Marty Lipton's poison pill

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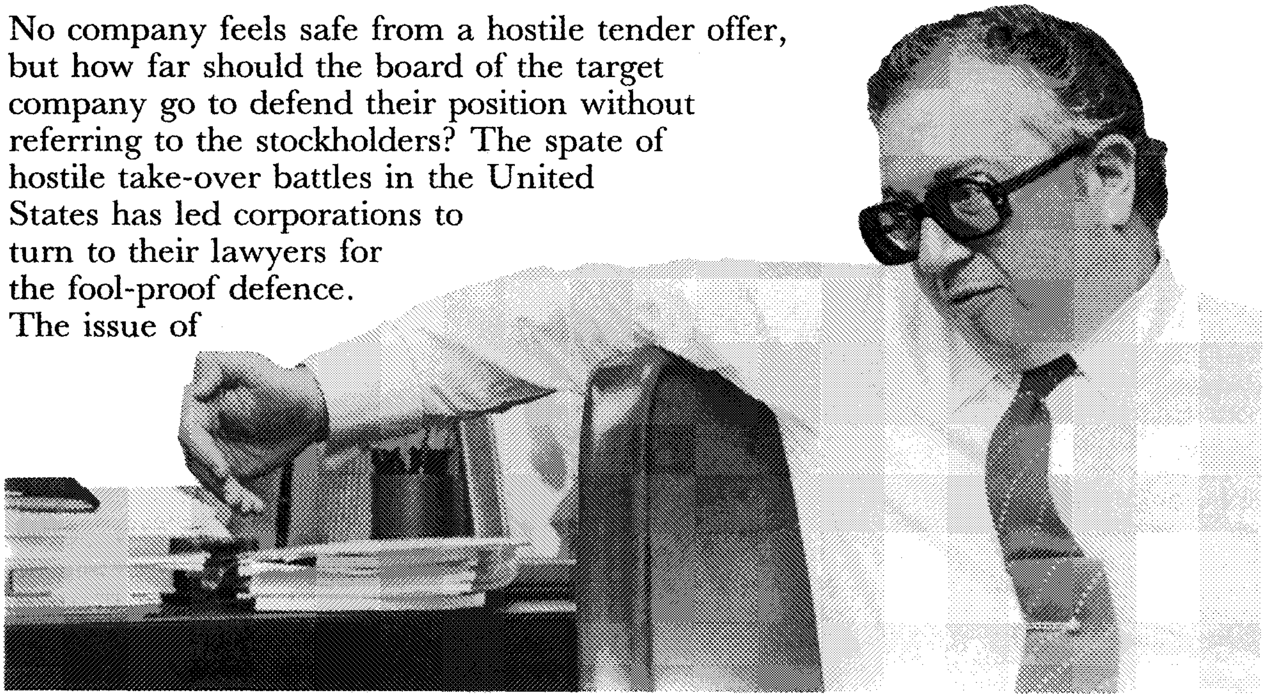
No company feels safe from a hostile tender offer, but how far should the board of the target company go to defend their position without referring to the stockholders? The spate of hostile take-over battles in the United States has led corporations to turn to their lawyers for the fool-proof defence. The issue of



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convertible preferred stock is one way in which a US company may defeat a hostile takeover attempt. It is colloquially known as the poison pill and Martin (Marty) Lipton, co-founder of New York's Wachtell, Lipton, Rosen & Katz, is credited with its development. The poison pill is controversial. Wachtell, Lipton, a relatively small New York firm which has acquired an outstanding reputation in bankruptcy and merger work, is the only firm which advocates it use.

Others are less enthusiastic. At best, the critics say, the issue of convertible preferred stock is only one of many ways in which a target company's board of directors may gain the power and position from which to bargain in a hostile tender. At worst, it enables the directors to entrench themselves and prevent the company from being sold. The most serious criticism is that in issuing the poison pill, the board prevents the shareholders from deciding for themselves whether the company should be sold. However, even the critics admit that it can work.

As one investment banker/lawyer commented, 'It's not a panacea, but I'm not prepared to say that it cannot work or that it should be outlawed. Like other M&A tactics it is sometimes thought to be beyond the boundaries of fair play. You have to present it to your clients as something they can do, but at the same time you have to point out its negative effects. It may burden another friendly bidder, and may also create very bad public relations'.

