# A primer on Takeover defence

## *Introduction*

A hostile takeover is defined as the sum of the actions of an entity to take control of a company, by acquiring more than 50% of its voting shares without the knowledge of or against the will of the acquired company's management. Hostile takeovers are often attempted after a failed friendly negotiation when the acquirer decides to go around the board of directors that had objected to the acquisition. When attempting a hostile takeover, an acquirer might decide to adopt different strategies to take over a firm. The most common is a tender offer, where the acquirer will publicly announce an offer to purchase shares of the company at a premium, with the ultimate objective of obtaining enough voting shares to reach a controlling stake in the target's equity to complete the deal. Another one is a proxy fight, which aims at replacing a good portion of the board members by persuading existing shareholders to vote out current management. Lastly, an acquirer can attempt to purchase enough shares of the company on the open market to gain control. Hostile takeovers differ from friendly acquisitions, as in the latter the target's board of directors approves the acquisition and there are many different negotiations between the two parties before an agreement is reached.

There are different reasons to attempt a hostile takeover, and they are usually similar to the reasons why a friendly acquisition was attempted first. They often include the belief that the company may be significantly undervalued, the desire to gain access to the target company's brand, technology or industry footage, and the idea moved by institutional investors looking to effect change in a company's operations. Target companies for hostile takeovers exhibit similar characteristics from a financial analysis perspective, with low financial performance (EBIT/ASSETS) and low DEBT/ASSETS or low DEBT/EQUITY ratios. The reason why companies that display low levels of debt are considered more attractive for a hostile takeover is because they are seen as complacent and unwilling to seek resources to invest and promote company growth and, in turn, shareholder returns.

As for financial indicators, target companies for hostile takeovers are usually part of industries or markets with specific features that contribute to their chance of being acquired through a hostile takeover. Such features include, for example, the ownership structure of the market, with dispersed ownership structures more likely to undergo hostile takeovers since they are considered not as monitoring the board of directors closely. Other market characteristics that make a company more desirable to hostile investors are low entry barriers and loose regulation, which may lead to the development of a market for corporate control, especially if the country where the firm is located is going through an economic crisis. Other factors include the business cycle (measured through GDP growth rate), with evidence of an increase in hostile takeovers in times of positive growth rate, macroeconomic uncertainty (negatively correlated to hostile takeovers) and domestic freedoms, which are positively related to takeover activity.

Despite there being several features of companies that might make them a possible target, managers have figured out different actions to either prevent or stop a takeover attempt, collectively known as takeover defence strategies. Takeover defence strategies can be either preventive or active, depending on whether their purpose is to defeat outstanding takeover proposals or to prevent the event of a possible hostile takeover, and can range from mild to severe, depending on whether their objective is to force bidders to restructure their offers or to block takeover bids. While looking at takeover defence strategies, we consider the rationale behind takeover defence beyond managers ultimately retaining their positions. One possible reason is that they believe that the firm has hidden value, as managers have access to future prospects, such as ideas, patents and other private information that is not reflected in market prices. Thus, the value that they have estimated for the firm, which will be compared to takeover

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bids, will exceed the market price of the firm's stock and might be higher than the bids. Another reason to resist takeover attempts is that managers believe that their resistance will increase the stock price, and therefore even add value to stockholders. Indeed, while the negotiations are direct in a friendly merger or acquisition, they are often public and can go on for a long time in a hostile takeover. In these situations, target shareholders lack a bargaining agent and might benefit from a defence strategy to increase the share price. By slowing down one bidder, other potential competing bidders gain the opportunity to enter the auction for the target firm.

## *Preventive defence measures*

### Staggered board

Companies may adopt a staggered board approach, wherein the election of board members is structured in a way that members serve for terms typically lasting three years, with only about one-third, or even fewer, being elected each year. When a company utilizes a staggered board, an acquiring entity is compelled to win multiple consecutive annual elections to obtain a majority, making it a prolonged and uncertain process.

As a result, the literature has developed two opposing theories on layered board setup impact, finding evidence supporting both. This framework acts as a substantial defensive shield, impeding undesired takeover attempts by increasing complexity and lengthening the period a potential acquirer needs to assume control, while also allowing managers to focus on long-term objectives and negotiate better deals, leading to a positive impact of takeover defences on the bidding process: shareholders do receive higher deal premia from the increased negotiating power, as in the shareholders' interest hypothesis.

