A Review of Defensive Strategies Used in Hostile Takeovers

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A Review of Defensive Strategies Used in Hostile Takeovers

BY

CHIRAG SHAH

THESIS CHAIR: DR. JAMES D’MELLO
Chirag Shah, having been admitted to the Carl and Winifred Lee Honors College in 1994, successfully presented the Lee Honors College Thesis on April 12, 1996.

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"A Review of Defensive Strategies Used in Hostile Takeovers"

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"Greed is good. Greed clarifies, cuts through & captures the essence of the evolutionary spirit. Greed in all its forms—greed for life, for money, for love, for knowledge—has marked the upward surge for mankind."

Gordon Gekko (Michael Douglas in "Wall Street")

INTRODUCTION:

Current Activity: Nineteen Ninety Five smashed all records for mergers and acquisitions at home and abroad. An unprecedented $458 billion in deals were announced by U.S. companies, up 32% from the old record of $347 billion reached in 1994, according to the Securities Data Co. Similarly, deal count, which last year came in with 7,565 announced transactions, registered a new record as 8,954 transactions were announced in 1995. Globally, a record $866 billion in transactions were struck, up 51% from the $572 billion announced in 1994. The big highlights were banking, financial services, pharmaceuticals and big transactions in media and telecommunications. From diaper makers (Kimberly Clark-Scott Paper) and drug makers (Pharmacia-Upjohn) to software sellers (IBM-Lotus) and cartoon creators (Disney-Cap Cities), companies across the corporate landscape tied the knot in an effort to cut costs and boost earnings.

Table 1

The Biggest Deals Announced in 1995
U.S. deals involving change in majority ownership

<table>
<thead>
<tr>
<th>BUYER</th>
<th>ACQUISITION</th>
<th>TRANSACTION TYPE</th>
<th>VALUE (billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EDS Shareholders</td>
<td>Electronic Data Systems</td>
<td>Spinoff *</td>
<td>$21.00</td>
</tr>
<tr>
<td>Walt Disney</td>
<td>Capital Cities/ABC</td>
<td>Cash and stock acquisition *</td>
<td>18.83</td>
</tr>
<tr>
<td>ITT shareholders</td>
<td>ITT</td>
<td>Spinoff</td>
<td>11.60</td>
</tr>
<tr>
<td>First Bank System</td>
<td>First Interstate</td>
<td>Stock swap *</td>
<td>10.05</td>
</tr>
<tr>
<td>Chemical Banking</td>
<td>Chase Manhattan</td>
<td>Stock swap *</td>
<td>9.87</td>
</tr>
<tr>
<td>Hoechst</td>
<td>Marion Merrell Dow</td>
<td>Cash acquisition</td>
<td>7.12</td>
</tr>
<tr>
<td>Time Warner</td>
<td>Turner Broadcasting</td>
<td>Stock swap *</td>
<td>6.88</td>
</tr>
<tr>
<td>Kimberly Clark</td>
<td>Scott Paper</td>
<td>Stock swap</td>
<td>6.79</td>
</tr>
<tr>
<td>Pharmacia</td>
<td>Upjohn</td>
<td>Stock swap</td>
<td>6.32</td>
</tr>
<tr>
<td>First Data</td>
<td>First Financial Management</td>
<td>Stock swap</td>
<td>5.76</td>
</tr>
<tr>
<td>Seagram</td>
<td>MCA (Matsushita Electric)</td>
<td>Cash acquisition</td>
<td>5.70</td>
</tr>
<tr>
<td>NBD</td>
<td>First Chicago</td>
<td>Stock swap</td>
<td>5.30</td>
</tr>
<tr>
<td>Crown Cork</td>
<td>CarnaudMetalbox</td>
<td>Stock swap</td>
<td>5.20</td>
</tr>
<tr>
<td>First Union</td>
<td>First Fidelity</td>
<td>Stock swap *</td>
<td>5.07</td>
</tr>
<tr>
<td>Westinghouse</td>
<td>CBG</td>
<td>Cash acquisition</td>
<td>5.04</td>
</tr>
</tbody>
</table>

* Pending
** Wells Fargo successfully counterbid and acquired First Interstate for $10.93 billion

In 1995, it was stock and not cash that dominated M&A transactions as a mode of financing. Nearly 60% of all companies used stock as an acquisition currency in 1995, up from earlier years, partly aided by a booming stock market that effectively made purchases cheaper. Besides, companies would not want to leverage themselves up with borrowed money when stock swaps can be free. This trend was also fueled by a high level of the U.S. stock market's acceptance of stock as a liquid acquisition currency.
Looking at these mind boggling and record breaking numbers and dollar amounts of the merger transactions in 1995, one tends to question himself--WHY? The answer is, “To restructure”. With the real economic growth hovering between two and three percent, how can one possibly create that additional value needed for double-digit growth. In this era of globalization, for companies to maintain their competitiveness in regional and global markets within the parameters set by government-negotiated “managed trade agreements”, they simply have to restructure. A few of the restructuring tools include mergers & acquisitions, refinancing, management realignment, leveraged buyouts, and employees stock ownership plans. This thesis is intended to review the empirical data on previous mergers and acquisitions (involuntary or hostile) while exemplifying the five most targeted industries either in terms of their total takeover value or their numerical value of the deals struck. These industries include the commercial banking sector, radio and television broadcasting stations, electric, gas and water distribution, business services, and investment & commodity firms, and are used to identify a few successful and unsuccessful defensive strategies while analyzing their underlying circumstances.

**Types of Acquisitions**: The term acquisition is used to describe any transaction in which a buyer acquires all or part of the assets and business or all or part of the stock and other securities of the seller. Included within this general term are more specific forms of transactions such as:

1. **Merger**: is a combination of two corporations whose boards of directors approve and recommend the merger to the stockholders who in turn, approve the merger by a required favorable vote--normally two-thirds. In a merger, one of the two corporations--usually...
the seller—is merged into the other corporation which is referred to as the surviving corporation.

(2) **Consolidation**: is similar to a merger in every aspect except that a consolidation causes both of the corporations to merge into a new corporation referred to as the survivor corporation.

(3) **Asset Acquisition**: is an acquisition in which the buyer acquires all or a part of the assets and businesses of the seller, pursuant to a contract entered into between the buyer and the seller with the approval of the seller's stockholders.

(4) **Stock Acquisition**: is an acquisition in which all or a part of the outstanding stock of the seller is acquired by the buyer from the stockholders of the seller through a direct contractual relationship between the two parties.

The element of willingness on part of both, the buyer and the seller, distinguishes an acquisition from a *takeover*.

**HISTORICAL PERSPECTIVE**:

The history of merger activity in the United States has been characterized by four great merger waves with each one being identified with certain characteristics. The first wave which peaked at the turn of the century (1895-1905) is remembered for creating monopolies. During this period, a number of major single-industry firms such as U.S. Steel, Dupont and others evolved following some major changes in the economic infrastructure and production technologies which helped elevate to a certain extent, the transformation of regional firms into national firms. The second wave that started in the 1920's (1922-1929), was characterized by acquisitions of related firms (suppliers, customers, and competitors), but these mergers did not create monopolies. A large portion of mergers in the 1920's represented product extension mergers as in the cases of IBM, General Foods, and Allied Chemical, market extension mergers
in food retailing, department stores, motion picture theaters, and vertical mergers in the mining and metals industries. The third wave which began in the 50s (1950-1968), and peaked from 1966 through 1968, produced large conglomerate firms that adopted a diversification strategy into business activities outside their traditional areas of interest. And finally since 1974, the fourth wave has witnessed the gradual rise in horizontal and vertical megamerger deals between large firms. Each of these waves with a minor exception to the latter, were all associated with a period of sustained economic expansion and a long bull market while coming to an end with the collapse of the bull market. The fourth wave following the oil crises in mid-70’s, unlike its predecessors, has been the most gradual of all four waves, signaling a fundamental change in the economy and its effects on the perspectives or attitudes of firms towards acquisitions, particularly the hostile raids.

