INCREASED PRESSURE ON COMPANIES

UPTICK IN UNSOLICITED OFFERS

Although overall merger and acquisition activity has declined significantly since the onset of the financial crisis, one corner of the M&A world seems to be alive and well: unsolicited takeover bids.

In 2008, approximately 25% of all announced deals started with unsolicited offers, compared to only 12% of announced deals in 2007. In 2009, more than 18% of announced deals began with unsolicited offers (MergerMetrics). The first quarter of 2010 has brought even more unsolicited bids to the table: of deals worth $100 million or more announced in the first three months of 2010, five have been unsolicited (Thomson Reuters).

Notable recent unsolicited offers include:

- InBev’s offer for Anheuser-Busch.
- Roche’s offer for Genentech.
- Kraft’s offer for Cadbury.
- Air Products’ offer for Airgas.
- Astellas’ offer for OSI Pharmaceuticals.

The increase in unsolicited activity is likely to continue as buyers seek opportunities and potential targets fail to fully recover previous market prices. Many companies have accumulated large cash balances, in part as a response to the financial crisis, and many have stated that they would use those balances for attractive acquisitions. Despite the decrease in overall bank loans, lenders are still willing to finance deals for large, well-capitalized companies. The market values of the portfolios of many activist hedge funds and private equity funds have also rebounded, potentially providing a significant stimulus for takeovers.

SHAREHOLDER ACTIVISM

The use of takeover defenses, consistent with a board of directors’ exercise of its fiduciary duties, enables a board to reject an inadequate price or negotiate a price that represents a full and fair value for the target company (see Box, Takeover Defenses).

However, over the last decade, institutional shareholder advisory groups (such as RiskMetrics and the Council of Institutional Investors), labor unions, public pension funds and activist hedge funds have successfully lobbied for the dismantling of takeover defenses. They claim that many takeover defenses provide a convenient pretext for board entrenchment rather than protect shareholder value. Currently, corporate governance activists are using the financial crisis to further deprive corporations of takeover defenses and discourage boards from resisting acquisition proposals. Once a takeover offer becomes public, a resistant board is likely to face reputational risk, litigation and a proxy fight.
Combining the ability to get majority support for advisory resolutions under Securities and Exchange Commission (SEC) Rule 14a-8 with the threat of withholding votes for directors who do not implement the advisory resolutions, these activists have stripped many corporations of their protection against hostile takeovers. Today, US public companies have far weaker anti-takeover defenses than in previous years:

- Only 17% of companies in the S&P 500 had shareholder rights plans by the end of 2009, down from 60% of companies as recently as 2002.
- Only 32% of the companies in the S&P 500 had a staggered board by the end of 2009, down from 60% in 2002 (sharkrepellent.net).

Meanwhile, boards have become increasingly sensitive to shareholder influence, especially in the context of the current economic climate. As a result of the Sarbanes-Oxley Act of 2002 and the stock exchange governance rules adopted after the Enron and WorldCom scandals, boards now consist almost entirely of independent directors. The proliferation of corporate governance blogs and articles, and the backlash from the financial crisis, make boards very conscious of best practices. The financial press tends to label companies that redeem their shareholder rights plans or de-stagger their boards as “shareholder friendly” or “at the forefront of corporate governance best practices.”

Although the pressure may be intense, companies would be unwise to simply follow the trend of dismantling their takeover defenses without considering the potential consequences. At the same time, it is important that the board maintain positive relations with its shareholder base. Since institutional shareholders own more than 60% of the shares of US public companies, they have considerable leverage and are likely to determine the outcome of almost every takeover battle. Any takeover defense that does not take that fact into account is unlikely to lead to success.

**BEING PREPARED**

The most effective way to deal with hedge fund activity and unsolicited bids is to be prepared. This improves a company’s ability to deter coercive or inadequate bids or to secure a high premium in the event of a sale of control of the company. Before a hedge fund strikes or an unsolicited bid is received it is crucial that directors:

- Understand their fiduciary duties and the company’s defensive posture.
- Are familiar with the company’s strategic plan.
- Are aware of viable financial and strategic alternatives.
- Become familiar with any change in control restrictions in the company’s financing documents and other material contracts.

