

Proactively Adopting a Poison Pill in Response to the COVID-19 Crisis

Tailored considerations for boards of directors and management in the current environment.

Key Points:

- Hostile takeover activity and stockholder activism often correspond with or follow periods of extreme market volatility and investor uncertainty. In the current environment, a significant uptick in adoptions of stockholder rights plans (so-called “poison pills”) is expected as companies confront a sharp decline in stock prices and face public valuations that may not be reflective of long-term intrinsic value.
- The terms of the rights plan — specifically duration, triggering thresholds, and timing of stockholder approval of the rights plan (if any) — should be tailored to the circumstances the board cites to justify the adoption of the rights plan.
- A narrowly tailored rights plan coupled with disclosure as to the specific threats the board is seeking to address should be sufficient to address the customary concerns of proxy advisory firms, governance advisory groups, and leading institutional investors, whose policies traditionally disfavor proactive adoption of rights plans.
- Companies impacted by significant stock price declines should proactively consider preparing rights plan materials, reviewing the rights plan with the board, and either adopting or putting the rights plan “on the shelf.”

The Impact of COVID-19 on Company Vulnerability

Over the last month, global financial markets have experienced unprecedented volatility in connection with the coronavirus pandemic (COVID-19). Investor concern about the impact of COVID-19 has led to market-wide sell-offs, resulting in companies across nearly every sector experiencing sharp stock price declines. Current market conditions are prime for hostile takeover activity and shareholder activism, and as such, a significant uptick in rights plan adoptions is expected as companies face sharp declines in stock prices and public valuations that may not be reflective of long-term intrinsic value. Indeed, a record-setting 11 public companies adopted poison pills between March 12 and 25 across a variety of industries. As boards grapple with the immediate and long-term implications of COVID-19, they should consider whether to implement defensive measures to attempt to proactively combat near-term coercive or abusive takeover and control practices.

This *Client Alert* addresses some of the questions Latham & Watkins is discussing with public company clients as they consider adopting a stockholder rights plan as a defensive measure in response to the impact of COVID-19 on the business and financial environment in the United States.

What COVID-19 and Market Conditions Should a Board Consider When Adopting a Rights Plan?

Adoption of a rights plan has been consistently upheld in Delaware as a reasonable response to threats of abusive takeover or control tactics, even if no current takeover proposal is pending. Nonetheless, a board should always identify the underlying conditions that have led to the adoption of a rights plan, as well as any specific threats to the company that the rights plan is intended to address, and thoughtfully tailor the terms of the rights plan to those circumstances and threats. Unattributed significant stock accumulations, activist approaches, and unsolicited bidder interest all have served to support adoption of rights plans in the past, even absent an overt takeover bid or identified activist stock accumulation.

Underlying conditions that support a board's adoption of a rights plan in the current environment may include:

- Current substantial declines or significant volatility in the company's stock price, such that current trading prices are not reflective of the board's view of long-term fundamental value
- Substantial disruption to business operations in the company's sectors and geographies of operation as a result of COVID-19, including impacts on employees, customers, commodity pricing, and supply chains due to mandated closures of business and borders
- Potential short-term financial distress due to reduced revenue streams and operational challenges that might be amplified by the company's capital structure, such as indebtedness coming due or potential covenant violations or other defaults
- The inability of the company to effectively and fully communicate with its stockholders, including institutional investors, while operations of both the company and its investors are disrupted by the crisis
- Challenges in effectively responding to external threats in a timely manner due to limitations on the availability of a company's workforce and advisors and limited bandwidth and capacity of counterparties to facilitate a robust board review of strategic alternatives
- Dramatic reduction in market capitalization and substantial increases in daily trading volumes, such that larger stock accumulations become more economically feasible for activist investors and hostile acquirers and can be executed more effectively within the 10-day window to file a Schedule 13D, while early-warning mechanisms like pre-merger notification requirements under the Hart-Scott Rodino Antitrust Improvements Act of 1976 may require larger stock accumulations before value-based reporting thresholds are met
- The likely duration of these challenges for the economy generally and the particular sectors and geographies in which the company operates

