

# The Controversial 'Poison Pill' Takeover Defense: How valid are the Arguments in Support of it?

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## **Abstract**

In today's world of business, Mergers and Acquisitions (M&A) are an indispensable part of corporate strategy. However, not all mergers and acquisitions are friendly and the threat of hostile takeovers has led to the development of a wide range of anti-takeover defenses. This paper looks at one of the most controversial takeover defenses, the 'poison pill'. This assumes significance in light of the fact that M&As, including hostile takeovers, are not merely a North American phenomena and defensive tactics used in this region are spreading to other regions. This paper examines the merits of various arguments used in support of the poison pill taking into consideration previous research on takeover defenses. It finds that

poison pills have a strong deterrent effect on takeovers and the bargaining power argument does not provide sufficient economic rationale for shareholders to leave the decision to the board. The paper concludes that the use of a poison pill without a provision for shareholders review, particularly when combined with an effective staggered board, strongly suggests that management entrenchment and shareholder activism in this direction is a natural consequence. The paper recommends design of takeover defenses that align the interests of both shareholders and management.

**Key words:** Mergers, Acquisitions, Hostile takeovers, Poison pills.

## Introduction:

In 2007, the value of announced Mergers and Acquisitions (M&A) crossed the \$ 4 trillion mark (Capaldo, Dobbs and Suonio, 2008). This is higher than the GDP of many countries and highlights the importance of M&A in today's world of business. Many companies consider M&A an indispensable part of their corporate strategy (Harding, Shankar and Jackson, 2013; Singh, 2012) and according to Lovallo, Viguerie, Uhlaner and Horn (2007), 30% of the growth of large corporations come from M&A. As more and more companies turn to M&A in their quest for growth, the worldwide number and value of M&A will continue to rise. Earlier, M&A were seen as a North American phenomenon; however, the trend changed in the 90's with other regions like Europe and Asia Pacific contributing significantly to worldwide M&A statistics (Black, 2000, Gaughan, 2011). With a number of high value M&A deals being reported from emerging economies (Anandan, Kumar, Kumra and Padhi, 1998; Chakravarti, 2013; Kumar, 2009), one can now safely label M&A as a worldwide phenomenon.

Most M&A are friendly, which means that the directors of the acquirer and the target negotiate and finalize a mutually acceptable deal. However, when the negotiations fail, the acquirer is left with the option of either backing off or mounting a hostile takeover. In case of a hostile takeover, the acquirer makes a direct tender offer to the shareholders of the firm to buy the required number of shares. When a hostile bid is made (or anticipated), the board of the target can either remain passive letting the shareholders decide, or mount defenses to protect the company from being taken over. Some of the defenses available to the target are given in appendix -1. Of the various defenses listed, the poison pill is considered extremely effective in preventing or delaying takeovers (Barry and

Hatfield, 2012; Mallette and Fowler, 1992; Subramanian, 2003). At the same time, it is also one of the most controversial of defenses and its use is questioned by a number of researchers (Bebchuk & Farrell, 2001; Gruener, 2005; Macey, 1998).

This paper looks at various arguments made by the proponents of the poison pill and examines the validity of these arguments from a shareholders perspective. Using the findings reported by various researchers on the deterrent value of the poison pill and increase in takeover premiums, the paper uses a simple decision tree analysis to examine the validity of the bargaining power argument used in support of the pill. Other arguments favouring the use of the poison pill are also examined to see if the pill is beneficial to the shareholders. In the following section, a brief overview of the poison pill is provided. It is followed by a section that explores the controversy surrounding the poison pill by looking at the arguments for and against it. The subsequent section examines the arguments in favour of the pill from the perspective of the shareholder and in the final section, conclusions are drawn and recommendations made.

## What is a poison pill?

In its simplest form, the poison pill is a shareholders' rights plan, which excludes the acquirer. Of the many variants of the poison pill, the flip-in and the flip-over types are the most common. The board of directors can adopt these pills at any point in time without the shareholders' approval. On adoption, the rights get attached to the shares and are traded along with the shares. The rights get detached from the shares and are exercisable only on the occurrence of an event called the triggering event.

The flip-in pill: The pill, when triggered, gives all

existing shareholders other than the acquirer, the right to buy shares of the firm at a discounted rate. This makes it more expensive for the acquirer to complete the takeover as more shares are introduced into the market. It dilutes the value of the shares already held by the acquirer and reduces the percentage of shareholding of the acquirer.

**The Flip-over pill:** The pill gets triggered when an acquirer crosses a threshold level of shareholding (for example 20%) or makes a bid for a certain amount of shareholding. At this point, the shareholders, other than the acquirer, get a right to buy shares at a deep discount in the merged / surviving entity after the merger. This right is exercisable only on the merger of the target with the acquiring firm. This pill releases its poison when the acquiring firm acquires all the shares of the target firm and merges with it. The flip-over pill transfers wealth from the shareholders of the acquiring firm to the shareholders of the target firm.

The board of directors can adopt a poison pill at any time in anticipation of a hostile bid or have one prepared and kept ready to be adopted when a hostile bid is announced. They can also suspend the application of the pill in case of a friendly takeover. So the poison pill acts selectively at the discretion of the board.