Lipton defends the poison pill as a method of protecting stockholders from the ill effects of the different kinds of ploy that are common in today's M&A battles — especially the two-tier, front-end-loaded tactic. In this case, a bidder does not have to tender for all of the outstanding common stock of the company: it can bid for a small but controlling percentage and choose whether to purchase the minority shares later. If the bidder does decide to purchase the other shares, there is no guarantee that it will offer as high a price for them as it did to get the controlling block. This in turn can prompt a stampede to sell to the bidder. Shareholders may fear that if they wait, they risk not being able to sell their shares at all or have to sell them at a lower price.

The scheme, claims Lipton, also protects the target company from partial offers by raiders which do not intend a second step until they can raise finance by using the assets and credit of the target.

Lipton claims that the poison pill is designed to protect those stockholders who wish to retain their equity interest in the company. 'There's nothing poisonous about it. What it does is enable a minority shareholder of a company that has been acquired to maintain an equity investment, and protects him from being frozen out'.

How it works

Having decided that the bidder's offer is not acceptable, the target board issues to the stockholders a tax-free dividend in the form of convertible preferred stock. Each stock converts into a larger number of common shares. In response to an unsolicited tender offer by Brown-Forman in 1983, the Lenox Company issued convertible preferred stock to its shareholders. Each preferred stock holding would convert into 40 shares of common stock. Although the cash dividend on the original outstanding common stock is reduced, there is a dividend on the preferred stock that is usually large enough to result in the shareholder receiving greater cash payments than he did before the preferred stock was issued. This creates an incentive for the holder to refuse a tender.

The poison is contained in the stock's flip-over provision. The flip-over is activated as soon as the bidder's acquisitions reach a 'control threshold' — ie, a level chosen by the target's board of directors. At that point, the convertible preferred transforms into voting stock of the bidder. If the bidder's acquisitions reach the next threshold, also chosen by the target board, the convertible preferred stock (now of the bidder) becomes redeemable to the holder at the cash offer price for the target.

Lenox's proposed defence

The Lenox preferred stock was convertible into voting common stock of an acquirer in the event of a merger in which Lenox did not survive or Lenox common stock was changed into or exchanged for other stock, cash or property (the flip-over provision). The preferred stock also contained special voting rights which required a 95 per cent class vote of the new preferred to approve a division, combination or reclassification of the preferred stock or a charter amendment which materially altered the rights or preferences of the preferred and a 75 per cent class vote if Lenox was acquired by a company which was not a reporting company under Section 13 or 15(d) of the Exchange Act.

The poison pill aspect of the Lenox preferred stock was its flip-over provision: in any business combination in which Lenox did not survive or the Lenox common stock was exchanged, the Lenox preferred stock was convertible on a formula basis into the voting stock of the acquirer. The poison pill thus threatened to dilute the voting control which the Brown family possessed over Brown-Forman and was expressly intended to deter Brown-Forman from proceeding with its offer. To ensure that shareholders could not eliminate this poison pill provision, it was provided that the provision could not be amended unless 95 per cent of the new preferred stock approved.

In issuing this poison pill, the target board has assured all target shareholders that they will receive a fair and equitable price for their stock, if they want to sell. If they sell, they will be selling equity in the bidder, whose capital structure is affected and management threatened. This is the poison.

Instances of the poison pill's use

Since 1981 the poison pill has only been considered as a defence publicly five times. As one investment banker pointed out, 'If you look at the poison pill's history, you'll see that as an idea it has not swept the nation. This is the business of fads and fashions. And aside from being controversial, it is not clearly an effective defence'.

As targets of hostile tender offers, the boards of El Paso, Lenox, Superior Oil, Enstar and Bell & Howell all considered using it. Of those five, only Enstar and Bell & Howell actually issued convertible preferred stock. According to George Katz, another name partner of Wachtell, Lipton who heads the firm's litigation department and is handling the case for Bell & Howell in the Delaware Chancery Court, 'There will be a decision this summer in Bell & Howell. National Education Corporation (the bidder) has made a motion for summary judgement attacking the validity of the poison pill as a matter of Delaware law. That should be the first substantive determination as to whether or not the posion pill, which I prefer to call the antidote, is legally sustainable'.

