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A New Takeover Threat: Symbiotic Activism

The Pershing Square-Valeant hostile bid for Allergan has captured the imagination. Other companies are wondering whether they too will wake up one morning to find a raider-activist tag-team wielding a stealth block of their stock. Serial acquirers are asking whether they should be looking to take advantage of this new maneuver. Speculation and rumor abound of other raider-activist pairings and other targets.

Questions of legality are also being raised. Pershing Square and Valeant are loudly proclaiming that they have very cleverly (and profitably) navigated their way through a series of loopholes to create a new template for hostile acquisitions, one in which the strategic bidder cannot lose and the activist greatly increases its odds of catalyzing a quick profit-yielding event, investing and striking deals on both sides of a transaction in advance of a public announcement.

The bidders conspicuously structured their accumulation plan to outflank the SEC's outdated "early-warning" rules and the Hart-Scott-Rodino Antitrust filing requirements (by taking advantage of Regulation 13D's 10-day filing window, and using derivatives, for which clearance is only needed to exercise options, not to buy them). They also took express pains to sidestep Rule 14e-3 which outlaws insider-trading in connection with a tender offer, by styling themselves as co-bidders and not (yet) proceeding towards a tender offer.

This new stratagem emphasizes the crying need for the SEC to bring its early-warning rules into the 21st century, as we have been urging for several years. The SEC should forthwith move to close the 10-day filing window and the wide loophole opened by ever-more-complex derivative trading schemes. The only argument that anyone has come up with against fixing these rules is that activist hedge funds need the extra "juice" to excite them enough to shake up corporate America. Even if this argument had any merit applied to activism designed to "improve" underperforming companies – which we believe it does not – it most certainly should not trump the need for fair and transparent securities markets, with full, prompt disclosure of large block accumulations, direct or derivative. Moreover it holds absolutely no water when the goal is to give hostile bidders a "leg up" (to the tune of a billion dollar profit in one day on Allergan).

Perhaps the most novel (and, from corporate America's perspective, disturbing) aspect of this new stratagem is the partnership between an activist hedge fund and a strategic acquirer to establish a bigger beachhead more quickly and cheaply than had previously been thought possible. Under current rules, strategic bidders do not need an activist to pursue this tactic. They could on their own buy options up to 4.9% in the target, and then scoop up as many more as they can in the ten days after crossing the 5% threshold before having to unmask themselves. The activist however brings several favors to the party, in addition to some financing. One is the questionable hope that it can legally close on the options and thus control 10% of the target's stock (and votes) sooner than its strategic partner could. A second is a large megaphone, and the willingness to wield it in ways that a public company likely would not, to press the case for their deal. A third is that the activist hedge fund specializes in covert accumulations, a skill set that a strategic buyer would have to master. But the most important thing it brings to the team is its willingness to bet billions of dollars without performing any due diligence beyond a basic review of the target's public documents. This is easier for an activist hedge-fund given its incentive compensation structure than for a public company.

This then is the true danger of the new Valeant-Pershing Square tactic: it is premised on a short-term "quick-profit" mentality and reliant on an inherent conflict-of-interest. Pershing Square is betting billions of dollars that it can "knock over" Allergan. It doesn't care much who buys the target: it would apparently like Valeant to win, but it makes a fortune if someone else pays a higher price. Valeant of course cares if it wins, but the cunning of the structure is that it also stands to make a tidy profit if a competitor takes its prize, unlike most failed bids where even the profit on a toehold investment would likely not cover the bidder's costs. In any case, Valeant is taking very little risk for its sizable "leg up" on its competition (by keeping its investment below the $76 million antitrust filing threshold). Pershing Square's risk is that Allergan manages to fight off the hostile bid and stay independent, which may well lead to a fizzling out of the takeover froth (a point they emphasize at every opportunity to induce Allergan shareholder support).

The structure is crafty, and good for Valeant and Pershing Square (as long as no bad facts emerge, such as undisclosed arrangements, that could get them in trouble). But is it good for the American economy and society? Allergan spends 17% of its revenue on research and development, compared to Valeant's 3%, and Valeant has said it plans to cut around 20% of the combined companies' 28,000 jobs in the merger. We do not believe that this is the sort of economic activity that policy-makers should be actively encouraging in their rule-making (or foot-dragging). Indeed, it appears that express statements in speeches and other forums from top officials in government, including the Chair of the SEC, have given activists encouragement that their behavior, however aggressive and self-interested, is favored in the corridors of power as well as the halls of ivy.

It is also not a coincidence that this attack comes shortly after Allergan dismantled its takeover defenses in the face of activist and institutional shareholder pressure. Shareholder governance activists and responsible institutional investors also need to take a good look at themselves and ask whether their insistence that American companies render themselves more vulnerable to hostile takeover bids like this one has increased the true value of their portfolios and improved our Nation's economy and its prospects, upon which the interests of investors ultimately depend.

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