### **History of the poison pill:**

Martin Lipton of the law firm Wachtell, Lipton, Rozen and Katz is credited with the invention of the poison pill (Futrelle, 2012; Wharton Alumni Magazine, 2007). It appears that Lipton developed the idea during two takeover battles - one in which General American Oil was defending itself against a bid from the corporate raider T. Boone Pickens and the other in which El Paso Company was defending itself against a takeover bid

(Wharton Alumni Magazine, 2007). The Speculative Debauch (2009) gives an interesting account of how Brown – Forman (manufacturer of Jack Daniels) approached Lenox for a friendly merger and on being rebuffed, launched a hostile bid at a 60% premium over the market price. Lipton was hired by Lenox to help with the defense. The board of Lenox while rejecting the offer from Brown Forman (BF) issued a 'Special Cumulative Dividend' to the shareholders of Lenox. The dividend was in the form of a right to purchase shares in BF at a deep discount in case BF and Lenox merged. This forced BF to increase its offer and enter into a negotiated agreement to acquire Lenox (The Kentucky New Era, 1983). After the successful use of the poison pill by Lenox, other firms started adopting the rights plan (poison pills) as a defense against hostile takeovers. According to Davis (1991), 60 percent of the fortune 500 firms had a poison pill by the end of 1989.

### **The Controversy**

The use of poison pills as a takeover defense has stirred up a huge controversy, which is still unabated. Many shareholders and shareholder organizations like the Institutional Shareholders Services (ISS) question the use of poison pills, particularly its adoption without shareholder approval (Brownstein and Kirman, 2004; Business Wire, 2011; Christopher and Fraidin, 2004; Gillan and Starks, 2000; Lindstrom, 2005; Thomas and Cotter, 2007). Takeovers present an opportunity for shareholders to realize a premium over the market price and poison pills make it difficult for acquirers to make a tender offer without the board's approval. This does not appear to be in the interests of the shareholders. Many claim that management driven by self-interest use poison pills to protect their jobs and privileges (Arikawa and Mitsusada, 2011; Forjan and Ness, 2003; Jensen & Ruback, 1983) and it is a devise

that entrenches existing management. When potential acquirers see the adoption of a poison pill, it signals management entrenchment and they may be dissuaded from making an offer. This affects the demand side of the equation and the price of the shares. The legality of the poison pill is also highly debated, because in many jurisdictions, the statutes clearly specify that shares belonging to the same class have to be treated equally. One of the distinguishing features of a listed company is the right to freely trade in the shares of the firm (facilitated by the stock exchanges) and shareholders can view the use of poison pills as an infringement of this right. Therefore, adoption of the poison pill can be seen as a violation of the board's fiduciary responsibility.

The advocates of the poison pill on the other hand, argue that poison pills benefit the shareholders (Comment and Schwert, 1995; Gordon, 2002; Lipton and Rowe, 2002). Their argument is based on what is widely known as the shareholders' interest hypothesis. Their main argument is that the poison pill increases the 'bargaining power' of the board resulting in higher premiums. They claim that the board is better positioned to decide whether the firm should be sold or not and cite a number of reasons why the board should have the right to negotiate and if necessary, reject the offer. Researchers (Strong and Meyers, 1990; Subramanian, 2003) visit a number of arguments put forth by the proponents of the shareholder interest hypothesis-

1. The acquirer cannot negotiate with each and every shareholder, particularly when the shares are widely held. In such cases, individual shareholdings are small and the advantage lies with the acquirer. For example, in a two-tiered offer, the individual shareholder faces a situation similar to that

confronting the players in a 'prisoner's dilemma' game and feels there is no option but to tender the shares. The board does not suffer from such a disadvantage.

2. The poison pill increases the bargaining power of the board and this leads to increased premiums.
3. When the stock of the firm is currently undervalued, the premium offered may not reflect the true value of the firm and the board is better positioned to assess and use this in the negotiations. This is because,
  - a. The board is privy to information on strategic investments made by the firm with the potential to yield positive results. Much of this information is private to the board and therefore, they are in a better position to estimate the true value of the firm.
  - b. Compared to the board, individual shareholders do not have the resources or the ability to assess the true value of the firm. If shareholders were to use the market price as a reference, the acquirer will be able to get away with offering a minimum premium.
4. The offer may not be the best possible and given time, the board would be able to find a buyer with a better offer.

Some proponents argue that the board should have the right to decide whether to sell the firm or not considering the impact on other constituencies like employees, local community, suppliers etc.

Given the controversy, a number of researchers have studied the impact of poison pills on the shareholders' wealth (Comment and Schwert, 1995; Datta and Datta, 1996; Malatesta and Walkling, 1988). At the core of the controversy is the question whether adoption of poison pills is in the interest of shareholders or an

attempt by the management to entrench themselves. In this context, the paper examines the validity of some arguments made in favour of the poison pill considering previous research in this field. It attempts to provide an integrative perspective using the findings reported by other researchers.

