Hostile Takeover Defense Strategies: A Practical Guide

What is a Hostile Takeover and How does it work?

A Hostile Takeover is often the result of the rejection made by the Board of Directors (BoD) of Company B of a friendly acquisition bid made by Company A, as Company A might still try to take control of Company B by going directly to the latter's shareholders and by making either a tender offer or stimulate a proxy vote behind the back of the BoD of Company B. The acquiring company's intention of taking over another firm is first marked by what is called the "toehold position", this term describes the acquiring company putting a foot in the door of the target company which involves the purchase of just less than 5% of the target's outstanding shares, the threshold at which the acquirer would be legally obliged to notify the trading authorities (e.g., the SEC) of its intentions in purchasing the stock and if it is planning to purchase more and how much. In fact, hostile acquirers keep below the 5% threshold as filing this SEC document would make the target firm aware of the takeover attempt. After the initial toehold position has been taken, the acquirer will keep making small purchases to go unnoticed or look innocent.

As anticipated, there are mainly two hostile takeover strategies, a Tender Offer or a Proxy Vote. Usually, only one of the two is used, but it is also possible to use both. A Tender Offer involves the acquirer making a bid to the target company's shareholders for their shares at a premium above market price (e.g., if the market price is $100, the offering price is $140, with a 40% premium). However, the offer is conditional and valid only if the acquirer is able to buy at least a certain number of shares, which is usually the remaining needed to gain control of the target company, if not enough shareholders welcome the offer, then the bid is cancelled. A Proxy Vote, instead, consists in the acquirer influencing shareholders in using a collective proxy vote to replace the target company's management with a more takeover friendly one which will then vote itself to allow the change of ownership. Most takeover attempts and strategies' success depend highly on whether current shareholders of the target company are happy with the current management, so if the latter is able to maximize shareholder value.

Pre-Offer Mechanisms

Despite the strategies through which hostile takeovers can be achieved, there are also strategies through which target companies can deter the attacks. Below we are going to explain a few of them, starting from Pre-Offer Mechanisms and also going through some real-life examples.

Poison Pill

First on the list is the so-called "Poison Pill" which involves the current management of the target company in allowing current shareholders to purchase more shares in the case of a change in ownership. As more shares are issued, the Poison Pill dilutes the voting rights of the current shares and the potential acquirer would need to purchase more shares to reach 50% ownership, making the takeover harder and less attractive.

The word "poison pill" comes from the time of wars and espionage, when spies brought poison pills that could be swallowed to avoid detection. If they thought they were about to be captured, spies might take these drugs, similar to how a target company would use poison pills to prevent hostile takeovers.

Wachtell, Lipton, Rosen, and Kantz were the first to use this strategy. During a takeover battle in the 1980s, Martin Lipton invented the technique as a shield. His client, a firm called General American Oil, was in the sights of T. Boone Pickens. Martin Lipton instructed General American Oil's board of directors to flood the market with new shares of the company's stock, diluting the equity and making the purchase even more costly.

Various methods have progressed since Lipton's use of the poison pill. The overall goal is to deter any outside takeover attempts by making the company less appealing or placing existing shareholders in a stronger position. Both of these objectives can be met by selling existing shareholders cheaper shares, thus diluting the future equity received by the acquirer and thus providing more equity to current shareholders.

The following three types of poison pill may be enacted:

- **Flip-in:** Established shareholders will buy company shares at a discount under the flip-in strategy. This discount is often significant, enabling current shareholders to combine their equity claim in the company's non-acquired part. This right to purchase is granted prior to the completion of the takeover or merger, and it is usually triggered when the acquirer reaches a certain ownership percentage threshold. The acquisition of discounted company stock dilutes the acquirer's equity, lowering the value gained for the price paid. Since each share now owns a smaller portion of the corporation, all shareholders now have equal voting power on the board. Current shareholders (excluding the acquirer) would, however, have essentially centralized control as a result of the discounted stock acquisition.
- **Dead Hand:** Once a certain number of shares have been purchased by the unwanted acquirer, new ones are automatically issued to every other existing shareholder, leading the aspiring owner's stock holdings, or percentage of ownership in the company, to become massively diluted. Although earlier court rulings prohibited the use of dead hand and no hand pills, more recent rulings have upheld their use.
- **No hand (slow hand):** Shareholder rights plan that prevents any member of a newly elected board from redeeming the rights to permit a takeover, if the majority of the new board is nominated or supported by the hostile bidder.

