

An Antidote for the Corporate Poison Pill

By Lucian Bebchuk

In a major decision issued last week, William Chandler of Delaware's Court of Chancery ruled that corporate boards may use a "poison pill"—a device designed to block shareholders from considering a takeover bid—for as long a period of time as the board deems warranted. Because Delaware law governs most U.S. publicly traded firms, the decision is important—and it represents a setback for investors and capital markets.

The ruling grew out of the epic battle between takeover target Airgas and bidder Air Products. Air Products made a takeover bid for Airgas in 2010, increased it several times, and kept it open until last week's decision. Airgas's directors argued that defeating the premium offer would prove, in the long run, to be in shareholders' interests. As the Chancery Court stressed, however, the directors based their opinion solely on information publicly available to shareholders. Why should shareholders, who have powerful incentives to get it right, not be permitted to make their own choice between selling and staying independent?

Chancellor Chandler stated that he would have preferred to let shareholders make the choice at this stage, as they "know what they need to know . . . to make an informed decision." But he felt that denying shareholders' right to choose was required by previous Delaware cases, which recognized directors' right to block offers out of concern that shareholders would accept them "in ignorance or a mistaken belief" concerning the value of remaining independent.

Yet the empirical evidence indicates that when directors use their power to block offers, it often proves detrimental to shareholder interests. A research project I am carrying out with colleagues John Coates and Guhan Subramanian has found that boards that defeated premium offers failed on average, even in the long run, to produce returns for their shareholders that made remaining independent worthwhile.

Moreover, the power of boards to block bids weakens the disciplinary force of the market for corporate control. A substantial body of empirical research indicates that boards' increased insulation from such discipline is associated with lower firm value and worse corporate performance and decision-making.

Despite the Delaware court's decision, investors still have recourse—because a poison pill is powerful only as long as the directors supporting it remain in place.

Airgas's directors were able to use a poison pill for more than a year because Airgas's board is "classified." As such, only one-third of directors come up for election in each annual meeting, so replacing a board majority requires waiting through two annual meetings.

If, by contrast, a company's shareholders could replace a majority of its board more quickly, the board's power to block a takeover bid would be correspondingly weakened.

Support for changing corporate governance arrangements to allow for board declassification is expressed in the proxy voting guidelines of many investment managers, including American Funds, BlackRock, Fidelity and Vanguard. Indeed, shareholder proposals in favor of board declassification have received average support exceeding 65% of votes cast in each of the last five years. This makes sense given the evidence (documented in a 2005 article I co-authored with Alma Cohen, and confirmed by subsequent research) that board classification is associated with lower firm valuation.

In response, public companies have been agreeing to declassify, thus committing not to block an offer favored by shareholders for too long. The number of S&P 500 companies with classified boards declined to 164 in 2009, from 300 in 2000. Still, there's a great deal of room for improvement: Among the 3,000 public companies with takeover defenses tracked by FactSet, about half still have classified boards.

While incumbents have for now won the right to use poison pills indefinitely, pressure by shareholders could substantially limit their toxicity. That would produce considerable benefits for investors and for our capital markets.

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