The research is of significance to researchers, practitioners and regulators, not only in the U.S., but also in other regions because M&A is now a worldwide phenomenon, with significant contribution from North America, Europe and the Asia Pacific region. According to Shankar and Varma (2012), the Asia Pacific region presently accounts for 24% of the global M&A and its share of global M&A deals will continue to grow. The contribution of the emerging markets to global M&A is also on the rise and according to Platt (2010), they account for 27.4% of the worldwide M&A. Finding that organic growth alone cannot help them

meet their growth targets to become global players, an increasing number of Asian companies have turned to cross border acquisitions (Kumar, 2009; Shankar and Varma, 2012; Bhagat, Malhotra and Zhu, 2011; Grant Thornton International Business Report, 2013) and a number of high value M&A have been reported from emerging economies. The acquisition of IBM's PC business by Lenovo and the takeover of Corus by Tata Steel, widely reported in the popular press, are indicative of a trend (The Guardian, 2004; The Financial Express, 2007). In India, the acquisition of Corus by Tata Steel was followed by the acquisition of Novelis by Hindalco and Jaguar Land Rover by Tata Motors (The Economic Times, 2010). In China, Lenovo followed up its global expansion with the acquisition of the German PC maker Medion and CCE in Brazil (Backaler J, 2012). Figure 1 and 2 clearly show the increasing trends in outbound and inbound M&A from emerging economies.

Fig: 1 – Number of M&A (outbound) deals – Asia and Emerging Economies

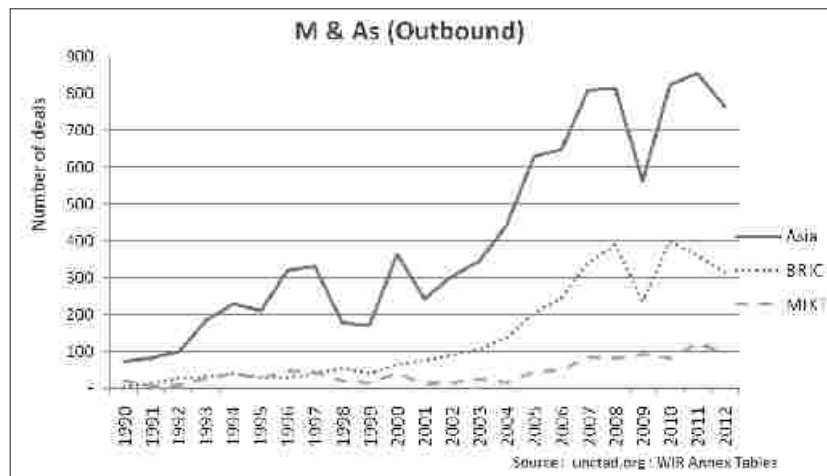
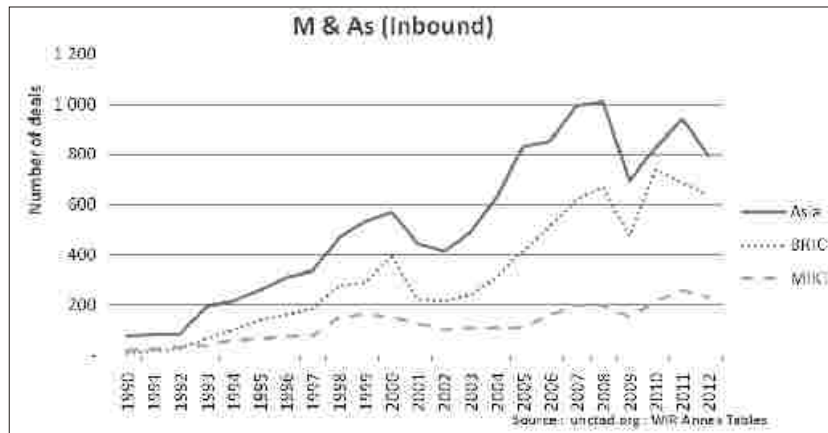


Fig: 2 – Number of M&A (inbound) deals – Asia and Emerging Economies



With increase in M&A, the threat of hostile takeovers also increases. Quoting Vishwanathan of RSM Astute Consulting, The Economic Times (2012) says that the threat of hostile takeover has always been present in India, but it has gone up with the new takeover code. Hostile takeover attempts in India like Autoriders' attempt to take over Saurashtra Cements, Sterlite's attempt to take over Indal and Pramod Jain's attempt to take over Dalmia's Golden Tobacco when seen with successful takeovers like that of Raasi Cements by India Cements and Zandu Pharma by Emami clearly indicate that the threat of hostile takeovers is real (Das, 1998; Mallinath, 1998; The Economic Times, 2009; Business Standard, 1998; Livemint, 2008). Faced with hostile takeovers, managers in these regions are likely to consider the use of takeover defenses like poison pills to protect themselves. In addition, with globalization and liberalization, regulators in many regions may be required to consider modifying existing laws or introducing laws on the use of poison pills.

Emerging economies can draw a parallel from Japan. According to Kato, Fabre, and Westerholm (2009), M&A have been on the rise in Japan from 2003 and the use of the poison pill started in 2004. They claim that the yearly adoption rate for poison pills in Japan has accelerated from 2 in 2004 to 372 in 2007. They

attribute this to rise of foreign investments and changes in Japanese corporate law. The use of the poison pill by a Japanese company Bulldog Sauce made news when it was challenged in the court (Chen, 2007). Kang (2013) argues that managers in other regions of the world are likely to lobby for the pill considering its effectiveness and the belief that the U.S. sets the standards for M&A. They quote the example of Japan and Korea on how this type of argument prevailed. Gilson (2004) claims that the poison pill can be more harmful in Japan than in the United States in the absence of institutional infrastructure that has an ameliorating effect and recommends caution in changing laws to facilitate the use of poison pills as a defensive measure.