Any delay or inconsistency in responding to hedge fund criticism or an unsolicited bid may lend a
degree of credibility to the criticism or bid and ultimately undermine the effectiveness of the company’s response. Companies should take the following steps to be prepared:

- Assemble the right team.
- Maintain a plan.
- Consider other options.
- Consider applicable fiduciary duties.

**ASSEMBLE THE TEAM**
To deal with bidders and activists, the board should create a team comprised of a few key officers, one or more financial advisors, legal counsel, a proxy solicitor and a public relations firm and be able to convene a special board meeting promptly. The company should establish a program for financial advisors and legal counsel to periodically update directors on the current takeover and activist environments, fiduciary duties and recent developments, including recent legal decisions.

**MAINTAIN A PLAN**
The company should maintain an up-to-date strategic plan, but should refrain from creating a valuation of the whole company or its parts. It is important that the company has an investor relations strategy before it needs it — the company must be able to demonstrate convincingly that the board and management are actively focused on the company’s performance and stock price. The company should also maintain dialogue and relationships with shareholders, especially large shareholders, because the willingness of large shareholders to side with management in the face of an unsolicited bid, at least for some period of time, will be important.

The company should analyze its financial alternatives in advance, including any potential merger partners or divestitures of under-performing assets that may (or may not) be available. When confronted with an unsolicited proposal, the threshold question for any target is: “is now the right time to sell?” The target’s board and management must align themselves with the company’s message in response to any third party approach. While the response to any particular situation will depend on the relevant facts and circumstances, a proactive stance, a well-considered strategic plan and a prompt response is likely to be the most effective way to thwart unwanted attention from activists or potential hostile bidders. Having plans and strategies in place will give the company the broadest range of good options if unsolicited activity materializes.

**CONSIDER OTHER OPTIONS**
If an activist hedge fund or unsolicited bidder does appear, the board has several options other than adopting a takeover defense, including:

- **Communication and negotiation.** The target’s board may choose to meet with the activist or bidder. If possible, the target should obtain a standstill agreement (perhaps in exchange for entering into a confidentiality agreement and giving the bidder or activist access to non-public information). The standstill agreement, by restricting the bidder’s ability to acquire additional stock of the target, gives the target more time to seek other, more beneficial alternatives or to negotiate with the bidder to obtain a higher price.

- **Restructuring.** The target may choose to take proactive restructuring steps to create near-term value. For example, the target could choose to acquire another company or complete a spin-off. This type of restructuring causes the target’s stock price to better reflect the true value of the target’s various businesses, and thus deter hostile bidders and appease hedge fund activists looking for a profit.

- **Leveraged share repurchase, extraordinary dividend or recapitalization.** These mechanisms may also be used to ward off unsolicited bidders by boosting the share price of the target. A target’s best defense to an unsolicited proposal is to have a strong stock price that reflects its full value.

- **Third party alternatives.** The target can:
  - pursue a friendly merger with a “white knight” (a white knight agreement usually contains lock-ups and break-up fees);
  - conduct an auction for the sale of the company; or
  - place a block of stock with a friendly shareholder, or “white squire,” who agrees to support management.

- **Litigation.** The target may fight back with litigation and/or complaints to regulators. However, burning bridges with litigation or with regulators in the face of an attractive offer is a risky defensive move.
TAKEOVER DEFENSES

The most effective takeover defenses are the shareholder rights plan (or “poison pill”) and the staggered board.

POISON PILL
A shareholder rights plan, or poison pill, involves issuing rights that attach to, and trade with, the target’s common stock unless and until the rights are triggered. Poison pills are designed to ward off unsolicited bids by severely diluting any shareholder who acquires more than a specified percentage (usually 15%) of the target company’s shares without the prior approval of the company’s board. The board retains the power to redeem the pill if it decides to approve an offer, which encourages hostile bidders to negotiate with the board. The poison pill is one of the most effective structural deterrents against hostile bids ever developed. A target’s board can usually implement a poison pill quickly without a shareholder vote, knowing that it has been endorsed by the courts.

