The Daily Deal
& Silicon Valley News
Charting the deal economy

Latham & Watkins
Article Reprint
with our compliments

Lessons of TRW

Reprinted from *The Daily Deal*

By Charles M. Nathan

The final returns are in. TRW Inc. won an important victory in its fight to turn Northrop Grumman Corp.'s hostile bid into a board-controlled auction when TRW shareholders voted to maintain a poison pill equivalent under Ohio's anti-takeover statutes.

In fact, TRW's victory was so resounding that it didn't need to rely on the controversial statutory exclusion of votes by arbitrageurs and others who purchased their TRW stock after the Northrop Grumman bid was announced.

The decisive vote to support a poison pill equivalent stands in marked contrast to the numerous nonbinding votes that occur every proxy season on poison pill redemption. In these votes, shareholders led by institutions almost invariably cast a majority of ballots against maintenance of poison pills.

The TRW vote flies in the face of not just one but two pillars of conventional wisdom:

- Shareholders will not vote for a poison pill, no matter how reasonable the arguments are and how impassioned management is in support of the pill.
- Shareholders, given an opportunity, will always vote to facilitate a hostile bid, because at best it will stimulate a bidding contest and at worst any premium is better than no premium.

There are several major lessons from TRW.

First, the shareholder voting system in the United States is badly but not totally broken. Proxy voting absent a real-life economic issue is conducted by rote. Institutions have been driven by fiduciary duty concepts from the old-school mechanic of always voting the management.

In its place they have substituted the politically correct mechanic of adopting the Council of Institutional Investors and Institutional Shareholder Services policy of always opposing poison pills, shark repellents and other causes du jour.

While in any given case an institution's vote may make sense on the merits, the merits are not allowed to intrude because they are too costly and cumbersome to weigh. Institutions simply cannot afford the time and expense of reviewing each and every proxy vote, yet are bound to exercise a fiduciary duty of care with respect to their thousands of proxy votes each year. The almost universal solution has been to adopt a rigid, internally developed voting policy or to delegate the voting decision to an independent third party, such as ISS.

The only exception to the institutional abdication from exercise of conscious judgment is, not surprisingly, where concrete "money" issues are at stake. In proxy contests arising from hostile-takeover bids or fights for control of the board, institutions go off auto-pilot and carefully weigh the pros and cons of both sides before casting their ballot.

This observation brings us to the second important lesson of the TRW vote: In real life, poison pills can create shareholder value, and when they do so shareholders may support their retention.

Mr. Nathan is a partner in the New York office of Latham & Watkins and co-chair of its global M&A practice.

The shareholders of TRW defied conventional wisdom that any hostile bid should be allowed to go forward because a majority of them agreed on three critical issues:

- Management's restructuring plans would create a higher present value than the Northrop Grumman bid and needed time to be implemented.
- Management could be trusted to implement its restructuring plan.
- And no single white knight would emerge to buy the entire company at a better price.

Having reached these conclusions, it made sense to vote for retention of the statutory poison pill. Otherwise, Northrop Grumman might have been able to stampede the market into tendering a majority of TRW shares and end the auction before management's restructuring plan could be realized.

This exercise in shareholder rationality raises a tantalizing third lesson: Perhaps companies shouldn't fight so hard to maintain their poison pills in the face of shareholder proposals for repeal.

The activist institutional-shareholder community has been relentlessly attacking 50 to 60 companies a year with nonbinding pill redemption proposals.

In addition, there has been an ongoing search by this constituency for a binding voting mechanic to force pill redemption, which one day could be successful.

Corporate boards have consumed a significant amount of political capital in fighting off these attempts to dismantle the poison pill edifice that was established in the late 1980s. As the pressure on boards grows to undertake governance reforms in the post-Enron era, defense of the poison pill may become increasingly difficult and politically more costly.

A calculated strategic retreat might be in order.

If we can believe that TRW demonstrates the rationality of institutional shareholders when real money is at stake, it might not be too great a leap of faith to adopt a policy of voluntarily repealing poison pills where companies are not under concrete threat of unilateral change of control. In doing so, companies could and should preserve the flexibility to install a pill if a threat later emerges.

This policy would remove a major irritant in shareholder relations, avoid the risk of repeated shareholder resolutions for repeal of the pill and, most important, avoid the company's being backed into a position of losing the pill at the hands of a binding shareholder resolution.