Staggered Board

Another important defense strategy is the "Staggered Board" which consists in grouping members of the BoD into different Classes, and once per term only one Class of directors is open and can be elected. Since the hostile acquirer is looking to replace the BoD, it would take more time to reach the majority in the BoD as only a few Directors can be replaced each term. For example take two firms, the first has a BoD of 20 Directors which is unitedly re-elected in a year, and the second has a BoD made of 20 Directors grouped equally in 5 Classes and one class per year is re-elected. If a hostile acquirer would target the first company, it could change 11 Directors and gain the majority just in one yearly election. Instead, if the acquirer was to target the second company, then it would need at least three years to change 11 Directors and gain the majority.

Poison Put

Poison Put is another strategy which aims to prevent a hostile takeover. Unlike the Poison Pill, it aims to do so through bond, rather than stock. issuance. Its beginnings can be traced back to the 1998 KKR's $25bn takeover of RJR Nabisco. Due to a significant part of the deal being debt financed, the asset manager decided not to refinance Nabisco's debt, deeming it outstanding and reducing the company's value by $1bn. As such, the Poison Put was devised as a tool to protect the existing debt holders from unexpected ownership changes.

However, it evolved to become one of the methods protecting companies from hostile takeovers. As mentioned, the practice relies on issuing new debt with a set maturity. Unlike a usual bond, it contains a covenant which implies that in case the company is acquired, the bond will be redeemed before the initial maturity. As a result, the new owner will be obliged to instantaneously repay the outstanding debt, thus inducing a severe financial strain. Overall, the Poison Put increases the sum to be paid for acquiring the target company by the debt to be repaid in case of acquisition.

This type of defence against a hostile takeover can substantially increase the cost of potential acquisitions, effectively rendering them economically illogical, marked by an extremely high mark-up. If initial valuations set a company at $100m and $50m of bonds are issued, then the transaction automatically increases by 50%. Further, some Poison Puts exercise a premium in case the bond is redeemed early. That only further increases the debt which needs to be repaid after the target company is acquired. Nevertheless, the method may be perilous for heavily indebted firms. Although bond issuance does not dilute the ownership structure, it obliges the issuer to repay the borrowed amount, obviously. Hence, if too much debt is issued, it can actually backfire, inducing growth hampering financial troubles.

Example of a Poison Put in use is a 2010 unsuccessful takeover of Casey's General Stores (NASDAQ: CASY) by Couche-Tard (TSE: ATD.B). In Casey's notes there was a costly and unusual "poison put" feature in favor of the noteholders, designed to entrench Casey's Board and management at the expense of the Casey's shareholders. Under the "poison put" feature associated with the notes, Casey's is required to pay the noteholders approximately $95m in penalties based on current treasury rates, in addition to the outstanding principal amount and accrued interest on the notes, if any party acquires 35% or more of the outstanding shares of Casey's. The financing makes it almost $2 per share more expensive to acquire Casey's - that is $2 that could have gone to the shareholders but instead were designated for noteholders in the event of any such acquisition.

Golden Parachute

Parachutes save lives. Golden Parachutes do not, but they are interesting nevertheless and worth knowing. Behind the term hide clauses which remunerate top executives in case a company is acquired. The aim is, of course, to deter a potential hostile takeover by decreasing the value of assets through high severance packages. These may include stock options, bonuses, or increased severance pay.