### Examining the merits of the arguments in support of the poison pill:

Starting with the bargaining power argument, various arguments in support of the pill are examined in this section. In addition, the issue central to the controversy - the motivation of the board /management in adopting poison pills is also discussed.

#### *The Bargaining Power Argument -*

The most important argument in support of the pill is the increased bargaining power it provides to the board (Bates and Becher 2012; Comment and Schwert, 1995; Heron and Lie, 2006). According to this argument, deferring to the board is in the shareholders' interest because the board can then negotiate from a position of power and extract higher premiums. Comment and Schwert (1995) found higher premiums associated with takeover defenses. Heron and Lie (2006) also found that firms with poison pills and / or defensive payouts received higher premiums compared to firms lacking such defenses. Bates and Becher (2012) report a positive correlation between the likelihood of a bid revision and the presence of a classified board. However, Subramanian (2003) did not find evidence in support of the bargaining power argument. He compared the premiums received by firms incorporated in states that authorize the most potent pills with those incorporated in states that provide the least statutory support for the pill. The difference between the premiums received was not significant. Earlier, Pound (1987) also did not find any evidence of firms with takeover defenses receiving higher premiums. The variations in the results can be explained by the fact that directors of a firm have substantial bargaining power even in the absence of defenses like the poison pill. Acquirers prefer a friendly takeover and in most cases negotiate with the board before resorting to a hostile bid. Many firms have used these negotiations to increase the premium without resorting to defenses like the poison pills. Therefore, increase in premiums can be expected both in hostile and friendly bids. When we consider the *average* premium over a large number of transactions based on whether the takeover is friendly or not, differences in the results are not surprising because the groups are not equal in size. Further the timing of the studies and the region from which these samples have been

generated are bound to influence the results.

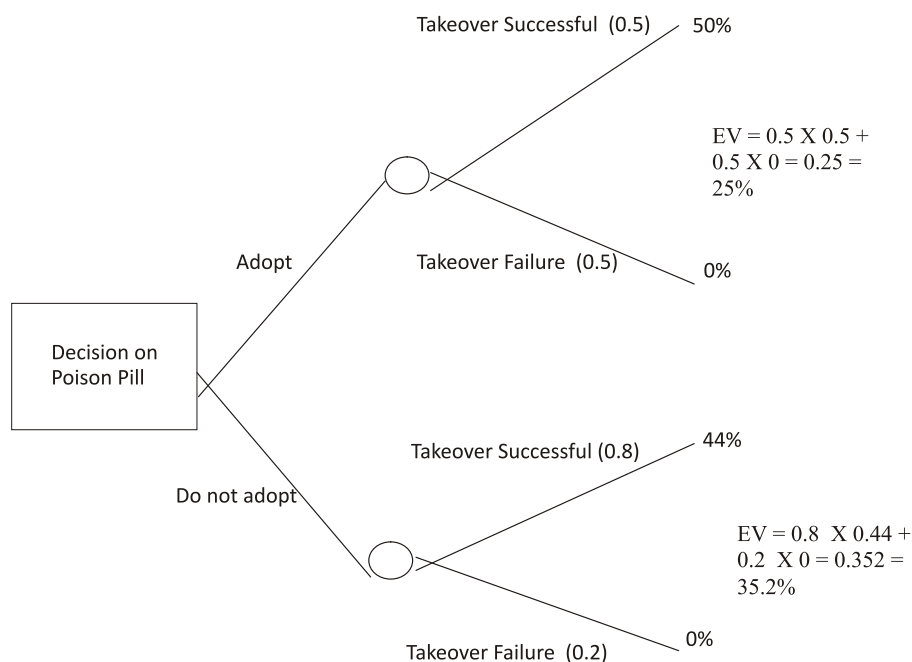
While the increased bargaining power argument is intuitively appealing, it is fundamentally flawed. The question we should be asking is not whether poison pills increase the bid premium when the bids succeed, but whether it provides sufficient economic rationale for shareholders to defer to the board. While an acquirer might increase the premium in face of resistance, there is a limit beyond which the acquirer will walk away. It is therefore important to recognize that increased premiums come at the cost of a lowering the probability of success. In a study of takeover defenses adopted at the IPO stage, Field and Karpoff (2002) found that takeover defenses like the poison pill reduces the likelihood of a subsequent takeover. Bates and Becher (2012) found that auctions with contested initial bids are 29.9% less likely to be completed. In the case of morning after pills, Comment and Schwert (1995) report substantial reduction in the probability of a takeover (down to 50% from 76%). Bebchuk, Coates and Subramanian, (2002) found that 60% of the targets with Effective Staggered Boards (ESB) remained independent against a hostile takeover compared to 34% of the non-ESB targets, indicating that the likelihood of a target being acquired is reduced by the use of takeover defenses. In a study of 574 takeover attempts (both friendly and hostile), Sokolyk (2011) found over 80% were successful. The success rate for hostile takeovers however was only 32%. Based on the above, one can conclude that resistance from the board backed by takeover defenses would reduce the probability of takeover by 26% to 30%.