The question whether increased merger activity is a good thing for the economy, however, remains unresolved and unlikely to be resolved by focusing solely on the experience of the firms involved. A positive view would argue that mergers represent an unambiguously positive shifting of assets into their best use and provide the best mechanism for ensuring that managers act in the shareholders’ interest. A more neutral view would be that the level of merger activity is just a by-product of this asset shuffling and has no particular externality; it fluctuates from time to time corresponding to the fluctuations in the number of shares traded. And the negative view usually downplays the merger frenzy by associating its downside effects on R&D, labor, and the economy as whole in terms of real output.
Table 2

**Mergers & Acquisitions**

*Overview of External Growth*

Firms seeking Growth in order to achieve benefits of

- Externally -- Taking Over Operations of Another Firm
  - which has the advantages of
    - Rapid Expansion
    - Immediate Cash Inflows
    - Reduction of Risk
    - Economies
  - which requires financing
    - Cash Payment
    - Issuance of Stock
    - which is influenced by
      - Antitrust Legislation
        - Sherman Act
          * Prevents Monopolies and illegal trade
        - Clayton Act
          * Restrains combinations between competitors
        - Celler-Kefauver Amendment
          * Prevents monopolies in individual markets
          * FTC can order divestment of stock or assets
    - which is enforced by
      - Antitrust Division of Justice Department
      - Federal Trade Commission
DETERMINANTS OF MERGERS:

"It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard for their self-interest."
Adam Smith

"Economic Motives": The most frequently hypothesized causes of mergers are to bring about an increase in profits by either increasing the market power of the firm or reducing its costs or through a combination of both. Mergers can increase a firm's market power in several ways, depending upon the type of merger involved. The simplest case is undoubtedly the horizontal merger. A merger between two firms in the same industry that increases the acquiring firm's market share may allow it to engage more effectively in tacit or explicit collusion with other firms in the industry and thereby be able to charge a higher price. Horizontal mergers can also raise barriers to entry if they are coupled with cost reductions, in turn causing an existing or potential entrant to deter from competing with cost-efficient larger firms. Vertical & conglomerate mergers have also been deemed to have anti-competitive effects through backward integration and reciprocity respectively. Each form of merger can also be a cause of cost reductions. When plant or multiplant economies of scale in production exist, a horizontal merger can be the source of cost reductions for firms of less than minimum efficient size. Vertical integrations also reduce production costs when production processes require closely integrated steps in the production chain or by reducing the transportation costs between steps in the production chain or by reducing the uncertainties involved in successive stages of production,

3 Adams and Brock 163.
and thereby enhance the firm’s efficiency. Besides, all three forms of mergers can be sources of reduction in various overhead (overlapped) costs of production. Through mergers, efficiencies of scale & job cuts can be achieved as a result of financial and managerial synergies, in turn boosting profits even while revenues stay flat. For these very reasons, mergers can help companies continue to grow, even in a slowing economy.

"Speculative Motives": A flip side to the above hypothesis is that mergers are in part or perhaps entirely motivated by speculative or expectational motives. It seems reasonable to assume that at any given time there will be differences in individual expectations about the future profit stream of a firm and thus about the present value of that firm's stock. In a period of rising stock market prices, mergers will take place whenever outsiders gather information about the firm's prospects that the present holders do not obtain or foresee. The large capital gains that accompany bull markets can lead to windfall gains for speculators, making them defiant in their already speculative and high-risk ventures; like investing substantially in what may seem like a potential takeover target.

"Managerial Motives": The possibility that mergers may be motivated in part by managerial efforts to make personal gains from the mergers that are not shared by both sets of stockholders, leads directly into the broader set of hypotheses falling under the heading of "managerial theories of the firm". Growth has been central to the corporate culture, since only through real growth can the economy promise more for the future in return for today's investment in labor, capital and technology. And acquisitions offer management precisely what they are looking for: a short cut to demonstrate corporate growth. However growth maximization does not necessarily imply or result in profit maximization. Mergers are an obvious and quick way to expand a firm's size, and managers who are willing to sacrifice some profits and the present value of a firm's stock to achieve sales or asset growth may be willing to
undertake mergers that cannot be explained on other grounds. It can therefore be inferred upon that managers who pursue sales or growth maximization through acquisitions, are acting in direct conflict with shareholders' objectives of profit maximization. Besides, the managers of acquiring firms are betting with other people's money—represented by the value of their company's stock—hence, it would not be unreasonable to say that managers of acquiring firms tend to be risk takers willing to bet against the unfavorable odds of success, to achieve a self-fulfilling prophecy.

**MACROEFFECTS OF MERGERS:**

Among the most important policy questions related to mergers are those concerned with their effects on concentration and on competition among other things. Surprisingly, increased concentration does not necessarily imply a decline in the effectiveness or vigor of competition. The rise in the level of aggregate or market concentration—the proportion of economic activity controlled by the largest firms in the economy—in most industrial countries after World War II also witnessed during the same period, a rise in competition, thanks to the massive liberalization and declining trade barriers, causing an increase in world trade and foreign investments.

The basic context of corporate development is a profit seeking enterprise where the maximization of shareholder-wealth is presumed to be the central driving force. However, in the United States—and, to a greater extent, elsewhere in the world—constituencies other than private stockholders are becoming an increasingly influential factor in the evaluation of a target: organized labor, environmental protectionists, and government agencies overseeing antitrust violations. Organized labor, if not evaluated carefully, could prove fatal for the company in its post-merger operations. Environmental protection organizations and agencies have also been growing in importance as a result of increasing societal concerns, and tend to have a considerable influence in determining regulatory sanctions. In the antitrust area, each merger wave has
witnessed a new legislative proposal that institutes various barriers or disincentives in an effort to
discourage future consolidations with certain characteristics.

As viewed in the past that Wall Street reacts negatively to R&D expenditures, also
viewed as sunk costs until they are recovered. Therefore, a company, growing and promising as
it may seem in the long run, can be appraised substantially in the short run if its R&D
(overlapped) costs are trimmed through a strategic acquisition. The bottom line is that
acquisitions are the flesh and blood of “restructuring” that doesn’t mix well with the fat created
from “inefficiencies” caused as a result of excessive labor costs, environmental expenses, and
overlapped R&D sunk costs. 4

4 Alan J. Auerbach. Corporate Takeovers : Causes and consequences. (Chicago : The University of
### The Top 10 Target Industry Sectors in 1995

<table>
<thead>
<tr>
<th>TARGET INDUSTRY</th>
<th>VALUE (billions)</th>
<th>MARKET SHARE</th>
<th>NO. OF DEALS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks, Bank Holding Companies</td>
<td>$154.87</td>
<td>17.80%</td>
<td>1,154</td>
</tr>
<tr>
<td>Radio and Television Broadcasting Stations</td>
<td>61.49</td>
<td>7.10</td>
<td>553</td>
</tr>
<tr>
<td>Electric, Gas, and Water Distribution</td>
<td>54.26</td>
<td>6.20</td>
<td>305</td>
</tr>
<tr>
<td>Business Services</td>
<td>49.10</td>
<td>5.60</td>
<td>1,816</td>
</tr>
<tr>
<td>Drugs</td>
<td>37.21</td>
<td>4.30</td>
<td>311</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>35.10</td>
<td>4.00</td>
<td>442</td>
</tr>
<tr>
<td>Insurance</td>
<td>33.47</td>
<td>3.80</td>
<td>579</td>
</tr>
<tr>
<td>Paper and Allied Products</td>
<td>30.63</td>
<td>3.50</td>
<td>293</td>
</tr>
<tr>
<td>Investment &amp; Commodity Firms, Dealers, Exchanges</td>
<td>30.63</td>
<td>3.50</td>
<td>1,188</td>
</tr>
<tr>
<td>Food and Kindred Products</td>
<td>28.81</td>
<td>3.30</td>
<td>849</td>
</tr>
<tr>
<td><strong>Top 10 Sector Totals</strong></td>
<td><strong>$515.57</strong></td>
<td><strong>59.10%</strong></td>
<td><strong>7,490</strong></td>
</tr>
<tr>
<td><strong>Industry Totals</strong></td>
<td><strong>$871.10</strong></td>
<td><strong>100.00%</strong></td>
<td><strong>21,698</strong></td>
</tr>
</tbody>
</table>

*Source: Securities Data Co.*
As shown in Table 3, 1995’s overall merger activity witnessed a distinct concentration among the top ten targeted industries with respect to their total market value as well as the volume of deals announced. I will further my research on the identification of successful and unsuccessful defensive measures by reviewing the empirical data exemplifying these industries. The target firms in these industries share some of the following characteristics which include:

1. A low stock price in relation to the replacement cost of assets or their potential earning power.
2. A highly liquid balance sheet with large amounts of excess cash, a valuable securities portfolio, and significant unused debt capacity.
3. Good cash flow relative to current stock prices.
4. Subsidiaries or properties which could be sold off without significantly impairing cash flow.
5. Relatively small stock holdings under the control of incumbent management.

