ANALYSIS OF TAKEOVER DEFENSES AND HOSTILE TAKEOVER

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Introduction

A takeover bid is an acquisition of shares carrying voting rights in a company in a direct or indirect manner with a view to gaining control over the management of the company. Such takeovers either take place through friendly negotiations or in a hostile manner.

When the takeover takes place in a hostile manner, i.e. against the wishes of the target company, the target company often adopts certain measures to prevent or discourage the acquirer from taking over the target company. In practice, these defenses often also serve as leverage that target companies could use in negotiating higher offers. Most of these defenses have evolved over the past 50 years. Some of them are required to be approved by the shareholders before they are carried out while others are not. Moreover, some are very strictly regulated in India while others are not. These defenses provide benefits such as stalling for time, providing direct competition to the bidder and threaten high transaction costs.

Most countries regulate these defenses by enacting laws. These defenses are challenged in court of law many times by the acquirers. The use and regulation of these defenses in India vary from those in other countries.

Takeovers and their Regulation in India

Takeover of companies is a well-accepted and established strategy for corporate growth. In India, there is a trend among the promoters and established corporations towards consolidation of market share, and diversification into new areas through acquisition of companies and in a more pronounced way through mergers, amalgamations and takeovers.

Regulation of takeovers in India

The first attempt at regulating takeovers was made in a limited way by incorporating a clause viz. Clause 40 in the listing agreement, which provided for making of public offer by any person to acquire 25% or more voting rights in a company. This was later brought down to 10%. Then came the SEBI Takeover Regulations of 1994 which was followed by the
setting up of Bhagwati Committee in 1995 to review these regulations. The SEBI Takeover Regulations, 1997 were based on the report of Bhagwati Committee. The Second Amendment Regulations were notified in 2002.

Regulation 23 of the SEBI Takeover Regulations 1997 deals with the general obligations of the target company. The Bhagwati Committee desired that the regulations should have definite provisions making it obligatory for the target company to transfer the shares and allow changes in the board of directors once the acquirers fulfill their obligations under the regulations.

The Committee Recommended that

- Till the offer formalities are completed, the target company shall be precluded from inducting any person or persons nominated by the acquirer or belonging to his group into the board of the target company or in management of the target company during the offer period (Reference: Part II of the Report - sub regulation (7) of Regulation 22 and sub-regulation (3) of Regulation 23).

- The target company shall exclude any person or persons connected with the acquirer from participating in any matter(s) relating to or arising from the offer (Reference: Part II of the Report - sub-regulation (9) of Regulation 22 and sub-regulation (3) of Regulation 23)

- Management changes can be made after closure of the offer and deposit of full amount in a special account with the bank. (Reference: Part II of the Report - proviso to clause (a) of sub-regulation (3) of Regulation 23).

- To begin a healthy trend as obtaining in developed markets, the board of directors of the target company, if they so wish, may send their unbiased comments on any bid to their shareholders keeping in view the fiduciary responsibility of the directors and for that purpose, seek the opinion of an independent merchant banker or a committee of independent directors. The directors of the target company shall be liable for any misstatement or concealment of material information in the discharge of this function. (Reference: Part II of the Report - sub-regulation (4) of Regulation 23 and sub-regulation (6) of Regulation 45)

- The board of directors of the target company shall facilitate the acquirer in verification of securities tendered for acceptances. (Reference: Part II of the Report - sub-regulation (5) of Regulation 23).

1. www.sebi.gov.in/Index.jsp?contentDisp=SubSection&sec_id=1&s.
Once the acquirer fulfills his obligations under the regulations as certified by the merchant banker, the target company shall:

- Transfer the shares in the name of the acquirer;
- Allow proportional representation on the board to the acquirer or give control over the company, as the case may be. (Reference: Part II of the Report - sub-regulation (6) of Regulation 23)

**Hostile Takeovers**

A hostile tender offer made directly to a target company’s shareholders, with or without previous overtures to the management, has become an increasingly frequent means of initiating a corporate combination. As a result, there has been considerable interest in and energy expended on devising defenses strategies by actual and potential targets. One of the largest hostile takeovers is the 200 billion takeover of German Co. Mannesmann by Vodafone.