Therefore, it is important to analyze whether the gains from higher premiums (received in successful takeovers) offset the loss of premium when a takeover

fails. According to Heron and Lie (2006), the average additional premium resulting from takeover defenses is 6%. Bebchuk, Coates and Subramanian (2002) found that in the subset of successful takeovers, firms with ESB received 5% higher premiums on the average compared to firms that did not have these defenses. Quoting a J P Morgan study, Pearce and Robinson (2004) claim that corporations that deployed poison pills have received an average 4% higher premium at takeovers compared to companies without such a defense. Compare this to the 45.64% average premium offered by acquirers in unsuccessful takeovers which the shareholders stand to lose (Heron and Lie, 2006). Bebchuk, Coates and Subramanian (2002) also report an average final bid premium of 44.1% for targets with defenses like the ESB and 42.4% for firms without such defenses.

The analysis in this section tries to answer the question whether it makes sense to introduce a poison pill and risk the opportunity of receiving a premium of around 44% for the sake of an additional 6%. For this analysis, the probability and the increase in premium figures are based on the findings from earlier research mentioned above. The probability of an uncontested bid succeeding is taken as 80% and the probability of a hostile bid succeeding is taken as 50%. The increase in premium due to takeover defense is taken as an *average* of 6%. When this situation is analyzed using a decision tree (see fig 3), the expected value is higher for firms *not adopting* takeover defenses like the poison pill. Though the increased bargaining power argument appears rational on the face of it, the decision tree analysis clearly shows that the increased bargaining power from the poison pill does not benefit the shareholders.

Fig. - 3





The result of the above analysis is robust even when the increase in *average* premium received by firms with poison pills is quadrupled from 6% to 24% and when the risk (reduction in the probability of success) due to the use of poison pills is reduced to only 7% (down to 7% from 30%). In appendix –3, using decision trees, the expected values at the indifference points on adopting a poison pill or not adopting are shown. It is reached only when the average increase in premium due to the pill more than quadruples to 26.4% from 6% or when the risk (due to lowering of the probability of bid's success) is reduced to a negligible level of 6.9%.

The bargaining power argument is also flawed on another count. Consider the conflict of interest inherent in a takeover situation. How can anyone be sure that the management would not misuse the bargaining power to entrench themselves? A number of researchers and the popular press (Hartzell, Ofek and Yermack, 2004; Heitzman, 2011; Sorkin, 2002) have highlighted cases where the management used the bargaining power to negotiate private benefits for themselves at the cost of the shareholders. The average bid premium increase of 4% to 6% mentioned above is probably a notional increase extracted by the management to save face, while negotiating substantial private benefits in the form of continuity of jobs or cash settlements. According to Comment and Schwert (1995) management wielded considerable bargaining power throughout the 1980's and not just after the spread of modern antitakeover defenses. That it is possible to increase bid premiums without the use of poison pills is evident from various cases. For example, the takeover of Zandu Pharma by Emami (Livemint, 2008) was resisted by the promoter-controlled board till the bid premium more than doubled. If the board has only the shareholders' interest in mind, they can negotiate with the power

they already have. In case they feel that the final offer is not in the interest of shareholders, they can communicate this to the shareholders and let them decide. In a number of cases, like that of Alco Stores, the shareholders' decision to reject the merger with Argonne (which was recommended by its management), shows that shareholders can and do reject unattractive deals (The Wall Street Journal, 2013). The fallacy in the bargaining power argument can be illustrated with an analogy. Imagine a lawyer in an important case usurping the right to take the final decision on a settlement offer without consulting the client. This would make any client uncomfortable. Therefore, the question is not whether the board should have bargaining power, but whether the board should have a *veto power* on the takeover decision. Poison pills, particularly when combined with an effective ESB, results in a veto power that is not in the shareholders' interest.

#### *Expertise of the board and informational asymmetries:*

Supporters of the pill claim that individual shareholders do not have the expertise or the resources to arrive at the true value of the firm. Because of their small shareholdings, they may not find it worthwhile to invest resources in finding the true value of the firm (Bainbridge, 2006). Even if this is true, nothing stops the board from communicating the estimated true value to the shareholders eliminating the disadvantage faced by them. The board cannot forget that the expertise purchased by them and the additional resources available to them belong to the shareholders. Further, this 'true value' estimated by the board is only an estimate and anyone with some knowledge or experience in valuation would agree that it is based on a number of assumptions, some of which may be questionable. According to Easterbrook

and Fischel (1981), in efficient capital markets, the market price reflects the collective wisdom of all traders and even if a better estimate can be made, the cost of it would exceed the gains from the knowledge. Therefore, in developed economies like in the United States of America, sufficient expertise lies with the market analysts and the market price is a reasonable estimate of the true value of the firm on a stand-alone basis.

The argument that the board is better positioned to estimate the true value of the firm because of informational asymmetries, particularly with respect to strategic decisions and investments made by the firm, can also be addressed in a similar manner. It is possible that the board has some private knowledge about the future benefits of these decisions (Meulbroek, Mitchell, Mulherin, Netter, & Poulsen, 1990; Stein, 1988) and this information is not routinely shared with the shareholders. However, a takeover attempt is not a routine event in the life of a firm. It is an extraordinary event and if the board has some information that can help the shareholders decide, it should be shared with them. If not in great detail, sufficient information on why they believe the price is not right can and should be shared. Whether the shareholders believe the board or not depends on the board's track record and the quality of information provided. The market tends to react positively to efforts by the management to improve the performance of the firm (Denis and Kruse, 2000) and to information that future earnings are likely to increase (Easterbrook and Fischel, 1981). However, if the firm's performance has been consistently poor and there is no evidence of the board taking any action to improve the performance, shareholders would find little reason to believe the board.

