

M&A Commentary

February 2011

Adoption of Poison Pill to Deter Activist Investor Opposition to Negotiated Mergers

Highlights

- The recently announced cash acquisition of Compellent Technologies by Dell included a novel feature. Compellent, which did not have a poison pill in effect, adopted a poison pill at the behest of Dell when it approved the merger agreement.
- The Compellent pill presumably was included by Dell in its “deal protection” requests to deter hedge funds and other activist shareholders from accumulating a large position in Compellent stock as a base from which to run a “vote no” campaign against shareholder approval of the acquisition agreement.
- The Compellent merger-related poison pill clearly seems to be a reaction to several takeover situations in the past year in which activist shareholders have mustered a successful vote no campaign against a merger, including the proposed acquisition of Charles River Labs by WuXi and the proposed Blackstone acquisition of Dynegy.
- These highly visible and successful vote no campaigns have brought to the forefront concerns on the part of merger partners of a return of organized activist investor merger opposition, which had become endemic in 2006 and the early part of 2007.
- This M&A Commentary examines the legal issues surrounding merger-related poison pills. The Commentary concludes that adoption of a merger-related pill at the instance of an acquirer should not pose legal issues under Delaware law at least in ordinary situations.

Introduction

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.¹ 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. Icahn’s proposed acquisition of Lear Corporation in the summer of 2007 is one the most memorable of the worst cases. After Icahn refused to raise his final price to “buy-off” 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.

The financial crisis and resulting swoon of the public company merger market in 2008-2009 put an end to concerns about vote no campaigns in the M&A context, and many in the M&A community soon came to regard them as a relic of a former golden age, probably not to be seen again for a long while. However, notwithstanding the spotty return of the public M&A market, organized opposition to announced deals resurfaced in 2010, most prominently in Blackstone’s proposed acquisition of Dynegy and WuXi’s proposed acquisition of Charles River Labs.

Presumably in response, Dell insisted that Compellent Technologies adopt a poison pill in conjunction with entering into a merger agreement with Dell. According to Compellent's preliminary proxy statement, Dell made poison pill adoption an explicit and consistent requirement of its acquisition proposals during the several month negotiation that preceded signing of the deal. While this one instance doesn't make a trend,² it does suggest examination from several points of view:

- Is the legal analysis of the validity of a specifically merger-related pill different from other pills?
- Will a merger-related pill pass legal muster, and what are the key issues in the legal analysis?
- Should acquirers insist that targets that don't have poison pills in place adopt a poison pill simultaneously with the signing of the acquisition agreement?
- How should targets respond to acquirer requests for adoption of a poison pill?

Validity of Merger-Related Pill

In the wake of recent Delaware pill cases,³ it is clear that a poison pill adopted in any circumstance will be analyzed as a defensive tactic under the *Unocal/Unitrin* line of cases.⁴ In brief, this test as applied to poison pills has several steps:

- First, the board must reasonably identify a threat to the company that supports adoption of a poison pill.
- Second, the pill's operation must be proportional in relation to the threat.
- Third, the pill (in combination with all other defensive structures) cannot be preclusive of shareholder exercise of the franchise and, in particular, must not have the effect of preventing a successful proxy contest.
- Fourth, the pill cannot be coercive in the context of shareholder exercise of the franchise.

Recently, VC Strine applied the *Unocal/Unitrin* doctrine to a conventional poison pill in his decision on Yucaipa's suit against a Barnes & Noble pill adopted in the face of Yucaipa's rapid accumulation of stock and threatened proxy contest.⁵ The analysis of this case is instructive in the context of assessing the validity under Delaware law of a merger-related pill.

Is There a Reasonable Threat? VC Strine was realistic in assessing whether the Barnes & Noble board could reasonably conclude that Yucaipa's activities could pose a threat to Barnes & Noble and its shareholders. While the typical fact situation in the context of a merger-related pill 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 company to be concerned about the possible damage a large shareholder or shareholder group (*i.e.*, one exceeding a traditional pill trigger threshold) could wreak in threatening or running a vote no contest.