The Golden Parachute is a mechanism as frequently used, as it is criticized. Although it does deter potential takeovers, it can also promote unhealthy practices and remunerate executives which underperform. As such, the critics of the method claim that the "parachutes" often act to harm the company and against the shareholders' duty to act in the best interest of the firm. The period after the 2008 financial crisis has seen a trend of reducing the bloated severance packages and other clauses initiated when a company is taken over. On the other hand, the proponents assert that the Golden Parachute allows for easier retention and hiring of executives. Further, it can also remove potential drags in a merger process by reassuring current executives that their spots will be retained. However, as it may be easier to justify in industries prone to mergers, it is hard not to see the problem with gigantic sums paid to some CEOs.

More recently, a golden parachute was at the center of a blocked merger between Staples (NASDAQ: SPLS) and Office Depot (NASSDAQ: ODP). The CEO of the latter was set for a $31m pay-out had the merger went through. Nevertheless, even high eight figure sums do not prevent takeovers. One of the more recent examples is Meg Whitman, who received a total of $35.6 m of severance after Hewlett Packard's (NYSE: HPQ) disintegration in 2016. Also in 2016, when Dell merged with EMC (NYSE: EMC), the latter's CEO received $27 m in compensation. Overall, at the end of the day, there is a limited number of executives which must be paid off in case of a takeover. Hence, although often extremely high, the Golden Parachute's shouldn't be considered as the most effective methods of preventing a hostile takeover.

Post-Offer Mechanisms

Post-offer defense mechanisms are used after a target company receives a bid for a hostile takeover. Unlike pre-offer defense strategies that are more concerned with proactive steps, post-offer defenses are employed when there is a real threat of a hostile takeover. The examples of post-offer defense mechanisms are the following.

Greenmail Defense

The Greenmail defense refers to the target company buying back shares of its own stock from a takeover bidder who has already acquired a substantial number of shares in pursuit of a hostile takeover. It is a costly defense, as the target company is forced to pay a substantial premium over the current market price in order to repurchase the shares. In exchange for receiving the premium and profit, the raider agrees to halt attempts at a hostile takeover. Although this strategy is legal, the acquirer is effectively blackmailing the target company, in that the target must pay the acquirer a premium, through the share buybacks, in order to persuade it to cease its takeover attempt.

How does it work?

1. Company A acquires a large stake in company B by purchasing shares from the open market.

2. Company A threatens a hostile takeover but offers to sell the shares back to the target company at a premium price (above market value) and promises to leave the target company alone upon the target company repurchasing the shares.

3. Company B uses shareholder money to pay the ransom but company B's value is reduced, and Company A walks away with a significant profit.

One famous example involved Goodyear Company and Sir James Goldsmith. In 1986, Sir James Goldsmith held an 11.5% stake (at an average of $42.20 per share) in Goodyear Company and threatened to take over the company for $4.7bn ($49 per share). In response, Goodyear agreed to repurchase the existing shares from Sir James for $49.50 per share ($620.7m), provided that Sir James refrained from purchasing any Goodyear stock for 5 years. In the end, Sir James made about $93m in profit. Additionally, to prevent another takeover attempt in the future, Goodyear offered to repurchase 40 million shares, with 109 million shares outstanding, at $50 per share, in an open offer to all shareholders. Ultimately, the defense strategy cost Goodyear more $2.6bn.

Crown Jewel Defense

When there is a takeover attempt by another company, often the goal of the acquiring company will be to obtain the most valuable information and operations that make up the "crown jewels" of the target. The crown jewel defense strategy involves selling these assets, often at a discount, to a third party or spinning off the assets into a separate entity. A company can employ this defense by creating anti-takeover clauses which compel the sale of their crown jewels if a hostile takeover occurs. The main goal of the crown jewel defense strategy is to make the target company less attractive to the raider since the acquirer would not receive the desired operations or information if they proceeded with the takeover.

How does it work?

