Takeover Preparedness and the New Hostile M&A Environment

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The recent financial turmoil has left many public companies' market capitalizations at 10-year lows. Such depressed stock prices and the inability to access traditional sources of financing, coupled with the gradual erosion of antitakeover defenses under the pressure of corporate governance groups, have left many public companies vulnerable to a hostile overture or an activist investor campaign. At the same time, other companies – particularly in the technology and pharmaceutical sectors – are flush with cash and searching for bargain acquisition candidates. In this article, we provide a brief overview of the recent spike in hostile takeover activity and proliferation of activist campaigns and outline steps that companies should take to better prepare themselves for responding to hostile and dissident situations.

Last year saw a sharp uptick in hostile takeover attempts, especially in the large cap (greater than $1 billion) space. According to Thomson Financial, in 2008 there were 17 large-cap hostile takeover attempts of U.S. targets, compared to only five in 2007. Despite this increase in unsolicited bids, which included Microsoft's $44.6 billion bid to acquire Yahoo!, Samsung Electronics' $5.9 billion bid for SanDisk. and Cadence Design Systems' $1.6 billion bid for Mentor Graphics, most of these public offers collapsed before a deal could be reached (notable exceptions include King Pharmaceuticals' $1.4 billion bid for Alpharma and Inbev's $46.4 billion bid for Anheuser-Busch).

The hostile M&A trend has continued into 2009 aided, in part, by the continuing decline in stock prices. In fact, as of the end of February, hostile takeover activity accounted for over 38% of 2009 announced public M&A deals in the United States, according to FactSet MergerMetrics. And recently, a number of unsolicited efforts have turned into negotiated transactions. Recent examples include: Roche Holding's $42.5 billion all-cash bid for the remaining 44% of Genentech that it does not already control (which resulted in a $46.8 billion negotiated transaction between the parties); and Japan's Astellas Pharma's $1.1 billion all-cash offer for CV Therapeutics (which threw the latter into the arms of white knight Gilead Sciences, who offered $1.4 billion). Hostile acquirors have also not shied away from offering their stock as acquisition currency. Examples include Exelon's $6.2 billion all-stock offer for NRG Energy and CF Industries' $2.8 billion all-stock offer for Terra Industries, which, in an ironic twist, has led CF Industries to become itself the target of a $3.6 billion unsolicited cash and stock offer from Canada's Agrium.

Not surprisingly, mid cap companies are not immune to unsolicited bids, which may come from both strategic and financial players. The past few months have seen an increasing number of such situations, including Mill Road Capital's $78 million cash bid for R. G. Barry; Knowledge Learning's $141 million bid for Nobel Learning; Elliot Associates' $529 million bid for Epicor Software, and Kudelski SA's $127 million offer for the shares of OpenTV it does not already own.

The examples described above and all the others that make it to the public arena are just the proverbial tip of the iceberg. For every hostile bid that has hit the news wires in the past 18 months, many more private bear hug letters have been delivered to public companies and their

boards. In many cases, these private bear hugs have resulted or will result in negotiated transactions. The once maligned hostile takeover has again reemerged as a legitimate M&A strategy embraced across the corporate spectrum.

At the same time that companies are facing an acceleration in hostile takeover activity, activist investors have become a fixture of the corporate landscape. The financial crisis might have had an impact on the causes these activists advocate – many understand that in the midst of a recession, proposals for outright sales or dividend recaps of issuers might not necessarily be the best strategy – but the crisis has not deterred them from advocating change in situations where they believe change is warranted. In the last few months, spin offs, share buyback programs and detailed proposals to improve operational efficiency and review business plans are among the alternatives to outright sales that have gained increasing favor among activists. In fact, traditional activist investors are becoming as a whole more sophisticated in their platforms and views of their targets as many of them seem to be stretching their investment horizons. Corporate governance initiatives – such as "say on pay" and majority vote proposals – are also gaining wide popularity among activists and are expected to figure prominently in activists' campaigns during the 2009 proxy season.