Defenses can take the form of fortifying oneself, i.e., to make the company less attractive to takeover bids or more difficult to take over and thus discourage any offers being made. These include, *inter alia*, asset and ownership restructuring, anti-takeover constitutional amendments, adoption of poison pill rights plans, and so forth. Defensive actions are also resorted to in the event of perceived threat to the company, ranging from early intelligence that a “raider” or any acquirer has been accumulating the company’s stock to an open tender offer. Adjustments in asset and ownership structures may also be made even after a hostile takeover bid has been announced.

**Factors Determining Vulnerability of Companies to Takeover Bids**

The enquiry into such strategies is best initiated by an analysis of factors, which determine the “vulnerability” of companies to takeover bids. It is possible to identify such characteristics that make a company a desirable candidate for a takeover from the acquirer’s point of view. Thus, the factors which make a company vulnerable are:

- Low stock price with relation to the replacement cost of assets or their potential earning power;
- A highly liquid balance sheet with large amounts of excess cash, a valuable securities portfolio, and significantly unused debt capacity;

• Good cash flow in relation to current stock prices;
• Subsidiaries and properties which could be sold off without significantly impairing cash flow; and
• Relatively small stockholdings under the control of an incumbent management. 3

A combination of these factors can simultaneously make a company an attractive proposition or investment opportunity and facilitate its financing. The company’s assets may act as collateral for an acquirer’s borrowings, and the target’s cash flows from operations and divestitures can be used to repay the loans. 4

Analysis of different defenses and their Evaluation in India

Financial Defensive Measures to Hostile Takeovers

I. Adjustments in Asset and Ownership Structure

Firstly, consideration has to be given to steps, which involve defensive restructuring that create barriers specific to the bidder. These include:

1. Purchase of assets that may cause legal problems as this involves purchase of interest in companies with the excess cash before the target companies, in companies which are involved in serious litigation which would have bearing on the latter’s performance in the future.

2. Purchase of controlling shares of the bidder itself

3. Sale to the third party of assets which made the target attractive to the bidder, and

4. Issuance of new securities with special provisions conflicting with aspects of the takeover attempt. An example of this type of defense is found in Lenox’s defense against the takeover bid by Brown-Forman Distillers Corporation in June 1983

A second common theme is to create a consolidated vote block allied with target management. Thus, securities are issued through private placements to parties friendly or in business alliance with management or to the management itself. Moreover, another method can be to repurchase

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4. Ibid.
publicly held shares to increase an already sizable management-allied block in place.⁵

A **third** common theme has been the dilution of the bidder’s vote percentage through issuance of new equity claims.⁶ However, this option in India is strictly regulated vide Section 81A and Regulation 23 of the Takeover Code, 1997. A hostile bidder in these circumstances usually fails in the bid if the bidder has resource constraints in increasing its interest proportionately.

**II. The “Crown Jewel” Strategy**

A central theme in such a strategy is the divestiture of major operating unit most coveted by the bidder- commonly known as the “crown jewel strategy”. The hostile bidder is deprived of the primary intention behind the takeover bid. A variation of the “crown jewel strategy” is the more commonly known as radical “scorched earth approach”. Vide this novel strategy, the target sells off not only the crown jewel but also properties to diminish its worth.

However, the experts’ opinion is that such a radical step is self-destructive and unwise in the company’s interest. Firstly, divestiture of assets by the target company in the face of a hostile takeover bid will send wrong signals to the market. The market will have the knowledge that the divestiture has been resorted to in the face of self-preservation by the company. This will allow potential buyers of such assets to bid their time and allow the company to push the selling price of such assets to the minimum, even below its market price. Consequently, the benefits derived by the company as a result of such defensive restructuring will be minimal. On the contrary, the proceeds of the divestiture will, as usually is, be used in the repurchase of stocks at an inflated price on the market, the prices having skyrocketed consequent to the rumors of a possible takeover bid. A

Deeper analysis will reveal that the shares being purchased in the market at the inflated prices is worthless, as the “scorched earth strategy” would have left the company without any appreciable assets. The end result would be that the major stockholders of the company would be in control of an unduly high proportion of stock without any appreciable value.

