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The Resilient Rights Plan:
Recent Poison Pill Developments and Trends

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INTRODUCTION

Shareholder rights plans were developed more than 30 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 who may disproportionately affect governance. This paper updates papers first published in April 2009[1] and April 2011[2] and documents and analyzes recent rights plan trends.

Recent years brought a number of important developments affirming the legality and demonstrating the effectiveness of shareholder rights plans:

- Though adoption continues to be rare, particularly among large corporations, a traditional rights plan is a legally valid and powerful tool for protecting the board's determination to reject an unsolicited takeover proposal that the board believes in good faith is inadequate and not in the best interests of the corporation and its stockholders.

- Corporations have continued to modify their rights plans to address the changing nature of equity ownership by including derivatives, swaps and other synthetic equity positions within the definition of "beneficial ownership." While this approach to more modern abuses has not yet been fully tested in court, it survived a motion for injunctive relief in the *Atmel* case.[3]

- NOL rights plans gained prominence due to the recession, in which many corporations generated significant net operating losses ("NOLs"). NOLs may be used to reduce future income tax payments and have become valuable assets to many corporations. Despite the turnaround in the economy, adoption of NOL plans remains significant. This trend is

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[1] *See The Resurgent Rights Plan: Recent Poison Pill Developments and Trends*, available at http://www.lw.com/upload/pubContent/_pdf/pub2628_1.pdf.

[2] *See The Resilient Rights Plan: Recent Poison Pill Developments and Trends*, available at http://www.lw.com/thoughtLeadership/recent-poison-pill-developments-trends-april-2011

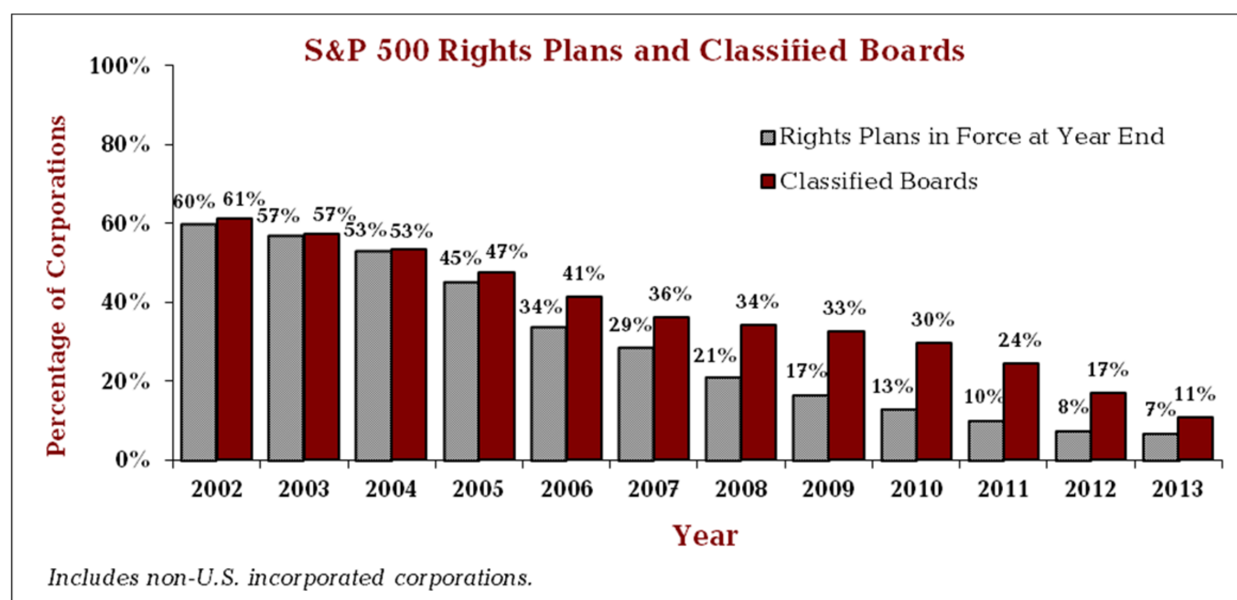
[3] Atmel Corporation, Current Report (Form 8-K) p. 3 (Nov. 16, 2009).

likely to continue given the effectiveness of these plans, the well-reasoned Delaware decision upholding Selectica's NOL plan and, in some cases, the collateral defensive benefits.

I. RIGHTS PLAN TRENDS

A. Rights Plan Utilization and Terms

The use of rights plans spread widely after their introduction in the 1980s. Indeed, in 2002, approximately 60 percent of Standard & Poor's 500 corporations had rights plans in place. However, as illustrated in the following chart, usage of rights plans declined beginning in 2003, as did the use of the classified board, albeit at a slower rate.[4]



Factors that drove the decline in recent years in the use of rights plans and classified boards include:

- proxy advisers, such as Institutional Shareholder Services ("ISS"), adopting policies recommending that shareholders vote "withhold/against" directors of corporations that adopted or renewed rights plans, or failed to declassify their staggered boards;[5]

[4] Unless otherwise noted, empirical data regarding rights plans throughout this paper is provided by, or derived from data provided by, SharkRepellent.net.

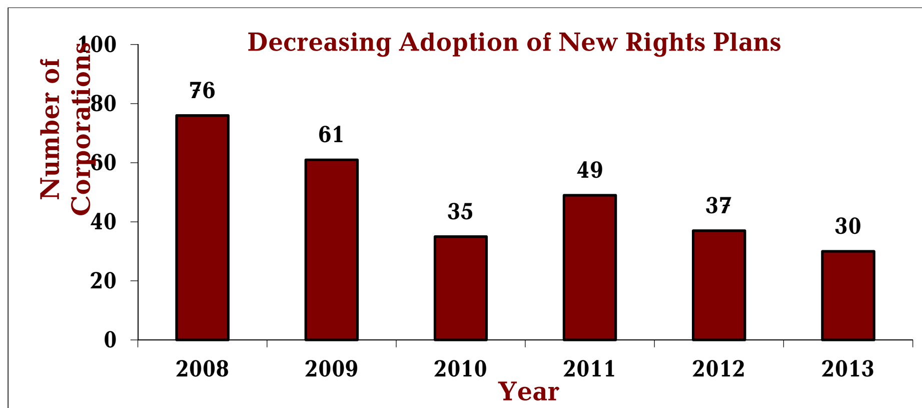
[5] *See* ISS, *2014 Institutional Shareholder Services U.S. Proxy Voting Guidelines Summary*, March 12, 2014, *available at* http://www.issgovernance.com/files/ISSUSSummaryGuidelines2014March12.pdf. Note that since 2005, it has been ISS's policy to recommend a withhold/against vote for the entire board of directors (except new nominees) if the board adopts or renews a rights plan without shareholder approval. ISS's current recommendations are discussed below in Part I.B.

- an increase in the prevalence of majority voting policies, which increased the impact of adverse advisory firm recommendations following adoption or renewal of a rights plan without shareholder approval; and

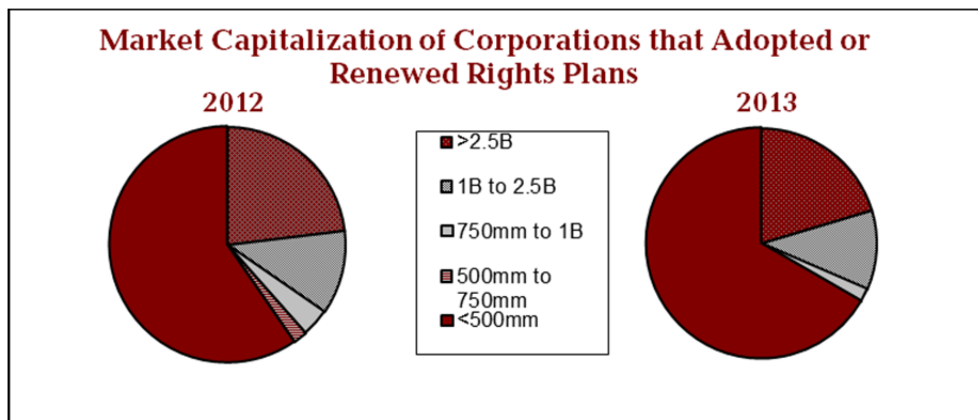
- perhaps most important, wider employment by boards of the strategy to put a rights plan "on the shelf" to be deployed quickly and only if necessary in response to a specific threat.

The following statistics illustrate certain important recent trends in rights plans.

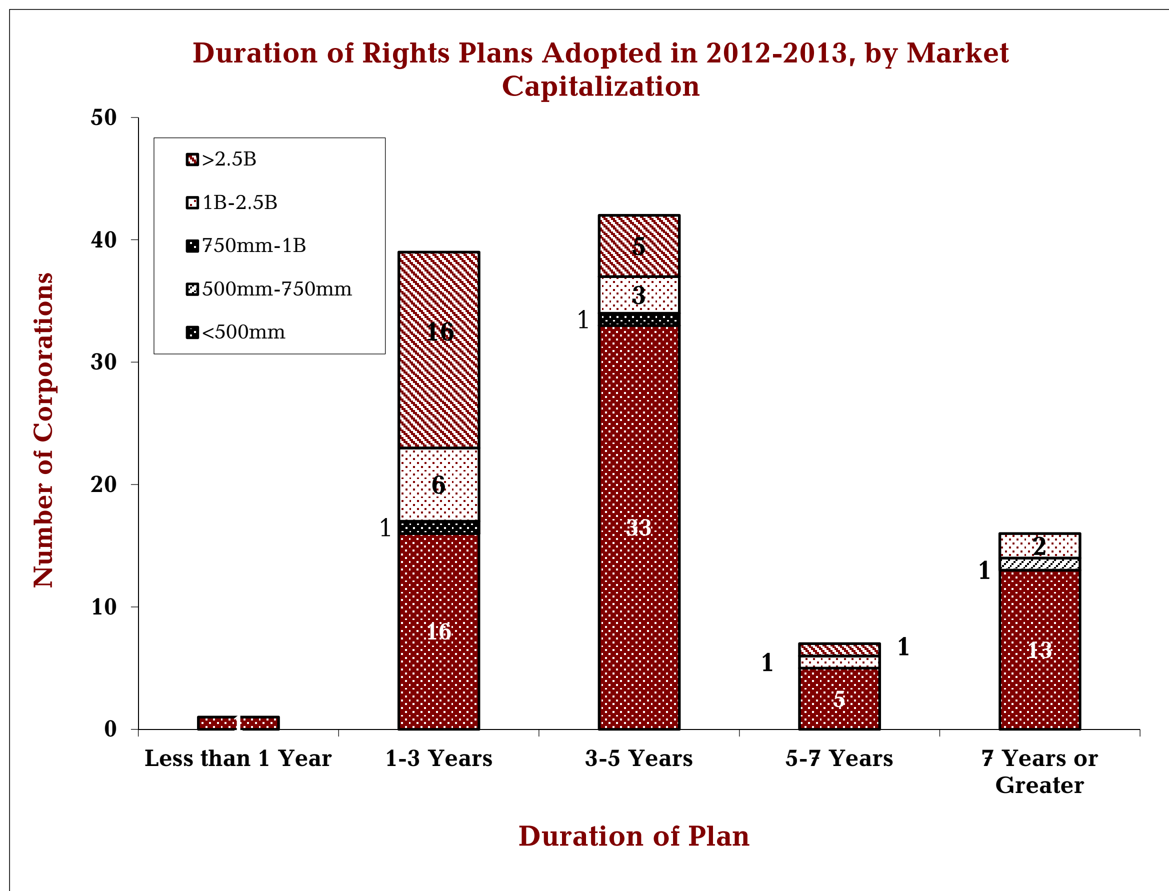
- *Decrease in Initial Adoption of Rights Plans.* In 2008, the adoption of first time rights plans peaked in connection with the substantial deterioration in the U.S. equity markets that accompanied the recession and heightened the perceived threat of abusive takeover transactions. Since 2008, the number of corporations adopting rights plans for the first time has generally been in decline, with only 30 such adoptions in 2013.



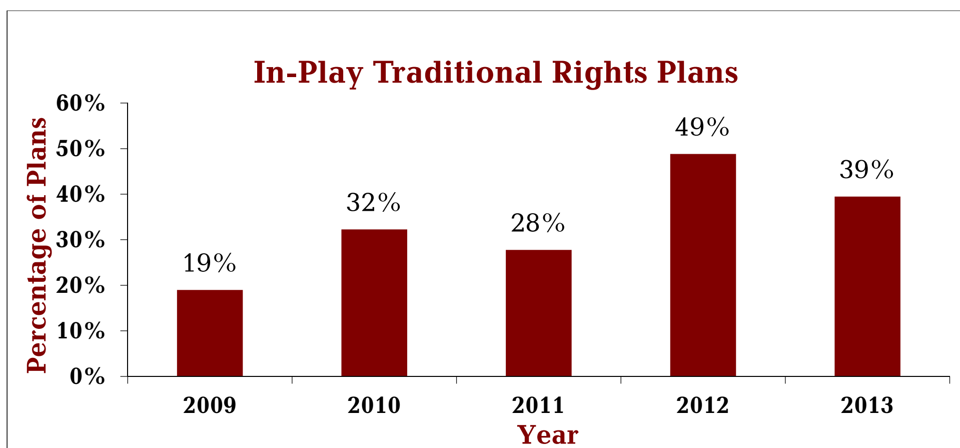
- *Rights Plans Adopted by Smaller Capitalization Corporations.* Corporations with market capitalizations of less than $500 million continue to be the primary users of rights plans. Thirty-six small-cap corporations adopted or renewed rights plans in 2013, and 31 did so in 2012.



