ONDERZOEKSRAPPORT NR 9222

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November 1992

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* *The authors thank Piet Sercu and Lambert Vanthienen for constructive criticisms.*

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After the raid on the Société Générale in 1988 "poison" or "dry" warrants were adopted by several Belgian publicly quoted companies to safeguard corporate control. The case of the Générale made large minority owners aware of the possibility of a hostile take-over bid on their firm. Simultaneously, following the raid on the Société Générale, adjustments in Belgian corporate law stimulated the creation of this new poison pill. The technique of the poison warrant consists in the issuance of warrants that entitle the holder to purchase shares under specific conditions. The warrants typically are issued at a zero price and assigned solely to the controlling shareholders. They can only be exercised around the time of a raid. In case of exercise the firm under attack issues the required number of new shares. Also the exercise price (i.e. purchase price of the shares) is not fixed in advance; only the rules according to which the price is to be calculated are determined beforehand. Typically the exercise price is equated to the average of the stock's market price in a period extending from several months before the bid to just a few weeks before the hostile offer. In practice the exercise of the warrants guarantees the controlling shareholders a majority ownership.

This paper discusses the technique of the poison warrant. It shows that, at least from the perspective of economic logic, the poison warrant is very much at odds with the current take-over legislation. Although this legislation is aimed at protecting the interests of the small owners, the poison warrant technique benefits mainly the controlling shareholders, possibly even to the detriment of the small owners. Furthermore, some beneficial take-overs may not take place, or if they take place, the public take-over price per share may be lower¹. Even in the latter case, large target owners are better off with poison warrants than without.

1. *The technique has proven to be a very powerful deterrent : so far no company that has adopted poison warrants has come under a raider's attack.*

Section 1 of this paper discusses the main legal rules governing poison warrants and the adjustments in Belgian law that stimulated their creation. Section 2 considers the economic consequences of the adoption of these warrants. Finally section 3 offers some conclusions.

1. THE LEGAL FRAMEWORK

After its introduction in Belgian corporate law in 1984, Belgian companies have extensively used authorized capital as a hostile take-over deterrent. In case of a raid, this technique has been used by the board of directors of the target to issue new shares quickly and assign them to befriended groups, normally at a price equal to the average stock market price in the period (i.e. a few days, possibly even a month) immediately preceding the announcement of the offer. For defence purposes a share issue within authorized capital had two major advantages relative to an ordinary share issue. First, once authorized capital was adopted (by agreement of the shareholders' meeting), the board of directors could decide about the creation of new shares any time within a period of five years after adoption and for a any amount up to authorized capital.² Second, if at the time of approval a few formal legal requirements were honoured, new share issues in the framework of authorized capital did not need to obey the preemptive rights rule.^{3 4} However the adoption of the London City Code rule n°21 in Belgian law after the raid on the Société Générale in 1988, decreased the usefulness of authorised capital as a defensive tactic. Since the adoption of this rule the board of directors can no longer issue authorised shares after the launching of a take-over bid, except when such a defensive issue is explicitly covered in the authorizing decision of the shareholders' meeting. Furthermore, and more importantly, even in the case of such an authorization, the increase in equity should not exceed 10% of outstanding equity and all newly issued shares should immediately be fully paid.⁵

2. An ordinary share issue always requires the consent of a shareholders' meeting prior to the issue.

3. This rule assigns to all shareholders a first right to subscribe to the new shares in proportion to the number of shares they already own.

4. The limitation of preemptive rights always requires a special report of the board of directors wherein it should be stated that such limitation is in the interest of the company. The accounting data communicated at such an occasion to the shareholders' meeting should be certified by the public accountant of the company.

5. The law of July 18, 1991 imposed further limitations on the use of authorized capital when combined with the exclusion of preemptive rights.

Especially the limitation on the amount of shares issued triggered the need for a new poison pill. In addition, in 1989 a new take-over legislation came into force, imposing stricter rules on the take-over process. Hence, at that time, for those wishing to deter a raider, the ideal new poison pill should circumvent the most stringent requirements of the new legislation. It turns out that the poison warrant comes close to this ideal deterrent.

