

Microsoft Moves on Yahoo Icahn Begins Yahoo Board Battle

The billionaire investor proposed a slate of directors to replace Yahoo's board, but will Microsoft take the bait?

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As if an abbreviated bear hug from Microsoft (MSFT) weren't enough, Yahoo (YHOO) now has a new foe: Carl Icahn. The billionaire corporate raider launched a battle to win control of the board of the embattled Internet pioneer, nominating a slate of 10 dissident directors that includes himself.

Icahn outlined his intentions in a May 15 letter to Yahoo Chairman Roy Bostock, faulting Yahoo for how it handled the takeover approach from Microsoft, which on May 3 walked away. "The board of directors of Yahoo has acted irrationally and lost the faith of shareholders and Microsoft," Icahn wrote.

Nominees include Icahn lieutenant Keith Meister, Dallas Mavericks owner Mark Cuban, former Viacom (VIA) Chief Executive Frank Biondi Jr., and John Chapple, former chief executive of wireless carrier Nextel Partners, now owned by Sprint Nextel (S).

Expect July 3 Fireworks

In his scolding letter, Icahn says he was prompted by Yahoo shareholders who hope he'll be able to negotiate a successful merger with Microsoft. The software maker abandoned its takeover bid after failing to agree with Yahoo on a price. Microsoft says it offered \$33 a share while Yahoo held out for \$37. "It is unconscionable that you have not allowed your shareholders to choose to accept an offer that represented a 72% premium over Yahoo's closing price of \$19.18 on the day before the initial Microsoft offer," Icahn wrote.

The proxy battle could have a long-lasting impact on the future of Yahoo, already under pressure from investors dismayed by slowing growth in its core businesses amid competition from Web-search leader Google (GOOG). "I and many of your shareholders strongly believe that a combination between Yahoo and Microsoft would form a dynamic company and more importantly would be a force strong enough to compete with Google on the Internet," Icahn wrote. May 15 was the deadline set by Yahoo for proposals to be considered at its July 3 shareholder meeting.

The challenge for Icahn and the new directors, if elected, is to entice Microsoft back into the fray. In announcing that it would drop its unsolicited \$47.5 billion bid for Yahoo, Microsoft declined to launch a proxy fight itself. The company has also said it has moved on. Presumably Icahn has some sense that Microsoft is willing to reconsider a bid—one high enough for a savvy investor like himself to earn a tidy profit. At Microsoft's last reported bid of \$33, shares bought at the \$27.14 close on May 14, up more than 5% from two days ago, would increase another 22%. Icahn's gain would likely be even greater because he bought shares before the recent rise.

According to the letter, Icahn bought about 59 million Yahoo shares in the preceding 10 days. At the May 14 close, that holding would have been worth about \$1.6 billion. Icahn also sought clearance from the Federal Trade Commission to buy as much as \$2.5 billion worth of Yahoo stock.

Microsoft Reaction Is Unclear

Other nominees are Adam Dell, managing general partner of venture capital firm Impact Venture Partners; Harvard Law School professor Lucian Bebchuk; Edward Meyer, chief executive officer of investment management firm Ocean Road Advisors; Brian Posner, former CEO of asset management firm ClearBridge Advisors; and Robert Shaye, co-CEO of New Line Cinema, owned by Turner Broadcasting System.

Recent news reports indicated Icahn had not yet received a thumbs-up from Microsoft. Indeed, Microsoft may even be unhappy with Icahn's interference, says John Aiken, managing director of Majestic Research. Microsoft eschewed its own proxy fight amid concern it would result in an exodus of talent or push Yahoo to seek alliances, such as with Google, that would prove unattractive to Microsoft. What's to say an Icahn-led proxy fight wouldn't have the same effect?

On the other hand, Microsoft might welcome the pressure Icahn's move would put on Yahoo, without Microsoft having to do the dirty work itself. If Icahn is successful in getting his own slate elected—or at least pressuring Yahoo to back some new directors he controls—he could kill the poison pill that would make the company prohibitively expensive to a hostile bidder. That would pave the way for Microsoft to return with a friendly bid. "Microsoft remains the likely candidate," says corporate governance attorney Claudia Allen, chair of Chicago law firm Neal, Gerber & Eisenberg.

Risks in Icahn's Move

Icahn, who in recent years has agitated for change at companies including Motorola (MOT), has some wind at his back. Some high-profile shareholders such as Gordon Crawford at Capital Research & Management have expressed unusually public criticisms of Yahoo and its board for not coming to an agreement with Microsoft.

So have some smaller shareholders, such as Eric Jackson, who led a campaign to unseat former Yahoo Chief Executive Terry Semel last year and recently told BusinessWeek he's unhappy with co-founder and current CEO Jerry Yang. "If I'm a small shareholder, I would appreciate Carl Icahn forcing the issue," says Espen Eckbo, founding director of the Center for Corporate Governance at Dartmouth College's Tuck School of Business.

Presumably Icahn would want to get the highest possible price for Yahoo. However, it's uncertain that would result from a proxy fight alone. Icahn's move, says Eckbo, could end up reducing Yahoo's bargaining position if it drags on and results in an outflow of talent or somehow makes Microsoft less likely to revisit a bid. So Icahn likely would want to move quickly to get the two companies together.

Ask.com's "Extraordinary Opportunity"

Icahn's other options for extracting further value from a Yahoo stake appear limited. Various other possible deals, such as Yahoo alliances with Google on search ads or with Time Warner's (TWX) AOL unit or News Corp.'s (NWS) MySpace unit, haven't materialized yet. Yahoo also holds some valuable stakes in overseas Internet companies such as China's Alibaba. But analysts have indicated that none of those options would likely hike Yahoo's value to the \$33-a-share level that Microsoft said was its last offer.

Rivals of Yahoo and Microsoft, including Google and a raft of smaller competitors, are poised to take advantage of the current uncertainty. "It's an extraordinary opportunity for Ask.com," says Jim Safka, CEO of the small search site owned by IAC/InterActiveCorp. (IACI). "We're not going to miss a beat trying to exploit the distraction."

Ultimately, says Aiken, "Most people believe that Microsoft at some point will get the deal done." But the road to a Yahoo acquisition clearly has a few more twists and turns.