A combination of these factors makes the target an attractive investment opportunity while simultaneously facilitating the acquirer’s financing. The firm’s assets can be used as collateral for an acquirer’s borrowings, and the target’s cash flows from operations and divestitures could be used to repay the loans.
EVOLUTION OF HOSTILE TAKEOVERS:

"They throw cats and dogs together and call them elephants."

Andrew Carnegie

Foreign competition, rising labor costs, and changing product markets have been reworking the economic landscapes of industrialized nations. Nowhere have such changes been more apparent than in the United States, where these changes are forcing a continual record-breaking era of M&A, that has witnessed a rise in hostile takeover attempts (a relatively new phenomenon in this field). Hostile takeovers are primarily the result of power, whether it is in terms of actual control, monetary gains, or just for the satisfaction of an individual’s ego. It is true that the number of hostile deals remain relatively small compared to the total number of transactions. However, in aggregate dollar terms—and in terms of their social and economic impact—these hostile deals deserve the utmost priority and attention by a firm’s management; especially for firms in the banking, entertainment, and the utilities industry as these three industries topped the 1995’s most targeted industries’ table in terms of their total market value.

TAKEOVER DEFENSES:

The hostile tender offer made directly to a target firm’s shareholders, with or without previous overtures to management, has become an increasingly frequent means of initiating a corporate combination. As a result, considerable interest has been aroused in determining efficient and effective defensive measures to counter these hostile bids. Arguments from managerial defensive actions are grounded on the desirability of creating an auction for the

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5 Adams and Brock 83.
target, the coerciveness of tender offers, and the bargaining role of management. Opposing arguments emphasize increased costs of takeovers and the resulting inefficiency in the market operation for corporate control. An extreme view would cite that the coerciveness of tender offers should not be a matter of concern, given that the takeover market is competitive. In either case, defensive measures have been increasingly adopted by firms of all sizes and especially the ones falling under the highly targeted industries’ category. Some of the defensive measures are discussed below:

**Green Mail**: The term, also known as targeted repurchase of stock, refers to the buying of shares by the target firm from the raider at a significant premium over the current market price. The funds required pay the raider for the stock repurchase, are obtained by issuance of new debt securities. However, other shareholders cannot tender their shares and are thus exposed to the additional risk the firm has undertaken as a result of the debt issue. To profit from a greenmail, the raider must hold less than 10% of the outstanding shares of the target firm. The SEC considers any investor owning more than 10% to be an insider. Also, if the stock is sold in less than six months, the profits may be forfeited if the shareholders sue.

More so than with other defensive measures, an agency problem surfaces with the payment of greenmail. In theory, the objective of the firm is to maximize shareholder-wealth. The managers, acting as agents of the firm’s owners (shareholders), are supposed to engage in activities that are intended to maximize the wealth position of the shareholders. The agency problem arises when the interests of the shareholders are not coincident with the interests of the managers. Payment of greenmail to stop a corporate raider can serve the management’s interests with respect to their job safety, monetary compensation, and associated perks, but may or may not serve the best interests of the shareholders who are not eligible for the premium payment.
The payment of greenmail is defended on the grounds that the shareholder will be better off in the long run by getting rid of the raider on the assumption that the raider would harm the interests of the other stakeholders in the firm. However, empirical data shows that the board of directors of the target firm that pays greenmail is usually sued by unhappy stockholders on the grounds of unfairness with respect to premium payments. Cases are frequently dropped if the firm’s stock appreciates after the payment of greenmail or when the firm is acquired by another bidder for a higher price. Even otherwise, the courts tend to side with the directors as the issue is “Intent”, and it is difficult to prove that the directors have not acted in good faith. However, starting in mid-80’s, many firms began instituting measures to preclude the payment of greenmail. The provisions include prohibition of stock repurchases at a premium from investors with ownership of 5% or more of the outstanding stock. In addition, many firms also require that premiums for stock repurchases be made available to all shareholders.

**Golden Parachutes**: refer to separate provisions made in the corporate charter for compensating executives when fired under a change-of-control clause. The provision usually calls for a lump-sum payment or payment over a specified period at full or partial rates of normal compensation. This type of severance contract has been increasingly used by the Fortune 500 firms as M&A activity intensified in the 80’s, reflecting an increase in one’s susceptibility to hostile takeovers.

The majority view on golden parachutes now is that these control-related contracts encourage managements to accept a change of control that enhances shareholder gains and thereby reduces the possibility of a conflict between shareholders and managers in change-of-control situations. This would also restrain managers from undertaking unwanted short term, high risk defensive measures that are in direct conflict with their long term goal of shareholder wealth maximization. However, certain extreme cases of golden parachutes have created a stir.
among the public and are often viewed as “rewards for failure”. One example of an extreme case is the golden parachute payment of $23.5 million to six officers of Beatrice Companies in connection with its leveraged buy-out in 1985. One of the officers received a $2.7 million package even though he had been with the company for only 13 months. Another officer received a $7 million package after being recalled from retirement only seven months before. Also in 1985, the chairman of Revlon received a $35 million package consisting of severance pay and stock options. Even in these extreme cases, the golden parachutes were small when compared to the total acquisition prices of $6.2 billion in the Beatrice LBO and $1.74 billion in the Revlon acquisition respectively. It is estimated that the cost of golden parachutes is less than one percent of the total cost of a takeover in most cases. For this very reason, golden parachutes are not considered to be an effective takeover defense.

**Poison Puts**: Corporate bond quality often deteriorates following the issuer’s leveraged recapitalization, leveraged buyout, or other forms of control change. Since 1986, some new bond issues have provided their holders with poison put covenants as a protection from the risk of takeover-related credit deterioration of the issuer. This investor protection device, however, has often been viewed as an antitakeover mechanism. This view is substantiated by the fact that the right to put is triggered by a change of control only in the cases of hostile takeovers. This kind of put may well protect management but not necessarily the bondholders if the eventual acquisition was a friendly one.

Exercise of the put after an unfriendly takeover can be very costly to the bidder if the bond prices are selling at a discount. However, if the situation is reversed, it could be an ineffective form of defense when the bond prices are already selling at a premium, in turn forcing the bondholders to lose their premium while not being able to exercise their options.
Regulatory Defenses: Regulation of securities is closely related to regulation of merger and acquisitions activity, since takeovers are carried out by means of the securities markets. Special characteristics of securities which make them vulnerable to being used fraudulently mandate regulation to increase public confidence in the securities markets. The Securities Act of 1933, following the stock market crash of 1929, called for registration of public offerings of securities. The Securities Exchange Act of 1934 established the Securities and Exchange Commission to regulate securities market practices; it also specified disclosure requirements for public companies (Section 13) while setting out the procedural requirements for proxy contests. A number of other securities laws in the late 1930s and 1940s applied to public utilities, bond indenture trustees, and investment companies. The Securities Act of 1933 and Securities Exchange Act of 1934 provided the framework for subsequent regulation. Most of the more recent legislation in the M&A area with respect to hostile takeovers has also been in the form of amendments to these two acts. It was not until 1968 that Congress moved to regulate tender offers. As amended in 1970, the Williams Act requires that anyone who intends to make a tender offer that would produce personal ownership of more than 5% of the target’s outstanding stock, is required to provide the SEC with a statement (Schedule 13D) disclosing the purchaser’s identity, the source and amount of funds for the purchase including details about financing, the purpose for ownership of the stock, the number of shares owned, and details of any arrangements the would-be purchaser has made with others with respect to the acquired stock. Further, the statute requires persons making recommendations to security holders of target firms with regard to the acceptance of tender offers to file an information statement with the SEC (Schedule 14D).