1.1. Poison warrants and the new take-over legislation

One of the main themes of the new take-over legislation is the protection of the small owners. Given the importance of large shareholders in Belgian publicly quoted firms, this protection boils down to assuring that the small owners are treated on an equal footing with the large ones. To reach this goal the legislation requires a bidder firm to offer all security holders the same price (i.e. the one price rule) and bid for all the shares, warrants and convertible bonds of the target (i.e. the 100% rule). The only exception is the case in which the bidder wants to acquire such a small fraction that, added to the stock it already owns, it accounts for no more than 10% of the votes. Also any counter or new offer should carry a price of at least 5% above the competing or previous offer (i.e. the upbidding rule). As of the time the target company has been informed of the take-over bid, the actions of the board of directors are limited to conducting the daily transactions and informing the small shareholders. Before the take-over starts the bidder has to draw up a prospectus, subject it to the approval of the regulating authorities (they check the prospectus w.r.t. the correctness of the information it contains) and issue this prospectus publicly. In case of a cash payment, the bidder has to deposit resources with a financial institution beforehand sufficient to cover all security purchases. If the bidder firm pays with securities, it has to guarantee beforehand that it has enough securities available or the legal authority to have them issued.

As mentioned before, from the point of view of the target's controlling owners, the poison warrant, first introduced in 1988, comes close to the ideal deterrent. At odds with the 100% rule, a poison warrant issue implicitly allows a partial offer: its use has similar consequences as a share issue combined with an offer by the large owners to buy 100% of the newly issued equity. This partial offer is sure to succeed, also if the contractual purchase price turns out to be very low relative to the offer of the bidder. Because of the way the purchase price of the new shares has been fixed, the warrant holders also escape the upbidding rule mentioned before. Furthermore the warrant technique circumvents the limitations on the scope of actions the target can undertake after announcing a public bid: although issuing new shares is not part of the daily operations of a company, the board may, even should, undertake the issue. The reason is that the new legislation does not exonerate the board from respecting obligations taken up before the offer. For the poison warrant this means that, as the warrant creates an obligation for the company to issue a share, this obligation should be honoured notwithstanding the fact that the warrant may only be exercised after the launching of a bid. Furthermore, and this is vital, unlike authorized capital the warrants escape the clause that the capital increase should not exceed 10% of existing capital. This follows from the fact that from the legal perspective (contrary to authorised capital), via warrants, the board of directors does not have to interfere in an active way at the time the new shares are issued. Also on the level of information obligations, the warrant technique has important advantages. At the time of the share issue (i.e. following the exercise of the warrants), neither the target firm nor the purchasing large shareholders have to issue a prospectus. As a rule, just as in the case of authorized capital, the shareholders' meeting has to approve the creation of poison warrants.⁶ This follows from the fact that issuing warrants is subject to the same formal rules as a normal decision to increase equity. However, although the increase in equity is only realized at the time of warrant exercise, this latter action does not necessitate any formal decision anymore. To be sure, the equity figure in the corporate charter has to be adapted upon exercise, but this is no more than a pure formality fulfilled by the notary public on simple demand of a director.

6. Warrants can also be issued by the board of directors within the framework of authorized capital if preemptive rights are respected.

Consequently the only information requirement about the terms of the poison warrant contract is at the time of creation. Afterwards only the fact that the warrants have been exercised is made public by a simple announcement in the Annex of the Official Journal.⁷ Concerning financial obligations, the warrant holder is also in a very advantageous position. Contrary to the bidder, the warrant owner does not have to immobilize any financial resources to pay for the transaction. Even more, the company can accept a minimum payment of 25% per newly issued share.⁸

Warrants issued without adhering to preemptive rights have a few disadvantages though. First, these securities cannot be exercised beyond a period of five years after issue; hence every five years the poison warrants have to be reapproved by the shareholders' meeting. Second, any additional contractual stipulation imposing an obligation to exercise in case of a raid, is invalid. And last but not least, when these warrants are exercised in the course of a bid, the shares issued in exchange are registered⁹; and those shares can not be transferred in a period of twelve months following issue. However right now there are no rules regarding the price at which, in case of a bid, these shares can be sold to the bidder after those twelve months have passed. Nevertheless this lack of rules need not imply that if large target shareholders immediately agree to sell the newly issued "warrant" shares through a forward contract, the forward price could be higher than the one paid to the small shareholders. In fact legal specialists are of the opinion that the regulating authorities would not tolerate such an agreement.

7. It should be noted however that if warrants are issued to non shareholders or at least distributed in a way not corresponding with the preemptive rights (which is the case in practice), the same special rules apply as in the case of a normal share issue with limited preemptive rights (see footnote 3).

8. One more advantage of the warrants is that the law protects the owners against dilution at the time of a normal share issue. At the occasion of such an issue, the warrant owners may exercise the warrants, disregarding any contractual condition to the contrary.