Nonetheless, this method has its limitations. According to the managerial entrenchment hypothesis, management opportunistically uses this takeover defence to defend their job against takeover threats. Insulating from the market-for-corporate-control discipline, shareholders and the firm are damaged because of a diminished sense of responsibility among the management, who might lack the incentive to achieve peak performance if they are shielded from immediate removal.

### Poison pill

The poison pill is a strategic mechanism deployed by companies to deter hostile takeover bids. This strategy includes various forms, such as the "flip-in" poison pill, which enables existing shareholders the opportunity to buy additional shares at a discount if an outsider tries to acquire a substantial stake, often defined as more than 20% of the company's shares, without board approval. Another approach, namely the "flip-over" poison pill, permits the shareholders of the target company to buy shares in the acquiring company at a reduced price once a merger is finalized. These strategies efficiently dilute the equity of the aspiring acquirer, making the takeover more expensive and less appealing. Beyond its defensive utility, the poison pill can empower the targeted company in negotiations, potentially securing higher premiums for its shareholders in any eventual sale. Nonetheless, this strategy has its own risks too. Indeed, the usage of these types of defensive takeover strategies can lead to distrust among shareholders because they may see these as moves by management to entrench themselves at the expense of shareholder interests, particularly if it makes it more difficult for shareholders to benefit from premium offers for their shares.

A notable example of a company deploying the poison pill defence strategy was Twitter in 2022, which activated this approach after Elon Musk acquired just over 9% of its common stock. This move by Twitter aimed to prevent any entity, person, or group from gaining control via open market accumulation without offering a fair control premium to all shareholders or allowing the board sufficient time to make informed decisions; Subsequently,

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Twitter's board unanimously accepted Musk's $44bn buyout proposal on April 25th, transitioning from a defensive stance to reaching an agreement on the acquisition.

**Golden parachutes**

Golden parachutes involve contracts that grant significant severance benefits to senior executives if the company experiences a takeover or similar change in leadership. These benefits often include additional compensation, equity options, and enhanced retirement plans, effectively increasing the financial burden on potential acquirers and acting as a deterrent, all while securing the economic interests of the company's upper management. The relevance of such arrangements notably escalated in the US during 2022, with the average exit compensation for CEOs soaring to $12.9m, a 62% increase from the $7.9m recorded the previous year. Keeping the takeover of Twitter as an example, Musk, after closing the takeover of the social network company, immediately decided to remove the chief executive, Parag Agrawal, finance boss Ned Segal, and Vijaya Gadde, the head of legal, policy and safety. As a matter of fact, the three of them, under the golden parachute clauses, were entitled to $122m in compensation for previous share awards, a year's salary plus some insurance payments. Nevertheless, golden parachutes come with their share of controversies. Critics argue that they can be a poor use of company funds, especially when the payouts are exorbitantly high and they might also create a moral hazard, where executives could make decisions that are not in the best interest of the company or its shareholders, prioritizing their financial gain over corporate health.

## *Active defence measures*

**White knight**

The white knight defence occurs when a friendly acquirer intervenes in a takeover bid by purchasing the target company. Typically, this manoeuvre is deployed when the target company is on the brink of being acquired by an unfriendly bidder, often referred to as the "black knight". While the target's management and board still have to concede the potential loss of independence and majority ownership, the white knight's offer is preferred because it presents more favourable acquisition terms compared to the original hostile takeover. An alternative approach within this defence strategy is called White Squire, where the friendly acquirer purchases only a partial stake in the target company, sufficient to repel the hostile acquirer but without having majority control. Once the original threat of a hostile takeover is fent off, the third party typically divests its shares, allowing the target company to maintain its independence. In exchange for obstructing the hostile takeover, it may receive various compensations, such as a board seat, generous dividends, or discounted shares.