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Legal Position in India

However, the practice in India is not so flexible. The Companies Act, 1956 has laid down certain restrictions on the power of the Board. Vide Section 293(1); the Board cannot sell the whole or substantially the whole of its undertakings without obtaining the permission of the company in a general meeting. However, there are no restrictions of the sale of a single immovable property, which does not form an undertaking. Hence, primarily there are no restrictions on the power of the Board to deal with the properties of the company, unless they are action against the interests of the company.7

The SEBI (Substantial Acquisitions and Takeover) Regulations, 1997 vide regulation 23 prescribes general obligations for the Board of Directors of the target company. Under the said regulation, it will be difficult for any target company to sell, transfer, renumber or otherwise depose off or enter into an agreement to sell, transfer, and encumbrance or for disposal of assets once the predator has made a public announcement. Thus, the above defense can only be used before the predator/bidder makes the public announcement of its intention to takeover the target company.

Similarly, Clause 40 B (12) of the Listing Agreement prohibits a company from selling its any assets of a substantial amount without obtaining the approval of the company in a general meeting.

III. The “Packman” Defense.

This strategy, although unusual, is called the packman strategy. Under this strategy, the target company attempts to purchase the shares of the raider company. This is usually the scenario if the raider company is smaller than the target company and the target company has a substantial cash flow or liquid able asset.

IV. Targeted Share Repurchase or “Buyback”

This strategy is really one in which the target management uses up a part of the assets of the company on the one hand to increase its holding and on the other it disposes of some of the assets that make the target company unattractive to the raider. The strategy therefore involves a creative use of buyback of shares to reinforce its control and detract a prospective raider. But “buyback” the world over is used when the excess money with the company neither gives it adequate returns on reinvestment

in production or capital nor does it allow the company to redistribute it to shareholders without negative spin offs.

**Legal Position in India**

Buyback of shares has been introduced in the Companies Act, 1956 and SEBI has come up with guidelines to regulate it. This allows the corporate to use it to safe guard against a prospective raider as well as to increase their earnings per share (EPS) and net asset value (NAV). The provision of buyback therefore allows a company to use its assets more productively. Despite the obvious advantages the actual process of buyback is strictly regulated by the regulations of SEBI in this regard to ensure transparency and accountability to protect the investors. The buyback can only be made from free reserves after getting approval from the shareholders via a special resolution. The reason for undertaking the buyback has to be disclosed as does the true financial position of the company. The company is further prohibited to make an issue of shares for a year after the buyback and cannot make such an issue to fund the buyback. If the offer to buyback is made during the period of a public offer it will have to comply with the conditions prescribed for a “competitive offer”. In addition, the offer once made cannot be withdrawn unlike a public offer under the Takeover Regulations. This means that if the raider withdraws its public offer it would imply that the target company would still have to go through with the buyback. This is an expensive proposition if the only motivation for going in for the buyback was to dissuade the raider.

**IV. “Golden Parachutes”**

Golden parachutes refer to the “separation” clauses of an employment contract that compensate managers who lose their jobs under a change-of-management scenario. The provision usually calls for a lump-sum payment or payment over a specified period at full and partial rates of normal compensation. This type of a severance contract has been increasingly used even by the largest Fortune 500 firms. By the mid 1980s, about 25% of the Fortune 500 firms had adopted golden parachute features in their employment contracts for top management. Expert’s view is that golden parachutes, by nature control-related contracts, help reduce the conflict of interest between the shareholders and managers in change of control situations.