1. Company A approaches Company B with a bid offer to purchase the company.

2. Company B rejects the bid offer.

3. Company A pursues the acquisition anyway by offering to buy shares of Company B at a premium.

4. Company B reaches out to a friendly company C to purchase Company B's assets. Company B and Company C sign an agreement that Company B will purchase back its assets at a slight premium once the hostile bidder is gone.

5. Since the most valuable assets of Company B are gone, Company A retracts its hostile bid.

6. With the hostile bidder gone, Company B repurchases its assets from Company C at the predetermined price.

A real-life example of this practice is the Suez-Veolia case, two water and waste management leaders in France which since October 2020 are still today in a dispute, as last year Veolia launched a takeover attempt of Suez purchasing as much as 29.9% of stock for $3.4bn.

The announcement of a takeover defense strategy intended to permanently discourage Veolia triggered a sell-off, which left Suez's shares trading further below Veolia's 15.50 euro offer. In the event of a complete takeover, Veolia has publicly stated that it will sell Suez's French water company to appease antitrust authorities. Suez has taken steps to protect the asset by enacting a security known also as "the crown jewels." The plan is to create a Dutch foundation to own a symbolic yet powerful piece of the division, ensuring that it does not become isolated from the rest of the community. It is hardly a foolproof defense if the objective is to make Suez unbuyable. For example, in an attempt to fend off Lakshmi Mittal in 2006, steelmaker Arcelor tried and failed to do anything similar, though it did end up receiving a higher bid. Suez's strategy may be undone if the board receives a sufficiently compelling bid. Veolia, overall, is unlikely to see this as a deal breaker on its own.

Pac-Man Defense

The Pac-Man defense occurs when a target company attempts to acquire its potential acquirer when a takeover bid has already been received. Just as the acquirer is attempting to buy up a controlling number of shares in the target company, the target likewise begins buying up shares of the acquirer in an attempt to obtain a controlling interest in the acquirer. Such a strategy is only possible if the target company has enough financial resources to purchase the required number of shares in the acquirer. In an attempt to scare off the would-be acquirers, the takeover target may use any method to acquire the other company, including selling its own assets and non-core business units, borrowing cash, and using its war chest. The acquirer, seeing control of its own firm threatened, will often cease attempting to take over the target.

How does it work?

1. Company A is attempting a hostile takeover of Company B by purchasing shares of Company B, with the goal of obtaining a controlling interest.

2. Company B realizes this and uses its assets to purchase large numbers of shares of Company A.

3. Company A sees the potential risk of being taken over by Company B and decides to abandon its hostile takeover attempt.

White Knight Defense

The white knight defense is a strategy that involves the acquisition of a target company by a partner company, called a "white knight", as it is friendly to the target. Typically, the white knight agrees to pay a premium above the acquirer's offer or agrees to a restructuring supported by the target company's management. This is generally a strategy of last resort. The target company accepts the fact of being taken over, but can at least opt to be taken over or merged with a friendly company, as opposed to being the victim of a hostile takeover. The company sees the friendly bidder as a strategic partner, one who will likely keep the current management in place and who will provide shareholders with better value.

How does it work?

1. Company A approaches Company B with a bid offer to purchase the company.

2. Company B rejects the bid offer.

3. After its offer is rejected, Company A attempts a hostile takeover of Company B. It is now cast in the role of a black knight.

4. Company C sees that Company B is undergoing a hostile takeover attempt by Company A.

5. Company C offers to buy Company B by offering better takeover terms and a promise to retain the current management team and preserve the company's core business. It is now acting as a white knight.

In 2008, global investment bank Bear Stearns sought a white knight after facing catastrophic losses during the global credit crisis. The company's market capitalization had declined by 92%, making it a potential target for a takeover and vulnerable to bankruptcy. White knight JPMorgan Chase & Co. agreed to purchase Bear Stearns for $10 a share. While this was a far cry from the $170 a share the company traded for just a year earlier, the offer was up from the $2 a share JPMorgan initially offered shareholders.

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