The Antitrust Pre-merger Notification Act of 1977 provides the Justice Department and the FTC, which share enforcement responsibility for the Clayton Act, with the authority to challenge proposed mergers that “may substantially lessen competition” before they are
completed. The Act requires that certain major acquisitions by tender offer be delayed for a fifteen-day waiting period to permit the government to examine the antitrust implications of the proposed acquisition. The waiting period may be extended by the departments for an additional 10 days. The law affects companies of $100 million or more in sales or assets that expect to merge with companies of $10 million or more in sales or assets.

In addition to federal regulation of M&A activity, a number of states have enacted legislation to protect corporations headquartered within the state boundaries. Reincorporating in states that have enacted restrictive takeover statutes may be a useful delaying tactic. Whereas the Williams Act requires that a tender remain open for a minimum of fifteen days, some states' statutes may require as much as sixty days. Many of these statutes have been designed to protect local corporations from outside tender offers, and, thereby, protect incumbent management by forestalling takeovers. Their constitutionality, however, is being tested in the courts because it is argued that they are preempted by the Williams Act. The intent of the Williams Act was that tender offers be settled in the market place. In any event, while the lawyers argue, the target firm gains time, and if effectively used, could shift the lead in the target's favor.

**White Knights**: refer to friendly firms or individuals who save the company from a hostile takeover by acquiring it. Corporate America's acceptance of "Bigger is Better" is reflected in its willingness to get bigger at any cost--either by being acquired or through acquisitions--as they are different sides of the same coin. However, friendly takeovers which tend to be preferable to the management than its hostile counterparts, come at an opportunity cost to the target's as well as the knights' shareholders. The target's shareholders lose out on the lost opportunity to make that extra buck from a potentially higher bid from the hostile acquirer. The white knight's shareholders lose out on the increased probability of a failure as a result of a non-
strategic and rushed merger that could have its toll on the post-merger operations of the new firm.

**Poison Pills**: refer to the creation of securities by target companies that provide holders with special rights exercisable only after a certain period following the occurrence of a triggering event such as a tender offer for control or the accumulation of a specified percentage of target shares. These rights in essence make it very difficult or expensive for the bidder to acquire control of the target firm. These tactics economically "poison" the would-be acquirer if swallowed.

Poison pills are generally adopted by the board of directors without shareholder approval. Usually the rights provided by a poison pill plan can be altered quickly by the board or redeemed by the firm anytime before they become exercisable following the triggering event. These provisions force the bidder to negotiate directly with the target’s board of directors. Hence, the proponents argue that poison pills do not prevent all takeovers but they do enhance the target board’s ability to bargain at their terms. However, the opposite view holds that poison pills are one of the most potent defensive device that entrenches management while negatively affecting shareholder wealth. There are five main types of poison pills which are summarized as follows:

(a) **Preferred Stock Plans**: Also referred to as the original plans, these plans have provisions that give dividends of convertible preferred stock to the holders of common stock and entitles holders of the preferred stock to one vote-one share and somewhat higher dividends than ones distributed to holders of the convertible preferred stock. If a trigger point is reached, preferred stockholders are given priority in redeeming their holdings for cash at the highest price the largest block holder paid for acquiring the majority stake in the past year, and if the acquiring party merges with the firm, the preferred stock can be converted into the acquirer’s common stock with a total market value no less than the redemption value in the first case.
The original plan is thus seen to be designed to deter coercive two-tier tender offers or to avoid dilution that can be effected by a majority shareholder. A partial tender offer for the preferred stock is likely to fail because holders of the preferred stock have no incentive to tender their shares, as they are guaranteed to receive the highest price paid by the bidder. Modified two-tier offers may still be possible. For instance, the bidder could buy most of the preferred and half of the common stock at a lower price through a formal merger transaction.

(b) Flip-Over Rights Plans: have been the most popular poison pill defense since introduced in late 1984. Under this plan, shareholders receive a common stock dividend in the form of rights to acquire the firm’s common or preferred stock at an exercise price well above the current market price, and if a merger occurs, the rights “flip over” to permit the holder to purchase the acquirer’s shares at a substantial discount. Note that the flip-over plan does not prevent an acquirer from obtaining a controlling interest in the target. However, mergers or transfers of assets which are the primary goals of most takeovers become prohibitively expensive unless the acquirer obtains most of the rights, which again would be an expensive course as holders of these rights tend to hold them for the highest possible return which is usually realized when the rights are exercised.

(c) Ownership Flip-In Plans: allows holders with rights to purchase target shares at a large discount if an acquirer accumulates target shares in excess of a threshold or a “kick-in” point which is generally between 25 and 50 percent. The acquirer’s rights are void. Hence, this provision imposes losses on the acquirer and dilutes the acquirers’ majority stockholder’s equity stake. Ownership flip-in plans thus deter acquisitions involving a substantial equity position by any means and could be made more effective when combined with flip-over provisions.

(d) Back-End Rights Plans: Under these plans, shareholders receive a rights dividend. If an acquirer obtains shares of the target in excess of a limit, holders excluding the acquirer can
exchange a right and a share of the stock for senior securities or cash equivalent to a back-end price set by the target firm’s board of directors. The back-end price is higher than the stock’s market value at the time and thus back-end plans set a minimum takeover price for the firm. Back-end plans deter acquisition of a controlling interest. A conditional tender offer for less than the back-end price will not succeed because rights have an incentive to hold out for the higher back-end price. This again promotes the free-rider problem as described in previous poison pill plans.

(c) Voting Plans: are implemented by declaring a dividend of preferred stock with voting rights. In some cases, if a party acquires a substantial block of a firm’s voting stock, preferred holders other than the larger block holder become entitled to supervoting privileges. It is thus difficult for the block holder to obtain voting control. In a different case, long-term (three or more years) holders of preferred stock are entitled to more votes per share than short-term holders, making it more difficult for a bidder to acquire voting control rapidly.

In conclusion, all five poison pills share a common characteristic; they promote the free-rider problem, thereby causing a tender offer conditional on shareholders surrendering their pill securities to the bidder to fail. Hence, it is not feasible for a hostile bidder to avoid penalties imposed by these pills.

Leveraged Recapitalizations: This technique of financial restructuring was first developed by Goldman Sachs for Multimedia in 1985. It is considered to be a defensive tactic because in most cases the recapitalization, also known as leveraged cash-out (LCO), has been implemented in response to a hostile bid. In a typical recap, outside shareholders receive a large one-time cash dividend and insiders (managers) and employee benefit plans receive new shares instead of the cash dividend. The cash dividend is financed mostly by newly borrowed funds, both senior bank debt and through mezzanine financing (subordinated debentures). As a result,
the firm’s leverage is increased to an abnormally high level, in turn, cutting off a major source of acquisition financing for a potential raider, in turn, discouraging leveraged takeovers. Simultaneously, equity ownership of the management also rises and thereby ensuring the remaining stakeholders of “true” efforts by the management for the maximization of shareholder wealth. In contrast to most other defensive measures, LCO’s provide decent returns to shareholders that are comparable to a takeover. Although the technique has grown in popularity, leveraged recapitalization carries a great deal of risk. In order to meet its debt obligations, a highly leveraged company needs stable cash flows, which can be a problem if the economy experiences a downturn. Strong management with viable and growth oriented strategic plans with sufficient alternatives as a backup is the key for a recap to succeed in the long run.