9. Generally, in Belgium, shares are bearer.

1.2. Poison warrants and insider trading regulation

There is also an interesting interaction between poison warrants and the insider trading regulation introduced since 1990. This latter regulation prohibits anyone who has acquired inside information (i.e. news that is not yet publicly available) either to trade shares or advise to buy or sell or communicate such information to third parties. A restrictive reading of the insider trading rule would imply that the poison warrant holder could escape this prohibition. Whenever it is beneficial to do so and as soon as the warrant holder knows about an imminent bid, s/he can exercise these warrants and sell the shares to the bidder. This warrant holder does not "buy" a share, so there is, on his/her part no violation of the insider trading rules. Simultaneously, shares acquired through warrants that were issued without honouring preemptive rights but before the opening of the bid, would also escape the obligation of registration and restriction of twelve month non transferability. However experts expect that neither the courts nor the regulating authorities would accept this interpretation. Hence, it is unlikely that in practice, the "premature" exercise of the warrants, on the basis of privileged information, would be immune under the insider trading laws.

2. THE ECONOMIC CONSEQUENCES

The poison warrants are likely to affect the distribution of take-over gains in case of a bid. We would also expect them to influence the likelihood of a take-over.

2.1. Poison warrants and the distribution of take-over gains.

From the previous section it is clear that poison warrants imply an unequal treatment of control contestants: the "outside" bidder is disadvantaged relative to the "inside" bidder - warrant holders. Probably the most important advantages the inside bidder derives from the poison warrants, are financial. In section 1.1 it has been pointed out that only the warrant holders are allowed to undertake a partial offer; furthermore the price may be much lower than the outside bidder's.

Empirical research over the period 1970-1990 indicates that in Belgium, bidders have offered, on average, a premium of 45 to 48% relative to the target's stock market price six months before the announcement of the offer. Most of the stock market reaction in anticipation of a possible offer takes place in the month before the bid.¹⁰ As indicated before, the purchase price in the warrant contract normally is based on market prices of at least several weeks before the offer, i.e. it is based on prices not yet reflecting the imminence of a take-over bid.

Also relative to the small target shareholders, use of poison warrants is likely to benefit the large owners, even if the latter receive the same price per share as the small owners. To illustrate this consider the following numerical example. Suppose that the large target shareholders initially own 25 of the 100 shares. To simplify the calculations, we assume the bidder's initial ownership in the target is 0. Under the current owners' control the target produces a future dividend stream worth 800, i.e. before any news of a take-over enters the market, the per share price is $800/100 = 8$ (i.e. we assume that, given the available information, the market prices shares correctly). Suppose that if the bidder would fully own the target, this firm would produce a total benefit stream worth 1400.¹¹ Hence, given the current number of shares the bidder would be prepared to pay up to a maximum of $1400/100 = 14$ a share. The poison warrant contract allows the current large shareholders to issue 60 shares at a price equal to the market price in a period before the news of the raid reaches the market, i.e. at 8 a share. Assuming the large owners use their warrant rights and immediately fully pay in cash, the bidder values the firm at $1400 + \text{cash payment for new shares} = 1400 + 8 \times 60 = 1880$ or per share $1880/(100+60) = 11.75$. Suppose that in its initial offer the bidder ignores the existence of the warrants and offers 11 per share (i.e. he offers 100 shares $\times$ 11 = 1100 for the target). Also assume that after warrant exercise and successful negotiations the bidder finally acquires the large owners' shares through a forward purchase at 11 a share¹² and the small owners sell out also (i.e. the bidder pays 160 shares $\times$ 11 = 1760 for the target). In this example the small owners do not gain or lose in absolute terms due to the use of the

10. See VAN HULLE, VERMAELEN and DE WOUTERS (1990), VAN HULLE (1991).

11. The 1400 includes also control or strategic benefits of the bidder (e.g. another firm owned by the bidder can increase its profits after the bidder has gained control over the target on the basis of a new and favourable business contract with the target) ; see also section 2.2.

12. See section 1.1. The time value of money is disregarded for simplicity.

warrants. However for the large shareholders the existence of the poison pill makes a very large difference in their profits. If they would not have had the warrants and sold out at 11 a share, they would have received net 25 shares $\times$ 11 = 275. With the use of the warrants they walk away with $[(25 + 60) \text{ shares} \times 11] - [60 \text{ shares} \times 8] = 455$. In fact if the large shareholders would have known about the raid beforehand and, instead of using the warrants, would have bought 60 additional shares in the open market at 8, their profits would have been identical. Relative to this insider trading the procedure with the warrants avoids the problem of purchasing large packages in a stock market that may be quite thin. But foremost it avoids the question of illegality of insider dealings, at least if the warrants are not exercised "prematurely".¹³ In the present example, as compared with insider trading, the small owners are better off in the poison warrant situation however. With the warrants, as a group they receive 75 shares $\times$ 11 = 825; with insider trading they only net $[(75 - 60) \text{ shares} \times 11] + [60 \text{ shares} \times 8 \text{ (i.e. the purchases by the insiders)}] = 645$.