Enstar is in the middle of a proxy contest, instituted by one of its stockholder/directors, who doubted that the company's board and management will try to sell the company in good faith. He pointed out that the Enstar stockholders specifically voted to reject other M&A defensive measures that were proposed by the Enstar management one year before the board issued the poison pill. Other Enstar shareholders have begun litigation against the company, claiming that the poison pill stock issue, 'is a scheme designed to entrench the management of Enstar and to preserve the power, perquisites and control enjoyed by Enstar's current officers and directors'.

Both El Paso and Lenox reached agreement with their respective bidders before the convertible preferred stock was issued. In the case of El Paso, the stock price was not affected. In the case of Lenox, the price was raised by US $3; but lawyers who represented Brown-Forman insist that the poison pill had nothing to do with the price increase.

In the Superior Oil contest, most of the participants and onlookers, with the exception of Lipton, said that Superior's attempt to issue the poison pill so angered the company's stockholders — especially Howard Keck, who had recently stepped down from running the company — that it actually precipitated the sale of the company. According to an investment banker who was involved, the oil company's board chose to announce the stock issuance on the day before a public holiday, hoping that nobody would notice and try to stop the issuance. However, Howard Keck did notice and was enraged. The day after the holiday saw the filing of a suit against the company and the beginning of a successful effort to solicit proxies from the company's shareholders that would amend the company's byelaws. The board felt it had no choice but to rescind the proposed issue of preferred stock. A member of Howard Keck's team commented, 'It's a despicable technique. Fortunately in this case we had someone who was willing to spend the sums necessary to stop it quickly. If you don't have such a person, the stock is issued so quickly that before you know it, there's nothing you can do'.

How Wachtell, Lipton bill

In its guide for acquisition work, a one page statement of billing policies, the firm lists five criteria for its billings.

The standard charges are based on four factors. Firstly, time is charged at an average of US $250 per hour. This charge is then adjusted to take into account the complexity of the deal, the intensity of the firm's involvement; and the responsibility and result of the transaction. These three factors can result in a trebling of the basic hourly rate.

There are four further considerations for Wachtell billings. If the firm is involved in developing an acquisition or take-over strategy for the corporation and depending on the degree of responsibility and the result, the bill can be several million dollars.

Statements are rendered for each separate transaction and will not necessarily contain details of personnel involved or a break down of time spent and charges.

Statements are rendered monthly or on conclusion of a matter. These monthly statements do not represent final charges but an account for the client.

The firm does not establish retainer relationships. There may be a minimum fee of US $100,000 for some acquisitions.

Marty Lipton with litigation name partner George Katz: defending Bell & Howell's poison pill

Are shareholder's rights affected?

The decision to issue convertible preferred stock is made by the company's board of directors, not by the stockholders. The stockholders do not have a say in what sort of terms and conditions will be attached to the stock when it is issued. But, for the directors to issue preferred stock the shareholders must have already voted to give the board what is known as 'blank cheque authorisation'. If the board has tried, but failed, to get the stockholders' consent for the preferred stock issue the existence of the blank cheque authorisation means that the board can still go ahead with the issue. Hence the stockholder fury when the target company's board issues a stock that will make it more difficult to sell the company even though the stockholders refused to approve other measures that would have defended the company.

Though Wachtell, Lipton does represent bidders as well as targets, the firm has taken a pro-target management stance. At the beginning of one of its client memos, Wachtell, Lipton states that among other things, 'a corporation has the absolute right to:
— have a policy of remaining an independent entity;
— have a policy of refusing to entertain takeover proposals;
— reject a takeover bid;
— take action to remain an independent entity; and
— guarantee its shareholders a right to retain an equity interest in the corporation even if someone is successful in obtaining control and forcing a second-step merger.

If the shareholders want to sell their property, the target board still has the right to refuse to even consider the offer and to put into effect whatever defences the directors wish, according to Lipton.

The popularity of the two-tier, front-end-loaded tender offer does raise the possibility of unequal treatment for all stockholders. Lipton claims that, 'What poison pill devices do is give the board of directors of the target company an equalising transaction, so as to try and assure the shareholders of the target company that they will all be treated equally and that they will all receive a price that the board of directors of the target company determines to be a fair price. So it's a way of balancing off the power of the front-end-loaded two-tier tender offer. It's a very powerful takeover device'. However, it is still the board of directors which decides which price is fair and which is not.

