Activist Shareholders Outfoxing Top Execs;

Seek more control over poison pills in takeovers

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Daniel Del'Re
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In medieval Europe, mothers who didn't want daughters to marry specific suitors would smear the girls' faces with charcoal and dress them in ugly clothes until the men went away.

The practice resembles what's happening in today's corporate governance scene. The only difference is that some daughters are hot to tie the knot while their mothers are not. Some moms even use the corporate equivalent of "poison" to scare suitors.

Lately, more and more shareholders at large firms are clamping down on provisions that let corporate boards and top executives pick merger or other deal partners.

The reason is money. Today's heated environment for mergers and acquisitions raises the stakes. It pushes shareholders to gain some control over takeover defenses.

Investors in acquired companies stand to reap hefty premiums on the market price of their shares when suitors emerge. Bidding wars have pushed up the value of deals by 15% to $1.1 trillion this year even though the number of M&As has fallen, says financial research firm Dealogic.

Whether top management should call the shots on M&As has big implications at a time when activist shareholders are rattling corporate boardrooms and executive suites.

Managers need to follow the issue closely since recent legal face-offs between companies and shareholders show that shareholders are gaining the upper hand. Some defensive strategies used by boards and managers to ward off unwanted takeovers may also be on the way out, if recent court cases are a guide.

Much of the ruckus has to do with a practice called poison pills.

Poison pills force a company to issue new shares or take on debt. This raises acquisition costs for would-be raiders and increases the price that investors get to tender their shares.

Top managers and boards defend poison pills as shields against corporate raiders who often want to take control of a company just to sell off its assets.

Corporate governance advocates, on the other hand, feel that poison pills deter takeovers and effectively insulate poorly performing managers and directors.

In 2005, shareholders voted on 86 proposals to restrict the use of poison pills and other anti-takeover board prerogatives, according to Institutional Shareholder Services, which advises investors on how to vote their proxies. So far this year, there have been 72 votes with 26 pending.

On average, almost 70% of voting shareholders favored these proposals, compared to 63% in 2005. Each of the 12 poison pill proposals that have gone before shareholders this year garnered a majority of votes.

The growing power of shareholders in takeovers was highlighted in September when Harvard Law School professor Lucian Bebchuk persuaded the Delaware Chancery, the most sophisticated corporate law court in the U.S., to let him include a proposal on the proxy of computer services giant CA, formerly Computer Associates.

Bebchuk, holding just 140 CA shares, wanted to change the company's bylaws so that poison pills would require shareholder approval or unanimous board approval.

At CA's Sept. 18 shareholder meeting, 41% of the votes were cast in favor of Bebchuk's proposal, which failed to get the majority needed to change the company's bylaws. Still,Bebchuk's camp felt he won a battle for shareholder rights simply by getting his proposal onto the proxy and in front of shareholders.

"We are glad that shareholders had the opportunity to consider the issue for themselves," said Michael Barry, Bebchuk's attorney. "That's really what we set out to do."

Proxies are the front line in the battle of anti-takeover defenses.

Proxies are legal documents that let shareholders vote on issues such as choosing auditors, selecting board members and considering proposals for bylaw changes.

Getting proposals on proxies gives investors a greater voice to demand change if their elected representatives -- board directors -- fail to hold management's feet to the fire. For this reason, boards often dispute whether shareholder proposals belong on the proxy.

Bebchuk's lawsuit follows recent shareholder efforts to use proxies to change corporate bylaws, including those covering poison pills.

There are more cases of shareholders getting a leg up. In April, News Corp. settled a lawsuit with shareholders by letting them vote on the existing poison pill. The vote's slated for Oct. 20.

In May, the trade union Unite Here included a proposal on Hilton Hotels' proxy asking shareholders to nullify the existing poison pill. Unite Here, which holds Hilton shares in pension funds for members, argued that the poison pill would discourage takeover offers that could provide investors a premium on their shares' market value.

In its proposal, Unite Here stressed that shareholders made out well in recent hotel acquisitions. Billionaire investor Carl Icahn in November offered a 23% premium over the average share price of Fairmont Hotels to acquire a majority ownership stake. That same month, buyout firm Blackstone Group offered a 33% premium over La Quinta's share price to acquire the discount lodging chain.

Ultimately, 68% of votes and a majority of Hilton's investors backed Unite Here's plan to dismantle the poison pill, a resounding victory for the union.

Hilton's board has gone on record disputing whether the proposal is binding.

In many cases, companies preempt legal entanglements with shareholders by getting the Securities and Exchange Commission to issue a "no action" letter stating that a refusal to include a proposal on a proxy would not violate shareholder rights.

When CA took this route to fend off Bebchuk, he sued. Vice Chancellor Stephen Lamb, presiding judge, said he could not decide the merits of either side's argument until shareholders had actually voted, but that SEC regulations would not let CA omit Bebchuk's proposal from the proxy.

Had shareholders voted in favor of Bebchuk's proposal, it would have become a bylaw, and then the legality of the issue would be "ripe" for adjudication, Lamb wrote in his brief.

Since Bebchuk failed to muster a majority of votes, the dispute between Unite Here and Hilton Hotels is the next front in the dispute over poison pills. "We expect to see this issue and others like it come to the forefront of the investing public's attention as shareholders seek to exercise more authority as owners of the corporations they invest in," said Bebchuk's attorney, Barry.

Some governance experts say poison pills are on their way out.

"I think the long-term future of poison pills, under Delaware law, is dim," said Charles Elson, head of the University of Delaware's corporate governance center. "Companies need to think of alternative ways to increase shareholder value."