**Shark Repellents**: Precaution is the best form of reaction. Following this principle, companies, with shareholder approval, are increasingly incorporating antitakeover amendments, popularly known as shark repellents, in the firm’s charter. Failure to pass might be taken as a vote of no confidence in incumbent management and may provide a platform for a proxy fight or takeover attempt where none had existed before. In general, shark repellents impose new conditions on the transfer of managerial control of the firm through a merger, tender offer, or by replacement of the board of directors. There are four major types of antitakeover amendments.

(a) **SuperMajority Amendments**: These amendments require shareholder approval by at least two thirds vote and sometimes as much as 90% of the voting power of outstanding capital stock for all transactions involving change of control. However, in most cases, the supermajority provisions have a board-out clause which provides the board with the flexibility to determine when and if the provisions would be in effect.

(b) **Fair-Price Amendments**: These are supermajority provisions with a board-out clause and an additional clause waiving the supermajority requirement if a fair price is paid for all
purchased shares. The fair price is commonly defined as the highest price paid by the bidder during a specified period and is sometimes required to exceed an amount determined relative to the book value of the target company. Thus, fair price amendments defend against two-tier tender offers that are not approved by the target's board. A uniform offer for all shares to be purchased in a tender offer and in a subsequent clean-up merger or tender offer will avoid the supermajority requirement. Since the two-tier tender offer is not essential in successful hostile takeovers, the fair-price amendment is the least restrictive among the class of supermajority amendments.

(c) **Classified Boards** : Another major type of antitakeover amendment provides for “staggered” or “classified” boards of directors to delay the effective transfer of control in a takeover. Management’s purported rationale in proposing a staggered board is to assure continuity of policy and experience. For example, a nine member board might be divided into three classes, with only three members standing for election to a three-year term each year. Thus, a new majority shareholder would have to wait for at least two annual meetings to gain control of the board of directors. Effectiveness of cumulative voting is reduced under the classified-board scheme because a greater shareholder vote is required to elect a single director. Variations on antitakeover amendments relating to the board of directors include provisions prohibiting the removal of directors except for cause, and provisions fixing the number of directors allowed to prevent “packing” the board.

(d) **Authorization of Preferred Stock** : The board of directors is authorized to create a new class of securities with special voting rights. This security, typically preferred stock, may be issued to friendly parties in a control contest. Thus, this device can be classified as a defensive measure against hostile takeover bids. The new issuance if executed properly, can effectively
dilute the bidder’s equity position while simultaneously tilting the balance of power in favor of the management.

Other amendments that management may propose as a takeover defense include:

(1) Abolition of cumulative voting where it is not required by state law.

(2) Reincorporating the charter in a state with more accommodating antitakeover laws.

(3) Provisions with respect to the scheduling of shareholder meetings and introduction of agenda items, including nomination of candidates to the board of directors.

(4) Antigreenmail amendments which restrict a company’s freedom to buy back a raider’s shares at a premium.

In response to the rise in hostile takeovers, the use of shark repellents as a defensive device, has become increasingly frequent regardless of the type of industry or the size of the firm.

Employees Stock Ownership Plans: ESOP is a type of stock bonus plan which invests primarily in the securities of the sponsoring employer firm. They were established by Congress in 1974 as a way to encourage employee ownership of corporations while providing attractive incentives such as tax breaks among other things to the corporations. ESOPs also offer corporations a low-cost borrowing alternative where the proceeds are not required to be used solely for employee benefits. ESOPs also provide corporations with less restrictive and a cost-effective alternative to pension plans. But most important of all, ESOPs can be used by the management as a takeover defense against hostile raiders. As discussed earlier, M&A especially hostile acquisitions usually have negative effects on labor among other stakeholders. Hence, ESOPs when carefully planned and executed, can be a useful deterrent device against hostile takeovers. However, their effectiveness in this regard is still being decided by court interpretations having to do with the voting rights of unallocated shareholders.
A Review of TakeOver Defenses Used in Five Industries over the Last Decade:

With the help of my mentor, Dr. D'Mello who has an on-line subscription to the Securities Data Company's world-wide M&A database, I was able to download a brief synopsis detailing vital data about companies in the five most targeted industries (see Table 3) and that have used defensive techniques against hostile raiders since 1985. Surprisingly enough, among the thousands of mergers that have occurred in the last decade in these five industries alone, I came up with only 30 deals in which some sort of defensive technique was used against unsolicited offers. This seems to reflect a structural change in the mind-set of corporate America in favor of the clause "Bigger is Better". However, as small as the sample may seem, the total market value of these hostile bids amounted to $36.77 billion in these five industries alone--significant enough to substantiate the purpose of this thesis: to evaluate commonly used defensive techniques and the extent of their success through the use of empirical data. This evaluation, however, has its limitations. To begin with, the sample of the data although complete, remains a drop in this ocean of mergers. And like any other model or theory, a series of assumptions accompany this one too. They are:

(1) Size of both firms are assumed to have no impact on the outcome.

(2) The market value of the acquisition and post merger effects are assumed to be constant with respect to regulatory (antitrust) evaluations.

(3) The three determinants of mergers (discussed earlier) are assumed to be constant for the sample.

(4) The defensive tactics are evaluated as an independent variable.

Despite the limitation and assumptions stated above, the defensive techniques in various combinations showed a high rate of success. "Success" refers to the achievement of the end goal by the target's management: prevention of a hostile takeover by the bidder. This definition
includes takeovers by white knights and even subsequent deals with the bidder as long as the final outcome is “friendly”. Anything else falls under the unsuccessful category. Going by these parameters, 24 bids (80% of the sample) were successfully averted either with external assistant from a white knight or through lockup agreements that forced friendly outcomes with the acquirer or simply because of effective execution of defensive tactics that made the target unattractive causing the raider to withdraw. One case is still pending as of April 1, 1996, while the rest of the five cases were forcefully acquired by the bidder. Although small in absolute terms, hostile takeovers still represent 17% of the total sample and the market value of these raids, $14.66 billion, amounts to 40% of the total hostile bids.

The most commonly used defensive techniques were white knights, self-tenders, poison pills with and without flip-over provision, and a combination of asset and stock lockups. These techniques were either used by themselves or in a combination with other techniques. The following table breaks down the above mentioned techniques:

<table>
<thead>
<tr>
<th></th>
<th>Times Used</th>
<th>Successful</th>
<th>Unsuccessful</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pending</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><em>Self-Tender</em></td>
<td>6</td>
<td>6</td>
<td>0</td>
</tr>
<tr>
<td><em>White Knight</em></td>
<td>13</td>
<td>8</td>
<td>4</td>
</tr>
<tr>
<td><em>Poison Pills w/Flip-Over Prov.</em></td>
<td>5</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td><em>Poison Pills w/o Flip-Over Prov.</em></td>
<td>12</td>
<td>5</td>
<td>1</td>
</tr>
<tr>
<td><em>Lockup (Asset and/or Stock)</em></td>
<td>3</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>
### Table 4: A Breakdown of Cases by the Target's Industry Group