In 2008, according to FactSet SharkRepellent, there were 123 proxy contests, compared to 108 in 2007. As of the first week of March, there have been 58 proxy contests announced for 2009 stockholder meetings. For example, Carl Icahn has nominated dissident slates for Amylin Pharmaceuticals (which is also the target of activist Eastbourne Capital Management), and Biogen Idec. Meanwhile, Mario Gabelli's GAMCO has announced dissident slates at CH Energy Group, Telephone and Data Systems, Gaylord Entertainment, and Trans-Lux, among others. Given the state of the market, proxy advisory firms and institutions investors appear to be more willing to support "short slates" – that is, dissident slates for less than a majority of the board.

It is important to note that the label "activist investor" is used to refer to a broad group of institutions and individuals, but activists' causes and methods can differ dramatically. Some activists, including some hedge and pension funds, are long-term investors that will only become vocal publicly as a measure of last resort to protect an existing investment. Others view activism as a primary tool in their arsenal for generating returns for their investors. Many of these activists will actually take positions in companies whose stock is depressed where they believe a management shake up or a quick sale can produce an immediate return. Among the most aggressive of these activists, the use of public letter writing campaigns – public statements released via news wires and securities filings criticizing and sometimes even ridiculing board members and management – is not uncommon. Other activists, including individual crusaders and social advocacy groups, have narrow agendas, but typically do not have the financial resources available to hedge funds and other financial players. The efforts of these activists should nevertheless not be underestimated by boards: Rule 14a-8 under the Securities Exchange Act provides a mechanism for even small shareholders to make proposals at an annual meeting that could have a significant impact on a corporation. Indeed, proxy access initiatives at the federal and state levels are likely to accelerate in the near future.

As boards face the looming specter of an acceleration in hostile M&A and activist shareholder activity, they are also as a whole less prepared than they have been in recent years to

fend off such attacks. Corporate governance groups have been relatively successful in the last few years in pressuring companies to voluntarily surrender a number of anti-takeover protections that were viewed as fairly standard at the beginning of the decade. The stigma that shareholder rights plans and staggered boards carried was such that many companies were prepared to forgo their protections during the boom years that preceded the current financial crisis. According to FactSet SharkRepellent, between December 2006 and December 2008 the percentage of S&P 500 companies with a staggered board decreased from 41% to 34%. During the same period, the percentage of S&P 500 companies with a rights plan decreased from 34% to 21%.

In light of these recent trends, public companies and their boards can take a number of practical steps to better prepare for, and respond to, a hostile bid or an activist campaign.

Keep the Board Engaged and Informed. Every company should ensure that its board of directors is actively engaged and informed about the company's performance (on both an absolute and relative basis), current industry trends, the company's shareholder profile, the company's vulnerabilities and its attractiveness to potential hostile acquirors. A well-informed board will be better prepared to quickly react to the sudden appearance of a hostile acquiror or activist investor.

In the current environment it may be prudent for a board to hear presentations from one or more financial advisors about their views on the company's historical and projected performance and market trends, and from the company's outside legal counsel about their views on the company's vulnerability to a takeover. Given the extraordinary financial market turmoil and the heightened scrutiny to which financial institutions are subject, boards and management teams should not necessarily assume that they will always be able to obtain an inadequacy opinion from a reputable investment bank in the face of a substantial premium offer simply because the stock is trading at a five- or 10-year low. A continuous dialogue between the board and its legal, financial and public relations advisors that enhances the board's understanding of the company's financial position and prospects is far more valuable than an on the shelf "one-size-fits-all" 20-page response plan to a hostile situation.

It is important to keep in mind that companies receiving hostile bids in the next few months will also be bargaining under the shadows of Yahoo!/Microsoft and other battles of 2008, where targets were successful in fending off hostile bids only to see their stock fall precipitously in the months following withdrawal of the bid.