However, adoption or extension of a rights plan can weaken shareholder support of a board of directors. Companies considering adopting or extending rights plans should anticipate their investors’ reactions and think about whether to adopt “shareholder friendly” features and to evaluate the triggering thresholds given the concentration of ownership of their shares. For more information on poison pills and RiskMetrics’ 2010 guidelines, search Poison Pills on our website.

STAGGERED BOARD
The staggered or classified board structure generally consists of three groups or classes of directors, with each group composed of roughly the same number of directors. Directors have three-year terms, with one class up for election each year. A staggered board prevents a bidder from obtaining control since the entire board cannot be replaced in a single proxy contest. Even with a staggered board, one-third of the board can be replaced and can then exert pressure within the boardroom to negotiate, and ultimately approve, the proposal. In this way, the bid may still be accepted, but only to the extent that the board of the target has had an opportunity to negotiate and explore other alternatives.

OTHER STRUCTURAL DEFENSES
In addition to staggered boards, many companies have other structural defenses in their charters or by-laws. Typical structural defenses include:

- Prohibitions on shareholders’ ability to act by written consent. This provision denies a bidder the ability to remove and replace directors without a shareholders’ meeting.
- Prohibitions on shareholders’ ability to call a special meeting. This provision confines all business to the annual meeting, limiting the “window of vulnerability” to a proxy contest to once per year.
- Restrictions on the ability to remove directors without cause. This provision prevents dissident shareholders from removing directors for any reason other than fraud, criminal acts and so on.
- Limits on both the number of directors serving on the board and the right of shareholders to fill board vacancies. These provisions prevent “packing” the board through dissident shareholders filling newly created vacant seats.
- Allowing the board to amend by-laws. This gives the board flexibility to modify defenses as needed.
- Requiring a supermajority vote to amend certain by-law provisions. This provision limits the ability to change the target’s governing documents to facilitate a takeover.
- Prohibitions on the ability to put forward shareholder proposals or to nominate directors at shareholder meetings without advance notice to the target. This provision limits the use of last-minute proposals and gives the board advance notice of any issue or nomination.
- Flexibility in setting the annual meeting. This allows the board to determine the best time for the annual meeting, subject to state law requirements.
- Blank check preferred stock. This allows rights plan implementation.

STATE STATUTES
In addition to these structural defenses, certain states have adopted statutes that provide additional defenses applicable to corporations incorporated in their state. These include:

- Fair price statutes.
- Constituency provisions.
- Control share acquisition statutes.
- Interested shareholder statutes.

Many of these statutes have effects similar to that of the poison pill in that they prevent a takeover absent prior approval of the board of directors of the target.

For more information on takeover defenses, search Defending Against Hostile Takeovers on our website.
Just say no. The target can just say no. However, this is difficult to do indefinitely in situations where institutional investors and hedge funds own more than a majority of the shares and are insisting that the board maximize shareholder value. It may also increase litigation risk. While Delaware courts are generally thought to support a “just say no” defense, doubt continues to be expressed within certain elements of the deal community.

CONSIDER FIDUCIARY DUTIES

When responding to a takeover threat, the board must consider what enhanced fiduciary duties apply and what it must do to protect itself against any future shareholder litigation (see Box, Fiduciary Duties). The key to good business judgment is to show that the board acted in good faith and on a reasonable basis.

The board should consult with its legal advisors to determine whether there are any conflicts of interest. Where members of the board have personal conflicts with respect to the proposal, they should refer these matters to a committee consisting of independent directors who do not have any conflicts. By doing so, any question as to the board’s “good faith” is negated.

As with all fundamental decisions, the board should follow a careful process of considering all the material questions as to the proposal. It is important that the board obtain:

- Careful and thorough financial information.
- Advice from management and an independent financial advisor.
- Legal advice from independent counsel.

In takeover situations, the courts carefully scrutinize the procedures followed and the independence and qualification of the experts who advised the board.

The views and opinions expressed in this article are those of the authors and do not necessarily represent those of Sullivan & Cromwell LLP or their clients.