One can of course argue that, as the warrants give the large owners "de facto" a majority position in the firm, the latter are in a strong negotiation position and hence can drive up the price per share. However this need not always be true. For example, suppose that if the bidder firm initially disregards the existence of the warrants, it would open with a price of 12 (instead of the previous 11) for the non diluted shares. Its total outlay for the target would then be 100 shares $\times$ 12 = 1200. In view of its own valuation of 1400, the take-over would still give it a profit. However a price of 12 for the diluted shares implies a total cost of 160 shares $\times$ 12 = 1920 which is more than 1880 (i.e. 1400 + 60 shares $\times$ 8). Hence either no take-over takes place (in which instance the small owners pass up the bid premium) or else the public offer price is reduced to maximally $1880/160 = 11.75$. As a reduction in the public share price is not allowed in Belgium (i.e. the upbidding rule of section 1.1), in practice, a rational bidder would anticipate the dilutive effect of the warrant exercise and open the public bidding with a price below 11.75. In the latter case the small owners clearly lose.

13. See section 1.2.

2.2 The impact on the likelihood of a take-over

The preceding subsection has shown that the poison warrants are likely to make a take-over more expensive, and hence less likely. The example has indicated two possible sources of surplus outlays: the increase in the number of shares and the improvement in the large owners' negotiation position. However the implicit majority position created by the warrants also reduces the likelihood of a take-over occurring. From an economic perspective a take-over should take place if it increases economic efficiency and hence total wealth. However with majority owners efficiency increasing take-overs need not take place. To see this consider the subsequent extension of the example in 2.1.. Suppose that next to their portion of the dividend stream, the large owners also receive control or strategic benefits worth 450 (for example, another firm owned by the controlling owners makes extra profits on a favourable business contract with the target firm). Hence before the raid, the large owners receive benefits worth $25 \text{ shares} \times 8 + 450 = 650$ while the total economic value produced by the target under current management is $800 + 450 = 1250$. Since it could drive up this economic value to 1400, a take-over by the bidder firm would improve efficiency. After the issue of 60 additional shares at 8 a piece, the large target owners receive total benefits worth $[(25 + 60) \text{ shares} \times 8] + 450 = 1130$, or $1130/(25 + 60) = 13.3$ a share. As these owners have a majority position, the bidder cannot gain control without their agreement. Obviously, the latter won't sell out as long as the price offered by the bidder does not match the benefits from holding on to the target's shares. Hence the bidder has to offer at least a price of 13.3 a share. As the diluted per share value is only $(1400 + 8 \times 60)/(100 + 60) = 11.75$ for the bidder, a price of at least 13.3 is too expensive. A rational potential bidder anticipates this and abstains from bidding altogether. It is well known that with minority owners an efficiency improving take-over is more likely to succeed, at least when there are no poison pills. The reason is that then the large shareholders, if they wish to maintain control, have to launch a counterbid under the normal take-over rules. Under these circumstances, winning the contest is likely to be too expensive for the less efficient control contestant.¹⁴

14. E.g. see HARRIS and RAVIV (1989), VAN HULLE and SERCU (1992).

3. CONCLUSIONS

This paper has shown that the poison warrants allow large shareholders to circumvent many important rules of the Belgian take-over legislation at the time of the threat of a hostile bid and offers important financial benefits to the large shareholders of the target. Two important sources of these benefits are the fact that the warrant technique implicitly allows the large owners to make a partial offer and the fact that this partial offer may carry a low price (as compared to the "outside" bidder's). Hence if "inside" and "outside" control contestants are to be placed on a more equal footing, simply requiring a warrant exercise price equal to the outside bidder's offer price does not fully solve the problem. For the outside bidder has to offer this price (usually containing a substantive premium) to all the securities, whereas the insider only has to buy a fraction of the shares. And as the insiders buy the shares straight from the firm, the small owners only benefit from this payment to the extent that it increases the per share value. Because of this unequal treatment of the inside and outside control contestant, the best bidder need not win and hence efficiency improving take-overs need not take place. In case such a take-over does take place, the warrants shift a larger fraction of the gains towards the large owners.

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