



## Recent Poison Pill Developments and Trends

Posted by Charles M. Nathan, Latham & Watkins LLP, on Tuesday May 12, 2009

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Shareholder rights plans were developed more than 25 years ago to fend off opportunistic hostile offers and other abusive takeover transactions. Rights plans deter unauthorized stock accumulations by imposing substantial dilution upon any shareholder who acquires shares in excess of a specified ownership threshold (typically ten to twenty percent) without prior board approval. Although the freewheeling takeover environment of the 1980s is now a distant memory, corporations today face continued threats of abusive takeover transactions, as well as threats from activist and other "event-driven" investors. The credit crunch and the resulting recession, accompanied by substantial deterioration in U.S. equity markets, has exacerbated these vulnerabilities.

Perhaps predictably in light of recent events, there was a resurgence in the adoption and use of rights plans in 2008 and the first quarter of 2009. Using data derived primarily from FactSet's [Sharkrepellent.net](#), this paper documents and analyzes these trends, including:

- rights plan adoptions, generally, and adoptions by small cap companies, in particular;
- NOL rights plans (plans with less than 5% triggers designed to protect a company's net operating loss carry-forwards ("NOLs") and certain other tax attributes);
- expirations versus extensions of existing rights plans;
- rights plans that include synthetic equity provisions;
- the duration of rights plans;
- trigger thresholds; and
- rights plans with corporate governance-related features.

We posit that the increase in adoption of rights plans in 2008 and the first quarter of 2009 is attributable to the deterioration in equity values, increased hostile activity, the proliferation of activist abuse of synthetic equity positions including total return swaps, coordinated "wolf-pack" tactics, the reduced utility of HSR as an early warning system for issuers and the decline in shareholder proposals to redeem rights plans. Considered together, these factors have lead

many corporations to reconsider the widely accepted strategy of keeping a rights plan on the shelf to be deployed quickly in response to a specific threat. The premise for the on-the-shelf strategy—that a board will have sufficient time and opportunity to pull a rights plan “off the shelf” if necessary—has recently eroded due to the advent of synthetic equity abuses and wolf-pack strategies that may not trigger a filing under the Williams Act until an investor wants to make its campaign public. Additionally, the precipitous declines in market capitalization suffered by many corporations have enhanced a sense of vulnerability to hostile bids and resulted in the loss of efficacy of HSR as an early-warning mechanism. Boards of directors are concluding that the adoption of rights plans is necessary and prudent under the circumstances and that they will be less exposed to investor backlash for doing so. Indeed, many boards of directors are confident that they can effectively manage investor relations following the adoption of a rights plan given current market conditions.

The past year also brought a number of important developments related to the next generation of rights plans:

- Following the well-publicized case involving CSX Corporation, and in light of the changing nature of equity ownership in the U.S., corporations have modified their rights plans to include derivatives, swaps and other synthetic equity positions within the definition of “beneficial ownership.” However, these new definitions of beneficial ownership are untested and may be imperfect. For example, certain provisions included in next generation rights plans intended to capture ownership of synthetic equity positions (which we categorize as: (i) the Full Ownership Approach; (ii) the Double-Trigger Approach; and (iii) the Atmel Approach) may be overly broad or may undermine the deterrent effect of dilution of the triggering shareholder’s ownership position that underpins rights plans.
- To address coordinated wolf-pack campaigns by activist and other event-driven investors, who may seek to execute their strategies without disclosure of their coordinated activities, at least one corporation has modified its rights plan to treat parties acting in concert or acting with “conscious parallelism” as having formed a group for purposes of determining beneficial ownership under the rights plan. This could be a particularly important issue for public companies because the wolf pack tactic (as opposed to ownership of synthetic equity described above) has been used virtually exclusively by the activist investor community in campaigns against corporations, often culminating in successful proxy contests or other change-of-control events as documented in the CSX case. The market’s knowledge of the formation of a wolf pack (either through word of mouth or public announcement of a destabilization campaign by

the lead wolf pack member) often leads to additional activist funds entering the fray against the target corporation, resulting in a rapid (and often outcome determinative) change in composition of the target's shareholder base seemingly overnight. Many investors take the position that these coordinated activities are not conducted pursuant to any formal agreement, arrangement or understanding and thus are not required to be disclosed under applicable federal securities laws, which denies companies of the key benefits of the Williams Act (affording timely notice to the target company and other investors) and rights plans (avoiding the accumulation of outcome determinative equity positions).

