

March 10, 1997

The Poison Pill -- Some Current Observations

It is almost 15 years since our firm developed the first version of the poison pill. That version was designed to deal with the two-tier, front-end-loaded, junk-bond-financed, boot-strap, bust-up takeover. It accomplished its purpose and withstood legal attacks. We continued to improve the pill and two years later the direct precursor of the present-day pill was litigated in the Household case. Household established definitively the legality of the pill in Delaware and thereafter its use spread rapidly. Today, well over 1500 companies have adopted pills and it continues to be the best way to empower a board of directors to deal with a hostile tender offer, without depriving shareholders of their voting rights. The basic legality of the pill is settled in all major states and its use in effectuating the just-say-no defense has been confirmed by the courts. The pill remains the best time-tested means for boards to enhance shareholder value. Yet the pill continues to be disdained by academics of the Chicago School and activist institutional investors. We continue to recommend its adoption and renewal.

State-of-the-Art Pill. The most effective pill is a flip-over and flip-in pill with a threshold of 10-20% and with the exchange feature if the flip-in is triggered.

Chewable Pills. In order to satisfy activist shareholders, some companies have resorted to a pill that does not apply to a cash offer for all of the outstanding shares. While a so-called chewable pill has some limited utility and may avoid a proxy resolution attack, it is not effective in most situations and does not substitute for the state-of-the-art pill.

Proxy Resolutions. Shortly after the pill became popular with major companies, activist institutional shareholders, like CREF, sponsored precatory resolutions attacking the pill. Today many institutions blindly vote for such resolutions and currently companies with very large institutional ownership may expect about 50% of the shares to vote for such resolutions. In 1996 anti-pill resolutions went to a vote at 14 companies (passed at 8) and on average received 53.4 percent of the votes cast. Generally those companies had performance problems and the anti-pill resolution vote usually bears a direct relationship to performance.

The attack on the pill is ill-founded and little more than a nettlesome diversion. Whether a company should have a pill is a board of directors issue, not a shareholder

issue. (However, there is a January 1997 Oklahoma Federal District Court opinion, applying Oklahoma law, holding that a company was required to submit to a shareholder vote a bylaw amendment to force redemption of any pill not previously approved by a shareholder vote. We think such a bylaw would be invalid in Delaware.) Recent comprehensive studies show beyond doubt that the pill does not depress share value and that companies with pills that are taken over achieve substantially higher values for their shareholders than companies without pills. Accordingly, if the board of directors determines that having a pill is in the best interest of the company and its shareholders, the company should not redeem its pill even if more than 50% of the shares vote for an anti-pill resolution. A pill is essential to the Board's ability to fulfill its fiduciary duties in the takeover context. Companies should not allow concern that they might become the target of an anti-pill resolution to deter them from renewing their pills. Indeed, failure to renew may be misinterpreted as receptivity to a takeover proposal.

Dead-Hand Pills. The typical hostile takeover attack consists of a tender offer combined with a proxy fight to replace the board of directors with new directors who will redeem the pill. Some companies have adopted pills that become nonredeemable by the board of directors if more than 50% of the board has been replaced. This type of pill has been argued to raise questions under the legality standards of the Delaware cases. It nonetheless may be advisable for companies that are subject to a consent solicitation or that do not have a staggered board. Such a pill may prove most defensible if the period of time that it is not redeemable is limited to that which would provide sufficient time for efforts to maximize shareholder value -- say, 120 to 180 days.

The Pill in Merger Agreements. The pill can play a major role in protecting stock merger agreements from hostile attack. A party to a stock merger can agree not to redeem its pill until the drop dead date in the merger agreement. In a merger of equals, each of the merger partners may agree to keep its pill in place until the drop dead date, thereby providing substantial deterrence against interference with the merger.

The pill today is an integral part of the basic corporate structure in the United States. It has proved its worth in a multitude of situations and continues to be the most important factor in any takeover situation.

M. Lipton