- At the outset, it is clear that the threat to the company addressed by a merger-related pill 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). No one ever dreamed that a board of a target company subject to *Revlon* duties would utilize a poison pill (whether in existence at the time of the deal or newly adopted in conjunction with the deal) to preclude a superior competing bid. Use of a poison pill to deter a **superior** competing acquisition proposal in order to preserve an agreed **inferior** acquisition in most circumstances would be a breach of fiduciary duty.⁶

- Rather, the threat addressed by a merger-related pill 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 harm the company and its shareholders.⁷
- A target board could also reasonably conclude that the uncertainty caused by a vote no campaign might damage the stability of the company 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 crater. Admittedly, a target announcement that it has agreed to be acquired creates business continuity and employee morale risks. Typically, targets go to great lengths to “sell” the advantages of the acquisition to customers and employees and are typically relatively successful. However, the effort to maintain customer relationships and employee morale is never easy. 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.
- 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. Why, the directors might ask, should the board permit short term investors to “game” long term investors in this fashion? Wouldn’t it be reasonable to protect long term investors and assure their receipt of the full consideration, rather than allow short term activist investors to play Russian Roulette with 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 pill 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 pill under the *Unocal/Unitrin* doctrine. Put simply, a merger-related pill should be as valid a form of deal protection under *Unocal/Unitrin* as a no-shop provision, a force the vote provision and a termination fee, all of which are routinely accepted as reasonable target board responses to threats to the company posed by possible third party activities.
- Finally, as is the case with all large shareholders and shareholder groups, there is the omnipresent threat that an activist investor or investor group might continue buying stock, succeed in blocking the merger through its vote no campaign and wind up obtaining working control of the company without payment of a control premium to other shareholders. VC Strine’s analysis of this threat in the Barnes & Noble situation seems equally applicable to an activist shareholder or shareholder consortium initially motivated by the desire to defeat a pending merger proposal.

Is a Poison Pill a Proportional Response? This question almost inevitably blends into the issue of preclusion. Both lead the courts to review the impact of the pill on the exercise of the shareholder franchise.

- As formulated by VC Strine, the proportionality test (often articulated as whether the defensive measure is reasonably related to the threat) goes to a pill’s impact on the exercise of the franchise under the facts of the particular case. In the Barnes & Noble situation, Strine concluded that the pill was not preclusive of a Yucaipa victory in a proxy contest, notwithstanding that Riggio (the founder of Barnes & Noble) owned nearly 30 percent of the stock, the other directors and officers owned 3.26 percent and the employees owned an additional 6 percent (which, for purposes of analysis, Strine assumed would vote as a single block against Yucaipa in a proxy contest). VC Strine reached his conclusion regarding the possibility of a successful proxy contest in part on the basis that expert testimony, including that of Yucaipa’s proxy solicitor, persuaded Strine “there is good reason to believe that

- This, of course, is the analysis that the Delaware courts have used in many other poison pill challenges.⁸ In effect, unless the target company and its insiders control close to an absolute majority vote, the pill's preclusion of the formation of a proxy soliciting group in excess of its trigger percentage will not be found to be an unreasonable or non-proportional response. The Delaware courts will not strike down a pill because it precludes the insurgents from "buying" their way to a proxy contest victory through acquisition of shares in excess of the pill's trigger threshold, as long as they have an opportunity to win a proxy contest through persuasion of unaffiliated shareholders.
- Opponents of a merger-related pill could argue that the motivation for a merger-related pill is different from that of a more general pill adopted when no threat has materialized. But this argument is, at bottom, no different from a claim that a pill adopted in the teeth of a proxy contest cannot be valid because it is intended to impede the insurgents. To date, no Delaware decision has invalidated a pill because it was adopted in the face of a concrete threat. There doesn't seem to be a reason why the merger context should be viewed differently, once the court accepts the reasonability of a board's determination that a threat does exist.

Preclusion and Coercion. The foregoing discussion of proportionality likewise answers the question of preclusion. And, in the context of a merger-related pill, it is difficult to see any argument that the pill is coercive.

Design Issues for Merger-Related Pills

Duration. Because of its purpose, there usually will be no reason for a merger-related pill to have a term of more than a year. Accordingly, it should not raise any issues with ISS or other proponents of limited duration pills.

Trigger Threshold. The most common trigger threshold for a poison pill is 15 percent, and 10 percent is also very common. Little attention has been paid to the relationship of the trigger to large holdings of shares by insiders. However, in VC Strine's opinion in the Barnes & Noble case, he implicitly suggests that the trigger threshold should be reasonable in relation to large inside holdings.⁹ Accordingly, we suggest caution in using relatively low threshold triggers in situations in which there are far larger inside control blocks. A too obvious disparity might be used as the basis for a claim that under the particular circumstances the low threshold pill is unreasonable or non-proportional to the actual threat.

Treatment of Derivatives. It is increasingly common for poison pills to include derivative-based long positions in the definition of the term "beneficial ownership" to prevent use of derivatives to evade the threshold ownership percentage.

