Columbia Law School
Scholarship Archive

Faculty Scholarship Faculty Publications

2000

Poison Pills and the European Case

Jeffrey N. Gordon
Columbia Law School, jgordon@law.columbia.edu

Follow this and additional works at: https://scholarship.law.columbia.edu/faculty_scholarship

Part of the Business Organizations Law Commons

Recommended Citation
Jeffrey N. Gordon, *Poison Pills and the European Case*, 54 U. MIAMI L. REV. 839 (2000).
Available at: https://scholarship.law.columbia.edu/faculty_scholarship/3649

This Article is brought to you for free and open access by the Faculty Publications at Scholarship Archive. It has been accepted for inclusion in Faculty Scholarship by an authorized administrator of Scholarship Archive. For more information, please contact scholarshiparchive@law.columbia.edu, rwitt@law.columbia.edu.

Poison Pills and the European Case

Jeffrey N. Gordon

Professor Coates has given us a welcome opportunity to revisit the question of shareholder rights plans, or poison pills. It is interesting to evaluate a revisionist's view of an important empirical debate — but less because of the role that empirical evidence may have played in the evolution of U.S. corporate law doctrine and more because of the relevance of that debate to a world, especially Europe, that is waking up to the vigorous market in corporate control. If contested takeovers involving target firms such as Gucci, Telecom Italia, Paribas, and Mannesman are headline grabbing events in 1999 and 2000, what follows next in the moves towards European economic integration? What defensive measures, if any, should we encourage on the part of target management of an European Union company faced with a hostile takeover bid?

To give away the punchline, I am critical of the implicit defense in Professor Coates's paper of poison pills as they have evolved in U.S. practice, finding that defense in the spirit if not in the words of his paper. Instead, I think that a different evolutionary path that focuses on shareholder choice in the formulation and use of poison pills might well be possible and desirable for European corporate governance.

There is an implicit contradiction, I think, between two papers that Professor Coates has discussed: *The Contestability of Corporate Control: A Critique of the Scientific Evidence* and *An Index of the Contestability of Corporate Control: Studying Variation in Legal Takeover Vulnerability*. In the second paper, Professor Coates shows how carefully constructed defensive measures, especially a pill as protected by a classified board, stretch out the time period required for success in a hostile bid. This realization affects planning both by a well-advised potential target and by an acquiror in picking out a target. The intended consequence of the defensive activity is a selection effect, built on the view that an acquiror is more likely to go after more vulnerable targets and will stay away from less vulnerable targets. I take it that Professor Coates's ultimate objective in devising this Contestability Index is to show its predictive power in precisely this way.

But — and this is key — there is no reason to think that the contestability of the target maps onto the quality of target management or its fidelity to shareholder value. Effective pill-based defensive measures will skew the selection of potential targets. A hostile bidder will act not where it perceives the greatest potential value-added, but, rather, the greatest gains given the vulnerability of the target. So, if Professor Coates is right in his *Contestability Index* paper, there is bound to be a loss from this selection effect, an efficiency loss for shareholders overall. I take this conclusion to be at odds with the spirit of the first paper: that pills are not a management entrenchment device but merely a mechanism to structure a rational bidding process.

I believe pills can and do serve that function, but, regrettably they are overbroad — much overbroad — for that purpose. As one observes how managements and their advisors have pushed such devices as deadhand pills and no hand pills,[1] despite the clear inconsistency with norms of shareholder governance, it strains credulity to think that *shareholder value* has been the only management motive.[2]