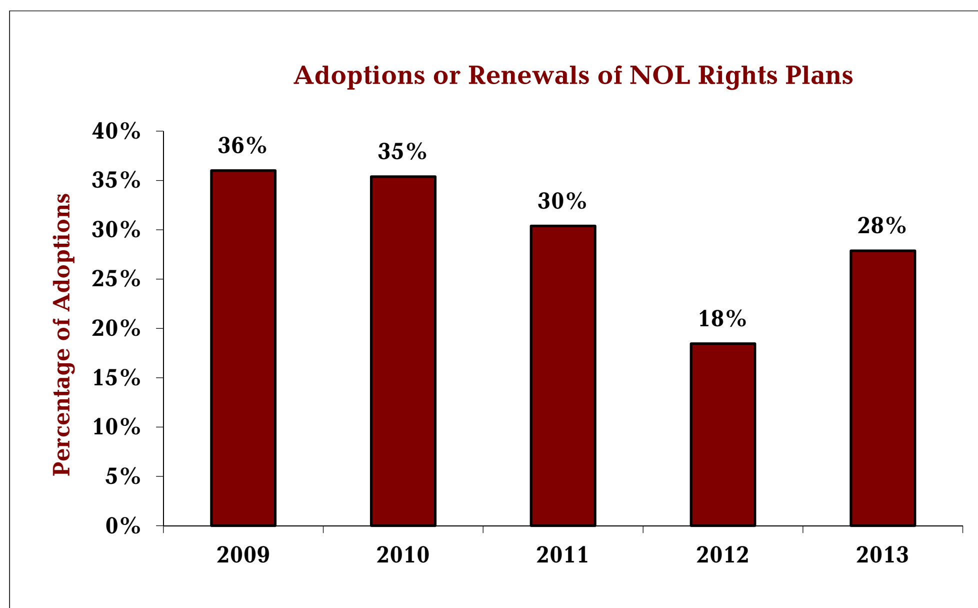
- *Short Duration Rights Plans.* Shorter duration rights plans have become the new norm, with 85 percent of rights plans adopted in 2012 and 2013 having a duration of five years or less, perhaps reflecting a strategy of coordinating rights plan terms with investor communications emphasizing the temporary nature and tailored purpose of the rights plan.



- *In-Play Rights Plans*. Nineteen corporations adopted rights plans in 2013 while they were "in-play," and 21 corporations did so in 2012. "In-play" adoptions include rights plans adopted (i) to thwart an unsolicited or hostile takeover offer, (ii) to safeguard a friendly merger by preventing any third party from launching a challenging offer, (iii) in response to disclosure of a significant stake purchase, and (iv) in connection with a company's plans to explore strategic alternatives, including a sale of the company. Historically, rights plans were routinely adopted, and in-play adoptions did not represent a large percentage of adopted or renewed plans. However, despite the decrease in the overall number of adoptions of traditional rights plans, the number of in-play adoptions has remained steady. Accordingly, the proportion of rights plans adopted by corporations in-play has increased since 2009.

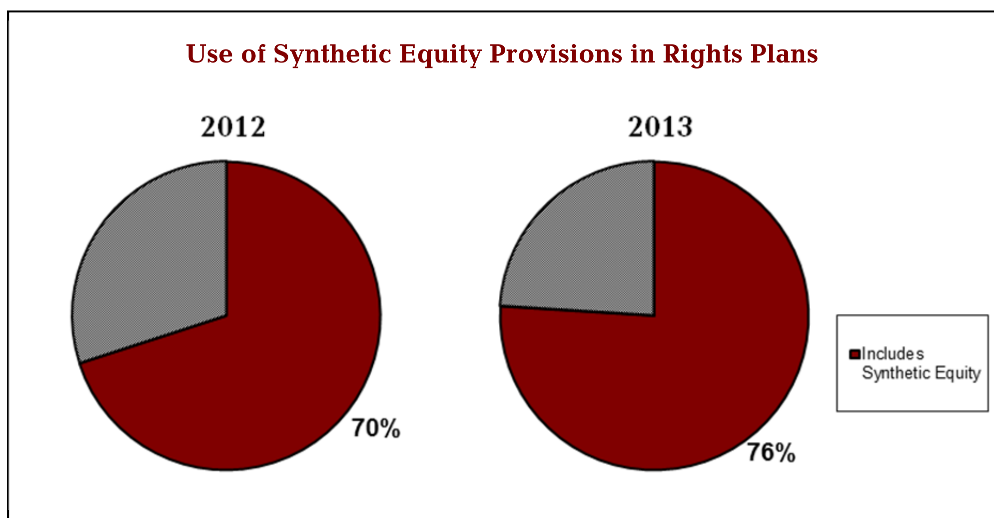


- *NOL Rights Plans.* NOL rights plans continue to account for a significant portion of all rights plans adoptions, although at a rate slightly less than the years immediately following the recession. Seventeen NOL rights plans were implemented in 2013, which constituted 28% of all rights plan adoptions and renewals. The corporations implementing NOL rights plans in recent years include several well-known corporations such as AOL Inc., Ford Motor Company, J.C. Penney Company, Inc., Krispy Kreme Donuts, Inc. and Tenet Healthcare Corporation.



- *NOL Rights Plans and Shareholder Votes.* One hundred percent of NOL rights plans adopted in 2012 and 2013 and put to a vote to date were approved by shareholders. Of those with available vote totals, a significant majority passed by 80 percent or more.

- *Synthetic Equity Provisions.* First appearing in the 2008 rights plans for Micrel, Incorporated and Clarus Corporation, it is now fairly customary to include synthetic equity positions for the purposes of determining whether a rights plan has been "triggered." Seventy-six percent of all traditional rights plans adopted or amended in 2013 contained provisions including synthetic equity positions, as did 70 percent of 2012 traditional rights plans.



Corporations seeking to adopt new rights plans, or to extend the terms of existing rights plans, can submit the question to a shareholder vote, or include other provisions favored by corporate governance activists that require periodic review of rights plans by independent directors or permit certain qualified offers to go directly to the shareholders. The following statistics illustrate the prevalence of these corporate governance–related features in rights plans in 2012 and 2013:

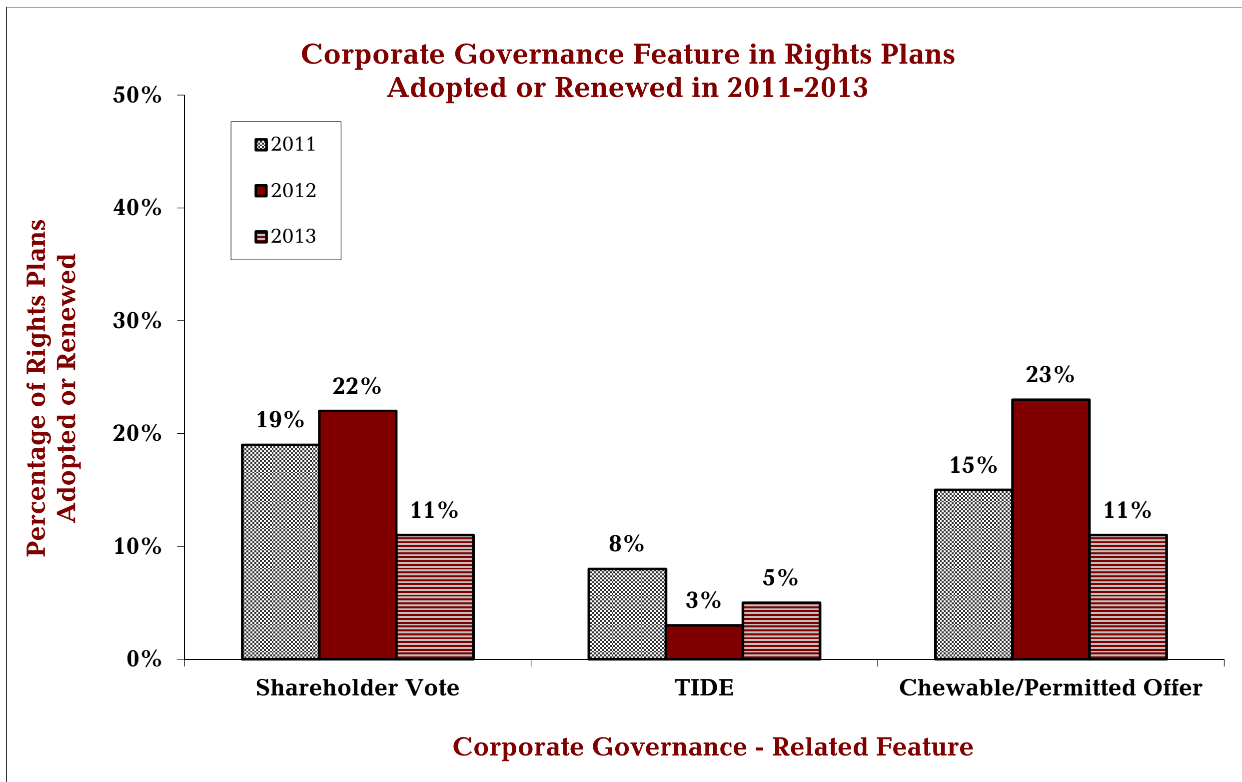
- *Shareholder Vote.* Sixteen percent of all traditional rights plans adopted in 2012, and 14 percent of those adopted in 2011, were put to a shareholder vote. To date, eight percent of all rights plans adopted or amended in 2013 have been put to vote, however this proportion may increase to 2012 and 2011 levels as proxy season progresses.

- *Three-Year Independent Director Evaluation (TIDE).* A TIDE feature requires independent director evaluation of rights plans every two to three years. This feature is now all but obsolete: five percent of rights plans adopted or renewed in 2013 contained this feature, and only three percent did in 2012.

- *Chewable Rights Plans and Permitted Offers.* The chewable feature and the permitted-offer feature provide exceptions to the trigger of a rights plan for a qualified offer for the corporation. Qualified offers are typically all cash, fully financed and open for a set time and may require a certain premium to the corporation's current or historical stock price. Eleven percent of plans

adopted or renewed in 2013 contained either the chewable feature or the permitted-offer feature.

We continue to question the strategic motivation for including these provisions, particularly those providing for chewable rights plans or permitted offers, except when a company intends to put the rights plan to a shareholder vote and wishes for ISS to recommend that shareholders vote in favor of the rights plan. Eighty percent of traditional rights plans put to a shareholder vote in 2012 and 2013 included a permitted offer provision, likely in order to comply with ISS's policy, as described below in Part I.B. of this article. Without regard to ISS policy, it seems contrary to the interests of shareholders to constrain the discretion of a board of directors to use a rights plan to defer an offer or enable an auction through a provision exempting an ostensibly "premium" bid that the board does not believe reflects a corporation's full value.



B. Increasing Scrutiny by Proxy Advisory Firms

The continuing decline in the traditional rights plan is in large part attributable to the role played by proxy advisory firms like ISS. ISS's policies continue to evolve to provide increased scrutiny of the adoption of rights plans. Until the 2010 proxy season, it was ISS's policy to recommend, on a one-time basis, a withhold/against vote for the entire board of directors[6] if the board did not commit to putting a rights plan to a shareholder vote within 12 months of adoption or reneged on a commitment to put the rights plan to a vote.

ISS's new recommendations provide for increased scrutiny of boards adopting rights plans.[7] ISS stated that this policy change "aims to encourage companies to seek shareholder approval of poison pills."[8] The policy provides:

- ISS will recommend a withhold/against vote for all director nominees annually for corporations with a staggered board and at least every three years for corporations with annually-elected boards if the board adopts a rights plan with a term of more than 12 months or renews any existing rights plan without shareholder approval. This review continues until the rights plan expires or is redeemed. A commitment or policy that puts a newly-adopted rights plan to a binding shareholder vote may potentially offset a withhold/against recommendation.

- ISS will recommend a withhold/against vote each year a corporation has a rights plan in effect with a "dead-hand" or a "modified dead-hand"[9] feature. The "dead-hand" feature has been unenforceable under Delaware law since *Quickturn Design Systems v. Shapiro*[10] in 1998, so it is not a viable provision for the vast majority of U.S. public corporations.

- ISS will recommend a withhold/against vote on a one-time basis if a board makes a material change to an existing rights plan that is adverse to the shareholders, and does not obtain shareholder approval of the change.

- ISS will review each director nominee on a case-by-case basis if the board adopts a rights plan with a term of 12 months or less without shareholder approval, taking into account the following factors:

    - The date of adoption of the rights plan relative to the date of the next meeting of shareholders (whether the

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[6] For all rights-plan related recommendations, ISS will review new director nominees who joined the board after the action on the rights plan occurred on a case-by-case basis.

[7] RiskMetrics Group, *2010 U.S. Corporate Governance Policy Updates*, Nov. 19, 2009, *available at* http://www.issgovernance.com/files/RMG2010USPolicyUpdates.pdf.

[8] RiskMetrics Group, *2010 Corporate Governance Policy Updates and Process Executive Summary*, Nov. 19, 2009, *available at* http://www.issgovernance.com/files/RMG2010PolicyUpdateExecSumm_0.pdf.

[9] Rights plans of these types include restrictions on which directors are qualified to redeem the plan. For example, a plan may limit redemption authority to only continuing directors (those in place as of the date of the adoption of the plan), their designated successors, or those not affiliated or associated with the acquiring person are qualified to redeem the plan.

[10] C.A. Nos. 511 and 512, 1998 (Del. Dec. 31, 1998).

corporation had time to put the rights plan on the ballot for shareholder ratification given the circumstances);
  - The corporation's rationale for adopting the rights plan;
  - The corporation's governance structure and practices; and
  - The corporation's track record of accountability to shareholders.[11]

This change in policy to a regular review of boards adopting rights plan with terms over 12 months may have contributed to the increase in the adoptions or renewal of rights plans with terms of a year or less from 8 percent in 2009 to 19 percent in 2010. Recently, a substantial portion of adopted traditional rights plans, 45 percent in 2013 and 35 percent in 2012, have had one-year terms, reflecting both a desire to fall within the "case-by case" standard and that terms are often customized to address a perceived short-term threat, a feature which can improve the likelihood of receiving institutional shareholder support for a rights plan adopted in the face of such a threat.