#### *The Other Constituencies and a better offer Argument:*

One interesting argument put forth by the proponents of the poison pill is that the board needs to consider other constituencies like the employees, suppliers, customers etc., in deciding whether a takeover is desirable. Even without a change in management control, employees face layoffs and suppliers face loss of orders or delay in payments. Denis and Serrano (1996) report that a number of firms that resisted takeovers and remained independent subsequently resorted to restructuring to improve performance. There are no guarantees that these restructuring activities will not be similar to those planned by the acquirer to improve performance and therefore, the impact on other constituencies still remain. Contracts and statutes protect these other constituencies. A change in management does not affect the operation of these contracts or statutes. Quoting them as the reason for resisting takeovers is equivalent to clutching at straws.

The argument that given time, the board would be able to identify an acquirer with a better offer is a valid argument if the poison pills are designed to address this issue. Companies can design what are known as shareholder friendly pills (Lindstrom, 2005) that automatically exempt or provide for a shareholders' vote if the offer meets certain criteria (for example, cash offers for all the outstanding shares with the open offer period of 60 days). The 60 days window provides time for the board to identify an alternate buyer and set the auction in motion. Even if the process of identifying an alternate buyer is not completed in the time period, providing for a shareholders' vote on the pill provides the board with an opportunity to present their case and convince the shareholders not to accept the offer.

### *Motivations for resisting takeovers:*

The question that is central to the use of the poison pill and probably one that is most difficult to answer is the motivation of the board/ management. It would be naïve not to acknowledge the conflicting interests in a takeover situation. The proponents of the pill claim that 'shareholder interest' is the primary motivation whereas opponents of the pill claim that management is motivated by 'self interest'. It is likely that both the motivations are present in a decision to use the pill, but no management would articulate its self-interest as a valid reason for resisting the takeover. Research on the characteristics of firms adopting the poison pill and the post deal careers of the CEOs provide some insight into these motivations. Several researchers (Bebchuk, Cohen and Farrel, 2009; Comment and Schwert, 1995; Datta and Datta, 1996; Dahya and Powell, 1998; Malatesta and Walkling, 1988; Strong and Meyers, 1990) have found that many firms adopting poison pills and other takeover defenses perform poorly during the year(s) preceding the adoption of the pill. They found that these firms perform poorly on the market and also on a number of financial measures. Datta and Datta (1996) found that these firms underperform compared to their industry cohorts. Given the poor performance, the CEOs of these firms would find it difficult to find a job once their company is taken over. According to Mallette and Fowler (1992), directors of a target firm are usually dismissed shortly after a successful takeover. Hartzell, Ofek, and Yermack (2004) found that two-thirds of the CEOs leave their firms at the time of the merger and only 36% of the one-third who remain survives beyond two years after the deal. According to them, for CEOs who leave, it is probably the end of their careers. With very low probability of finding another job, the threat of losing their jobs is a powerful motivator for opposing

takeovers, even if they are beneficial to shareholders.

Every day, some shareholder or the other sells his /her shares on the stock market. The management has the responsibility to manage the firm efficiently and ensure that the shares trade at their true value. When the firm performs poorly, the management is expected to take proactive steps to improve the performance of the firm. Instead, if they adopt defenses that prevent the shareholders from accepting an offer at a premium to the market price, it only indicates self-interest. Shareholders are therefore sceptical when the management does nothing to improve the poor performance at the bourses, but express concern at the inadequacy of an offer at a substantial premium over the market price. Yahoo's resistance to Microsoft's offer is an interesting case study. Microsoft offered to acquire Yahoo at \$33 per share and Yahoo rejected it as inadequate (Associated Press, 2008). On May 3, 2008, Microsoft finally decided to withdraw. According to the historical prices available on Yahoo finance (nd), Yahoo's share price closed at \$25.72 on May 5, 2008. On November 30, 2008 the share price dropped to as low as \$ 8.94. On July 29, 2009 its shares traded at \$15.14. The highest monthly share price did not cross the \$33 level from May 2008 to August 2013. How does one justify the rejection of Microsoft's offer at \$33 as being inadequate when share prices did not rise above Microsoft's offer in the five years following the withdrawal? It is therefore clear that the management of poorly performing firms is more likely to adopt poison pills to entrench themselves.

## Conclusions and Recommendations:

The discussions in the previous section clearly highlight the weakness in the 'bargaining power' argument for adopting the poison pill. It is clear from the decision tree analysis that shareholders stand to gain more by not adopting a poison pill. Therefore, poison pills are not in the interests of the shareholders. While other arguments like informational asymmetries and ability to arrive at the true value of the firm appear reasonable, they should not be used to dis-empower the shareholders.