I agree with Professor Coates that the empirical evidence on poison pills is difficult to assess but would add an additional set of reasons. What the "pill" is, as a strategic and tactical matter, has changed substantially since its first adoption. For example, in the 1986-89 period the Delaware Chancery Court shaped the pill as a time-released remedy: it gave management an opportunity to offer shareholders a transactional alternative to a raider's bid but could not be maintained indefinitely so as to prevent shareholders from accepting a noncoercive bid.[3] The Delaware Supreme Court changed the rules in 1990 in *Paramount Communications, Inc. v. Time Inc.*[4] In practice, a board now has the power to "just say no" to a hostile bid, subject to the shareholder prerogative of replacing the board. The early 1990's saw two new developments: raiders perfected the takeover methodology of coupling a hostile bid and proxy contest, and managements loaded up on stock options. Both changes reduce the defensive effects of a poison pill. So, early in the period, the pill was a limited entrenchment device (albeit one that invited potentially value-destroying restructuring), later in the period the

1. Both of these innovations were adopted to combat the bidder strategy of coupling a hostile bid with a proxy contest to gain control of the board and thus the power to redeem the pill. A deadhand pill purports to restrict the power to redeem the pill to continuing directors, i.e., those directors nominated by the incumbeant management team. A no-hands pill (or delayed redemption pill) restricts board power to redeem a pill at all for a time period following a change in board control. The Delaware Supreme Court has rejected both of these measures as trenching on the board's managerial authority. *See* Quickturn Design Systems, Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998). Other courts have been more permissive. *See* Invacare Corp. v. Healthdyne Tech., Inc., 968 F. Supp. 1578 (N.D. Ga. 1997) (applying Georgia law). *See generally* Jeffrey N. Gordon, *"Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder-Adopted By-Laws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511 (1997).

2. As Richard Pryor famously remarked about the denying spouse caught in *flagrante delicto*: "Honey, who are you going to believe, me or your lying eyes?"

3. The leading case in *City Capital Assoc. v. Interco Inc.*, 551 A.2d 787 (Del. Ch. 1988).

4. 271 A.2d 1140 (Del. 1990).

pill was a strong entrenchment device (which reduced the incentive for restructuring) and still later, the entrenchment effects somewhat declined (without reviving the incentives to restructure). Empirical studies that collapse these different effects into "the pill" are of limited value.

I certainly agree with Professor Coates that, as pills became commonplace so that all firms had one, actual or virtual, the announcement of pill adoption was merely a signal — and often an ambiguous one — of managerial intentions, rather than an event that changed the target's vulnerability to takeover. Thus, the only pill studies that may conceivably shed light on the question of pills and shareholder value focus on the early adoptions. Entirely apart from potential methodological objections, changes in the strategic and tactical effects of a pill, however, render those studies of limited usefulness for guiding current policy.

The fact that pills have not stopped hostile bids in the United States hardly answers the concerns. First, notice the change in bidders, who have shifted from the control entrepreneurs of the 1980's to the deep pocket companies of the 1990's. Only established companies can finance and wait out the costly delay of a proxy contest needed to disarm a pill, a credible threat of which is an important element for a hostile acquisition. Yet, control entrepreneurs may supply a necessary corrective to the empire-building tendencies that are common among acquirors. Such was the role of at least some of the financial bidders of the 1980's in disaggregating ungainly conglomerates. Second, firms have instituted very expensive executive compensation systems to encourage managers to yield to a hostile bid despite their having the legal authority to resist. Recent empirical work suggests that executive compensation is greater in the most protective states, such as Pennsylvania, and in firms otherwise protected, and that increased compensation is skewed to stock options.[5] Where firms build in enough incentives, poison pills are no problem, but note that shareholders bear the costs.