If a board accedes to ISS's policy goals and submits a rights plan for ratification by the corporation's shareholders, in making its determination as to whether to recommend approval or rejection of the rights plan, ISS will review the rights plan on a case-by-case basis, focusing on the features of the plan. ISS provides that the rights plan should have the following attributes:

- No lower than a 20 percent trigger, flip-in or flip-over;
- A term of no more than three years;
- No dead-hand, slow-hand or similar feature that limits the ability of a future board to redeem the rights plan; and
- A shareholder redemption feature (also known as a qualifying offer clause); if the board refuses to redeem the rights plan 90 days after a qualifying offer is announced, 10 percent of the shares may call a special meeting or seek a written consent to vote on rescinding the rights plan.[12]

ISS notes that the corporation should also thoroughly explain its rationale for advocating adoption of the rights plan and that ISS will take into consideration the corporation's existing governance structure, including board independence, existing takeover defenses, and any governance concerns. ISS has a separate policy regarding NOL rights plan proposals, which is discussed in Part IV.B.4 of this article.

Despite ISS's goal of encouraging boards to submit rights plans for ratification by shareholders, only 12 percent of non-NOL rights plans were submitted for ratification in 2012 and 2013. When a board of directors is faced with a threat to the corporation, it may determine that adopting a rights plan that effectively addresses the threat is of greater

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[11] *See* ISS, *2014 Institutional Shareholder Services U.S. Proxy Voting Guidelines Summary*, March 12, 2014, *available at* http://www.issgovernance.com/files/ISSUSSummaryGuidelines2014March12.pdf.

[12] *Id.*

concern than the possibility or expectation of an adverse withhold recommendation by proxy advisory services. Further, the terms ISS would require to obtain its endorsement of a rights plan often denude the plan of most of its important defensive attributes in the face of a pending threat.

C. Analysis of Recent Trends in the Adoption of Rights Plans

Although ISS's policies have drastically reduced the number and duration of rights plans that are adopted, corporations continue to exercise the right to adopt a rights plan, in the absence of a specified threat or purpose. In 2013, 43 percent of all rights plans were routine adoptions, meaning the company was not "in-play" and the rights plan was not adopted to protect the company's NOLs, as were 35 percent in 2012. Further, most of these rights plans, 74 percent in 2013 and 82 percent in 2012, had terms longer than the twelve months or less that ISS prefers.

We believe that the following factors account in substantial part for the continued adoption of routine rights plans:

- *Proliferation of Activist Abuse of Synthetic Equity Positions.* The nature of equity ownership in U.S. corporations continues to evolve due to the proliferation of derivative, swap and other transactions in the marketplace. For example, a so-called "total return swap" allows an investor to create the economic equivalent of ownership of an equity security. Many investors take the position that this type of economic relationship does not confer beneficial ownership of the underlying equity security within the meaning of, and is not required to be disclosed under, the Williams Amendments (the "Williams Act") to the Securities Exchange Act of 1934 (the "Exchange Act").[13] When deployed for takeover purposes, these transactions permit investors to manipulate their economic interests in a manner that may deprive a corporation and other shareholders of sufficient time or ability to make informed voting and other decisions. The threats from these types of transactions are highlighted by the proxy contest in 2008 involving CSX Corporation.

- *Weakness of Schedule 13D Reporting System.* Securities and Exchange Commission rules require that investors report beneficial ownership of more than five percent of a voting class of a company's equity securities on a Schedule 13D within ten days of the purchase. This lengthy window provides an investor with less than five percent ownership ten days to rapidly acquire additional shares before disclosing the increase position. Pershing Square Capital Management recently used this tactic to acquire a 16.5 percent stake in J.C. Penney and an 11 percent stake in Fortune Brands prior to disclosure.

- *Coordinated Wolf-Pack Tactics.* The battle for CSX also highlighted the threat posed by activist and other event-driven investors executing their strategies in coordination with other like-minded investors without

[13] Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

disclosing their coordinated activities. 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 the Williams Act as group action. These types of activities implicate many of the same concerns that validate rights plans (e.g., the acquisition of effective control without paying a control premium or the de facto neutralization of the board's role in transactions for corporate control), and in 2008 practitioners sought to implement new technologies to expand the definition of beneficial ownership in rights plans to capture and deter coordinated abusive activities. The validity of such language is uncertain, however, as highlighted by the Barnes & Noble case discussed below.

- *Reduced Utility of HSR "Early Warning System."* Mid- and large-cap corporations have historically relied upon the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"),[14] which requires a filing for acquisitions of approximately $76 million of voting securities, to provide advance notice of potential share accumulations and enable timely implementation of a rights plan. This early-warning system has an important defensive advantage over the applicable disclosure rules under the Williams Act—the HSR Act generally bars accumulations until expiration of a 30-day waiting period. This warning system is not effective for share accumulations at small-cap corporations. Indeed, for a corporation with a market capitalization of $250 million, an HSR filing is not required until the stock accumulation exceeds 30 percent of outstanding shares, which is far above the 15 percent level at which a customary rights plan would cap a hostile bidder. The HSR warning system is also ineffective against the use of synthetic equity and can easily be avoided even with traditional "physical ownership" through the simple expedient of making purchases of target stock through multiple vehicles with different ultimate ownership as determined under the HSR rules.

- *Decline in Rights Plan Proposals.* Shareholder activism against rights plans remains minimal. The 2012 proxy season saw only seven shareholder proposals to redeem rights plans, and the 2013 season saw just six proposals.

Taken together, these factors may lead some 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—is eroded by 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, as well as the stark evidence of weakness in the Schedule 13D rule evidenced by J.C. Penney and Fortune Brands. Most corporations address the threat of synthetic equity by expanding the definition of beneficial ownership in their rights plans. Furthermore, corporations with smaller market capitalizations are the primary adopters of rights plans, reflecting their vulnerability to "surprise" accumulations not forewarned by HSR filings or Schedule 13D reporting. Considering the foregoing, boards of directors may conclude that the adoption

[14] Pub. L. No. 94-435, 90 Stat. 1383 (1976) (codified as amended in scattered sections of 15, 18, 28 U.S.C.).

of a rights plan is necessary and prudent under the circumstances and that they would be less exposed to investor backlash for doing so.

II. TRADITIONAL RIGHTS PLANS

A. Illustrating the Power of the Traditional Rights Plan: *Air Products v. Airgas*

In 1988, the Delaware Court of Chancery advanced the theory that, at some point in response to an unsolicited takeover offer, a rights plan would fulfill its purpose and a board acting in good faith would be required to redeem the rights plan. The decision, *Capital City Associates v. Interco Inc.*,[15] considered Interco's response to an unsolicited all-cash all-shares tender offer. Interco's board believed the unsolicited offer was inadequate and, therefore, used a rights plan to block the unsolicited takeover offer. As an alternative to the unsolicited offer, the board developed a proposal to restructure the corporation, which the board believed was financially superior to the unsolicited offer. Chancellor Allen held that the board's continued use of the rights plan was not reasonable, as the rights plan had fulfilled its purpose to increase the options available to shareholders. Indeed, according to Chancellor Allen, the rights plan "serve[d] the principal purpose of 'protecting the restructuring'—that is, precluding the shareholders from choosing an alternative to the restructuring that the board finds less valuable to shareholders."[16] The Court found that this defensive measure could not be justified as reasonable in relationship to the threat, and so it ordered redemption of the rights plan.

The Delaware Supreme Court overruled Chancellor Allen's opinion in *Interco*, however, in *Paramount Communications, Inc. v. Time Inc.*,[17] stating:

> Plaintiff's position represents a fundamental misconception of our standard of review under *Unocal* principally because it would involve the court in substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors. To the extent that the Court of Chancery has recently done so in certain of its opinions, we hereby reject such approach as not in keeping with a proper *Unocal* analysis.[18]

Under *Paramount* Communications, so long as a board of directors demonstrated good faith and reasonable investigation, and undertook a reasonable defensive action in response to a threat facing the corporation, the Court would not intervene to require redemption of a rights plan.

This continues to be the rule in Delaware. Indeed, in a recent hostile takeover battle, the Delaware Court of Chancery upheld a board's use of a rights plan against an unsolicited all-cash, all-shares offer, even though the board maintained the rights plan to block the unsolicited offer after losing one proxy contest for the target's board. That decision, *Air*

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[15] 551 A.2d 787 (Del. Ch. 1988).
[16] *Id.* at 790.
[17] 571 A. 2d 1140 (Del. 1989).
[18] *Id.* at 1153, specifically referencing *Interco* and its progeny.

Products and Chemicals, Inc. v. Airgas, Inc.,[19] solidifies the power of a rights plan in preserving a board's authority, when acting in good faith and after reasonable inquiry, to determine the long-term business strategy for the corporation.

The rights plan at issue in the case, containing a 15 percent trigger threshold, was adopted in 2007—two years before the events leading to the lawsuit occurred. Airgas also had several other protective devices already in place, including:

- a classified board structure, requiring two annual meetings to obtain control of the board;
- protection under Delaware General Corporation Law Section 203, which prohibits business combinations with any interested shareholder for a period of three years following the time that such shareholder became an interested shareholder, unless certain conditions are met; and
- a Certificate of Incorporation that included a supermajority merger approval provision for certain business combinations—primarily those with an interested shareholder.[20]

Air Products' actions proceeded as follows:

- October 2009—Air Products first expressed interest in acquiring its rival, Airgas, in a private meeting between the two corporations' CEOs.
- November–December 2009—Airgas rejects Air Product's private $60 per share all equity deal.
- December 2009—Air Products increased its offer to $62 per share in cash-and-stock.
- January 2010—Airgas again rejected the private offer.
- February 2010—Air Products went public with its offer, launching a fully-financed, all-cash, structurally non-coercive, non-discriminatory tender offer to acquire all outstanding shares of Airgas for $60 per share.
- February 2010—Airgas filed a 14D-9 with the Securities and Exchange Commission ("SEC"), recommending that its shareholders not tender shares into the offer, arguing that the offer grossly undervalued the corporation.
- March 2010—Air Products launched a proxy contest, seeking the nomination of a slate of three independent directors in the upcoming annual meeting.
- September 2010—Air Products succeeded in electing its slate of directors.

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19 *Airgas*, 2011 WL 806417 (Del. Ch. Feb 15, 2011).
20 *Id.* at *6.

- July–December 2010—Air Products increased its price, in multiple price bumps, ultimately settling on a "best and final" offer of $70 per share. Airgas filed several amendments to its 14D-9, continuing to recommend against tendering.

Notably, in the board meetings held to evaluate Air Products' tender offers after September 2010, Air Products' own nominees sided with the Airgas board in reaching the business judgment that Air Products' offer was inadequate, based in part on the advice of three investment banks, as well as in reliance on Airgas's robust and long-standing strategic plan and related forecasts, developed in 2007 and updated in 2009.[21]

In addition to its proposed slate of directors, Air Products' proxy contest contained several bylaw proposals, including one requiring the 2011 annual meeting to be held in January, well in advance of the traditional August date. A month later, Airgas amended its bylaws to push back the 2010 annual meeting from August to "on such date as the Board of Directors shall fix," which was then set for September 15, 2010.[22] At the September 15 meeting, a majority of shares voted to approve Air Products' bylaw proposal, and Airgas immediately filed suit to invalidate the new bylaw. The Delaware Supreme Court ultimately invalidated the bylaw, holding that annual meetings must be spaced approximately one year apart.[23]

In the rights plan litigation, Air Products alleged that the Airgas directors breached their duties to shareholders by not redeeming the rights plan. The Court of Chancery analyzed the case under *Unocal*, noting that the heightened *Unocal* standard should be used whenever a board takes a defensive action in response to a hostile takeover, even when the insurgent's own nominees are on the board and support the corporation's actions.[24] Under *Unocal*, the Court found that the board's decision not to redeem the rights plan was a reasonable response, made after careful consideration.

The Court expressed doubt that any real threat was present, and a belief that the rights plan had already served its legitimate purpose. The rights plan, when combined with the Airgas staggered board, afforded Airgas over a year to inform its shareholders and express its views, which was "more time than any litigated rights plan in Delaware history."[25] The Court also noted that the rights plan provided leverage for the board to cause Air Products to increase the offer price by $10 per share. However, the Court also acknowledged that it was bound under existing Delaware Supreme Court precedent, which recognizes "substantive coercion" as a legally cognizable threat under *Unocal*.[26] As defined in *Unitrin*, substantive coercion is the risk that shareholders may accept an inadequate offer because of "ignorance or mistaken belief" regarding the board's assessment of the long term value of the corporation's stock.[27] Ordinarily, this risk is framed as the product of shareholders' lack of information, misunderstanding or simple disbelief of the board's expressed views. However, the risk articulated by Airgas arose from the significant

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[21] *Id.* at *23.
[22] *Id.* at *12.
[23] Airgas, Inc. v. Air Products & Chemicals, Inc., 8 A.3d 1182 (Del. 2010).
[24] *Airgas*, 2011 WL 806417, at *25-27.
[25] *Id.* at *3.
[26] *Id.* at *37.
[27] Unitrin Inc. v. American Gen. Corp., 651 A.2d 1361, 1385 (Del. 1995).

number of arbitrageurs holding the corporation's stock.[28] Nearly half of Airgas's shareholder base was comprised of short-term, deal-driven investors who would tender at any price promising a significant return on their investment—even if they knew that the offer grossly undervalued the corporation. The Court found that such a threat should also be considered substantive coercion. This reaffirmation of the "substantive coercion" doctrine may likely prove valuable in the context of activist abuses as well.