Lipton did not consider the shareholders' rights to be affected. 'Shareholders are always permitted to sell their property. The shareholders of Carter Hawley Hale are free to go out and sell their stock right now'. Carter Hawley Hale is currently the target of a bid by Limited Inc and is being advised by Wachtell, Lipton.

Lipton's rationale is that the board of directors knows better than the shareholders what will be best for the shareholders in the long run. 'The board has the right to say "Look, we think that the offer is not adequate. We think that we could get a better deal for you". Or, "We think that the long-term interests of our shareholders would be better served if the company remained independent, that in the long term you'll do better". And that's a judgement for the board of directors to make'.

Lipton's primary argument is economic. He pointed to two studies produced by the US investment bank Kidder Peabody at his request. One study looked at 38 companies that successfully resisted takeover bids between 1973 and 1982 and remained independent for at least one year after the bids, and again compared the takeover bid price with the market price at February 1983. Lipton concluded that, once various adjustments had been made, it was clear from the studies that the shareholders were better off and that the board's judgement was justified. In the study Lipton claimed that Kidder Peabody, 'Analysed every one of those transactions from 1973 to 1982 and adjusted for all those different things (cash dividends, discount rates based on the consumer price index), and it turns out that in 90 per cent of the cases, the shareholders were better off with the tender offer having been defeated than if they sold their shares in the tender offer. That's fair justification for a board of directors taking the position that they don't want to accept a tender offer and that the shareholders will be better off in the long run in retaining their investments.'

A spurious argument

Studies by other banks of stock prices before, during and after hostile tenders took care to compare stocks of companies in the same industries and to attempt to factor in the influence of changes in the market as a whole. If the market rises, then it follows that particular companies' stocks will also rise. In one particular study, it was found that there was a slightly significant statistical trend showing those companies that paid to buy back blocks of their own stock at a premium did not outperform the market later. However, those same companies had been outperforming them before.

Perhaps it would be more reasonable to say that those companies that outperform the market are more attractive to bidders when the companies' stocks are undervalued, and are more likely to have boards which will fight to remain independent. As one lawyer commented, 'You'd only use the poison pill if you didn't have time to do anything else or if you didn't want the shareholders to vote on it. You can achieve the same result by amending the company's charter through a shareholder vote long before the crisis hits. If you use it because there isn't time for anything else, it's a mark of stupidity: any company should be aware of the likelihood that it will become a target. So there you've reason to wonder whether the management is good enough; after all they didn't want the shareholders to vote, you are disenfranchising them; and that should be illegal'. Another lawyer commented, 'The question is whether a company's board of directors is justified in using whatever tools they have at hand to fend off a tender offer. Even if they are justified, the effect is to disenfranchise the shareholder, and that's very bad'.

Lipton, however, can answer these complaints by pointing to another client memo circulated to clients last year, which contained a description of the poison pill plan. The introduction to the memo urged clients to consider 'implementing the plan before a takeover situation arises'.

The memo continues by recommending that 'those companies that do not have sufficient authorised blank cheque preferred or common stock to implement the plan should consider obtaining stockholder authorisation at the next annual or a special meeting. Since the plan does not provide for supermajority votes or other shark repellents, and does provide for an increase in dividends, it should be much less difficult to obtain stockholder approval of the plan than fair-price charter amendments, even for those companies with a large percentage of their stock held by institutions.

Far from disenfranchising the shareholders, Lipton, in this memo, is urging companies which do not have blank cheque authorisation, to present the plan to the shareholders.

The Securities and Exchange Commission (SEC) which has said that it has serious reservations about the business judgement rule as justification for target companies' boards utilising certain defences against hostile tenders, as well as the bad public relations that the poison pill has created. However, Lipton, Katz and their colleagues continue to defend the strategy. As Lipton concluded, 'We're still advising companies to do it. We advised a major client to do it today. We believe that it is perfectly legal and that it is favourable to the shareholders; and we will continue to advise people to do it'.

Whether or not Lipton and his firm remain isolated in their defence and use of the poison pill convertible preferred defence, it is obvious that he and his colleagues deserve the reputation they have for being the best target counsel in the US. The ferocity of some of their opponents' attacks on the poison pill is an indication of how potent a weapon it is for defeating a hostile tender offer. □