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10. Ibid.
Legal Position in India

The primary provisions of law relating to the appointment and remuneration of directors of managing and whole time directors is contained in Section 269 read with Schedule XIII of the Companies Act, 1956. A review of Schedule XIII shows that the term of remuneration, which can be allowed without the approval of the Central Government, can hardly be called generous to an extent that would deter any prospective raider, even if provided at the maximum level possible.

Section 198 further lays down that an overall limit of remuneration to the directors at 11% of the net profits. However, the provisions, which govern a “golden parachute” employment contract in India, are Sections 318-320 which provides the compensation for loss of office. Thus, a perusal of the said provisions would lay down that payment as compensation for the loss of office is allowed only to the managing director, a director holding an office of manager or a whole time director. Therefore, a “golden parachute” contract with the entire senior management, as is the practice in the US, is of no consequence in India.

Moreover, payment of compensation is expressly disallowed if in the case of a director resigning as a consequence of reconstruction of the company, or its amalgamation with any other corporate bodies. An argument can be advanced that this provision would only apply to a director submitting his/her resignation, but not to dismissal from service vide a board meeting. However, corporate practice dictates that no director would actually remain in office after losing the confidence of its shareholder, in this case the acquirer of the company is a post-takeover situation.

Furthermore, there exists a maximum limit as to the quantum of the compensation, subject to the exclusionary categories, to the total of the remuneration the director would have earned for the unexpired residue of term of office, or three years, whichever is lesser.

Moreover, the Company Law Board had vide its notification opined that payment of any sum to a past or retiring Managing Director or whole time director would come within the purview of Section 310, and accordingly if is beyond the limits of Schedule XIII, would require the approval of the State Government. Thus, the restrictions in under the Companies Act, 1956

12. Section 318 (1) read with 318(3)(a) of the Companies Act, 1956.
13. Section 318 (3), the Companies Act, 1956.
are restrictive in nature do not allow the target company to put forth a substantial defense against takeovers in the form of “golden parachutes”.

**Practice in the USA**

An example of an extreme case is the golden parachute payment of $23.5 m. to six officers of Beatrice Companies in connection to its leveraged buyouts. One of its officers received a $2.7 m. package even though he had been with the company for 13 months.\(^{16}\) Another received a $7 m. package after being called from retirement 7 months before. Also in 1985, the Chairman of Revlon received a $35 m. package consisting of severance pay and stock options.\(^{17}\) However, it is the researcher’s opinion that even in these extreme cases the golden parachutes were small compared to the total acquisition prices of $6.2 b. in the Beatrice Companies and $1.74 b. in the Revlon acquisition. It thus appears that the cost of golden parachutes is approximately 1% of the total cost of a takeover in these cases.

**VI. Anti-takeover Amendments or “Shark Repellants”**

An increasingly used defense mechanism being used is anti-takeover amendments to the company’s constitution or articles of association, popularly called “shark repellants”. Thus, as with all amendments of the charter/articles of association of a company, the anti-takeover amendments have to be voted on and approved by the shareholders. The practice consists of the companies changing the articles, regulations, byelaws etc. to be less attractive to the corporate bidder.

**Legal Position in India**

Every company has the clear power to alter its articles of association by a special resolution as provided under Section 31 of the Companies Act. The altered articles will bind the members just in the same way as did the original articles. But that will not give the altered articles a retrospective effect.

The power of alteration of the articles as conferred by Section 31 is almost absolute. It is subject only to two restrictions. In the first place, the alteration must not be in contravention of the provisions of the Act, i.e., should not be an attempt to do something that the Act forbids. Secondly, the power of alteration is subject to the conditions contained in the memorandum of association, i.e., alter only the articles of the company as

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relate to the management of the company but not the very nature and constitution of the company. Also the alteration should not constitute a ‘fraud on the minority’.

Types of Anti-Takeover Amendments

There are four major types of anti-takeover amendments.