The Court cautioned that a board cannot "just say no" to a hostile tender offer.[29] The board's actions are subject to judicial scrutiny, and the board must act in good faith, after reasonable investigation and reliance on the advice of outside advisors, and persuade a court that a tender offer in this context poses a real threat.

The Court also addressed Air Products' argument that the combination of defensive measures in effect at Airgas, primarily the rights plan and the staggered board, should be considered preclusive, because the protective provisions would render the possibility of an effective proxy contest realistically unattainable. The Court did not accept this argument, noting that "preclusive for now" does not mean "preclusive forever,"[30] citing *Selectica* for the proposition that "[t]he fact that a combination of defensive measures makes it more difficult for an acquirer to obtain control of a board does not make such measures realistically unattainable, i.e., preclusive."[31] Even a significant delay would not be preclusive, so long as obtaining control at some point in the future is possible.

This decision serves as a clear articulation of the power of a rights plan when combined with a staggered board in preserving a board's authority to chart the course of the corporation. Not only was the combination upheld, but its use also successfully fended off the insurgent. Air Products already had three nominees on the Airgas board and was only seven months away from the next set of director elections when it withdrew its bid following the Court's decision.

B. <u>Activism Confronts the Rights Plan: *Third Point LLC v. Ruprecht*</u>

In a thirty year-long series of decisions beginning with *Moran v. Household International, Inc.*,[32] the Delaware courts have affirmed the value of shareholder rights plans to boards seeking to protect and maximize shareholder value. While this is often in the context of an unsolicited offer, as it was in *Air Products and Chemicals, Inc. v. Airgas, Inc.*,[33] discussed above, the Delaware courts have found that a board of directors, acting in good faith and on an informed basis with the advice of outside advisors, should be afforded substantial latitude to adopt and maintain rights plans with features responsive to the threats to corporations posed by activist hedge funds.[34]

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[28] *Airgas*, 2011 WL 806417 at *38.
[29] *Id.* at *1.
[30] *Id.* at *40.
[31] *Id.* at *41.`
[32] 500 A.2d 1346 (Del. 1985).
[33] *Airgas*, 2011 WL 806417 (Del. Ch. Feb 15, 2011).
[34] *See* Third Point LLC v. Ruprecht, C.A. Nos. 9469-CC, 9497-CC, 9508-VCP 2014 WL 1922029 (Del. Ch. May 2, 2014) and Yucaipa American Alliance Fund II, L.P. v. Riggio et al., C.A. No. 5465-VCS (Del. Ch. Aug. 11, 2010).

The most recent Delaware court decision on a rights agreement in the context of activism was in *Third Point LLC v. Ruprecht*,[35] regarding three activist hedge funds, Third Point LLC, Trian Fund Management and Marcato Capital Management LLC, which in mid-2013 accumulated significant stakes in Sotheby's. Both Third Point and Marcato disclosed their ownership on Schedule 13Ds and engaged in discussions with Sotheby's management and board regarding potential changes in strategy and leadership as well as consideration of strategic alternatives. In October 2013, Third Point, then holding a 9.4 percent stake of the company, filed a public "poison-pen" letter from its CEO, Daniel Loeb, to Sotheby's CEO, William Ruprecht. The letter raised concerns regarding the company's leadership, shareholder misalignment, strategic direction and board governance. Loeb indicated his willingness to join Sotheby's board and recruit other new directors, including from another large shareholder (presumably Marcato). Loeb emphasized the need to replace Ruprecht and to separate the roles of CEO and Chairman. Loeb also indicated he had already identified and spoken with potential CEO candidates.

In response to the activists' threats, Sotheby's adopted a rights plan with a two-tier structure. The two-tier structure provided for a 10 percent trigger threshold for shareholders filing a Schedule 13D and a 20 percent trigger for shareholders filing a Schedule 13G (available to "passive" investors). The rights plan also contained a "qualifying offer" exception, which provided that the plan would not apply to an offer for all of Sotheby's shares, and expired in one year unless it was approved by a shareholder vote.

In February 2014, after negotiations failed to avoid a proxy contest, Third Point nominated three individuals for election to Sotheby's board and requested a waiver from the rights plan restrictions to allow Third Point to purchase up to a 20 percent stake in the Company. Sotheby's board denied the waiver request. In response, Third Point sought to enjoin Sotheby's annual meeting, alleging that Sotheby's directors violated their fiduciary duties by adopting the rights plan and refusing to grant Third Point a waiver to acquire more than a 10 percent stake.

The Delaware Court of Chancery denied Third Point's preliminary injunction, applying the *Unocal* standard of review to the board's decision to adopt the rights plan and refusal to waive the 10 percent trigger for Third Point. With respect to the plan adoption, the court noted that an independent and disinterested board considered the potential for "creeping control" by several hedge funds simultaneously accumulating shares in a "wolfpack." The court held on a preliminary basis that the board acted reasonably in concluding that the activists posed a legally cognizable threat of obtaining a controlling stake without paying a control premium. Further, the court held on a preliminary basis that the board's adoption of the rights plan was reasonable in response to that threat, including the 10 percent trigger for Schedule 13D filers. Although the court viewed the two-tier trigger structure as "discriminatory" — differentiating between activist and passive investors — the plan was arguably better tailored to the circumstances by preventing activists from gaining control without paying a control premium and not unduly restricting passive investors' share purchases.[36] Ultimately, the court found the two-tier structure was a "complete non-issue" based upon the composition of Sotheby's shareholders and the court's holding on a

[35] C.A. Nos. 9469-CC, 9497-CC, 9508-VCP 2014 WL 1922029 (Del. Ch. May 2, 2014).
[36] *Id*. at 47.

preliminary basis that a 10 percent trigger for activist shareholders is reasonable and proportionate.[37]

With respect to the board's refusal to waive the rights plan so as to allow Third Point to buy up to 20 percent of the Company, the court indicated this was "a much closer question" since the threat of "creeping control" had disappeared when the waiver request was made.[38] Nevertheless, the court found that Sotheby's had a reasonable basis to believe that Third Point, which had been acting in an "aggressive and domineering" manner, posed a legally cognizable threat of exercising effective "negative control" from the accumulation of a 20 percent stake, or disproportionate control and influence over major decisions.[39] The court held on a preliminary basis that the board's refusal to grant the waiver request was reasonable in response to that threat.

Third Point also contended that the board was required under the more stringent standard set forth in *Blasius Industries, Inc. v. Atlas Corp.*[40] to provide a "compelling justification" for its refusal to waive the rights plan because, according to Third Point, the board acted for the primary purpose of infringing on the shareholder voting process. While noting that these arguments were at least colorable and raise policy concerns that deserve careful consideration, the court rejected the arguments on the record before it.

While the ruling in *Third Point* is on a preliminary basis, the decision emphasizes that Delaware courts review specific elements of defensive measures, including specific rights plans technologies, under a "range of reasonableness" standard. No feature of the rights plan automatically is deemed to be valid, absent a board's identification of the related threat, and other "soft" considerations may affect a court's assessment of a rights plan.

C. Merger-Related Rights Plans[41]

At the peak of the last public company merger frenzy in 2006 and early 2007, it was common for activist shareholders (mostly hedge funds and arbitrageurs) to mount "vote no" campaigns against announced deals.[42] Frequently such campaigns resulted in relatively small price bumps and an abandonment of the vote no campaign. On a few occasions, the vote no campaign sparked a bidding war. However, in a number of others, the vote no campaign ended with a worst-case result; defeat of the merger deal with no competing transaction in sight. Carl Icahn's proposed acquisition of Lear Corporation in the summer of 2007 is one the most memorable. After Icahn refused to raise his final price to halt an activist investor vote no campaign, the merger was voted down. Lear remained independent and, as a result of the virulent 2008 economic crisis, wound up filing for bankruptcy, wiping out all shareholder value.

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[37] *Id.* at 49.
[38] *Id.* at 50.
[39] *Id.* at 51.
[40] 564 A.2d 651, 659 (Del. Ch. 1988).
[41] This discussion draws from a Latham & Watkins LLP M&A Commentary. Charles M. Nathan, *Adoption of Poison Pill to Deter Activist Investor Opposition to Negotiated Mergers*, M&A Commentary (Latham & Watkins LLP, New York, N.Y.), February 2011, *available at http://www.lw.com/upload/pubContent/_pdf/pub3988_1.pdf.*
[42] *See* L&W M&A Commentary, "*Shareholder Pushback on M&A Deals*," Dec. 2007, available at http://www.lw.com/upload/pubContent/_pdf/pub2065_1.pdf.

The financial crisis and resulting swoon of the public company merger market in 2008–2009 muted concerns about vote no campaigns in the M&A context. Organized opposition to announced deals resurfaced in 2010, however—most prominently in Blackstone's proposed acquisition of Dynegy and WuXi's proposed acquisition of Charles River Labs. Concern about hedge fund and other activist opposition has, as a result, become more apparent and has led to, in one circumstance, a non-traditional use of a rights plan—a merger-related rights plan.

In connection with an acquisition announced in December 2010, Dell, Inc. insisted that Compellent Technologies adopt a rights plan in conjunction with entering into a merger agreement with Dell. According to Compellent's preliminary proxy statement, Dell made the adoption of the rights plan an explicit and consistent requirement of its acquisition proposals. While this one instance doesn't make a trend,[43] and Compellent's board did redeem the plan in settlement of plaintiff litigation, it does merit examination.

In the wake of *Yucaipa* and *Selectica*, it is clear that a rights plan adopted in any circumstance will be analyzed as a defensive tactic under the *Unocal/Unitrin* line of cases. Therefore, it is proper to evaluate the validity of a merger-related rights plan under the same standard. Under *Unocal*, the Court must first find that there is a reasonable threat. While the typical fact situation in the context of a merger-related rights plan is different in that the purpose of the potential vote no campaign is not to seat directors in a proxy contest, it seems eminently reasonable for a board of a target corporation to be concerned about the possible damage a large shareholder or shareholder group (*i.e.*, one exceeding a traditional rights plan trigger threshold) could wreak in threatening or running a vote no contest.

At the outset, it is clear that the threat to the target corporation addressed by a merger-related rights plan is not that a competing bidder will emerge. When that happens, the board should and presumably would negotiate with the competing bidder and the outcome would be a board decision on whether the competing bid is superior, which would give the board the right to invoke its fiduciary out under the merger agreement (or, in the case of a "force the vote" structure, recommend that shareholders vote down the original bidder in favor of the superior proposal by the newly emerged competing bidder). Rather, the threat addressed by a merger-related rights plan would be that the activist investor or investor group might be successful in scuttling the deal, either because it misjudges its leverage with the acquirer and its insistence on a price increase craters the deal, or because it thinks it will gain more economically by picking up some or all of the pieces after the deal busts. The experience in 2006-2007 makes clear that these are far from imaginary risks, and when they occurred did in fact result in the loss of the transaction opportunity for the corporation and its shareholders.[44]

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[43] During the hay day of bank mergers of equals during the second half of the 1990 decade, merger partners without pre-existing rights plans sometimes adopted rights plans at the behest of the counter party because of the perceived vulnerability of an at-market MOE to unsolicited competing bids at modest premiums to market. This practice faded away as the bank MOE wave subsided.

[44] *See, e.g.* Carl Icahn campaign against the merger of Mylan Laboratories Inc. and King Pharmaceutical which may have contributed to a mutual termination of the Merger Agreement; Richard M. Osborne Trust campaign against the merger of Corning Natural Gas and C&T Enterprises resulting in failure to obtain

A target board may also be able to reasonably conclude that the uncertainty caused by a "vote no" campaign might damage the stability of the corporation and its customer relationships as well as the morale of employees, causing loss of focus, job defections and the like, without regard to whether the "vote no" campaign ultimately causes the deal to fail. Admittedly, a target's announcement that it has agreed to be acquired creates business continuity and employee morale risks. The threat of a proxy contest over shareholder approval could make a difficult situation far worse because it inevitably will increase uncertainty and confusion about the outcome of the transaction. Such a concern is at least a close cousin to traditional "substantive coercion."

A target board also might believe that an activist "vote no" campaign could have the effect of encouraging long term shareholders to sell their stock in the market below the deal price, rather than take their chances on a contentious proxy contest that could result in the deal being voted down. It would be reasonable for a board to choose to protect long-term investors and assure their receipt of the full consideration, rather than allow short term activist investors to risk the success of the merger transaction.

Another important consideration for the target board, and in many instances the deciding consideration, would be the insistence of the bidder that adoption of a merger-related rights plan was a *sine qua non* for the deal. While such a demand by a buyer might be in the nature of a bluff, if the demand is pressed by the bidder and tested seriously but unsuccessfully by the target, it should serve as a distinct and important basis supporting adoption of a merger-related rights plan under the *Unocal/Unitrin* doctrine. In this regard, a merger-related rights plan might be evaluated under *Unocal/Unitrin* in a manner similar to a no-shop provision, a force the vote provision or a termination fee, each of which is often accepted as a reasonable target board response to the opportunities and risks presented in negotiated transactions.

A merger-related rights plan may well survive *Unocal/Unitrin* scrutiny. However, target boards should be careful when considering the adoption of a merger-related rights plan. As is true of all deal protection structures, adoption needs to be examined in the context of facts and circumstances of the particular situation, for not all vote no campaigns may pose the type of threat justifying such a rights plan.