Potential threats resulting from these challenges may include:

- The prospect of material stock accumulations by activist investors at disrupted market prices, who might seek to implement short-term changes in strategic direction, capital allocation, or business

operations, that could be disruptive at a time of crisis to management and the board's business planning and strategy for preserving long-term value for stockholders

- The prospect of material stock accumulations by potential buyers (whether strategic or private capital) at disrupted market prices that could facilitate unsolicited bids or contests for control of the company that do not reflect the long-term fundamental value of the company, and that occur at a time when stockholders lack sufficient information to properly evaluate the fundamental value of their ownership position
- The potential for unsolicited bidders taking advantage of market uncertainty and less competition to acquire the company at a depressed price given that some of the company's stockholders may be seeking near-term liquidity in a distressed market and not making investment decisions based on long-term fundamental value, and that many potential competing buyers may not be able to pursue a transaction because of other demands on their time and resources, lack of financing availability, or the ability to conduct in-person diligence

How Will the Terms of the Rights Plan Differ in This Environment?

Both (1) in establishing the reasonableness of the board's response to the perceived threats that lead to the adoption of the rights plan, and (2) as a matter of mitigating potential adverse investor reaction (as discussed below), the rights plan should be structured so as to clearly address the threats identified.

Trigger Threshold

A rights plan's primary deterrent effect is to limit stock accumulations above an ownership threshold that would "trigger" the plan's dilutive effects. The appropriate trigger threshold depends on the nature of the identified threat. In the circumstances of COVID-19 and associated market disruption, taking into account specific considerations related to the company and its perceived vulnerability is critical both in an evaluation of the rights plan as a reasonable response to the perceived threats to the company, and in providing an underlying rationale for the adoption of the rights plan to stockholders, proxy advisory firms, and other constituencies.

- A two-tiered trigger — typically a 20% ownership threshold for "passive" investors filing on Schedule 13G and a 10% ownership threshold for activist or other investors who are not filing on Schedule 13G — may be appropriate in circumstances where potentially disruptive hostile bidders or activist investors presently own or may acquire the company's stock given the ease of accumulation during the disrupted market environment, particularly if market capitalization of the company has shrunk dramatically. In other circumstances and for larger companies, a broad-based 10% to 15% ownership threshold for all stockholders may be appropriate.
- A trigger just shy of 5% to protect net operating losses (or NOLs) may be appropriate, particularly given (1) the enhanced value of such assets following adoption of the CARES Act, and (2) the potential for a substantial shift in stock ownership during times of market disruption, which could affect the utility and value of such assets.

Duration and Stockholder Approval

Rights plan duration is typically impacted by two principal factors: (1) the relationship of the duration of the rights plan to the likely duration of the conditions underlying the perceived threat that resulted in adoption of the rights plan, and (2) the governance policies of proxy advisory firms, particularly Institutional Shareholder Services (ISS), and the largest institutional investors, which impact their voting

recommendations regarding the election of directors at companies that have adopted rights plans that have not been approved by stockholders.

- While the duration of the COVID-19 crisis and its consequences cannot be predicted, much of the government intervention and associated policies contemplate resolution of *the economic consequences* of the pandemic in 2020. Accordingly, adoption of a shorter duration rights plan that ends in a year or less may be desirable. Conditions will, of course, vary by company, including sector and geography of operations.
- Absent the company's commitment to submit the rights plan for stockholder approval at the next stockholder meeting, advisory firms and larger institutional investors will generally default to annual "withhold" recommendations or votes with respect to all of the company's directors at each subsequent annual meeting while the rights plan remains in place; however, for rights plans of less than a year's duration, the vote will be considered on a case-by-case basis (see below for more). Accordingly, a rights plan with a duration that does not extend past the next stockholder meeting or commits to termination of the rights plan if stockholder approval is sought but not obtained is most likely to avoid a withhold vote recommendation. While these policies should not dictate against adoption of a rights plan of longer duration when necessary, accommodating them if consistent with the company's needs may be desirable in certain circumstances.