Let us turn to pills in the comparative U.S.-European context. The poison pill solved three problems in the U.S. transactional arena. First, the pill blocked procedurally or structurally unfair bidder tactics that might deprive shareholders of their legitimate share of the merger surplus, tactics such as the creeping tender offer, two-tier front-loaded bids, partial bids and orchestrated purchases from a small group of institu-

5. *See* MARIANNE BERTRAND & SENHIL MULLAINATHAN, EXECUTIVE COMPENSATION AND INCENTIVES: THE IMPACT OF TAKEOVER LEGISLATION (National Bureau of Econ. Research Working Paper No. 6830, 1998); MICHAEL H. HAID AND ERIC NOWAK, EXECUTIVE COMPENSATION AND THE SUSCEPTIBILITY OF FIRMS TO HOSTILE TAKEOVERS: AN EMPIRICAL INVESTIGATION OF THE U.S. OIL INDUSTRY (Dep't. of Fin., Johann Wolfgang Goethe-University Frankfurt Working Paper No. 32, 1999).

tional investors.[6] Second, in a world in which defensive measures were permitted, the pill provided a lower-cost and less damaging alternative to restructuring, stock buybacks, crown jewel asset sales, white squire deals and various scorched earth tactics that preceded it. The goal of the pill is like that of the neutron bomb: eliminate the hostile bidder but leave the target assets unscathed.

Neither of these two functions is necessary for European merger and acquisition practice, it appears. The European Union is on the verge of adopting harmonized regulation of takeover practice on the United Kingdom model, the so-called "Thirteenth Directive,"[7] which will eliminate many potentially troublesome bidder tactics. In particular, it would substitute the requirement of a "mandatory bid" for the pill's protection against creeping tender offers or partial bids. This means that a bidder who acquires a specified minority interest sufficient for control will be obliged to bid for the remainder of the stock at an "equitable price."[8] For example, a mandatory bid provision would have blocked the recent acquisition by LVMH of 36 percent of Gucci's stock.[9] Similarly, the proposed Thirteenth Directive would prohibit all non-shareholder-approved post-bid defensive measures, which substitutes for the pill's appeal as a non-destructive defensive measure.

Nevertheless, the pill has additional value in the United States that could be translated to Europe. This is the value of a reasonable measure delay. Although the market in corporate control, including hostile bids, has been a significant element in U.S. economic success over the past fifteen years, I believe that control markets potentially may create risks both to shareholder value and to overall efficiency. In part, this is

6. *See, e.g.*, Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert denied sub nom.*, Dickinson v. SEC, 460 U.S. 1069 (1983).

7. *See* "Amended Proposal for a 13th European Parliament and Council Directive on Company Law Concerning Takeover Bids," 9428/99 DRS 18 CODEC 368 (Interinstitutional No. 95/0381) (Text of amended proposal as it stands after the meeting of the EU Council of International Market Ministers on June 21, 1999) [hereinafter Thirteenth Directive]; European Commission, Directorate General, "Proposed Takeovers Directive — Questions and Answers" (Nov. 23, 1999) (located at <http://europa.eu.int/comm/internal_market/en/company/company/35.htm>, visited June 6, 2000. Adoption of the 13th Directive was delayed by an unrelated dispute between Great Britain and Spain over the status of Gilbrator that has now been resolved. Concerns that the German government might want to negotiate the directive following the December 1999 hostile takeover of Mannesmann have been allayed by recent government/industry agreement on implementing domestic legislation. *See* Ralph Atkins, "Germans Agree on Code to Govern Takeovers," FIN.T., May 18, 2000, at 10.

8. Thirteenth Directive, Art. 5 § 1. For contrasting analyses from an economic perspective, *compare* Ulrich Hommel, *Regulating the Market for Corporate Control: Lessons from Germany*, 3 INT'L J. BUS. 100 (1998) *with* Clas Bergström, Peter Högfeldt & John Molin, *The Optimality of the Mandatory Bid Rule*, 13 J.L. ECON. & ORG. 433 (1997).