<table>
<thead>
<tr>
<th>Target Name</th>
<th>Acquiror Name</th>
<th>Business Description</th>
<th>Hostile Techniques</th>
<th>Defensive Tactics</th>
<th>Lockup Description</th>
<th>Value (mil)</th>
<th>Outcome</th>
<th># of Days</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commercial Banks, Bank Holding Companies</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>First Interstate Bancorp.</td>
<td>Wells Fargo &amp; Co.</td>
<td>Banking</td>
<td>SS</td>
<td>WK</td>
<td>None</td>
<td>$10,929.90</td>
<td>Completed</td>
<td>166</td>
</tr>
<tr>
<td>Irving Bank Corp.</td>
<td>Bank of New York Co. Inc.</td>
<td>Banking</td>
<td>TO, TM, SS</td>
<td>PP, FO-PP, WK</td>
<td>None</td>
<td>$1,377.00</td>
<td>Completed</td>
<td>462</td>
</tr>
<tr>
<td>Marine Corp.</td>
<td>Marshall &amp; Isley Corp.</td>
<td>Banking</td>
<td>SS</td>
<td>WK</td>
<td>None</td>
<td>$597.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Michigan Nat'l Corp.</td>
<td>Comerica Inc.</td>
<td>Banking</td>
<td>WS, SS</td>
<td>WS</td>
<td>None</td>
<td>$354.90</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>LSB Bancshares Inc. of SC</td>
<td>BB&amp;T Financial Corp.</td>
<td>Banking</td>
<td>SS, Pooling of Interests, Collar</td>
<td>Lockup, SL</td>
<td>Option-771,894 @ $30/sh</td>
<td>$122.80</td>
<td>Completed Friendly</td>
<td>204</td>
</tr>
<tr>
<td>First Interstate Corp.</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Westamerica Bancorp</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Delta Bank &amp; Trust Co.</td>
<td>Hibernia Corp.</td>
<td>Banking</td>
<td>Going Private</td>
<td>PP, FO-PP</td>
<td>None</td>
<td>$100.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Florida Comm. Banks Inc.</td>
<td>Investor</td>
<td>Investment</td>
<td>TO</td>
<td>WK</td>
<td>None</td>
<td>$19.00</td>
<td>Acquired by WK</td>
<td>42</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$13,641.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Business Services</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Midcon Corp.</td>
<td>Occidental Petroleum Corp.</td>
<td>Oil &amp; Gas, Petr. Refining</td>
<td>WK, TO, TM, T-TO, SS</td>
<td>Lockup, AL, SL</td>
<td>Option-asset &amp; 7.5 mil. shs</td>
<td>$3,065.50</td>
<td>Completed Friendly</td>
<td>91</td>
</tr>
<tr>
<td>Midcon Corp.</td>
<td>WB Partners</td>
<td>Oil &amp; Gas, Petr. Refining</td>
<td>Going Private, TO, TM</td>
<td>ST, SS, WK</td>
<td>None</td>
<td>$2,539.80</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Manpower Inc.</td>
<td>Blue Arrow PLC</td>
<td>Business Services</td>
<td>TO, TM</td>
<td>WK</td>
<td>None</td>
<td>$1,327.60</td>
<td>Withdrawn</td>
<td>43</td>
</tr>
<tr>
<td>Gelco Corp.</td>
<td>Coniston Partners</td>
<td>Investment &amp; Comm. Frm</td>
<td>TO, TM, Going Private</td>
<td>ST, Law, FO-PP</td>
<td>None</td>
<td>$325.40</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Intelogic Trace Inc.</td>
<td>TRW Inc.</td>
<td>Electronic &amp; Elect. Equip</td>
<td>TO, TM</td>
<td>ST</td>
<td>None</td>
<td>$177.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Recognition Equip. Inc.</td>
<td>Prospect Group Inc.</td>
<td>Food &amp; Kindred Products</td>
<td>LB, OMO, TO, TM, T-TO, MBO</td>
<td>PP</td>
<td>None</td>
<td>$153.90</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Triad Systems Corp.</td>
<td>Volt Info Sciences Inc.</td>
<td>Electronics Industry</td>
<td>TO, TM</td>
<td>PP, FO-PP</td>
<td>None</td>
<td>$141.90</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>High Voltage Eng. Corp.</td>
<td>Hyde Park Partners LP</td>
<td>Investment &amp; Comm. Frm</td>
<td>TO, TM, Going Private</td>
<td>PP, WK</td>
<td>None</td>
<td>$108.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>Philip Crosby Assoc. Inc.</td>
<td>Alexander Proudfoot Wwide</td>
<td>Business Services</td>
<td>TO, TM</td>
<td>WK, Law</td>
<td>None</td>
<td>$90.00</td>
<td>Completed</td>
<td>524</td>
</tr>
<tr>
<td>Isomedix Inc.</td>
<td>Radiation Sterilizers Inc.</td>
<td>Health Services</td>
<td>Going Private, TO, TM</td>
<td>PP, FO-PP, Gold Par.</td>
<td>None</td>
<td>$37.00</td>
<td>Withdrawn</td>
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<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td>$8,027.40</td>
<td></td>
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<tr>
<td><strong>Radio and Television Broadcasting</strong></td>
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<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>CBS Inc.</td>
<td>Turner Broadcasting</td>
<td>Entertainment</td>
<td>TO, WS, SS</td>
<td>ST, WS</td>
<td>None</td>
<td>$5,455.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>LIN Broadcasting</td>
<td>McCaw Cellular Comm. Inc.</td>
<td>Telecommunications</td>
<td>TO, TM</td>
<td>PP</td>
<td>None</td>
<td>$5,080.00</td>
<td>Withdrawn</td>
<td></td>
</tr>
<tr>
<td>John Blair &amp; Co.</td>
<td>MacFadden Holdings Inc.</td>
<td>Printing &amp; Publ. Serv.</td>
<td>PF, TO, TM, T-TO, GP</td>
<td>WK</td>
<td>None</td>
<td>$362.00</td>
<td>Withdrawn</td>
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<tr>
<td>Storer Communications Inc.</td>
<td>Investor Group</td>
<td>Investment &amp; Comm. Frm</td>
<td>Proxy Fight</td>
<td>ST, WK</td>
<td>None</td>
<td>$40.00</td>
<td>Withdrawn</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$10,897.00</td>
<td></td>
<td></td>
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<td><strong>Investment and Commodity Firms, Dealers, Exchanges</strong></td>
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<td></td>
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<td></td>
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<tr>
<td>Income Opportunity Realty</td>
<td>DRF Acquisition Corp.</td>
<td>Investment &amp; Comm. Frm</td>
<td>Going Private, TO, TM</td>
<td>PP</td>
<td>None</td>
<td>$26.50</td>
<td>Withdrawn</td>
<td></td>
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<tr>
<td>Cypress Fund Inc.</td>
<td>NAV Partners LP</td>
<td>Investment &amp; Comm. Frm</td>
<td>OMO, TO</td>
<td>ST, Proxy Fight</td>
<td>None</td>
<td>$23.50</td>
<td>Withdrawn</td>
<td></td>
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<tr>
<td>Jefferies Group Inc.</td>
<td>Undisclosed Acquiror</td>
<td>Unknown</td>
<td></td>
<td>PP, ESOP</td>
<td>None</td>
<td>$50.00</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$50.00</td>
<td></td>
<td></td>
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<tr>
<td><strong>Electric, Gas and Water Distribution</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>$4,153.70</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

SS=Stock swap; TO=Tender offer; TM=Merger; WS=White Squire; WK=White knight; T-TO=Two-tier offer; LB=Leveraged Buyout; OMO=Open market operation; MBO=Management Buyout; PP=Poison Pills; FO-PP=Poison pills w/flip-over prov.; ST=Self-tender
<table>
<thead>
<tr>
<th></th>
<th># of Times Used</th>
<th>Successful</th>
<th>Successful w/(C)</th>
<th>Successful (C) Used</th>
<th>Unsuccessful</th>
<th>Unsuccessful w/(C)</th>
<th>Unsuccessful (C) Used</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Self-Tender</strong></td>
<td>6</td>
<td>6</td>
<td>5</td>
<td>WK, SS, PF, FO-PP</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>White Knight</strong></td>
<td>13 *</td>
<td>8</td>
<td>6</td>
<td>PP, ST, SS</td>
<td>4</td>
<td>2</td>
<td>PP, FO-PP, LAW</td>
</tr>
<tr>
<td><strong>Poison Pills w/Flip-Over Prov.</strong></td>
<td>5</td>
<td>4</td>
<td>4</td>
<td>PP, ST, LAW, GoLP</td>
<td>1</td>
<td>1</td>
<td>PP, WK</td>
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<tr>
<td><strong>Poison Pills w/o Flip-Over Prov.</strong></td>
<td>12 *</td>
<td>9</td>
<td>6</td>
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Table 6