A major concern is the deterrence power of the poison pill to stop any takeover at the whim of the management. While some researchers claim that the deterrence power of the poison pill is low (Comment and Schwert, 1995), it is difficult to accept this. It is the high deterrence power of the pill that has led to its widespread adoption. Otherwise, why would the boards adopt poison pills in the first place? Further, if the poison pill is not a serious deterrent, it should be routinely triggered or ignored by the acquirers. Since the introduction of the poison pill in the 1980's, it has been *knowingly* triggered only once by Versata Enterprises Inc (Gerstein, Faris, Kronsoble and Drewry, 2009). Even in this case, it is speculated that the pill was triggered to settle related disputes. In the case of Sir James Goldsmith's takeover of Crown Zellerbach, which involved a flip over pill, Sir Goldsmith avoided the negative effect of the poison pill by foregoing a freeze-out merger (Bainbridge, 2002). This is an impressive record spanning two decades and thousands of pills, highlighting the deterrence power of the poison pill. While individually on a stand-alone basis, none of the takeover defenses are impossible to breach, when combined, their power can be very high. It is a well-documented fact that a poison pill combined with an effective staggered board provides

an insurmountable defense (Bebchuk, Coates and Subramanian, 2002; Barry and Hatfield, 2011; Sokolyk, 2011). This can be easily understood using the analogy of the loaded gun. Neither the gun nor the bullet by itself is a great defense, but the defensive power of the loaded gun is unquestionable.

Another shareholder concern is the agency problem. The presence of conflicting motivations in a takeover decision is well known. The standard versions of the poison pill, instead of resolving the conflict only aggravates it by concentrating the power with the management. The very act of adopting a poison pill without shareholder approval is indicative of self-interest and raises the spectre of agency problem. Research on the relationship between insider ownership and adoption of the poison pill provides some insights on how this could be resolved. Mallette and Fowler (1992) found a negative relationship between insider ownership and the adoption of the poison pill. Rezaul, Dolph, and Andreas (1997) analyzed data of Dutch listed companies, and found that antitakeover defenses are increasingly adopted when firms have lower ownership concentration. Heron and Lie, 2006 explored this relationship and found that insider ownership is lower for firms with poison pills. It appears that with increase in internal ownership, the interests of managers and shareholders get aligned as managers also benefit from the premiums that are offered in a takeover. Changing the board composition to include minority shareholders might help. Encouraging ownership of stock by management can also help.

It is important that the management understands the concerns of the shareholders and designs defenses that do not force shareholders into an adversarial position. In light of increased shareholder resistance

and changing corporate governance norms, aligning the interests of the shareholders and management is the only option. While increase in employee ownership is a step in this direction, other avenues should also be explored. The management could take steps to resolve the agency problem by designing contracts that alleviate job concerns of senior executives in takeover situations. This can be in the form of golden parachutes, stock options etc. If these are put in place in advance and in a transparent manner, the agency problem is mitigated and trust between shareholders and management is bound to improve. The management can also increase the bargaining power of the board without sacrificing the shareholder interest by designing shareholder friendly poison pills. This would not only relieve the pressure from institutional shareholders and organizations like ISS, but also result in better ratings on the corporate governance indices.

### Appendix – 1 List of Takeover Defenses\*

1. White Knight
2. White Squire
3. Golden Parachutes
4. Litigation
5. Poison Pill
6. Sale of Crown Jewels
7. Pac Man defense
8. Green mail
9. Staggered Board
10. Buy back of shares
11. Restructuring or Recapitalization
12. Charter Amendments like fair price amendments, super majority rules, control share provisions.
13. Use of Employee Stock Ownership Plans (ESOPs)
14. Leveraged Buy Out (LBO)
15. Standstill agreements

\*The above is not an exhaustive list of defenses.  
Compiled from Depamphilis (2010); Weston, Mitchell and Mulherin (2004); Bruner (2004); Pearce and Robinson (2004)

## Appendix - 2

### How the Poison Pill works

**Flip-In Pill:** This can be understood using a simple hypothetical example. Firm A has issued 100,000 shares, which are currently trading at \$10 per share. The firm adopts a poison pill, which will get triggered when an acquirer reaches or crosses a threshold limit, say 20% (the limit can be set to any other %) shareholding or announces a bid for 20% or more of the target's shares. When either of this happens, the pill is triggered and each shareholder (other than the acquirer) gets a right to buy additional shares of the firm at a discount. For example, they could receive the right to buy one additional share for every share held by them at half the current market price (\$ 5 in case of firm A). Given that the total number of shares already issued by the firm is 100,000, if the acquirer triggers the pill by acquiring 20,000 shares, the remaining shareholders can buy 80,000 new shares issued by the firm at \$ 5 each on a pro rata basis. The total number of shares of the firm then increases to 1,80,000.

**How it increases the cost of acquisition:** Let us assume that the acquirer planned to acquire 50% of the shares in order to take control. In the absence of the poison pill, having already acquired 20,000 shares, the acquirer requires 30,000 shares to reach the 50% level. Assuming the acquirer is able to acquire these from the market without paying any premium, it would cost the acquirer \$300,000. However, if a poison pill is in place and it is triggered, 80,000 new shares are introduced into the market through the rights plan. The acquirer will now have to buy 70,000 shares to reach the 50% mark. If the prices hold firm at \$10, this would cost the acquirer \$700,000 (\$40,000 more than without the poison pill). Even

if the market were to adjust to the issue of additional shares and the shares trade at approximately \$8, the cost of acquiring 70,000 shares is \$560,000 (\$260,000 more than earlier). Therefore, the poison pill has effectively increased the cost of acquisition.

**How it dilutes the value of the shares held by the acquirer:** The market value of the shares held by the acquirer was \$200,000 (20,000 shares multiplied by \$10) before the poison pill was triggered. If the market adjusts itself and the shares now trade at \$ 8, the value of the shares held by the acquirer is reduced to \$160,000 resulting in a loss of \$40,000.