III. DERIVATIVE POSITIONS AND "WOLF PACKS" AS TRIGGERS

The previously nascent efforts to develop new rights plan technology to defend against modern threats from the abuse of synthetic equity has gained traction, with the inclusion of a synthetic equity trigger in rights plans shifting from a trend to a staple feature—such triggers were included in approximately three fourths of all traditional rights plans adopted or renewed in 2012 and 2013. Comments from Chancellor Chandler in a bench ruling during the *In re Atmel*[45] litigation discussed below, indicate that an appropriately tailored synthetic equity trigger should survive legal challenge. In contrast, provisions

shareholder approval; and Crescendo Partners campaign against the merger between Computer Horizons Corp and Analysts International Corporation resulting in shareholder defeat.

[45] No. 4161-CC (Del. Ch. filed Mar. 11, 2009).

capturing "wolf-pack" abuses have not become precedent, and the Delaware courts have not yet confirmed the ability to use a rights plan to address "wolf-pack" tactics by activist investors. Further, despite ample evidence of the risks posed by "wolf-packs",[46] the Barnes & Noble decision[47] suggests that a "wolf-pack" trigger may be viewed with some skepticism by the Delaware Courts. We discuss these modern threats, the new rights plan technology that has been developed in response, and recent treatment of that technology in the courts.

A. Modern Threats from Synthetic Equity Abuses

1. *Synthetic Equity*

The increasing prevalence of equity derivatives in the public markets has provided a mechanism by which the economic, voting and other attributes of stock ownership can be divided and traded separately. This enables an investor to have an economic interest in a corporation's common stock that may be different from its beneficial ownership for purposes of the Williams Act and related SEC filings.[48] The best example of this is "total return swaps" ("TRSs"), which allow an investor to create the economic equivalent of ownership of an equity security without ever acquiring traditional (often called "physical") ownership of the equity security.

TRSs are one type of derivative contract in which the "short party" (usually a bank) agrees to pay the "long party" the cash flows associated with a stated number (often called the "notional number") of shares of a corporation—i.e., any distributions the corporation pays to shareholders and any market appreciation of the stock. In exchange, the long party agrees to pay the bank a "financing fee" (usually computed as a spread over LIBOR on the notional value of the reference security position at the outset of the TRS contract) and any decrease in the market value of the underlying notional or reference security position. Typically, short parties hedge their TRS exposure by purchasing the underlying security in amounts identical to the notional number referenced in their TRS agreements. Many investors take the position that the economic relationships created by TRSs, although essentially creating indirect ownership by the long party of the reference security, do not confer beneficial ownership of the underlying equity security to the long party, are not required to be disclosed under applicable federal securities laws and would not trigger traditional rights plans.

Despite this view by some investors, TRSs and other forms of synthetic equity pose a threat when used by activist investors in a destabilizing campaign. Specifically, synthetic equity allows a long party to lay in wait undetected and to use its synthetic equity

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[46] *See* CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd* 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

[47] Yucaipa American Alliance Fund II, L.P. v. Riggio, 1 A.3d 310 (Del. Ch. 2010), *aff'd* 2011 WL 743427 (Del. Mar. 3, 2011).

[48] These SEC filings include Schedules 13D and 13G. A person who, directly or indirectly, is the beneficial owner of more than five percent of a corporation's stock must disclose certain information on either Schedule 13D or Schedule 13G. *See* 17 C.F.R. § 240.13d-1. Once the five percent threshold is reached, Schedule 13D requires the disclosure of contracts relating to the issuer's securities. In contrast, Schedule 13G (which relates to passive investments) has no similar requirement. *See* 17 C.F.R. § 240.13d-101, Item 6; 17 C.F.R. § 240.13d-102.

ownership to influence or determine a control contest at the time and in the manner of its choosing—a potent weapon for an investor seeking to gain or exert control or undertake a destabilizing campaign. For example, in a TRS, upon request of the long party, the short party is sometimes willing to unwind the TRS agreement by delivery of the hedge shares (even when the underlying agreement does not provide for physical settlement), allowing the long party to convert synthetic equity into physical equity very quickly. Even where this is not the case, the long party typically has the practical ability to terminate the swap whenever it chooses and can enter into the market to purchase shares at the very time the short party is liquidating its hedge position. Alternatively, since a fully hedged short party has no economic interest in the shares, it may be willing to vote the shares in accordance with the long party's preferences, even if not part of a formal arrangement. The likelihood of this increases when the long party is a valued customer of the short party.[49] This practice may not be as common as it once was, given that many short parties have adopted policies either to not vote the hedge shares or to vote the hedge shares in proportion to all other voted shares. Knowledge of these voting policies by the long party can easily affect the outcome of a shareholder vote and can be integrated by an investor into a proxy campaign against the target corporation. Under any of these approaches, the long party has the practical ability to quickly convert its synthetic equity position into a physical position or to direct or influence the voting of the hedge shares without acquiring conventional beneficial ownership until such time as it acquires the physical shares.

2. *Illustrating the Threat: CSX Corporation*[50]

In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*,[51] the United States District Court for the Southern District of New York considered whether and under what circumstances a long position under a TRS may be deemed beneficial ownership of the underlying stock requiring disclosure under the Williams Act. In this case, the hedge fund The Children's Investment Fund ("TCI") used TRSs to amass a total economic exposure equivalent to roughly 14 percent of CSX's outstanding common stock. Its physical securities never exceeded five percent, however, so it never filed a Schedule 13D.

The District Court, as a matter of first impression, considered whether a holder of cash-settled equity TRSs beneficially owns the referenced securities held by the short party within the meaning of Rule 13d-3(a).[52] Ultimately, the Court held that TCI possessed the

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[49] The Panel on Takeovers and Mergers, *Dealings in Derivatives and Options*, Consultation Paper Issued by the Code Comm. of the Panel (2005) PCP 2005/1, p. 5; *see also*, The Panel on Takeovers and Mergers, *Dealings in Derivatives and Options*, Statement by the Code Comm. of the Panel Following the External Consultation Processes on Disclosure Issues in PCP 2005/1 and PCP 2005/2 (2005) RS 2005/2.

[50] For an in-depth review of *CSX Corporation*, please see the Latham & Watkins LLP M&A Commentary. Blair Connelly et al., *CSX: Opportunities and Implications for Corporations and Activist Investors*, M&A Commentary (Latham & Watkins LLP, New York, N.Y.), June 2008, *available at* http://www.lw.com/upload/pubContent/_pdf/pub2238_1.pdf

[51] *See* CSX, 562 F. Supp. 2d 511.

[52] Rule 13d-3(a) promulgated under the Exchange Act provides that "a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares: (i) voting power which includes the power to vote, or to direct the voting of, such security; and/or (ii) investment power which includes the power to dispose, or to direct the disposition of, such security."

requisite investment and voting power to be deemed a beneficial owner, and that it also violated Rule 13d-3(b), an anti-evasion rule.

The Court noted that by virtue of the customary purchases executed by the intermediary "short" party in a TRS transaction, TCI knew its execution of TRSs would cause the counterparty banks to purchase CSX shares of common stock as a hedge, and likewise knew that it had the ability to cause the banks to sell their hedge shares when it unwound the TRSs. TCI's voting power over the shares emerged out of the consolidation of the banks it used for the arrangements. It shifted the majority of its TRSs to two banks, which would be subject to TCI's influence as a result of prior relationships and common interests. The Court further found that TCI violated Rule 13d-3(b) because it entered into the TRSs for the purpose of avoiding its reporting requirements under Section 13(d). The Court cited evidence that TCI's CFO had made statements indicating such intent, as well as emails discussing the need to make certain each of its bank counterparties remained below the five percent reporting threshold.

The Court found that TCI violated the Williams Act; however CSX was unable to achieve its desired relief—an injunction against the voting of the shares at the upcoming annual meeting. Precedent required that a defendant achieve a "degree of effective control" of the outstanding shares to allow for a finding of irreparable injury, which was not present here. Notably, CSX lacked a rights plan at this time. Had one been in place, the Court's finding of beneficial ownership would could have triggered the plan's provisions.

3. Illustrating the Threat: J.C. Penney Company/Fortune Brands

Although they did not result in litigation, additional recent examples of the potential threat of synthetic equity were the investments of activist hedge fund Pershing Square Capital Management in J.C. Penney Company and Fortune Brands, Inc. Through the accumulation of synthetic equity, including call options, Pershing was able to rapidly acquire a significant percentage of shares of each of these companies without moving the market and, most important prior to triggering any SEC disclosure obligations due to the "ten-day window" under Schedule 13D.

In its initial filing with the SEC in October 2010, Pershing reported a stake in J.C. Penney of 16.5%, totaling 39 million shares and 4.15 million options. Simultaneously, Vornado Realty Trust, another hedge fund, made a separate filing with the SEC disclosing ownership of a 9.9% stake. Both hedge funds indicated an intent to engage with management, take an active role in the investments and consult with each other regarding their investments. In January 2011, J.C. Penney added representatives from Pershing and Vornado to the company's board of directors. Later that year, J.C. Penney replaced its Chief Executive Officer. In September 2013, after publicly announcing dissatisfaction in the search for a new Chief Executive Officer, Pershing liquidated its stake and exited its investment in J.C. Penney for a loss of approximately $470 million, or about half of Pershing's initial investment.

Also in October 2010, Pershing reported in an initial filing with the SEC a 10.9% stake in Fortune Brands, again indicating the intent to engage with management and the board. By the end of the year, after talks with Pershing, the company announced that it intended to split into three businesses. Ultimately, only one of Fortune's businesses, the distilled

spirits business, now known as Beam, Inc., was retained, and in January 2014, Beam agreed to be acquired by Suntory Holdings Limited.

Had J.C. Penney had a rights plan in place, Pershing would have been unable to execute its rapid accumulation above 10-15% as either the acquisition or the exercise of the call options would have been effectively precluded by the rights plan.

B. Addressing the Abusive Use of Synthetic Equity Positions in Rights Plans

The ability and willingness of activist investors to utilize share accumulation strategies that leverage equity derivative positions to advance their agendas has made a prominent return to the hedge fund landscape. We describe below methods employed by boards of directors of public corporations in altering the traditional definition of beneficial ownership in rights plans to explicitly protect against a strategy of significant stock accumulation, based in part on equity derivative positions, to acquire often outcome determinative shareholding positions.

Approximately three fourths of traditional rights plans adopted or renewed in 2012 and 2013 contained language including derivatives or synthetic equity in the calculation of the beneficial ownership threshold that triggers a rights plan.[53] As this new rights plan technology has been implemented by corporations, various formulations of the definition of "beneficial ownership" have emerged. Two formulations are discussed below. The first approach seeks to capture all synthetic equity within the defined term beneficial ownership, without regard to any other factors (the "Full-Ownership Approach"), but operates only with respect to the long-party investor, not its counterparties. The second formulation captures synthetic equity only to the extent that a counterparty (or counterparties) holds physical shares as a hedge, but unlike the Full-Ownership Approach, operates against the counterparties, as well as the long party. This formulation was under review by Delaware courts in the now-settled *In re Atmel Corporation Shareholders Litigation*[54] (the "Full Dilution Approach").

1. The Full-Ownership Approach.

The Full-Ownership Approach contemplates that all equity derivative positions held by an investor will be included in the calculation of a shareholder's beneficial ownership for purposes of the rights plan trigger. The derivative ownership position is calculated based on the notional number of shares covered by each derivative contract to which an investor is party, as illustrated by the sample definition of "beneficial owner" below.

> A Person shall be deemed to be the "Beneficial Owner" of and shall be deemed to "Beneficially Own" any securities: . . . (iv) which are the subject of a derivative transaction entered into by such Person, or derivative security acquired by such

[53] Note that the synthetic equity trigger has not yet been blessed by Delaware courts, and may be impermissible under the corporate statues of certain other states, such as New York, which have enabled rights plans by express statutory authority and often effectively define what equity interests may be subject to the rights plan trigger.

[54] No. 4161-CC (Del. Ch. filed Mar. 11, 2009).

> Person, ***which gives such Person the economic equivalent of ownership of an amount of such securities due to the fact that the value of the derivative is explicitly determined by reference to the price or value of such securities***, without regard to whether (A) such derivative conveys any voting rights in such securities to such Person, (B) the derivative is required to be, or capable of being, settled through delivery of such securities, or (C) such Person may have entered into other transactions that hedge the economic effect of such derivative. In determining the number of Common Shares deemed Beneficially Owned by virtue [hereof], the subject Person shall be deemed to Beneficially Own (without duplication) the number of Common Shares that are synthetically owned pursuant to such derivative securities.[55]

Although the key threat from derivative ownership positions relates to the physical shares acquired by a counterparty for hedging purposes, this formulation calculates the derivative ownership position without regard to physical shares actually held by the counterparty as a hedge or, if the counterparty hedges through a derivative instrument, the physical position held by the counterparty's counterparty. This reflects an important simplifying assumption that counterparties to these types of derivatives contracts almost always hedge their exposure through ownership of physical securities or through ownership of matching derivatives that at the end of the "daisy chain" are ultimately hedged by physical securities. As such, this formulation could be viewed as over-counting beneficial ownership relative to the perceived threat where the counterparty (and its counterparties) do not actually hold as many physical shares as a hedge as the notional shares covered by the initial derivative contract. Boards of directors and their financial and legal advisors should consider whether this simplifying assumption is reasonable from a business perspective, in light of current market custom and practice, and in the context of the corporation's shareholder base as a whole. The Full Dilution Approach discussed below does not make this simplifying assumption, so it can be viewed as more narrowly tailored to the perceived threat, but it is more complex and arguably more difficult to administer because it may require tracking the physical shares held by direct and indirect counterparties.