Revisit the Company's Defensive Profile. Companies, with the assistance of their legal counsel, should conduct a comprehensive review of their defensive profiles to assess and understand what vulnerabilities they have and what defense mechanisms are available. A superficial "check the box" analysis, while convenient and inexpensive, may fail to uncover subtle vulnerabilities in a company's defenses. A company may believe it has the defensive protection provided by a particular provision in its organizational documents (such as a staggered board), but if that provision is poorly drafted, a hostile bidder may be able to exploit a flaw and render the protection useless before the company has time to react. For example, the protections of a staggered board are severely weakened if shareholders can unilaterally expand the size of the board and fill the newly created vacancies. Similarly, in the case of a Delaware corporation,

a bylaw purporting to limit the ability of shareholders to act by written consent is ineffective unless the corporation's charter sets forth the restriction.

All companies should understand that they cannot take at face value a provision written in a certificate of incorporation or bylaw without further legal analysis of its enforceability and a thorough legal analysis of potential loopholes.

On the Shelf Shareholder Rights Plans. Last year witnessed a relative surge in the number of poison pill adoptions. According to FactSet SharkRepellent, 127 poison pills were adopted in 2008, the most in any year since 2002, with 76 of these as first-time pill adoptions. Despite this recent surge, many companies – particularly those with large market capitalizations – still prefer to avoid the shareholder pressure that comes with having a rights plan in place. Many companies are opting to instead keep a rights plan "on the shelf," ready to be adopted on short notice if a threat materialized that requires such response. Such rights plans are not required to be disclosed to the public until such time as they have been formally adopted and implemented. Companies should work with counsel to ensure that the shelf rights plan incorporates the latest technical improvements and is tailored appropriately to the company. By educating itself thoroughly on the operation of the shelf rights plan, the board of directors and its advisors can be better informed and prepared when, and if, the time comes to implement such a measure.

Review Advance Notice Bylaws. As part of the review of their vulnerability to a takeover, companies should also pay careful attention to their current advance notice bylaw provisions. Such provisions require a stockholder seeking to propose nominations or have other business considered at a meeting of stockholders to submit information to the company about the nominations or business by a specified date prior to the meeting. Recent Delaware court decisions demonstrate that a lack of clarity in advance notice bylaw provisions could render these provisions inapplicable in certain critical circumstances. These decisions also evidence Delaware courts' preference to interpret those provisions in a manner that favors shareholders seeking to bring matters before a meeting. In light of these decisions, companies should identify and amend ambiguous advance notice bylaw provisions to make clear that these provisions apply both to company and non-company proxy materials and the nomination of directors, in addition to other business to be brought before the meeting. It has also become increasingly common for companies to enhance protections afforded by their advance notice bylaws by expanding the information required to be contained in the dissident's notice. It is now not uncommon, for example, for such notice to require a dissident stockholder to disclose hedging and other arrangements to which the dissident is a party at the time it delivers the notice of nomination or other business.

Know Your Shareholder Base. Given the increasing likelihood of companies becoming the target of hostile bidders or activist investors, it is more important than ever for boards to understand the composition of their shareholder bases and engage with them when appropriate. This is the time to revisit and strengthen the shareholder relations program and retain an experienced investor relations firm. A well planned stockholder outreach program that actively communicates to investors management initiatives and strategies might help preempt activist campaigns and allow the company to be better positioned to counter a hostile bid that the board considers inadequate.

Also, it is important to bear in mind that a potential unsolicited bidder may accumulate a substantial block of target stock before it is required to make any public filings relating to such purchases. This has been in evidence in a number of small and middle market takeover efforts. In light of this, companies may find it prudent to maintain a program for gathering and evaluating all available information concerning their stock, including the regular review of stock trading information and regular contacts with investment bankers and stock specialists to identify unusual trading patterns.

As recent events evidence, the ongoing financial crisis does present a favorable environment for opportunistic buyers, particularly those that are flush with cash, to make unsolicited bids for companies across the corporate spectrum. Public companies need to be aware of this market trend and, more importantly, lay the groundwork to be adequately prepared to respond to such an unsolicited bid in a manner that allows them to fully discharge their fiduciary duties to stockholders.