• 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. In most existing cases, however, the supermajority agreements have a board-out clause which provides the board with the power to determine when and if the supermajority provisions will be in effect. Pure or inflexible supermajority provisions would seriously limit the management’s scope of options and flexibility in takeover negotiations.18

• 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 the purchase of all the shares. The fair price is normally defined as the highest priced paid by the bidder during a specified period. Thus, fair-price amendments defend against two-tier tender offers that are not approved by the target’s board.

• Classified Boards

Another major type of anti-takeover amendments provides for a staggered, or classified, board of directors to delay effective transfer and control in a takeover. The much touted management rationale in proposing a classified board is to ensure continuity of policy and experience. In the United States, the legal position of such classified or staggered boards is quite flexible. An ideal example is when a nine-member board may be divided into 3 classes, with only three members standing for election to a three year term each, such being the modalities of the retirement by rotation. Thus, a new majority shareholder would have to wait for at least two annual general meetings to gain control of the board of directors.

In the Indian company law regime, the scope for such amendments is highly restricted. Section 255 of the Companies Act, 1956 is designed to

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eradicate the mischief caused by perpetual managements. At an AGM only one-third of the directors of the company, whose offices are determinable by retirement, will retire. Therefore putting the example in the Indian context, in case of 9 directors, 3 can be made permanent directors by amending the articles, i.e., one-third can be given permanent appointment, under Section 255. Thus the acquirer would have to wait for at least three annual general meetings before he gains control of the board. But this is subject to Section 284, which provides that the company may by an ordinary resolution; remove a director before the expiration of his period of office. Thus any provision in the articles of the company or any agreement between a director and a company by which the director is rendered irremovable from office by an ordinary resolution would be void, being contrary to the Act. Therefore to ensure domination of the board of the target management, there needs to be with the target management the strength to defeat an ordinary resolution.

- **Authorization of Preferred Stock**

  Vide such provisions where 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 a friendly party in a control contest. Thus, this device is a defense against hostile takeover bids, although historically it was used to provide the board of directors with flexibility in financing under changing economic conditions.

**VII. Refusal to Register Transfer of Shares**

Refusal by the board of directors to register a transfer is an important strategy to avert a takeover. The power to refuse can be present in the articles of association. This would bind the company and the members of the company, as an incident of the contract between them, i.e., the memorandum and articles of association. Therefore the registration of a transfer or a transmission cannot be insisted upon as a matter of right.

The articles of a public company can be used to confer absolute discretion on the board of directors to refuse to register transfer of shares. The object of such a provision is to arm the directors with powers to be exercised in special and exceptional circumstances where the transfer may be found to be undesirable in the interests of the company. Such a provision does not amount to a restriction on the free transfer of shares, as in the

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20. Section 256(1) of the Companies Act, 1956.
case of private companies. The power is fiduciary in nature and must be exercised bonafidely in the interests of the company.

On refusal of the directors to register the share sale, the Courts can interfere only in the following circumstances:

- malafide
- inadequacy of reasons
- irrelevant considerations

In *Bajaj Auto v. N.K. Firodia*, the Apex Court ruled that if the reasons given by the directors are legitimate the court will not overrule the decision merely because, the court itself would not have come to the same conclusion. However, after 1988 the CLB has wide powers to interfere with any abuse of power by the board.

The Supreme Court in *V. B. Rangarajan v. V. B. Gopalakrishnan*, held that the vendee can be denied registration of shares purchased by him on a ground stated in the articles. Thus, refusal to register on the grounds mentioned in the articles is within the meaning of ‘sufficient cause’ under Section 111(2) proviso of the Companies Act. The omission of Section 22A of the Securities Contract Regulation Act, 1956, has increased the grounds for refusing to register, i.e., not only restricted to the grounds mentioned under the section. But this has also led to the increased judicial scrutiny of the refusal, to see if it falls under ‘sufficient cause’.

**VII. Poison Pill Defenses**

A controversial but popular defense mechanism against hostile takeover bids is the creation of securities called “poison pills”. These pills provide their holders with special rights exercisable only after a period following the occurrence of a triggering event such as a tender offer for the control or the accumulation of a specified percentage of target shares. These rights take several forms but all are difficult and costly to acquire control of the issuer, or the target firm.