A potentially significant limitation of the Full-Ownership Approach is that, if and when a rights plan is triggered, economic dilution would not necessarily be suffered by the triggering investor with respect to its synthetic ownership position. Rights are only associated with physical shares, and thus would only be issued to holders of physical shares following a trigger event. Unless the counterparty to a derivative ownership position is deemed to be acting as a group with the triggering shareholder (which

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[55] Rights Agreement, dated as of May 25, 2010, between Xerium Technologies, Inc. and American Stock Transfer & Trust Company, LLC, as Rights Agent. Xerium Technologies, Inc., Current Report (Form 8-K), ex. 10.3 (May 25, 2010). The sample definition is one frequently used formulation. For other common formulations, see Rights Agreement, dated as of April 16, 2010, between Casey's General Stores, Inc. and Computershare Trust Company, N.A., as Rights Agent (Casey's General Stores, Inc., Current Report (Form 8-K) ex. 4.1 (April 16, 2010)) and Rights Agreement, dated as of May 20, 2009, by and between The J.M. Smucker Company and Computershare Trust Company, N.A., as Rights Agent (The J.M. Smucker Company, Current Report (Form 8-K) ex. 4.1 (May 20, 2009)).

ordinarily would not be the case), such that physical shares held by the counterparty would be deemed to be held by the triggering investor, rights issuable to the counterparty with respect to its physical shares would be fully exercisable and the counterparty would not suffer dilution from triggering the rights plan. Moreover, under the standard TRS contract, the counterparty would be obligated to make the triggering investor "whole" with respect to the counterparty's exercise of the triggered rights. Thus, the economic deterrent that underpins the effectiveness of a rights plan would not deter accumulation of a derivative ownership position unless the triggering investor also holds a sizable physical ownership position that would be diluted upon the triggering of the rights plan. Nonetheless, the Full-Ownership Approach appears to have had a prophylactic effect on counterparty willingness to enter into derivative arrangements which involve a scale of accumulations that could trigger rights.

2. The Full Dilution Approach.

A second formulation of the definition of beneficial ownership came before the Delaware Court of Chancery, though the case ultimately ended in a settlement. In this case, *In re Atmel Corp.*, defendant Atmel Corporation ("Atmel") received an unsolicited joint takeover bid from Microchip Technology, Inc. ("Microchip") and ON Semiconductor Corporation ("ON Semiconductor") to acquire Atmel for five dollars per share, or a 52.4 percent premium to Atmel's closing share price as of the prior day. Shortly thereafter, Microchip received regulatory clearance to move forward on acquiring 50 percent of Atmel's shares. At this time, Microchip held approximately four percent of Atmel's outstanding shares. Faced with the acquisition proposal, but believing it not to be in the best interests of its shareholders, Atmel's board of directors adopted an amendment to its existing rights plan to lower the trigger threshold from 20 percent to ten percent and to expand the definition of beneficial ownership to capture synthetic equity positions.

The amendment in Atmel expanded the definition of "beneficial ownership" used in the rights plan to include derivative contracts to which a shareholder is party, but only to the extent of the physical shares held by a direct or indirect counterparty. The definition of beneficial ownership in Atmel's rights plan provides, in relevant part:

> A Person shall be deemed the "BENEFICIAL OWNER" of and shall be deemed to "BENEFICIALLY OWN" any securities:
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> * * *
>
> (iv) which are ***beneficially owned, directly or indirectly, by a Counterparty under any Derivatives Contract*** (without regard to any short or similar position under the same or any other Derivatives Contract) to which such Person or any of such Person's Affiliates or Associates is a Receiving Party (as such terms are defined in the immediately following paragraph); <u>provided, however</u>, that the ***number of Common Shares that a Person is deemed to Beneficially Own pursuant to this clause (iv) in connection with a particular Derivatives Contract shall not exceed the number of Notional Common Shares that are subject to such Derivatives Contract***; <u>provided, further</u>, that the number of securities beneficially owned by each

> Counterparty ("Counterparty A") under a Derivatives Contract shall for purposes of this clause (iv) be deemed to include all securities that are beneficially owned, directly or indirectly, by a Counterparty ("Counterparty B") under any Derivatives Contract to which such Counterparty A is a Receiving Party, with this proviso being applied to successive Counterparties as appropriate.
>
> A "Derivatives Contract" is a contract between two parties (the "Receiving Party" and the "Counterparty") that is ***designed to produce the economic benefits and risks to the Receiving Party and that correspond substantially to the ownership by the Receiving Party of a number of Common Shares (the number corresponding to such economic benefits and risks, the "Notional Common Shares"), regardless of whether obligations under such contract are settled through the delivery of cash, Common Shares or other property,*** without regard to any short position under the same or any other Derivative Contract.[56]

The plaintiff, Louisiana Municipal Police Employees' Retirement System, on behalf of itself and other shareholders, filed suit on November 14, 2008, alleging that the directors of Atmel breached their fiduciary duties by amending the pre-existing rights plan to make it "significantly more onerous and potentially preclusive and destructive of shareholder value."[57] More specifically, the plaintiff claimed the inclusion of derivative interests in the definition of "beneficial ownership" is "overly broad and fatally vague,"[58] such that it would be difficult for shareholders and the corporation to determine how many notional shares covered by an equity derivative position should be included in the calculation of beneficial ownership.[59] In response, Atmel maintained that the amendment is clearly written and that it is not difficult for a party to ascertain the number of notional shares covered by a derivatives contract in order to calculate beneficial ownership.[60]

As described in Atmel's rights plan, the target corporation and an investor accumulating synthetic equity must calculate both the notional shares covered by a derivatives contract (which the investor can easily do) and the number of physical shares being used to hedge, directly or indirectly, each derivatives contract (which almost certainly requires inquiry to the investor's direct counterparty and potentially further inquiry by that counterparty to the next counterparty if there is a daisy chain of offsetting derivatives, back to the ultimate counterparty in such a chain) in order to calculate the number of physical shares to be included in beneficial ownership. In this way, the Full Dilution approach attempts to address the perceived oversimplification of the Full-Ownership Approach. However, the required inquiry would be potentially complex and could well be unworkable as a practical matter, either for the investor or for the corporation seeking to administer its

[56] McIntrye Aff. Ex. H at Para. D (emphasis added).
[57] Compl. Para 1.
[58] Compl. Para 7.
[59] Pl. Br. 2.
[60] Def. Br. 2.

rights plan at the appropriate time, particularly if counterparties declined to provide details on their hedge positions and/or strategy.

Moreover, unlike the Full-Ownership Approach, which does not seek to impose economic dilution upon the counterparty to a derivatives contract upon the triggering of a rights plan, the Full Dilution Approach would also seem to dilute the counterparty with respect to the physical shares held as a hedge. Under the Full Dilution Approach, the physical shares held by the counterparty are deemed to be beneficially owned by the triggering shareholder, so that the rights issuable to the counterparty with respect to their physical shares would be void and not exercisable following a triggering event. We wonder whether it is reasonable or appropriate to impose the economic dilution attendant to the triggering of a rights plan on an investment banking firm or other financial services company operating its derivatives trading business in the ordinary course of business.

In *In re Atmel*, the Full Dilution Approach survived an initial attack in the form of a request for an injunction. Plaintiffs filed a motion in February 2009 seeking an injunction barring enforcement of the "Derivatives Contracts" language in the rights plan amendment. Ruling from the bench, Chancellor Chandler denied the motion in May 2009.[61] Several months later, in September 2009, the parties reached a settlement. Atmel's board agreed to clarify the definition of "Derivatives Contract" to:

- Exclude broad-based index options, futures and publicly traded market baskets, and

- Apply only to contracts that include or reference a specific number of "Notional Common Shares."[62]

While the Full Dilution Approach does address a concern of the Full-Ownership Approach—the fact that an investor triggering a rights plan will only suffer dilution with regard to its physical ownership of shares—it also could be viewed as expanding the reach of the rights plan to a class of persons who is not generally perceived to be a threat.

3. Prevalence of Synthetic Equity Approaches

In 2012 and 2013, approximately 60 corporations adopted rights plans including beneficial ownership positions targeting synthetic equity. Twenty-five percent of such plans include the Full Dilution Approach, and 70 percent include the Full Ownership Approach. Nearly two-thirds of the rights plans permit the board, acting in good faith, to determine the number of notional shares.

4. Issues with the Developing Synthetic Equity Trigger.

Although expanding the definition of beneficial ownership to include a synthetic equity trigger may protect corporations from the abusive use of synthetic equity by activist investors, the trigger addresses complex financial instruments and implementing it may pose practical difficulties, including the risk of unintended consequences. This complexity

[61] Transcript of Record at 21, In Re Atmel Corp., C.A. No. 4161-CC (Del. Ch. May 29, 2009).
[62] Atmel Corporation, Current Report (Form 8-K) (Nov. 16, 2009).

places a premium on the board's authority to interpret the rights plan in a flexible and appropriate manner. For example, we are aware of a situation in which an investor purchased call options and simultaneously sold put options for shares of a single corporation's stock. This is a relatively common "paired put/call" strategy, and it is intended that only one of the two options would be "in the money" at any particular time. Under the traditional definition of beneficial ownership found in many rights plans, the shares underlying the call options would be included as shares that the investor has a right to acquire. If a rights plan also contains a synthetic equity trigger that includes call equivalent positions (derivative security positions that increase in value as the value of the underlying equity increases, including a short, or "sold" put option position) in the definition of beneficial ownership, then the shares underlying the put options may be included as shares beneficially owned by the investor. However, including both the shares underlying the call position and the shares underlying the short put position would result in "double counting" for purposes of establishing the investor's beneficial ownership under a rights plan. While technically the call options and put options can be viewed as two separate derivative securities, and may be viewed as such under a technical reading of a traditional synthetic equity position in a rights plan, the options cover the same shares economically, and only one will end up in the money. As a result, we recommend language clearly enabling the board to determine beneficial ownership in any rights plan with a synthetic equity trigger.

C. Threats from Wolf Packs

1. Wolf Packs

There are numerous examples of successful destabilization campaigns led by hedge funds with relatively small (often less than five percent) stakes in the target corporation and based in large part on parallel investing and seemingly coordinated activities by other hedge funds.[63] Although the members of these so-called "wolf packs" rarely sign a formal agreement, and almost never do so at the onset of their relationship, they often communicate informally and share strategies and goals regarding the destabilization campaign. The members also quickly accumulate stock positions in the target that, although small individually, are significant in the aggregate. 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 activities, although coordinated as a practical matter, are not conducted pursuant to any formal agreement, arrangement or understanding and thus are not required to be disclosed under applicable federal securities laws.

Members of the "wolf pack" typically do not report their formation, the members of the wolf pack or the intentions of the wolf pack under the Williams Act, unless they choose to do so for tactical reasons. This usually occurs only shortly before the wolf pack announces a proxy contest. By this point, key objectives of the Williams Act (affording timely notice

[63] For example, the investments of Carl Icahn and Pershing Square in Herbalife Ltd., JANA Partners and Elliott Management in Juniper Networks, Inc. and Third Point and Marcato in Sotheby's.

to other investors), and rights plans (avoiding the accumulation of outcome determinative equity positions) may no longer be achieved. For traditional rights plans, the absence of an agreement among the wolf pack members has been viewed as insulation against rights plans because the traditional rights plan imports a Williams Act definition of beneficial ownership, together with its group concepts. The result is that a wolf pack under a traditional rights plan might control 20 percent, or even 30 percent, of a corporation's shares, and the corporation is powerless to protect itself and its other shareholders. In these ways, wolf packs can circumvent the common early warning mechanisms upon which corporations have historically relied.

The potential concerns raised by wolf pack behavior have galvanized target corporations, and in many countries the political establishment, to seek to address these issues by expanding the concept of a "group" under the Exchange Act, or using "acting in concert," "concert party" or similar concepts in the equivalent share ownership disclosure regimes.[64] Moreover, unlike the use of equity derivatives to decouple attributes of share ownership, which was created in the context of, and driven by, trading strategies and economic considerations unrelated to change of control campaigns, the wolf pack 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 first mentioned above. However, as the recent Barnes & Noble case suggests, if rights plan language targeting wolf packs is too expansive, the language may be subject to challenge in, and be greeted with skepticism by, the Delaware courts.

2. *Illustrating the Threat: CSX*

In addition to the synthetic equity issue discussed above, the District Court in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*[65] also considered whether and at what point investors' coordinated activities would cause them to be deemed a group for Williams Act purposes. While TCI was acquiring its TRSs, the hedge fund 3G Capital Partners ("3G") directly purchased shares of CSX common stock, and at one point held roughly 4.4 percent of the outstanding shares. Between February and December of 2007, TCI and 3G frequently discussed CSX and, according to the District Court, coordinated their acquisitions and dispositions of CSX common stock and TRSs, as well as their preparations for a proxy contest with CSX.

After TCI unwound some of its TRSs and purchased roughly four percent of CSX's outstanding common stock, TCI and 3G held an aggregate physical position of roughly eight percent of CSX's outstanding common stock—above the five percent threshold for filing a Schedule 13D if they were acting as a group. However, TCI and 3G did not enter into a formal agreement to work together until December 19, 2007, and then only in the context of their contemplated proxy contest. On that date, TCI and 3G filed a Schedule 13D in which they disclosed that they collectively owned 8.3 percent of CSX's outstanding common stock, that they intended to conduct a proxy fight, and that TCI had TRSs with

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[64] *See, e.g.*, Chapter 5 of the UK Disclosure and Transparency Rules, *available at* http://fsahandbook.info/FSA/html/handbook/DTR/5, or Chapter 6 of the Australian Corporations Act, *available at* http://www.austlii.edu.au/au/legis/cth/consol_act/ca2001172/.

[65] *See CSX*, 562 F. Supp. 2d 511.

counterparties that gave it economic exposure to roughly an additional 11 percent of CSX's outstanding common stock.

