there will be an immediate decrease -- sometimes quite sharp -- in the price of its stock. That is the most "damaging" finding of the SEC study. The SEC's attempt to draw the conclusion from this study that poison pills are detrimental to shareholders, however, simply reinforces the conventional wisdom that an economist can "prove" anything he sets out to prove.

The poison pill, which was invented by the author of this article, has been adopted by over 300 major American corporations. The poison pill is neither poisonous nor a pill. It is an agreement between a corporation and its shareholders creating substantial additional values for the shareholders in the event of a nonnegotiated acquisition of the corporation. It has no impact on a negotiated acquisition. In a 1985 decision, the Supreme Court of Delaware in Moran vs. Household International upheld the legality of the poison pill, recognizing that it is an appropriate countermeasure to coercive takeover tactics and that its adoption is a proper exercise of business judgment by the directors of a corporation. The SEC argued unsuccessfully to have the pill held illegal in the Household case.

Since its loss in Household, the SEC has embarked on a continuing effort to show that poison pills are bad. The SEC's most recent study finds that adoption of the pill had no statistically significant effect on the stock market prices -- even within the artificially limited two-day window chosen by the SEC -- of the 245 companies that were included in the SEC's sample. Further there was no statistically significant effect on the stock market prices of companies that were not the subject of takeover speculation. These findings are consistent with the conclusions reached by all of the major investment banking firms that have studied the subject.

Not satisfied with this answer, given the SEC's institutional bias against the pill, the SEC study carves up the survey sample into subsets (e.g. companies subject to takeover rumors) seeking to find a "statistically significant" -- albeit less than 2% -- negative impact of the pill. Nonetheless, the SEC was unable to find, under any set of assumptions within the sample, a "statistically significant" negative impact on stock prices resulting from adoption of the type of pill that was the subject of the Household case.

On a more fundamental level, however, the SEC's limited study of two-day stock market effects has little relevance to the question whether the pill is good or bad. The performance of a company's stock over a two-day period is a remarkably short-sighted focus. The effects of poison pills must be examined in the broader context of the overall takeover environment and its long-term impact on individual companies and the economy as a whole.

The pill is the only practically effective means to level the playing field between raiders and targets. Absent the pill a target has only 20 business days following commencement of a hostile tender offer in which to find a white knight or to undertake a radical restructuring. The raider has unlimited time to study the target, prepare the attack, arrange financing and secretly accumulate shares in the open market. The great advantage that a raider has is the reason that, absent the pill, less than 10% of targets remain independent.

The pill gives the target more time. The pill gives the target a better opportunity to negotiate with a white knight or even with the raider. Under the extreme time pressure of a tender offer, absent the pill, the target could not hope to maximize shareholder values in negotiating with either a raider or a white knight. In these respects it is impossible to deny that the pill is beneficial to shareholders. It creates an opportunity to maximize shareholder values.

The SEC study's review of companies with pills that have been the subjects of takeover fights shows that the pill works exactly as it should. It demonstrates that, contrary to the position espoused by the SEC in the Household case, the pill does not prevent all takeovers or preclude takeover attempts, although it does help companies that determine to remain independent to do so. The study shows that 30 companies that adopted pills were the subject of hostile takeover attempts -- 16 were acquired; 14 remained independent. With respect to the 16 companies that were acquired, the study shows that in almost all the cases the value ultimately received by the shareholders (even after netting out increases in stock market prices generally) was greater than the initial bid.

From the beginning of the corporate era in the United States our courts and our legislatures have placed decisions as to a corporation's future -- including whether and when it is to be sold -- in the hands of the directors. The SEC study demonstrates that this policy is correct -- in over 80% of the cases the pill assisted directors to maximize shareholder values by getting a higher price than the initial bid. In its arguments against the pill, the SEC has pitted itself and its "business judgment" against the business judgment of thousands of independent corporate directors, holding the most responsible positions in American industry, who have voted to adopt pills for more than 300 companies in order to counterbalance coercive acquisition techniques.

The attack on the pill is part of a larger attack on defensive measures generally, indeed on anything that would operate to hinder or slow down in any way the growing flood of takeover activity. This attack is generated by those who promote the concept of a free market in corporate control as a guiding principle of economic policy, a concept that underlies the SEC study and is embraced by both the Chicago School economists and the corporate raiders. This concept is endorsed by the economists as part of their efficient market theories and their belief that our economy requires a constant stock market based reevaluation of corporate management to assure efficiency. It is endorsed by the raiders as a philosophical justification for their pillaging of American business for their own, and only their own, financial gain. The concept, however, is fundamentally flawed; to the extent it gains currency, it poses increasingly serious dangers to corporate and economic policy in our country.