The board of directors without shareholder approval generally adopts poison pills. Usually the rights provided by the poison pill can be altered quickly by the board or redeemed by the company anytime after they become exercisable following the occurrence of the triggering event. These

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provisions force the acquirer to negotiate directly with the target company’s board and allow some takeover bids to go through. Proponents of the poison pill argue that poison pills do not prohibit all takeovers but enhance the ability of the board of directors to bargain for a “fair price”.

Poison pills, also known as shareholders rights plans, basically entail the creation of a special class of stock designed specifically to discourage or ward off hostile takeovers by making the ultimate price tag much higher. A popular form of the pill enables existing shareholders to buy more stock for, say, half the current market price.

These pills are typically triggered when a hostile suitor acquires a predetermined percentage of company stock. At that point, all existing shareholders except the suitor are granted options to buy additional stock at a dramatic discount, thus diluting the acquirer’s share so as to head off a change in control of the company. “We strongly advise companies to continue to have a pill,” says Martin Lipton, the corporate lawyer credited with inventing the poison pill defense nearly 20 years ago. This is critical since very few companies fail to renew the pill after it expires, notes Lipton, a partner at Wachtell, Lipton, Rosen & Katz in New York City.

**Poison Pill trends in USA**

However, the best takeover defense is to combine a poison pill with a staggered board of directors, says Lipton and other takeover defense experts.

Moreover, experts say a staggered board of directors is a good way to keep a poison pill in place, as it allows for only a portion of the corporate board of directors to be elected each year. This prevents hostile acquirers from successfully staging a proxy fight because they will not be able to gain a majority on the board of directors in one year.

An example of Poison pill defense was the takeover of People Soft by Oracle. People Soft adopted a resolution which allowed the board to flood the market with new shares, effectively making a takeover too expensive to complete. Oracle filed a suit in the Chancery Court to remove the poison pill.

**Legal Issues Concerning Poison Pill Devices**

The legality of poison pills has been questioned in courts of law because they alter the relationships among the principals (shareholders)

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without their approval by vote. In most poison pills, the agents (board of directors) adopt rights plans, which treat shareholders of the same class unequally in situation involving corporate control. Thus, poison pills have been vulnerable to court review especially in the United States. 29

Conclusion

In recent years, a common shareholder view has evolved that defenses are management-entrenchment tools that create barriers to increasing corporate value. “Having a takeover defense in place can reduce the playing field of potential acquirers,” says Shez Bandukwala, senior vice president at Northbrook, Illinois-based Hilco Enterprise Valuation Services LLC. 30 “So it limits the type of premium they’ll be paid.” Shareholders are growing to be unhappy with takeover defenses of poison pill and staggered board. A study conducted by the IRRC in U.S. found that shareholder proposals to eliminate classified boards and supermajority vote requirements, and to eliminate or allow a shareholder vote on poison pills, have received support averaging at least 60 percent at companies.

Companies are becoming less inclined to use takeover defenses as shown by a study conducted in the USA only the defense of Golden Parachute is being increasingly adopted as compared to other defenses.

Takeover defenses however play an important role in corporate restructuring. Most of the takeover defenses that are frequently used by target companies in the US are restricted by the regulations and acts in India. This kind of corporate synergy requires that the legal paradigm so adjust itself, so that it is in a position to optimize the benefits that accrue from such restructuring. Such need has nowhere been more evident than in the case of regulation of takeovers. The legislature realising this, has entrusted the job of doing the same to SEBI. SEBI has endeavored to keep abreast with the market in this regard, as can be seen from the Bhagwati Committee’s scope of reference. But the time has come for the other substantive law, i.e., Companies Act to be a more accommodative towards such defenses. As this would enable takeovers to facilitate the removal of incompetent management and/or traditionally family owned companies and increase efficiency in a more competitive global market.