9. For an account of the LVMH stock purchase and the aftermath, *see* John G. Finley, *The Rise of the Hostile Bid in Continental Europe*.

because stock market volatility may open up possibilities for an arbitrage between stock markets and asset markets, through which market participants may capture disproportionate amounts of the merger surplus. Control markets that are too liquid can also interfere with human capital investments of managers and employees and with other investment decisions. The pill puts absorptive rods in the corporate control reactor, slowing down the pace of the conversions.[10] The United States has managed to luck into a shaky balance on this question, creating a Goldilocks control market — not too hot, not too cold. Perhaps Delaware courts get some credit as modulators, but, if so, certainly not by explicit doctrinal design.[11]

Europe may need to do something, but it can do better than the United States by following the road not travelled here of shareholder choice, a more reliable road. Early Delaware decisions that approved the pill took shareholder choice out of the game in the United States.[12] Shareholder activists have attempted to reclaim this lost territory with bylaw amendment proposals. Whether the Delaware court will permit this is a disputed question.[13] If it is rational to build in delay, there is every reason to believe that shareholders would be receptive to managers' arguments for a carefully designed ex ante measure that would accomplish this. For example, some have wondered if the apparent disparity in premia between transactions in Europe and in the United States is attributable to the greater bargaining power that the pill gives target management.[14] (The 100 percent premium that Mannesmann extracted from Vodafone AirTouch may lead to a revaluation of that view.) An alternative explanation is that the premium disparity may arise from the legal and cultural limitations on rapid cost-cutting associated with the European social compact. This may reduce the value of European busi-

10. This is, in principle, an empirically testable proposition. In my view, the empirical evidence on poison pills is largely irrelevant to the real issue: the shaping of a corporate control market nested in a broader system of corporate governance that fosters economic development. *See generally*, Jeffrey N. Gordon, *The Shaping Force of Corporate Law in the New Economic Order*, 31 U. RICH. L. REV. 1473 (1997).

11. *But see* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931 (1991) (ascribing the decision in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1990) to the Delaware Supreme Court's concern about potentially disruptive pace of takeovers).

12. Moran v. Household Int'l, 500 A.2d 1346 (Del. 1985); Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990).

13. *Compare supra* note 1 *with* Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-adopted By-laws: Taking Back the Street?* 73 TULANE L. REV. 409 (1998).

14. *See* Christian Kirchner & Richard Painter, A Modified Business Judgment Rule for European Takeover Law (forthcoming 2000 in Die Aktiengesellschaft, in German translation; English version on file with author) (discussing average premium data for European takeovers from THE DAILY DEAL, Jan. 6, 2000) [hereinafter Kirchner & Painter].

ness combinations and thus would predictably lead to lower premia. In any event, shareholders are sufficiently well equipped to evaluate the arguments on both sides of this question and take decisions about the appropriate design of a pill-like device.

The U.S. experience with shareholder voting on poison pills supports the idea of shareholder rationality. On the few occasions that U.S. companies have put poison pill proposals to shareholder vote, shareholders, including institutional investors, endorsed them. Such proposals tend to be more limited in duration and type than the pills unilaterally adopted by management.[15] In targeting firms for pill rescission resolutions, shareholder activists almost invariably pick firms that have egregiously underperformed the relevant industry index and institutional investors vote accordingly.[16] As sophisticated institutional investors in Europe come to understand the potential problems of active control markets, they will cooperate with management to devise appropriate solutions.

It may be that the European solution will vary significantly from the U.S.-style poison pill because of the legal barriers erected by the Thirteenth Directive itself. As a counterpoint to the mandatory bid, the proposed Thirteenth Directive limits defensive action on the part of a target board, very nearly a neutrality rule. Proposed Article 8 provides:

> 1. Member States shall ensure that rules are in force requiring that:
>
> (a) at the latest after receiving [public notice of a bid] and until the result of the bid is made public or the bid lapses, the board of

15. For example, shareholders approved pill proposals for Texaco in 1997 and for Horizon Mental Health Management in 1998. *See* INVESTOR RESPONSIBILITY RESEARCH CENTER, CORPORATE GOVERNANCE SERVICE 1998 BACKGROUND REPORT E: POISON PILLS 2 (June 25, 1998).