**How it dilutes the percentage holding of the acquirer:** Before the poison pill was triggered, the acquirer had a 20% interest in the firm, which is now reduced to 11.11% (20,000 of 1,80,000).

**Flip-Over Pill:** The working of the flip over poison pill can be understood using a simple hypothetical example. If the firm A adopts the flip-over pill, the terms of the pill can give the rights holder the right to acquire shares of the merged entity valued at \$ 10 in the market for \$5. This flip-over pill is extremely potent because post merger, it has the potential to transfer control of the merged entity to the shareholders of the target company (depending on the structure of the poison pill). The problem with the flip-over pill is that it does not release the poison until all the shares of the target firm are acquired and firm A is merged with that of the acquirer. If the acquirer does not acquire 100% of the shares or after acquiring all the shares of the target, does not merge with it, the firm is effectively taken over without the pill releasing its poison.

## The structure of the poison pill

There are different types of poison pills and the terms of the pill would depend on what the board expects to achieve using the pill. Following are some important features of the pill.

1. The life of the poison pill: is specified in advance and tends to vary from 3 to 10 years.
2. The redemption value: The firm has the option of redeeming the poison pill at any time during the life of the pill before it is triggered. The redemption value of the pill is normally set very low (for example 1 cent per right). In some cases, there is a small window of time (10 days) after the triggering event during which period the board can redeem the pill.
3. Waiver of the pill: The board can decide to waive the pill in case of a friendly takeover. This effectively forces the acquirer to negotiate with the target's board to waive the pill.
4. Exercise Price: The pill has an exercise price. This determines at what price the rights are exercised.
5. The trigger event: is an event on the happening of which the rights detach from the shares to which they are attached. For example, this is on an acquirer reaching a threshold level of shareholding, say 20% (it can be any other percentage). It can also be set to be triggered when an acquirer makes a bid for 20% or more of the shares.
6. Options: The pill can have a flip-in option, a flip-over option or both.

### Appendix -3

Fig. - 4

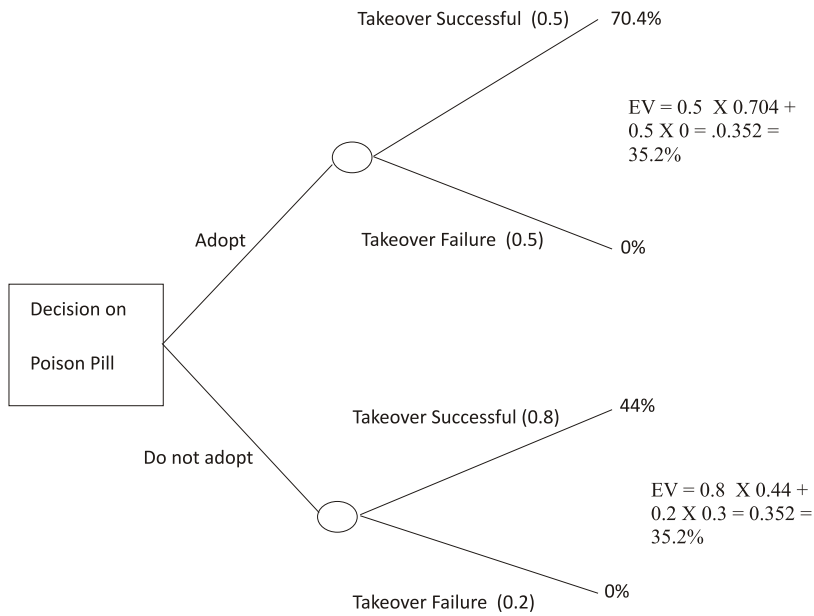
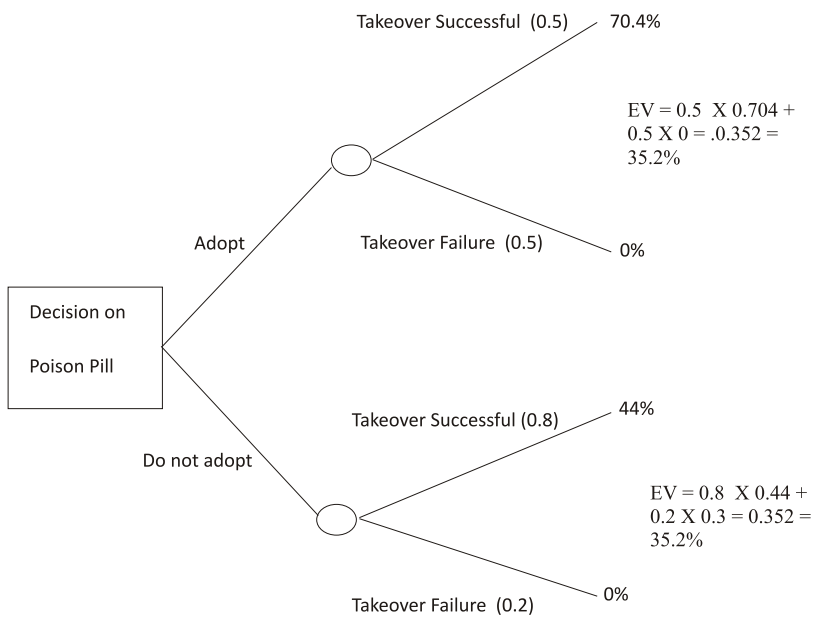


Fig. - 5



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