Although a white knight defence may not be the optimal scenario for a target company, it often represents the lesser of two evils. As a matter of fact, white knights often agree to retain the existing leadership team, refrain from divesting core business units, and continue operations at some specific facilities. However, given the fact that the target company is still ultimately sold and that management may struggle to find a white knight acquirer, this defence strategy is relatively infrequent. One of the most recent cases resembling a white knight strategy was Disney's [NYSE: DIS] acquisition of 21st Century Fox in 2018. The two parties had found an initial agreement for the acquisition when Comcast [NASDAQ: CMCSA] tried to disrupt the deal with an unsolicited higher bid. Disney then responded by elevating its offer, in a similar style to a white knight move, and ultimately completed the acquisition for $71.3bn. It must also be noted how the idea of a white knight acquirer also finds application in the context of purchasing distressed companies undergoing bankruptcy or insolvency proceedings. A notorious instance is JPMorgan's [NYSE: JPM] acquisition of Bear Stearns in 2008, following a staggering 92% decline in its stock price in the aftermath of the Great Financial Crisis.

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**Pac-Man strategy**

Deriving from the analogy to the classic arcade game, in a "Pac-Man" defence strategy the target company aims to prevent its hostile takeover by attempting to take over the acquiring company instead. Its primary aim, like any defensive strategy, is to render the acquisition extremely challenging for the acquiring company, with the hope that the attempt will be abandoned. As a matter of fact, the target company usually does not see the acquisition of the black knight as its end goal, but simply uses it as a threat to discourage the takeover.

For a company to execute a Pac-Man defence effectively, the target must possess substantial resources, as it essentially launches a hostile takeover of its own. This means having the financial capability to purchase a significant number of shares in the potential acquiring company, in order to pose a credible threat to the acquirer's control. Due to these reasons, it is a highly aggressive and expensive strategy. It often involves divesting assets or non-core business or increasing the company's debt burden to execute it. Shareholders may then suffer adverse consequences in the aftermath if the target company is compelled to sell vital assets, leading to a loss of value.

One of the earliest instances that made the Pac-Man known in US corporate history occurred in 1982, when Bendix Corporation sought to take over Martin Marietta, a firm specializing in aggregates and heavy building materials, by acquiring a controlling interest in Martin Marietta stocks. In response, Martin Marietta's management sold off multiple business segments and borrowed over $1bn to resist the takeover attempt by attempting a takeover of Bendix Corporation. This resulted in a protracted battle between the two companies, with Bendix Corporation eventually being acquired by Allied Corporation, acting as a white knight. This episode drew serious concern from SEC commissioners, although no federal prohibition was enacted. They acknowledged its potential benefits for shareholders under specific circumstances but emphasized that management employing this tactic must demonstrate that their actions are not solely driven by a desire to retain control. A more recent notable example of a Pac-Man acquisition defence occurred between German automakers Porsche [FWB: P911] and Volkswagen Group [FWB: VOW]. Porsche embarked on a hostile takeover of the larger Volkswagen Group by gradually acquiring a substantial stake in Volkswagen, eventually exceeding 75% ownership by 2008. However, following the 2008 financial crisis, Porsche faced financial difficulties as banks refused to extend further loans and demanded repayment due to breached covenants. This led the Volkswagen Group to capitalize on the situation by purchasing Porsche shares at a discounted price. Ultimately, Volkswagen succeeded in taking over Porsche entirely by 2012.

**Greenmail strategy**

From the combination of "blackmail" and "greenbacks", greenmail is a defensive strategy where a target company repurchases its shares at a substantial premium from the acquirer that was threatening a hostile takeover. The goal of Greenmail is to make a takeover financially unattractive to the acquirer by reducing its potential profits through the payment of a premium. Although it is not illegal, this strategy has raised legal and ethical concerns depending on its execution, as greenmail is often seen as a predatory practice where the acquirer profits from the premium without intending to carry on with the hostile takeover.

This defence strategy can be seen as a violation of fiduciary duty by the management of the corporation, who uses company funds to essentially retain their position without benefitting shareholders. Moreover, it is considered to be a costly and only temporary solution that does not address the issues that led to the hostile takeover, nor does it prevent future hostile bidders from demanding greenmail payments. For these reasons, laws and regulations have been introduced and made greenmail a much less common practice. For example, in 1987 the IRS introduced a 50% excise tax on greenmail profits and companies often have an anti-greenmail provision in their corporate charter, preventing the board of directors from approving greenmail payments.

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