Section 13(d)(3) of the Exchange Act provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person'" subject to the disclosure requirements of Section 13(d). A group is deemed to have acquired beneficial ownership of all the equity securities of the issuer beneficially owned by each member of the group as of the date of the agreement to act together, which may be an informal agreement proven by circumstantial evidence.

The District Court found that TCI and 3G, despite acting without an express, written agreement were, in fact, a 13D group based on the circumstantial evidence of concerted action. As TCI and 3G should have filed a Schedule 13D as a group months earlier than they did, they violated the Williams Act. However, as was mentioned previously, the Court could not grant the requested relief and enjoin the vote.

3. Assessing the Validity of a Wolf Pack Trigger: Barnes & Noble, Inc.

In *Yucaipa American Alliance Fund II v. Riggio*,[66] Yucaipa, an activist hedge fund, challenged a rights plan adopted by Barnes & Noble, Inc. containing a grandfather provision that exempted the current ownership of the corporation's founder, chairman, and largest shareholder, Leonard Riggio and a wolf pack trigger designed to aggregate the ownership positions of investors exhibiting wolf pack behavior. While Barnes & Noble amended the rights plan to remove the wolf pack trigger prior to the decision by Vice Chancellor Strine, his opinion includes language to suggest that the Court might have viewed the wolf pack trigger skeptically, had the trigger remained in the rights plan.

Barnes & Noble adopted its rights plan after Yucaipa American Alliance Fund II, L.P. and Yucaipa American Alliance (Parallel) Fund II, L.P. (collectively, "Yucaipa") made a rapid series of purchases of Barnes & Noble common stock, increasing its holdings to nearly 18 percent in the span of four days. In the Schedule 13Ds announcing its acquisitions, Yucaipa criticized Barnes & Noble's management and corporate governance policies and reserved the right to pursue a wide range of M&A transactions relating to the corporation. Yucaipa also filed Hart-Scott-Rodino Act notifications indicating its intention to purchase additional shares, potentially enough to give it a majority of the outstanding shares.

The rights plan, adopted in November 2009, contained a 20 percent trigger that aggregated the ownership of those participating in a wolf pack that was challenged by Yucaipa. As originally drafted, the language provided:

> A Person shall be deemed the "Beneficial Owner" of, and shall be deemed to "beneficially own," and shall be deemed to have "Beneficial Ownership" of, any securities:…
>
> (c) which are beneficially owned, directly or indirectly, by any other Person (or an Affiliate or Associate thereof) with which

[66] *Yucaipa*, 1 A.3d 310.

> such Person (or any of such Person's Affiliates or Associates) has (i) any agreement, arrangement or understanding (written or oral) for the purpose of acquiring, holding, voting (except pursuant to a revocable proxy as described in the proviso to clause (b)(ii) of this definition) or disposing of any voting securities of the Company or ***(ii) any agreement, arrangement or understanding (written or oral) to cooperate in obtaining, changing or influencing the control of the Company***.[67]

While the rights plan was a clear-day adoption (before any specific threat to Barnes & Noble existed), concerns about wolf pack activity emerged because of Yucaipa's aggressive activity, giving the wolf pack trigger added importance. At the same time Yucaipa was increasing its ownership, criticizing the rights plan and seeking an exemption from the board, another hedge fund, Aletheia Research and Management, increased its stake in Barnes & Noble from 6.37 percent to 17.44 percent.[68] In the 13D filed when it passed the 17 percent mark, Aletheia stated that it had no plans involving Barnes & Noble, but reserved the right to alter its decision. This move concerned the Barnes & Noble board, because in many past occasions, Aletheia's founder had followed the lead of Yucaipa's founder Burkle.

Despite the threat posed by Aletheia potentially acting in concert with Yucaipa, Barnes & Noble amended its definition of beneficial ownership when challenged. Likely hesitant to bring this issue of first impression before the Court, and wanting to focus instead on the more critical 20 percent trigger, Barnes & Noble amended its rights plan to remove the wolf pack trigger soon after Yucaipa filed its lawsuit. The amendment modified the definition of beneficial ownership to more strictly conform to a definition found in the Williams Act and in other rights plans that had previously been sanctioned by the Delaware courts.

After the modification, Yucaipa continued its challenge of the plan's definition of beneficial ownership, claiming that it was too ambiguous and provided no reliable guidance on what behavior would trigger the plan. In upholding the revised definition, the Court cited a letter from Barnes & Noble's lawyer to Yucaipa, explaining the amendment. The letter emphasized that the plan did not foreclose "agreeing to talk or meet about a proxy contest, participating in forums or group calls discussing the candidates or grievances of the dissident, [and] having a regional or group meeting with other investors."[69] The Court frequently emphasized the fact that the new language was substantively identical to language in rights plans that the Delaware court had previously upheld, and that it tracked the definition of beneficial ownership in Section 13D of the Exchange Act. The Court noted, "as it now stands, the Rights Plan's trigger is based on a well-recognized standard, which sophisticated investors…must address as a regular course of doing business due to provisions like § 13(d)…and which has been the subject of many judicial rulings."[70] Though the validity of wolf-pack language is still an open question,

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[67] *Id.* at 339 (quoting Barnes & Noble's Rights Plan § 1).
[68] *Id.* at 324.
[69] *Id.* at 340 (citing JX-778, letter from Sandra Goldstein to Stephen Alexander and David C. McBride, June 23, 2010).
[70] *Id.* at 338.

this discussion reveals some concern with a definition that extends beyond the "well-recognized standard" of Section 13D, particularly if phrased with ambiguity or unnecessary breadth.

IV. NOL RIGHTS PLANS

A. Protecting the NOL Asset

Traditionally, rights plans have been adopted to protect corporations against abusive takeover transactions. The introduction of the NOL rights plan, designed to protect net operating loss carry-forwards and certain other tax attributes, has expanded the reach of rights plans. NOL rights plans gained prominence due to the impact of the recession, as a result of which an increasing number of corporations generated significant NOLs that may be used to reduce future income taxes. Particularly for a corporation in financial distress, its NOL asset may have value far in excess of the corporation's current market capitalization. In this context, and in other situations in which significant NOL assets may be at risk, more corporations are adopting NOL rights plans in an effort to protect their NOL assets against the threat that changes in share ownership could limit their ability to use NOLs in the future.

B. NOL Rights Plans

1. The Threat Posed by an "Ownership Change."

Corporations that have experienced substantial operating losses may, for federal and state income tax purposes, "carry forward" net operating losses in certain circumstances to offset current and future taxable income, which will reduce federal and state income tax liability, subject to certain requirements and restrictions. These federal and state NOLs can be valuable assets, which may inure to the benefit of a corporation and its shareholders.

Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), and related Treasury regulations provide that if a corporation experiences an "ownership change" for tax purposes, its ability to use its pre-change NOLs in a post-change period could be substantially limited and delayed. These limitations can significantly impair the value of the NOL asset. An ownership change generally occurs if the percentage of the corporation's shares owned by one or more five-percent shareholders increases by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the prior three-year period or, if more recent, since the date of the last ownership change. Determining who is a five-percent shareholder for these purposes may be complex, as various special rules may apply, including those that result in a "public group" or entities acting in concert be treated as five-percent shareholders if they own in the aggregate five percent or more of the shares. Corporations with significant NOL assets often engage advisers to review the trading records of those corporations to determine whether any ownership changes have occurred, or if there are any threats posed by the possibility of future shareholder transactions.

In light of these risks and complexities, corporations with significant NOL assets often implement systems to monitor share ownership changes with the assistance of qualified outside experts. This monitoring can identify whether their cumulative ownership change percentages are approaching the applicable 50-percentage-point threshold. In circumstances where a bona fide threat exists to a corporation's NOL asset, the board of directors and its advisers should consider whether it is prudent to implement mechanisms to protect these tax assets.

2. The Protection Offered by an NOL Rights Plan.

One possible protection is the adoption of an NOL rights plan. An NOL rights plan has a lower trigger threshold (typically 4.99 percent), as compared to the ten percent to 20 percent trigger threshold typical in a traditional rights plan. The 4.99 percent trigger threshold is required in an NOL rights plan for two reasons. First, it deters additional shareholders from becoming five-percent shareholders. This is intended to mitigate the threat that share ownership changes present to a corporation's NOL asset, because changes in ownership by a person owning less than five-percent of the corporation's stock are not included in the calculation of ownership change for purposes of Section 382 of the Code. Second, it deters existing five-percent shareholders (who will be grandfathered at their pre-adoption ownership) from acquiring additional shares, thus limiting further purchases that would be included in the ownership change calculation. The definition of beneficial ownership in an NOL rights plan customarily conforms to the definition used under applicable tax laws, to determine whether an ownership change has occurred.[71]

Due to the specific focus of NOL rights plans on protecting NOL assets, there typically are additional "safety valves" to avoid unnecessary triggering if there is no threat to an NOL asset. For example, many NOL rights plans terminate automatically if the board of directors determines that an NOL has been fully used or is no longer available. Other NOL rights plans permit the board of directors to exercise discretion to waive a trigger *after* the applicable ownership threshold has been reached, if the board of directors determines that the share acquisition is not likely to impair or limit the value of the NOL asset. These safety valves are discussed below in more depth.

3. Limitations of the NOL Rights Plan.

While NOL rights plans afford protection of corporations' NOL assets, they do suffer from certain limitations. An NOL rights plan does not offer complete protection for a corporation's NOL asset. It cannot prevent an ownership change for tax purposes or prevent a potential acquirer from purchasing more than the 4.99 percent trigger threshold. It merely serves as a deterrent. Even an inadvertent acquisition can cause an ownership change to occur, but it would not likely trigger the rights plan—as NOL rights plans, like most traditional rights plans, have an exception for inadvertent acquisitions. In addition, in certain circumstances, sales by existing shareholders who historically held a five percent ownership position can result in an ownership change under applicable tax laws. An NOL rights plan will not prevent or restrict stock sales, so it will not protect against an ownership change due to stock sales. An alternative, more effective protection is to embed ownership limitations in the corporation's certificate of incorporation. This has

[71] *See infra* Part IV.B.7.

become a fairly standard protection for corporations with significant NOL assets emerging from bankruptcy, as the bankruptcy process facilitates adoption of a certificate of incorporation that includes ownership restrictions. However, amendments to the certificate of incorporation to impose ownership restrictions are difficult to implement outside of bankruptcy because they require shareholder approval under Delaware law and may be enforceable only against shareholders who vote in favor of the ownership restrictions or who become shareholders after the ownership restrictions have been approved.

Because of its low trigger threshold, an NOL rights plan may also fail to provide a sufficient deterrent effect. Any rights plan is ultimately an economic deterrent, with the effect measured by the cost to the acquirer of economic dilution. With an NOL plan, the dilution may be applied against a relatively small stake held by the acquirer. In the Selectica case,[72] acquirer Versata intentionally triggered an NOL rights plan, likely concluding that under the circumstances, the costs to the target corporation of a rights-plan trigger, in terms of legal and administrative costs, would exceed its own losses from dilution. Therefore, the threat of triggering the plan could be used as leverage.

Nor is an NOL rights plan an adequate substitute for traditional takeover defenses. Under Delaware law, a board of directors' actions with respect to an NOL rights plan will likely be evaluated in the context of the reasonableness of the actions in relation to its expressed purpose: protecting against threats to a corporation's NOL asset. The Delaware courts may view skeptically any attempt to adopt or use an NOL rights plan for traditional defensive purposes where no bona fide threat to a corporation's NOL asset exists. A board of directors considering whether to adopt an NOL rights plan should inform itself as to the nature and extent of the threat to the corporation's NOL asset by considering, among other things, the financial value of the NOL asset, the potential loss of value that the corporation would suffer if an ownership change occurred and the likelihood of an ownership change. Where the board of directors also perceives a bona fide threat from abusive takeover transactions, it may consider adopting a "second-level" ten percent to 20 percent trigger threshold in the NOL rights plan, which would allow the NOL rights plan also to serve as a traditional rights plan at the higher trigger threshold. In *Yucaipa*'s footnote 244, the Delaware Chancery Court suggested a similarly structured double-trigger, where direct holdings would be limited to five percent, but shareholders could enter into agreements, arrangements or understandings of up to 20 percent.[73]

4. Investor Reaction to an NOL Rights Plan.

The potential merits of NOL rights plans have been recognized by ISS, which began to signal acceptance of NOL rights plans from a corporate governance prospective in its guidance for the 2009 proxy season. That year ISS revised its policy position to accommodate NOL rights plans on a case-by-case basis.[74]

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[72] Selectica, Inc. v. Versata Enterprises, Inc., C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. Oct. 04, 2010); *see infra* Part IV.B.6.

[73] *Yucaipa*, 1 A.3d at 356, n.244.