A Review of Defensive Strategies

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<th>Types of Strategies</th>
<th>Extent of Success &amp; Failure</th>
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<tr>
<td>(6) Self-Tender</td>
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<tr>
<td>(13)* White Knight</td>
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</tr>
<tr>
<td>(5) Poison Pills w/Flip-</td>
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<td>(12)* Poison Pills w/o Flip-</td>
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<td>(3) Lockup (Asset and/or)</td>
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* One Case is Pending
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<tr>
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<th>Successful</th>
<th>Successful w/(C)</th>
<th>Unsuccessful</th>
<th>Unsuccessful w/(C)</th>
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<td>8.00</td>
<td>7.00</td>
<td>6.00</td>
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<tr>
<td>Successful w/(C)</td>
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Note: The table compares different strategic maneuvers in M&A deals. Each category represents the number of deals where a particular strategy was used, with variations in success and whether the move was accompanied by a condition (C).
CONSOLIDATION IN THE BANKING INDUSTRY:

A hostile market or industry is one in which too many competitors are pursuing too little customer volume. And when demand declines, hostility begins. But when hostility continues through the recession and into the expansion phase, the cause then, is increased competition. The problem, then, is too many players. And, the banking industry is witnessing precisely that—too many players for too little a market. The banking industry is consolidating at an unprecedented pace. 1995 was a year of megadeals, especially for the banking industry. Record breaking 400 bank deals, worth $58 billion, were announced last year while world-wide consolidations amounted to $154 billion. In contrast to the 80’s, when consolidation resulted primarily from bank failures, the 90s’ shrinkage in the banking industry is more often associated with competitive factors as a result of globalization and the changing regulatory environment. In fact, competition in the banking industry has never been more intense. For e.g. Blue-chip companies which were once banks’ traditional clients, can now easily obtain financing through the securities market. And middle-market businesses can turn to finance companies, such as GECC for favorable terms and credits that are subject to far fewer regulations. And retail customers too, may choose from a wide range of nonbank financial institutions that can deliver almost any financial product available in the market without establishing branches, in turn being able to provide services at competitive rates. To meet these competitive challenges, “cost containment” and “efficiency” have become the watch words of the banking industry. And one of the best ways to achieve these goals is by increasing the client base through diversification of financial products without significantly increasing overhead.

Banking is a mature industry with an antiquated distribution system and no proprietary products. The only alternative left to achieve and sustain economies of scale is for the industry to rationalize, with banks becoming fewer in number and larger in size. And acquisitions offer
the banking industry precisely that, creating an effective synergy between two banks. Mergers and acquisitions have become an industry-wide response to competitive threats. In 1975, there were 14,000 U.S. commercial banks. By the end of 1994, the number of banks had shrinked to 10,592 and is expected to consolidate till it hits the equilibrium of around 5,000 banks.⁶

**First Interstate v/s Wells Fargo:**

On October 18, 1995, Wells Fargo and Company, a west coast behemoth in the banking industry, launched an unsolicited offer to acquire First Interstate Bancorp based in Los Angeles, CA. Wells used stock swap as the form of acquiring which was countered with the use of a white knight (First Bank System) as a defensive tactic by First Interstate. This friendly agreement between First Bank which is based in Minneapolis—a deal that looked competitive in the early stages—was favored heavily by the target’s stakeholders including California’s legislative authorities, its labor union and the community in general as this merger was perceived to have fewer downsizing effects as a result of minimal overlapping (of market share). However, it became increasingly difficult for First Interstate to convince its shareholders that a First Bank’s union was in their best interest as Wells’ bid increased by approximately $1 billion. In comparison, Wells’ offer grew to dwarf First Bank’s by almost $1.5 billion over the course. Besides, First Bank received a major blow when SEC ruled that First Bank must suspend its stock buyback plan, a key element in its financing, for two years instead of the expected 90 days. With these factors combined, Wells Fargo and Company was eventually successful in acquiring First Interstate Bancorp for $10.93 billion. First Bank System also profited from this experience as it pocketed away $200 million in breakup fees.

As concluded later, and now substantiated by this example, white knights by themselves do not prove to be an effective form of defense. There are two main reasons which tend to affect

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this conclusion. As cited earlier, the change in the mindset of corporate America in response to globalization has had an aggregate effect on the economy forcing a structural change on the aggregate level. With respect to M&A's, this reflects a major shift in the intention of corporate raiders: To acquire targets for strategic purposes and not for short-term gains. Given these new parameters, a typical raider these days does not think twice to increase the takeover bids repeatedly, as long as the mission is completed. Secondly, white knights, the friendly acquirer, comes at an opportunity cost to the target's shareholders: Lost spread from a potentially higher takeover premium.

With these factors combined, I came to the conclusion that white knights by themselves fail to guard the target from hostile raids. However, my evidence does indicate the high success rate of white knights when used in a combination with other defensive measures such as "discriminatory" poison pills (w/o flip over provision). Antitakeover amendments, popularly known as shark repellents, along with legal defenses when combined with white knights, also prove to be effective.
CONCLUSION:

Empirical evidence indicates that the "discriminatory" poison pills, some defensive adjustments in asset and ownership structure through charter amendments, and targeted share repurchases have negative effects on stock prices but they reduce the success rate of takeover bids. These measures are sufficient by themselves but work better when used in combinations. Negative effects do not appear to be limited to those defensive measures that do not require shareholder approval. White knights when used in a combination with poison pills and self-tenders, proved to be highly effective. However, that comes at a cost to the shareholders–almost all cases showed the target management having had to settle for a lower bid. While self-tenders from my sample data generated a 100% success rate, they were used by themselves and in combination with proxy fights, legal defenses, and pills. Self-tenders are great for the shareholders who tendered their shares, but could adversely hit the remaining shareholders if the company fails to make up for the lost spread through its future earnings. Unlike most defensive actions taken in reaction to explicit takeover attempts, leveraged cash-outs do not negatively affect shareholder-wealth as the recap is always undertaken at a substantial premium over the stock’s market value.

Nondiscriminatory poison pills (mostly flip-over plans) and other types of antitakeover amendments including antigreenmail amendments, golden parachutes and poison puts do not show clearly, the negative effects on stock prices. However, this does not necessarily imply that they are not harmful to shareholders because they may signal an increased likelihood of a takeover bid as they may not be viewed as an effective defense by the market. Legal aid by itself does not provide good defense except in cases of outright antitrust violations (Microsoft-Intuit) which however, are rare to begin with. Litigation by targets are intended to increase the takeover premium or gain some time through its delaying effect to prepare for a planned defense.
What is the ultimate end of the game? Money. More money. And still more. The ultimate objective is not to win this takeover or that merger; it is to make money on the outcome. “Winning” control of this corporation or “losing” control of it to someone else is, in the larger scheme of things, essentially irrelevant. In the final analysis it is the monetary tally that matters. A raider can win by losing if he buys stock in the target firm early and at a lower price, and sells out later at a substantially higher price. He can get “greenmail” just for agreeing to desist from further attacks on a target company. A corporate acquirer can be “defeated” by a white knight, and fail to gain control of a targeted victim, but win by making millions on the sale of the target’s stock it had already acquired. Management can lose control if an outside raid succeeds, but win from golden parachutes that trigger multimillion-dollar severance bonuses, lifetime salaries, and even home mortgage buybacks.

The point of the game is profit. But as befits so bizarre a game, it is a peculiar kind of profit: profit without production. The game is played not to enhance manufacturing efficiency and productivity, not for research, development, and technological innovation, not to expand jobs for workers and raise the national standard of living, but in order to make profit for the players. Profit from intrigue. Profit from cunning and financial chicanery. Profit from threat, bluff, and

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counterattack. Profit from shuffling paper ownership shares. But above all else, profit without the burden of producing durable, tangible, real economic wealth. And all this is being done in the name of achieving "economies of scale".

**PRECAUTIONS**:

**Understand the Environment**: Threat is the key to being prepared. If you don’t know who might be aiming for an attack on your company when, your chances of survival—no matter what the merits of deal—are slim. Obvious place to watch: companies that need what you have and have the resources to do so. For example, IBM was looking to strengthen its software strategy; its unsolicited offer for Lotus shouldn’t have been surprising. Another important source of danger that most executives overlook are the annual reports of companies being priced in foreign currencies. Hence, even where a U.S. company looks fairly priced compared with domestic competitors, it may look cheaper in marks or yen.