One of the main assumptions of those who promote the concept of a free market in corporate control is that directors and managers of corporations are inherently self-interested: that left to their own devices, they will sacrifice the interests of their corporations and shareholders and instead act to promote their own self-interest. This assumption leads to the conclusion that a mechanism must be found to discipline directors and managers. The free marketeers argue that the discipline mechanism is found in takeover activity, "the market for corporate control." Thus, the argument continues, takeovers are to be promoted and takeover defenses discouraged. The free marketeers would eliminate all takeover defenses and prohibit directors from taking any action to oppose a takeover.

The main effect of the rule changes urged by the free marketeers would be to tie the hands of boards of directors in their efforts to serve their corporations and shareholders. At the same time, corporate raiders -- who are acting in their own self-interest and who are seeking to profit from acquisition of the assets of a target company that would otherwise belong to the target company's shareholders -- would be left completely unfettered in their tactics and techniques to force a sale or liquidation of the target company. And this would be done without any systematic evidence that the corporate raiders are better qualified to manage our economic resources than the directors and managers being "disciplined" in the market for corporate control.

It is the raider, not the board of directors, whose role is by nature self-interested; it is the raider not the board of directors, who owes no duty to the target's shareholders; it is by definition the raider's purpose to profit at the expense of the target company, its shareholders and its other constituencies. While these facts do not suggest that all non-negotiated acquisitions should be banned, they do suggest a need to examine acquisition techniques and abuses carefully as part of the whole picture before arriving at any policymaking decisions that restrict the pill or other takeover defenses. A board of directors is under a legal duty to act in what it considers the best interests of the corporation, its shareholders and its other constituencies. We do not need corporate raiders to police our board rooms. The attempt by raiders to portray themselves as "champions of the shareholders" is no more than a self-serving smokescreen.

During the past several years, takeover activity has markedly increased as raiders have developed new and powerful techniques -- such as two-tier offers, junk bond financing, open market purchase programs and bust-up, bootstrap bids -- to make any corporation a potential takeover target. Many of these offensive techniques are designed to place the maximum pressure on shareholders and companies to sell, allowing raiders to appropriate to themselves the long-term values that would otherwise belong to the target company and its shareholders.

The defensive measures developed in recent years, such as the pill, are only a partial, and not entirely adequate, response to these powerful takeover techniques. The defensive responses are an attempt to increase the bargaining position of boards of directors, as the representatives of companies and their shareholders, vis-a-vis the raiders. Despite these defensive mechanisms, however, takeover activity continues to increase and the ability of companies and directors to cope with coercive takeover tactics continues to deteriorate.

In the face of these developments, the proponents of a free market in corporate control propose to prohibit defensive measures, while suggesting nothing to curb or in any way address the very real and pressing problem of raider abuses. They, and the few courts that have been led astray by them, look at only one side of the scale. In the context of the development of the aggressive acquisition techniques to which it responds, the pill represents no more than an effort to restore some balance in the bargaining positions of directors and companies vis-a-vis raiders. If the pill were outlawed and the business judgment rule (which allows directors to reject unfair or inadequate takeover bids) narrowed, all the remaining weights from the companies' side of the scale would be removed, leaving the balance sharply and irretrievably tipped in the favor of raiders.

In fact, curbing takeover defenses while leaving offensive techniques unfettered would have an adverse effect on the economy as a whole. The effect of banning the pill or narrowing the business judgment rule would be to fuel the already historically high level of takeover activity, to destroy the remaining ability of companies to deal with coercive acquisition techniques and abuses, to encourage short-term profit seekers at the expense of long-term values and planning, to increase debt levels and undermine corporate and economic stability -- in sum, to spur and accelerate some of the most unhealthy effects and by-products of the current takeover frenzy. The short-term bias of those who would bar takeover defenses jeopardizes long-range planning and development. It jeopardizes research and development for long-term growth. It weakens the ability of American corporations to meet foreign competition and provide employment to Americans. It runs the risk that our industrial future will be sacrificed for the benefit of takeover entrepreneurs whose only interest is their own immediate financial gain. This fixation on the short-term needs to be curbed, not encouraged. If not, the consequences for the American economy may be disastrous.