[74] *See* RiskMetrics Group, *2009 Draft Policy for Comment: Net Operating Loss Poison Pills (U.S.)* (2008), *on file with author*, and RiskMetrics Group, *U.S. Corporate Governance Policy: 2009 Updates* (Nov. 25, 2008), *on file with author.*

In its most recent guidance, for the 2014 proxy season, ISS only recommends voting against a management-sponsored proposal to a corporation's shareholders to ratify a rights plan for the stated purpose of protecting the NOL asset if the term of the plan would exceed the shorter of (a) three years and (b) the exhaustion of the NOL asset. Otherwise, ISS advises shareholders to vote on a case-by-case basis, focusing on the following criteria:

- the trigger threshold, noting that traditional NOL plans have a trigger slightly below five percent;
- the value of the NOL asset;
- the inclusion of shareholder protection mechanisms, such as sunset provisions, that cause the termination of the NOL rights plan upon exhaustion or expiration of the NOL asset;
- the corporation's existing governance structure including board independence, existing takeover defenses, track record of responsiveness to shareholders, and any other governance concerns; and
- unspecified other applicable factors.[75]

Notwithstanding ISS's willingness to consider whether to recommend that shareholders vote in favor of NOL rights plans on a case-by-case basis, ISS has grown more skeptical of NOL plans, particularly in the context of NOL assets with limited value or utility. Further, a corporation adopting an NOL plan may still receive a recommendation from ISS that shareholders cast withhold/against votes for incumbent directors. In the context of director elections, ISS treats the adoption of an NOL plan without shareholder approval in the same manner as it treats adoption of a traditional plan without shareholder approval—that is, they will recommend a withhold vote if certain criteria are not met.[76] As discussed above in Part I.B., ISS's policy with regards to rights plans is to encourage boards to submit rights plans for ratification by shareholders. Of eight NOL rights plans adopted in 2012 and 2013 and submitted to a shareholder vote to date, all have received shareholder approval, and the vast majority have been ratified by an 80 percent margin. Since boards generally adopt NOL rights plans to protect a significant asset of the corporation, it follows that shareholders are generally supportive of the action and it appears that there is little risk to corporations to adhering to ISS's policy goals and submitting NOL rights plans for ratification by shareholders.

5. Examining Board of Directors' Motivations in Adopting NOL Rights Plan.

The primary rationale for an NOL rights plan is to protect a valuable tax asset of the corporation, not to deter opportunistic "hostile" transactions. However, like a traditional rights plan, an NOL rights plan deters share accumulations above the trigger threshold and presents the same board of directors' entrenchment-related concerns as traditional

[75] *See* ISS, *2014 Institutional Shareholder Services U.S. Proxy Voting Guidelines Summary*, March 12, 2014, at 26.

[76] *See supra*, Part I.B.

rights plans. While directors' actions on behalf of their corporation are generally protected by the "business judgment rule," the adoption of defensive provisions raises special concerns because such provisions may be deemed, among other things, to "perpetuate" the adopting directors in office. Accordingly, the Delaware courts have applied a heightened standard to boards' decisions implementing defensive measures.

As discussed below, because of its effect and its direct implications for hostile takeovers, the court in *Selectica* subjected the NOL rights plan at issue to the same heightened reasonableness scrutiny that it would have used for a traditional rights plan. Under the so-called *Unocal/Unitrin* standard,[77] a board of directors must demonstrate that (i) "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"[78] and (ii) a rights plan adopted is "reasonable in relation to the threat posed."[79] Measures that are otherwise inequitable, preclusive or coercive are not permissible.

A board of directors considering whether to adopt an NOL rights plan should inform itself as to the nature and extent of the threat to the corporation's NOL asset by considering, among other things:

- the value of the corporation's NOLs, as analyzed by and discussed with the corporation's financial adviser, as well as the potential loss of value that would result from an ownership change under Section 382 of the Code;
- the risk that future acquisitions could impair the corporation's NOL asset, in light of the current ownership of the corporation and the status of the ownership change analysis under Section 382 of the Code (often assessed with the assistance of an outside tax advisor); and
- that the NOL rights plan does not guarantee protection of the corporation's NOL asset because the sale of stock by significant shareholders may also result in an ownership change, thereby limiting the use of the corporation's NOLs to reduce future federal and state income tax obligations.

Similarly, a board of directors considering whether to grant a requested waiver of an NOL plan limitation on share acquisitions should assess the impact of the sought after share accumulation in the context of:

- the then cumulative ownership change, customarily with the assistance of an outside tax advisor;
- the current value and utility of the NOL asset, with the assistance of management and tax advisors, and sometimes a financial advisor; and

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[77] *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *see also* Unitrin Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995).
[78] *Unocal Corp.*, 493 A.2d at 955.
[79] *Id.*

- other probable or planned issuances by the corporation for purposes such as raising capital or issuance in acquisitions, for which the corporation may need to leave "headroom" in its cumulative ownership change.

Further, denial of a waiver for solely "defensive" reasons may face challenge for the reason noted under IV.B. 3 above. We also recommend waivers be time limited, so that if a shareholder does not execute all of its sought after exempted purchases within a specified period of time, the waiver expires as to the unpurchased shares. If multiple shareholders seek waivers at or around the same time, the board of directors may also detriment to equitably allocate the available accumulations under the NOL plan amongst those shareholders, particularly where one or more shareholders may later complain of discriminatory treatment in the granting of such waivers.

6. Testing the Technology: Selectica, Inc. v. Versata Enterprises, Inc.[80]

Until the end of 2008, the risk of economic dilution created by the rights plan had its intended deterrent effect. No shareholder had ever triggered a modern rights plan,[81] and the mechanics of a rights plan trigger were purely an academic exercise. Furthermore, the validity of an NOL plan had not yet been tested in court. This all changed with *Selectica*.

To protect its NOL asset, valued at approximately $150 million, Selectica implemented an NOL rights plan in November 2008 by reducing the trigger threshold of its existing rights plan from 15 percent to 4.99 percent. Selectica's existing five-percent shareholders, including Versata, were grandfathered under the NOL rights plan, subject to a trigger threshold of 0.5 percent above their pre-adoption ownership. Versata then intentionally purchased shares above its threshold, in what appears to have been a calculated effort to obtain leverage in an unrelated business dispute. Selectica's board of directors then used its rights plan to dilute Versata's position, exercising the feature that allowed the board of directors to exchange rights held by shareholders other than Versata for common stock on a one-for-one basis, rather than a traditional flip-in provision. The board also adopted a new NOL rights plan to maintain future protection for the NOL asset.

In October 2010, the Delaware Supreme Court upheld Selectica's NOL rights plan, affirming the prior decision of the Delaware Court of Chancery.[82] Applying the *Unocal* analysis, the Court held that NOLs are valuable assets, and that their protection may be an appropriate corporate policy meriting a defensive response when threatened. The Court further found that Selectica's board conducted a reasonable investigation and relied in good faith on the advice of experts, and that the threat posed by Versata was legitimate, especially given Versata's adversarial motivations. It also found that the reduction in the trigger threshold to 4.99 percent was reasonable, given the likelihood that a Section 382 ownership change could occur, the consequences the corporation would face if it did, and the fact that the new threshold was driven by tax laws and regulations and was not merely a standard created by the board or the Court of Chancery.

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[80] *Selectica,* 2010 WL 703062.

[81] Sir James Goldsmith's takeover of Crown Zellerbach involved a first-generation rights plan with a flip-over feature, but did not include the now common flip-in feature. Stephen M. Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law* 13–14 (Law & Econ. Research Paper No. 02-02), *available at* http://ssrn.com/abstract=347089.

[82] *Selectica,* 2010 WL 703062.

Versata claimed that the 4.99 percent trigger rendered the plan preclusive, since such a low stake would prevent an insurgent's ability to establish sufficient credibility in a proxy contest by signaling its commitment to the corporation.[83] The Court disagreed, emphasizing the tax-based need for a low trigger, as well as expert testimony of a proxy solicitor on the preclusion question. The court cited to ISS's policy to review NOL rights plans with triggers below five percent, on a case-by-case basis, if adopted to protect an NOL asset, and an expert presented several examples of successful proxy contests launched by challengers with less than 5.49 percent of a corporation's outstanding shares.

Versata further argued that Selectica had an additional defense in the form of a staggered board, and that this plus the low trigger would lead to preclusion. The Court disagreed, noting that if Versata's argument were correct, then any plan used in conjunction with a staggered board would fail, which would go against long-standing Delaware precedent.

We also understand that Selectica's decision to use the exchange feature, rather than the traditional flip-in provision, helped to bolster the argument that the directors acted reasonably, since it resulted in less dilution. Furthermore, the Court held that the enactment of a new plan after the exchange was reasonable because the general threat of a Section 382 change in control still remained.

Though it upheld the plan, the Court did reiterate the fact that analysis under *Unocal* is context specific. The Selectica plan was upheld because of the specific nature of the threat—a long-time competitor sought to increase the percentage of its stock ownership to intentionally impair corporate assets or coerce the corporation into meeting certain business demands under the threat of such impairment. The Court cautioned that its decision should not be treated as a stamp of approval for all 4.99 percent rights plan triggers, whether or not they are used to protect NOLs, and that even Selectica's plan would have to be reevaluated if it were retained in the face of a new threat.

7. *Defining Beneficial Ownership for NOL Rights Plans.*

The definition of beneficial ownership poses unique challenges in the context of NOL rights plans. Unlike the traditional rights plan, the NOL plan is designed to address issues present in the Internal Revenue Code. While the rights plan will be triggered according to the corporation's definition of beneficial ownership, the tax consequences will only attach as provided by Section 382 of the Code. Like the synthetic equity trigger, there are multiple options in crafting the definition of beneficial ownership.

One approach is to provide that securities are considered beneficially owned for the purposes of the NOL rights plan only if they would be considered beneficially owned pursuant to Section 382 of the Code. This language directly targets the threat at issue, and theoretically ensures that only true threats to the NOL asset will lead to a triggering of the plan. However, determining beneficial ownership under Section 382 is not a straightforward task and often requires nonpublic information regarding the nature and structure of a shareholder's ownership of shares of a corporation. Without access to this information, a board would be unable to monitor potential threats. Using this limited definition of beneficial ownership, a corporation may only find out that a shareholder

[83] *Selectica,* 2010 WL 703062 at *20.

impaired the NOL asset after the fact, at which time there may no longer be a threat to the corporation and the board ability to implement the dilution mechanism of the rights plan may be impeded.

Another approach to the beneficial ownership definition is to include securities that are considered beneficially owned pursuant to Rule 13d-3 of the Exchange Act in addition to those deemed beneficially owned by Section 382. Since Rule 13d-3 beneficial ownership requires public filings, it is easier for corporations to monitor this ownership. These public filings encourage communication between an investor and the corporation when the investor is contemplating purchasing additional shares, allowing the investor and the board to work together to determine if the potential acquisitions pose a threat to the NOL asset. However, this approach also has its drawbacks, as it may be over-inclusive. Rule 13d-3 beneficial ownership is more expansive than ownership under Section 382, which creates the risk of a trigger where there is no threat to the corporation's NOL asset—appropriate waiver provisions can address this concern, however.

Corporations may also need to be mindful of when to aggregate the ownership of a group of shareholders in the context of NOL plans because aggregation is affected differently under Section 382 than Section 13. Though the Barnes & Noble case involved a traditional rights plan, a footnote addressed NOL plans as well. The Court conjectured that an NOL plan may have to use a "more nuanced" definition of beneficial ownership, one that "distinguishes more finely between shares that are owned in the more common sense by a shareholder, and those 'beneficially owned' in the broader sense of being subject to 'agreements, arrangements or understandings…for the purposes of…voting."[84] Added legitimacy for an NOL rights plan, according to the Court, might come from a double-trigger, with a trigger of five percent for direct holdings that might impair the NOL asset, but 20 percent for the more expansively defined trigger.

8. Incorporating a Board's Post-Trigger "Safety Valve" in NOL Rights Plans.

Many NOL rights plans, such as the one in *Selectica*, permit a board of directors to exercise discretion to waive the trigger *after* the applicable ownership threshold has been exceeded, if the board determines that the share acquisition did not impair or limit the value of the NOL asset. Under this post-trigger "safety valve," the board must consider whether to dilute an acquirer who has already crossed the ownership threshold. The "after-the-fact" nature of the waiver may make the board susceptible to increased pressure because its decision will result in an immediate detrimental impact to the acquirer, will cause disruption to the corporation when the rights plan is implemented, and likely will result in litigation challenging the board's actions. Moreover, for an NOL rights plan, the corporation may suffer an ownership change when the rights plan threshold is crossed, in which case the corporation would already have suffered harm to its NOL asset. In this circumstance, the board may find it difficult to justify the implementation of a rights plan to the detriment of the acquirer when no further threat to the corporation's NOL asset exists, and so the corporation's actions may not survive *Unocal* analysis.

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[84] *Yucaipa*, 1 A.3d at 356, n.244 (quoting Rights Plan § 1).

However, in the context of a lower 4.99 percent trigger, the risk of an inadvertent trigger of the NOL rights plan grows substantially. As a practical matter, boards may be put in a difficult position where a post-trigger safety valve does not exist, if a shareholder passes the five percent ownership threshold but does not, by virtue of its ownership, constitute a threat to the corporation's NOL asset. In that context, the board will likely determine that triggering the NOL plan against the acquirer is not appropriate, and may be forced to engage in careful interpretation of the NOL rights plan to avoid a dilutive trigger. Most rights plans contain a provision for inadvertent triggers, which could alleviate this kind of threat, but that provision typically requires the acquirer to sell its holdings to below the five percent trigger threshold. A forced sell-down may not be necessary or desirable, however, if the ownership position does not create a threat to the NOL asset. Ultimately, any board considering an NOL plan should review the benefits and risks of a post-trigger safety valve to reach an appropriate determination regarding whether to include the provision in the plan.

CONCLUSION

While rights plan adoption levels continue to decline, corporations continue to recognize the benefit of adopting a rights plan to address a specified threat or purpose. In recent years, Delaware courts have provided a modern and strong foundation to the proper implementation and use of rights plan. The *Airgas* decision reaffirmed the unique and extraordinary tool a rights plan provided directors facing an inadequate offer and the *Third Point* decision demonstrated that a rights plan may be adopted and maintained by independent directors acting with good faith and care in response to the threat posed by activist shareholders. In addition, the *Atmel* and *Selectica* litigations provided the Delaware courts with the opportunity to uphold the validity of the next generation of rights plan, including triggers that have been expanded to include derivative and synthetic provisions, and plans employed to protect valuable assets of a corporation.

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. 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.