SHAREHOLDER'S RIGHTS PLAN AND OTHER DEFENSIVE MECHANISMS

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INTRODUCTION

Corporate world is a whole different cosmos paralleled to the real world we live in. A world with its own jurisprudence to be governed. Just like individuals, corporations are seen as individuals that subsist under the regulations. With a motive of growth, we can see vicious actions by corporations to both attack and defend each other and thereby survival and growth gives rise to new opinions, interpretations, ideas and strategies. Shareholders' Rights Plan or commonly known as the Poison Pill is one such exemplary innovations that helped multiply survival chances of a number of corporations. Poison pill is a mechanism which drastically changes the situation of corporations during hostile takeover. This paper seeks to provide a thorough explanation of the mechanism and also dwell into its birth and understanding it in the Indian context.

To ward off unwelcomed bid by an acquiring company, a target company uses the mechanism of poison pill and protect themselves from being taken over. The board of directors of a company acting as the brain for the corporation is entrusted to look out for the best interests of the company including the shareholders and with such limited managing capacity, they cannot control a takeover that is under the capacity of the shareholders. Mergers and acquisitions have become a huge business in the corporate world and the value of which is above 4 trillion dollars.[1] Most of the mergers and acquisitions are done in the nature of an agreement with the board of directors of

[1] (Capaldo, Dobbs and Suonio, 2008).

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a company, while about 20 percent of the others lead to a situation of hostile takeover. In such a situation the board of directors can either back out and watch the company being sold or use mechanisms such as the poison pill.

CAUSE FOR THE BIRTH OF SUCH MECHANISMS

The biggest cause for the defense mechanism rose due to the need of a company to protect itself from corporate raiders. Most corporate raiders usually offer unwelcomed bids and acquire a company and then sell parts of the company to make more profit than what they could have if they had sold the company in its entirety. While this is profitable for the acquirer and also providing a fair deal to the members of the company, it destroys all the hard work that has been put into growing the company as an institution.

One of the other reasons hostile takeovers are done is when a company wants to control the actions of the target company to either perform certain actions that will benefit the acquiring company or end the competition between the two corporations. In most cases, this is not in consonance with the interest of the board of directors or the shareholders. Therefore, the board of directors with the capacity to make decisions that are in the best interest of the shareholders have the right to use such mechanism to protect the company.

HISTORY

This strategic mechanism of making the acquisition of a company's share extremely expensive and hence the process less appealing, was first invented in 1982 by a lawyer named Martin Lipton. In the case where a corporate American raider T. Boone Pickens bid against General American Oil, Martin Lipton developed the idea of poison pill and used it as a defense[2]. After Martin Lipton used the mechanism in another case, poison pill became successful and was used by a number of

[2] (Wharton Alumni Magazine, 2007)

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corporate firms to defend themselves against hostile takeovers. "About 60 percent of the fortune 500 firms had a poison pill by the end of 1989"[3]. However, the legality of the mechanism was neither precedential nor had a legislative backing. While this was argued in a number of cases, the Delaware Supreme Court in one important case of ***Moran V. Household International, Inc.***[4] held that the decision of the board of directors to adopt the poison pill at any time without the approval of the board is in the interest of the shareholders and hence the legality was affirmed. Once this in-built mechanism held to be legal, it was adopted by most during hostile takeovers and thus became exceedingly expensive, more difficult and also exploits the acquirer's time. This deterrence caused a reduction in the number of hostile takeovers comparatively.

WORKING OF THE MECHANISM

Out of the many types of Poison Pill, the two most common are 'flip-in' and 'flip-over' rights plan. The idea is that there are some rights that are accompanied with the shares to all the shareholders of the target company except the acquirer. These right that are attached to the shares are kick-started only at a particular point called the 'triggering event'. The difference between the two is when these rights get activated. The board of directors can adopt this plan without the prior approval of the shareholders.

The triggering of a flip-in pill is a mechanism in which when the board triggers the pill, it allows all the shareholders except the acquiring shareholder to buy at an extremely cheap price and the board of directors hold the right to buy back the shares from all such shareholders at the same price at any time in the future. This with certainty will cause almost all the shareholders to exercise their right and buy the shares of the company for a much cheaper price which will lead to the dilution of percentage of shares of the acquiring shareholder. Now the board of directors approach the acquiring shareholder and asks him to give up ownership of some shares or the board would trigger another flip-in pill which would further dilute the acquirer's ownership in the company. If the

[3] Davis(1991)
[4] 500 A.2d 1346 (Del. 1985)

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acquirer takes the deal, then the board will buy back the shares sold to the other shareholders at the same discounted price. For example, if A has 35 percent of 100 shares of company D, and the board of directors to protect themselves launch a flip-in poison pill and float more 100 shares for all the shareholders except A, to purchase two shares for the price of one. Considering all the shares are bought, then A would end up having only 35 shares out of 200 shares of the company which means A now owns 17.5 percent shares of company D. Now the board approaches A and asks him to give up some of his 35 shares and to which if A does not agree, then another poison pill would be triggered and A's ownership would further reduce by a huge margin. Eventually A would end up selling his shares to have some minimal control and the board of directors then would buy back the 100 shares from other shareholders at the same reduced price.