How Does a Company Best Address Proxy Advisory Firm and Investor Reactions to Adoption of a Rights Plan in This Environment?

On March 19, the ISS Special Situations Research Team, which issues recommendations for contested stockholder meetings, indicated that "boards contemplating defensive maneuvers may want to consider that an effective response to the pandemic could be more advantageous than any pill." Notwithstanding this initial guidance from ISS, Latham expects that ISS, other proxy advisory firms, and the governance teams at large institutional investors are likely to continue to follow their existing policies and consider on a case-by-case basis rights plans adopted with a term of one year or less without stockholder approval. Accordingly, these firms and investors could be persuaded not to recommend or submit a withhold vote with respect to the directors at the next annual meeting if the rationale for adoption of the rights plan and its terms are effectively conveyed in the public announcement of the plan.

As a consequence, companies adopting rights plans for a limited duration (one year or less) should focus on thoughtfully and extensively articulating the board's rationale for adopting the rights plan and its specific terms, such as duration and trigger thresholds, in the press release announcing the adoption of the rights plan and in related disclosures, rather than using a generic form of press release that may have been prepared for a rights plan "on the shelf." The stated rationale and terms could include all or some of the conditions and threats outlined above, with specific linkage between the perceived conditions and threats, their application to the company, and the timing of the adoption of the rights plan, its duration, the applicable trigger thresholds, and the presence or absence of a requirement that stockholders approve the rights plan at the company's annual meeting. With respect to presence or absence of stockholder approval, the company may outline (1) timing of that stockholder approval, (2) the relationship to the 2020 annual meeting timing, and (3) the feasibility of communications with stockholders prior to the 2020 annual meeting given business and market conditions.

Should a Company That Is Not Adopting a Rights Plan Now Still Put One On the Shelf?

Putting a rights plan on the shelf means preparing the necessary documentation, educating board members on the purpose and function of a rights plan, reviewing board members' fiduciary duties in the context of the adoption of a rights plan, and consulting legal, financial, and investor relations advisors on the next steps in the process. While rights plans can be unilaterally and swiftly adopted by the board without stockholder approval, quick implementation in response to rapid accumulations or other emerging threats is best facilitated, and the legal record in any subsequent litigation enhanced, by thoughtful board review in advance of adoption as to the purposes, benefits, and mechanics of a rights plan. The preparation of appropriate documentation, including pre-clearance of the forms with the proposed rights agent who will be the company's counterparty under the rights plan, also facilitates swift adoption.

In the current business and market environment, with rapid and drastic swings in market values and dramatic changes in operational conditions, the ability of the board to act nimbly becomes even more important. Any company without a rights plan should consider putting one on the shelf in the near term in case changing conditions or new threats require rapid adoption at a future date. Further, even companies with a rights plan on the shelf today should consider whether the rights plan materials should be updated and reviewed with the board. In connection with reviewing a rights plan currently on the shelf or putting a plan on the shelf in the near future, boards should also undertake a comprehensive review of the early-warning mechanisms and activism response plans and teams they have in place in order to ensure their ability to respond effectively to rapidly changing conditions, including through adoption of a rights plan.

Conclusion

Hostile takeover activity and stockholder activism often correspond with or follow periods of extreme market volatility and investor uncertainty. A significant uptick in rights plan adoptions is expected as companies confront a sharp decline in stock prices and face public valuations that may not be reflective of long-term intrinsic value. Indeed, a record-setting 11 public companies adopted poison pills between March 12 and 25 across a variety of industries, including oil and gas, food services, kitchen supply, consumer products, and education. Companies and boards should take into account their specific circumstances when considering and preparing a rights plan, while tailoring the rights plan to cover identifiable threats without being overly expansive with respect to the duration and other terms of the plan. Latham recommends that companies impacted by significant stock price declines proactively prepare rights plan materials, review the rights plan with the board, and either adopt or put the rights plan on the shelf. Finally, as it is too early to understand all of the implications of COVID-19, companies should be mindful that the issues raised in this *Client Alert* are subject to change and that additional issues may need to be considered as matters develop.

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