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A Guide to Poison Pills

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This is the first of a two-part series that will address the nuts and bolts of stockholder rights plans, or poison pills, as defensive mechanisms for public companies. Next week's installment will focus on recent Delaware cases regarding poison pills, new technologies and recent trends.

Stockholder rights plans were born in the 1980s in response to the proliferation of corporate raiders making hostile bids for public companies, and were designed to provide public company boards of directors with a "poison pill" to defend themselves against hostile takeover bids. Stockholder rights plans allow the target board of directors time and leverage to negotiate for a control premium or other alternatives to hostile bids. Triggering a poison pill results, in theory, in unpalatable dilution to the potential acquirer's ownership interest and increased acquisition cost, thereby forcing a potential acquirer to negotiate with the target board of directors prior to completing any acquisition.

A poison pill typically has two triggers that will cause the rights to be distributed separately from the common stock and to become exercisable. The date this occurs is usually called the "distribution date."

One trigger occurs when a potential acquirer launches a tender offer for the purchase of at least a specified percentage of the stock of the target company. Upon this trigger, the rights are distributed and become exercisable. Upon a distribution, one right is usually exercisable to purchase the equivalent of one share of common stock at a fixed price (the "exercise price"), which is customarily set at a price representing the hypothetical appreciation of the stock over the duration of the plan.

The second trigger occurs when someone actually acquires beneficial ownership of stock over a specified percentage. The holder is usually given some time to divest itself of excess holdings, and if it does not, the rights undergo what is called a "flip-in." On a flip-in, each right, other than rights held by the holder that triggered the flip-in, becomes exercisable for the number of shares equal to the exercise price divided by one-half the then-current trading price of the stock. For example, if a company's stock is trading at $15 per share at a time when someone triggers a flip-in by acquiring 25 percent of the outstanding shares, and the rights have a $30 per share exercise price, each right, other than those held by the triggering holder, will enable the purchase of 4 common stock equivalents for $30 — an effective price per share of $7.50. Assuming all the rights are exercised, the holdings of the holder that triggered the rights will decrease from 25 percent to 6.25 percent. Typically, upon a flip-in event, the board can elect to exchange each right for one (or more) common stock equivalents in lieu of permitting the rights to be exercised for cash.

Poison pills were also adopted outside the hostile takeover context to protect corporate assets, such as a company's ability to offset future taxable income with net operating losses (NOLs). NOL plans typically trigger a flip-in at 4.99 percent of the outstanding shares compared to more typical trigger percentages of 15 percent or more.

The severe market correction of late 2008 and early 2009, the drop in M&A activity combined with several high-profile unsolicited takeover bids for large public company targets, including by other public company bidders, and the proliferation of synthetic derivatives may herald the potential rebirth of the modern poison pill.

FIDUCIARY DUTIES ASSOCIATED WITH POISON PILLS

The "business judgment rule" is a presumption that directors acted consistently with their fiduciary duties, were disinterested and carried out their functions in good faith, after sufficient investigation, and for acceptable reasons. A more rigorous level of judicial scrutiny is given to decisions of boards of directors with respect to defensive measures taken in an attempt to block hostile takeover attempts. In determining whether to enforce a stockholder rights plan or poison pill, Delaware courts apply the enhanced Unocal/Unitrin standard and accord directors the benefit of the business judgment rule only if (1) the plan was not preclusive or coercive, and (2) it was a reasonable response to a specific articulated threat. The decision of whether or not to adopt a poison pill involves the consideration of the necessity of the poison pill and the impact its adoption will have on the company and its shareholders. Consideration will also be given to the effect of a poison pill's adoption on the relationship between the company and its shareholders and whether complimentary defensive measures were adopted concurrently with the pill.

The principal potential benefit of a poison pill is the preservation of the board of directors' ability to evaluate unsolicited bids and to solicit alternative bids in order to maximize stockholder value. A poison pill will also deter an unsolicited accumulation of a control position without the payment of a control premium to all stockholders. In sum, it encourages negotiation with the board of directors so that the board is in a position to command a higher control premium payable to all stockholders.

ISS on poison pills

Institutional Stockholder Services, a nationally recognized proxy adviser, will recommend "withhold" or "against" votes for the entire board of directors (except new directors) if:

• The company adopts a stockholder rights plan with a term longer than 12 months, or renews any stockholder rights plan, including any "short-term" pill (12 months or less), without prior stockholder approval. A commitment or policy that puts a newly adopted pill to a binding shareholder vote may potentially offset an adverse vote recommendation.