The other type is the flip-over pill which is also triggered by the board of directors has a different mechanism. When the acquirer's shareholding in the company reaches a certain point, let's say 25 percent for example, or makes an unwelcomed bid, then the board of directors trigger the pill which promises the right to all the shareholders other than the acquirer to buy the shares of the company at an extremely low price after the merger or acquisition. This mechanism promises the right to the shareholders of the target firm to buy the shares from the shareholders of the acquiring firm. But the right will only become effective once the merger or acquisition is complete. Therefore, after the hostile takeover, with this mechanism, the acquirer will have to 'consume' the poison pill. Once the knowledge of the pill being deployed comes to the knowledge of the acquirer, he will back off to protect his interest.

OTHER DEFENSES

While the poison pill is the most effective and commonly used mechanism, there are other defenses used as well. In many cases, the poison pill is used with one of these defenses as an even more effective tool.

Staggered board is a mechanism in which only a selected number of members of the board of directors in a selected period of years. Since having a majority of the shares will allow to vote

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yourself as a member of the board of directors and having a majority of the members on the board of directors will allow you to control the actions of the company, staggered board is one of the best methods to elongate the process while making it more difficult to achieve the majority in the board.

White knight is the other mechanism in which the target company colludes with another company or a person who will always provide a higher bid compared to the acquirer company and therefore save the company from the unwelcomed bid. This mechanism of defense however is not as efficient as the others since it does cost the target company certain loss.

On the other hand, the defense of using the poison pill with the staggered board is not only efficient but also most effective and therefore is most commonly used by corporations around the world.

DECLINE OF THE OF POISON PILL

While on one hand, we have discussed the benefits of using such mechanism, we have keep in mind of the disadvantages of such mechanisms as well. First, during a 'flip-in' pill, it forces all the shareholders other than the acquirer to buy new shares and would otherwise threaten to reduce their shareholdings in the company. Second, it is not completely true that the board of directors will be working in the interest of the shareholders only and could also use such defenses for self-benefits which has to be curbed. Third, this discourages investors and companies that would actually improve the management condition of the target company and thereby improve the employment options of the employees. Fourth, the poison pill could have been used at the whim and fancies of the board of directors with no system of checks and balances.

For all of these above reasons, most jurisdictions felt the need to reduce the application of poison pill. "According to a report by Thomson Reuters Strategic Research, there have been no poison pill adoptions in the last quarter of 2007 from the Fortune 500 roster, no pills have been renewed and eight pills expired quietly during the first quarter of 2008. The trend of questioning poison pills began with a couple of large cap U.S Companies dismantling their takeover defenses in the

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year 2000 and they continued to be increasingly unpopular thereafter." The view that the hostile bidder might actually provide a meaningful position to the target company has been accepted.

LEGITIMACY OF THESE DEFENSES IN THE INDIAN CONTEXT

The poison pill mechanism even though effectively is not barred from being used as a defense in India, the effectiveness is restricted. Under the Stock Exchange Board of India Guideline, 2000 Chapter 13 restricts the transfer of shares of a company. The most substantial part of poison pill is providing the right to buy shares at an extremely low prices but under the code, it is not possible to sell shares at a discounted price as there are regulations that require it to be priced at minimum price thereby setting a threshold as the market price of such shares. While in poison pill, the board of directors suspend the situation for as long as they want, but in India the maximum period allowed for such shares are about 18 months after which they have to be renewed. Therefore, the mechanism of poison pill in India is not as effective as it could have been if not for the legislations of India.

The other defense of staggered board which is also a very effective defense for a takeover doesn't have the same effect in India. The staggered board allows for change in the board of directors every three years by the shareholders and thereby elongating the process of taking effective control of the board. While it is true that the corporations in India do too follow a similar procedure under Section 256 of the Companies Act, 1956, there exists another provision in the statute that grants the shareholders the power to remove all the directors of a particular company in just one of the meetings held by the shareholders under Section 284 of the Companies Act of 1956. Since a corporate rider would somehow manage to gain a majority in eliminating the board, it becomes considerably easy to substitute an entire board and therefore eliminating the effective power of Section 256 which allows a staggered board.

The third defense mechanism and the one that was found to be less effective in relation to the poison pill and staggered board was the White Knight. But contrastingly the defense of White Knight is more effective with respect to Indian Corporations. Since the latter is not specifically

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barred or restricted unlike the other two defenses, it is more preferable to be used by the board of directors during a hostile takeover. Furthermore, since it is permitted to bring in competition in the bidding process, the defense is feasible.

CONCLUSION

While considering the context in which these mechanisms are used, it is not right to say that the legislations in India will cause restrictions. This is so because, India as a developing country does not have as many as corporate riders or shareholders who's shareholding in the company is large enough to bring up majority decisions. But considering the growth in the corporate world, it seems more legitimate to have legislations that are less restrictive of the rights of the board of directors.

It is this balance that the legislators have to find between the right of the board of directors to protect the interest of the shareholder and to use their discretionary power for their personal interest.

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