- NOL rights plans gained prominence due to the recession, which is generating significant net operating losses at many companies. NOLs may be used to reduce future income tax payments and have become valuable assets to many corporations. If a corporation experiences an "ownership change" as defined by Section 382 of the tax code, then its ability to use a pre-change NOL in a post-change period could be substantially limited or delayed. While NOL rights plans afford some protection for a corporation's NOL asset, the protection is not complete. NOL rights plans cannot prevent an ownership change for tax purposes or prevent a potential acquirer from purchasing more than the triggering threshold. They merely serve as a deterrent. An amendment to the corporation's charter to include ownership limitations is arguably more effective, though perhaps more difficult to implement. Moreover, while the potential merits of NOL rights plans have been recognized by corporations as well as the proxy advisory firm, RiskMetrics Group, they remain untested by the courts, especially in terms of examination of the board of directors' motivations for adopting NOL rights plans. For example, a Delaware court will apply a heightened standard to boards' decision to adopt if the NOL rights plans are viewed as defensive measures, which we believe is a likely scenario. We may have a better understanding of this issue in the very near future as the NOL rights plan implemented by Selectica, Inc. and triggered by Versata Enterprises, Inc. is the subject of current litigation in Delaware. Selectica's situation demonstrates that an NOL rights plan is a limited defense against impairment of the NOL asset. It can deter, but not prevent, share trades that may result in an ownership change.
  
- Selectica's NOL rights plan was triggered in December 2008 by Versata Enterprises which became the first shareholder to have swallowed a modern rights plan by intentionally buying shares in excess of a rights plan's trigger amount. This situation has provided important lessons for the design and implementation of certain common

provisions found in virtually all rights plans. In particular, we argue the exchange feature (exchanging the rights on a one-for-one basis for common stock) offers significant advantages over a traditional flip-in rights plan because it provides certain and automatic dilution, no cash is required to exercise the right and it may have less impact on the NOL asset itself. The Selectica situation has also demonstrated the importance of adding “back-office” mechanics for the exchange feature. In particular, corporations should include a process to verify that rights being exchanged include rights held in “street name” through the Depository Trust Corporation. We also believe that it is preferable that an NOL rights plan be non-redeemable after the ownership threshold has been crossed so that no post-trigger waivers can be granted. As with traditional rights plans, this incentivizes a potential share purchaser to engage in a pre-purchase discussion to request a waiver from a board of directors. The board of directors can then consider the waiver in advance without undue pressure and grant it if the proposed share purchase does not threaten the value of the NOL asset. The board of directors should also institute a formal pre-clearance process which would demonstrate that the board of directors has adopted the NOL rights plan for the purpose of protecting the corporation’s NOL asset, not for entrenchment or other improper motives, and frames the board of director’s consideration of waiver requests in this context.

After years of decline, the rights plan experienced a resurgence in 2008. This may be a temporary result of the recession, as corporations buffeted by falling equity prices adopted measures to protect shareholders in a period of market volatility. However, the trend could outlive the recession. The Atmel and Selectica litigations likely will provide the Delaware courts with the opportunity to clarify the validity of the rights plan, including whether triggers can be expanded to include derivative and synthetic provisions and whether they can be employed not just to fend off hostile and abusive takeovers, but also to protect valuable assets of a corporation.

Whether the resurgence continues or abates, the increasing use of derivative and synthetic equity positions, coupled with the first trigger of a modern rights plan, dictates that increased attention be paid to the terms and mechanics of rights plans. No longer can advisers dredge up a stale rights plan and suggest that its terms sufficiently protect a corporation or that the complex procedures are unlikely to be tested. Instead, corporations and their advisers should evaluate rights plans to ensure that they contain customized state-of-the-art terms and mechanics that can offer fulsome protection against evolving threats.

The full paper is available [here](#).