• The stockholder rights plan has a dead-hand or modified dead-hand feature. A dead-hand or modified dead-hand feature attempts to limit the discretion of a future board to amend or redeem the rights. Such features attempt to attack the vulnerability of a poison pill to the replacement of a majority of the board by a hostile acquirer through a proxy contest. These features generally are not enforceable under Delaware law.

• The board makes a material adverse change to an existing poison pill without stockholder approval.

ISS will review companies with classified boards every year, and companies with annually elected boards at least once every three years, and recommend "withhold" or "against" votes for all nominees if the company still maintains a nonshareholder-approved poison pill upon such review. ISS will issue the "withhold" or "against" recommendation every year that a poison pill is in place with a dead-hand or modified dead-hand feature.

ISS will consider on a case-by-case basis the recommendations for all nominees if the board adopts a poison pill with a term of 12 months or less without stockholder approval, taking into account the following factors:

• The date of the poison pill's adoption relative to the date of the next meeting of shareholders — i.e., whether the company had time to put the poison pill on the ballot for shareholder ratification given the circumstances;

• The company's rationale for adopting the poison pill;

• The company's governance structure and practices; and

• The company's track record of accountability to shareholders.

ISS makes voting recommendations for poison pills put up for shareholder vote on a case-by-case basis, considering the plan features. ISS states that poison pills should have the following features: (1) no lower than a 20 percent ownership trigger for the flip-in; (2) a term of no more than three years; (3) no dead-hand, slow-hand or no-hand feature that limits the ability of a future board to redeem the pill; and (4) a stockholder redemption feature whereby if the board refuses to redeem the poison pill 90 days after an offer is announced, the holders of 10 percent of the shares may call a special meeting or seek a written consent to vote on rescinding the pill.

Out of the top S&P 1,500 companies, 284 (less than 20 percent) currently have a poison pill in force and, out of those 284 poison pills: Five have a "dead-hand" provision; four have a "no-hand" provision; and 10 have an "adverse person" provision, which gives the board power to reduce the triggering percentage where the potential acquirer is deemed adverse to the interests of the company.

ISS's influence is felt mainly in the decision to adopt a poison pill. Only about a quarter of companies that adopted, renewed or extended poison pills in 2010 publicly disclosed that those actions would be subsequently put to a stockholder vote. A board that neither wishes to subject its poison pill to stockholder approval, nor face annual or triennial adverse vote recommendations will normally allow an existing poison pill to expire without renewal and/or hold off implementing a new poison pill until a specific need arises. When the need does arise, ISS's view of appropriate plan features appears to have limited influence. For example, only approximately 20 percent of poison pills have a trigger at 20 percent or more, with approximately 69 percent having a 15 percent trigger.

On Nov. 19, ISS announced the publication of its 2011 global proxy voting guidelines. The 2011 guidelines will add a policy to recommend voting against new stockholder rights plans or amendments designed to protect against NOLs if the effective term of the protective amendment would exceed the shorter of three years and the exhaustion of the NOLs. If the term of the proposed protective or poison pill is shorter than three years or the exhaustion of the NOLs, ISS will base its recommendation on a case-by-case analysis.

IS A POISON PILL ADVISABLE?

Poison pills may be adopted once a particular threat has emerged, and at such a time the board may be less concerned with ISS voting policies. Because a hostile bidder may emerge without warning and may quickly seek to take control through a hostile tender offer, boards should consider having a "pill-on-the-shelf" that will be ready to be implemented quickly in response to a specific threat. The work involved in drafting and implementing a poison pill is not trivial, and the need to do so "from scratch" in the face of an actual threat can distract the board and its advisers at a time when resources are already under pressure from the threat itself.

Poison pills work best when the company has authorized blank-check preferred stock. Any company that does not have authorized blank-check preferred stock should consider amending its charter to add such a class. Boards should note however that ISS will consider proposals to add a class of preferred stock on a case-by-case basis, and will often recommend against a class of blank-check preferred stock unless it is "declawed," meaning that the board has committed that the preferred stock will not be used for anti-takeover purposes.

Before proceeding to adopt a poison pill, the board of directors should consider:

• Is the adoption of the poison pill necessary to maximize shareholder value?

• How will institutional shareholders view the defensive measure, and how will they likely respond?

• Will adoption lead to votes against existing directors?

• Is stockholder approval of the stockholder rights plan achievable?

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