16. Over the 1987-98 period, the annual average number of pill redemption proposals (typically in advisory, rather than mandatory, form) was approximately twenty. These proposals generally received votes of one third to a majority of shares. Shareholder activists almost invariably target underperformers. In 1998, for example, all targeted firms underperformed the S&P 500 index over a five-year period. *Id.* at 5. Even the Georgeson & Co. Study, which endorses poison pills, concedes that "shareholder proposal proponents tend to target companies with poor performance." GEORGESON & CO, CORPORATE GOVERNANCE: INSTITUTIONAL VOTING ON POISON PILL RESCISSION 4 (Nov. 1997).

There is debate over the sensitivity of institutional voting to relative performance among the targeted firms, with some evidence offered by IRRC and Georgeson that institutions follow guidelines in casting their votes rather than focusing on the very worst performers. This is a weak attack on the rationality of institutional voting, however, since by hypothesis all the firms on the targeted list are significant underperformers. Moreover, according to Georgeson, the determinative factor of the percentage vote is the composition of the shareholder body: activist institutions such as Fidelity and Wellington take an aggressive approach to proxy issues; other institutions are more passive. *Id.* at 2-4. This will, of course, disturb any correlation between votes for the proposal and the firm's performance, but it hardly makes out the case that Fidelity and Wellington are themselves irrational in casting votes in the proxy process.

> the offeree company should abstain from any action other than seeking alternative bids which may result in frustration of the offer, and notably from the issuing of shares which may result in a lasting impediment to the offeror to obtain control over the offeree company, unless it has the prior authorization of the general meeting of the shareholders given for this purpose, during the period of the acceptance of the bid.
>
> 2. Member states may allow the board of the offeree company to increase the share capital during the period for acceptance of the bid on the condition that prior authorization has been received from the general meeting of shareholders not earlier than 18 months before the beginning of the period of acceptance of the bid, with full recognition of the rights of preemption of all shareholders as provided for [in a prior directive].

This appears to erect two barriers to use of a U.S.-style poison pill: first, the need to obtain shareholder approval for any defensive measures during the pendency of the bid, and second, preemptive rights protection. Conceivably pre-bid approval of a mechanism that operated mechanically following a bid would solve the first problem, or technological advances in shareholder voting (e.g., use of the Internet) would permit post-bid approval.[17] Preemptive rights are a tougher problem, because the U.S.-style pill operates on the basis of a discriminatory share issuance that would penalize an unwanted acquiror. Nevertheless the way is open to creative minds to devise solutions that will fit both the constraints of the Thirteenth Directive and the objectives of shareholders.[18]

I offer as evidence a Wachtell Lipton Rosen & Katz client memo of February 4, 2000, in which a lawyer famous for his creative efforts with poison pills now proposes for Europe a mechanism by which a target facing a hostile bid commits itself to an auction if, within a specified period of time, its stock price does not exceed 125% of a hostile bidder's

---

17. *See* Kirchner & Painter, *supra* note 14, at 37.

18. Concededly, shareholder-choice mechanisms are unlikely to attend to the interests of other stakeholders. The U.S. experience with constituency statutes argues that those interests are best addressed outside the realm of corporate governance. In the face of a hostile bid U.S. managers have generally used this statutory power to balance interests of shareholders and stakeholders either to extract a higher price for shareholders or a better deal for themselves, but rarely to protect stakeholders such as employees. At best, this managerial discretion gives random, not systematic, protection to these interests, which, if important, deserve more reliable protection. Arguably the European corporate governance starting point, which admits of more "co-determination," literally or figuratively, would produce such systematic management attention to stakeholder interest in a takeover. This is part of Kirchner & Painter's rationale for a "modified business judgment rule for European takeover law." Any such a standard of managerial discretion would present difficult problems of judicial manageability and is likely in the near term to function like U.S.-style constituency statutes, i.e., poorly.

offer. This plan, and many others, build on shareholder choice — but not the U.S.-brand pill — may be a useful ingredient for the European takeover market.