**Beat the Raider at his own Game**: When a manager gets serious about making his company takeover-proof, he usually starts assessing his company the way a potential acquirer would. This involves benchmarking oneself on certain important financial measures such as stock market valuation, margins, and returns on capital relative to the industry average. For example, How would a buyer run your enterprise with more leverage? Which banks are likely to back a hostile bidder and at what rates and terms of financing? What return on equity could the raider reasonably expect? And finally, is the current market value of your stock fairly priced? If the analysis concludes that the stock is underpriced, try boosting its value. This can be done by changing R&D spending policies, capital expenditure program, and restructuring employee plans and other labor related plans. Wall Street usually reacts quickly and favorably to these changes. But be careful not to shoot yourself through suicidal defensive measures just because you think someone else is about to shoot you.
**Look Smart**: Don’t underestimate the importance of communicating often and openly with Wall Street. If analysts believe your company won’t disappoint them with quarterly earnings surprises or major strategic initiatives, the stock will tend to remain fairly priced, thus eliminating the undervaluation factor in hostile bids. When it comes to corporate control, a leader’s image in the press is an important reality and can play a crucial role in crises.

**Spruce up the Bylaws**: Despite all these preparations, one could still end up a target at an unfair price. Many executive teams, for example, fail to consider how their corporate governance mechanisms will work under the heat of a hostile bid. “Recapping” corporate charters as mentioned earlier in the paper, along with a combination of other defensive measures, can strengthen the company’s defense, necessary to bargain a fair price or refute the offer completely.
SUMMARY:

The key is in being proactive and not reactive. Companies should consider the following, in addition to their normal defensive planning:

Vulnerability to a proxy contest for seats on or control of the Board:

(1) Assure that staggered board mechanisms work and that certificate of incorporation and bylaw provisions dealing with the board of directors, cumulative voting and “lock-in” of these types of provisions would discourage unsolicited efforts to take control of the board.

Procedural control to conduct special shareholder meetings:

(1) Bylaws concerning the notice and voting requirements for shareholder meetings and voting by consent should effectively preclude shareholders from harassing the company by calling for a series of shareholder meetings to vote on disruptive shareholder proposals.

(2) Understand the limitations that the company may impose on shareholder proposals sought to be included within the company’s proxy statement.

Constantly oversee shareholder purchases and turnovers:

(1) This would help identify shareholders most likely to challenge the management and the Board through their trading patterns.

(2) Track trading in high volume periods and stay in close contact with investment bankers and proxy solicitors who can find out “what is really going on”.

(3) Know the background and history of individuals, entities and groups who make large purchases of your securities.

(4) Train investor relations personnel to report unusual or “revealing” shareholder inquiries to management.
(5) Compare trading volume with analysts’ reports.

(6) Evaluate trading patterns subsequent to purchase and sale filings by insiders.

(7) Be aware of arbs and investor groups that are known for “making things happen”.

Be familiar with Board appointees:

(1) Do background checks on prospective directors to determine their experience, involvement, and/or propensity to agitate for short-term maximization of shareholder value.

(2) Beware of investors and shareholder groups which demand representation on the Board of Directors.

(3) Consider when it does make sense to put an investor representative on the Board.

Understand and appreciate how the company is viewed by investors:

(1) Can the company’s value be enhanced if divisions are sold separately?

(2) How does deregulation and globalization affect the merger frenzy in your industry?

(3) Know on what basis is the company’s stock being marketed by the brokers.
GLOSSARY OF TERMS

**Bear Hug**: An unnegotiated letter offer, made directly to the target company's board of directors, that isn't very attractive but attractive enough to cause shareholder protests if the board refuses.

**Black Knight**: A party that makes a takeover offer that's hostile to the company's present management.

**Creeping Takeover**: A takeover by an acquirer that gradually buys enough open-market stock to control the firm.

**Crown Jewel Option**: Selling or optioning a firm's best assets to a third party to make itself a less attractive target.

**Drop-Dead Fee**: A fee paid to lenders by potential acquirers when the proposal fails and lines of credit to finance the acquisition aren't used.

**Flip-Over Provision**: A provision added to the charter of a target company allowing the conversion of preferred shares into common stock of the target company or acquiring company. This makes the takeover less attractive because it increases the number of shares that have to be bought.

**Freeze-Out**: Pressure on remaining minority stockholders to turn over their stock after a new owner has gained control of the company.

**Godfather Offer**: A tender offer so generous that management of the target company isn't in a position to refuse it.

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Golden Handcuffs: An employment agreement that makes it very costly for senior managers to leave the company.

Golden Parachute: Generous termination benefits approved for senior executives when someone else buys control of the company.

Gray Knight: A potential acquirer whose intentions aren't known; usually a third party that makes an offer to purchase a target after a black or white knight or both have done so.

Greenmail: The premium paid by the target to buy back its shares from a potential acquirer so that the acquirer will abandon the takeover attempt.

Jonestown Defense: Defensive tactics so extreme as to seem suicidal.

Junk Bond: A high-yield, high-risk debt often used to finance takeovers.

Killer Bees: A team of lawyers, bankers, and proxy solicitors kept on retainer by a company in case they are needed to fight a takeover.

Lady Macbeth Strategy: A tactic in which a third party appears to be a white knight but then changes and supports the hostile acquirer.

LBO: Taking control of a company using a high degree of debt in relation to equity. It stands for leveraged buyout offer.

Lockup Agreement: An agreement between the target company and the acquirer that makes the target very unattractive to any other acquirer.

Lollipop Tactic: Stopping a hostile takeover by allowing shareholders to tender their shares at a premium price if an unfriendly bidder buys a certain number of shares.

MBO: The purchase of a firm by its management (management buyout).

Mezzanine Financing: Intermediate-term LBO funding (two to ten years); investors often
receive equity in the form of stock options, warrants or convertible debentures as part of the deal.

**Nibble Strategy**: The purchase of a minority stock position in the target company followed by a tender offer for the remaining stock.

**Pac-Man Defense**: A tactic in which the target company tries to purchase control of the hostile acquirer before the hostile acquirer gains control of it.

**Poison Pill**: A tactic used by the target company to make the takeover expensive, such as issuing to common shareholders new preferred stock that they can profitably convert into common shares during a takeover attempt.

**Porcupine Provisions**: Corporate charter of bylaw provisions intended to thwart takeover attempts.

**Radar Alert**: Close monitoring of stock-market activity to determine if an outside party is accumulating stock for a hostile-takeover attempt.

**Raider**: A hostile outside party seeking to take control of a company.

**Recapitalization**: The radical alteration of the capital structure, such as the payment of a large cash dividend to shareholders, to make the target company less attractive.

**Reverse LBO**: An initial public offering by a company which was previously acquired in a leveraged buyout.

**Saturday Night Special**: A seven day cash tender offer for a company's stock. It usually begins on a Saturday so the target company has difficulty reaching its key advisers.

**Scorched-Earth Defense**: Tactic by the target to discourage acquirers by selling its assets,
making it unattractive, visions in the firm’s charter to discourage a takeover (such as poison pill).

**Showstopper**: Litigation designed to stop a hostile takeover attempt.

**Sleeping Beauty**: A takeover target.

**Stock Swap**: An acquirer offers a majority stake or a remaining interest of a portion of its public or private stock, rather than cash, as the principal consideration for the target company’s stock.

**Sweeping Purchase**: An acquirer makes stake purchases of all available shares with the intention of gaining control.

**Takeover**: The acquisition of one company by another.

**Tender Offer**: An offer (made directly to the shareholders) to purchase part or all of a company’s outstanding stock.

**Tidal-Wave Purchase**: A raider’s open-market purchase of a company’s stock in a short time period (the target company is overwhelmed).

**Tin Parachute**: Termination benefits for all employees in the event they lose their jobs following a takeover.

**White Knight**: A friendly firm or person who saves the company from a hostile takeover by taking it over.

**White Squire**: Attempts made by the target company to thwart an unsolicited or hostile bid by selling a block (less than a majority) of shares (usually convertible preferred with special voting rights) to a friendly third party.
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