- The most common example is for an activist insurgent to buy the "long" side of a total return swap to obtain the economic equivalent of conventional share ownership at far lower cost than owning shares outright. This would increase the activist insurgent's ability to profit on its campaign to block the merger, but from the target's point of view might tempt the insurgent to make an imprudent bet, cheaply acquired, on the upside of pushing the bidder to raise its price.
- Moreover, there is a pervasive concern that activists have the practical ability upon termination of a total return swap or similar derivative to purchase the target shares held by the swap counter-party to hedge its economic position, as well as the possibility that the activist can influence the voting of the hedge position by the counter-party. Even where the long party cannot affirmatively direct the vote by its hedged counter party, its derivative position can affect the vote if the derivatives dealer has a policy of not voting its hedging positions or of voting them in proportion to all other votes. Because merger and acquisition votes almost always require approval by a majority or supermajority of outstanding shares, a failure to vote has the same practical effect as a no vote, and a proportional vote will be of no use in establishing a majority or supermajority unless the percentage of for votes equals

As a result of these and other fears of possible “abusive” uses of derivatives, many current poison pills, including the Compellent Technology merger-related poison pill include derivative positions under the pill’s definition of “beneficial ownership.” We generally support the inclusion of derivatives in poison pills and see no reason for a different view in the context of merger-related pills.¹¹

Current pills also sometimes specifically include as “beneficially owned” shares underlying options, warrants and rights exercisable at any time in the future (not just in the succeeding 60 days which is the Section 13(d) beneficial ownership test). This was a feature of the Compellent pill which also seems desirable and appropriate in the context of poison pill design.

“Group” Definition. Another recently surfaced concern in the design of poison pills is whether and how to deal with so-called “wolf packs”—that is, informally aligned groups of activist investors working to a common goal but without an actual agreement, arrangement or understanding (written or oral) to vote or buy or sell in concert. Some recent pills have sought to capture wolf packs by expanding the definition of the term “person” or “beneficial ownership” to include concepts such as “acting with conscious parallelism,” “acting in concert” or “cooperating.”

An expanded definition of this type in a merger-related pill might well provoke a challenge based on a claim of vagueness and assertions that the vagueness impermissibly chills conduct that should not be precluded by a poison pill, such as shareholders’ right to discuss among themselves the pros and cons of a proposed merger and, worse, the very right of shareholders to vote no against a merger proposal. So far as we are aware, none of these expansions of the traditional Williams Act based definitions of “person” and “beneficial ownership” have been tested judicially.¹²

However, the attention paid to this issue by the litigants in the Barnes & Noble case and the fine line that would have to be drawn to separate permissible proxy solicitation efforts and communications among shareholders and impermissible wolf pack activities suggest that it could easily be counterproductive to include in a merger-related pill an expansive definition of “person” or “beneficial ownership” (that is, one going beyond traditional Section 13(d) based “group” concepts). Given its intended short life and limited goals, conventional definitions may be the better part of wisdom, notwithstanding the potential threat of a wolf pack based vote no campaign.¹³

Fiduciary Out. Although not needed structurally because the Target board always has a right to redeem a pill, is there a reason to include a fiduciary out clause that parallels, and is conditioned on exercise of, the fiduciary out in the merger agreement? Adding such a provision, making explicit the Board’s right to amend or terminate the pill would add favorable “optics.” However, we recommend that issues of redemption, amendment and maintenance of a merger-related pill in the context of competing bids be dealt with in the main merger agreement for simplicity, ease in drafting and better coordination with other deal protection provisions of the merger agreement.

Conclusions

A merger-related poison pill, although novel, will function no differently from a conventional pill that had been in effect prior to acquisition negotiations. Indeed, but for the accelerated demise of poison pills at the behest of corporate governance activists and proxy advisory firms, far more targets would have pills in place mooted the need to consider merger-related pills. Additionally, because a merger-related pill will typically have a 12 month or shorter lifespan, it shouldn’t stimulate antipathy from corporate governance activists or proxy advisory firms. Most important, for the reasons outlined above, we don’t think a merger-related pill will be as vulnerable to legal attack as violating the *Unocal/Unitrin* standard of review of defensive measures.¹⁴ For these reasons, we recommend that acquirers consider including adoption by the target of a merger-related pill as part of their deal protection requirements as a matter of course.

From the perspective of acquisition targets, the situation is not quite as simple. Unlike an acquirer which has no fiduciary duty issues at stake in requesting deal protection provisions, a target's board has to face up to the challenge of observing its fiduciary duty to get the best deal reasonably available for its shareholders and to protect its shareholders' ability to exercise their franchise. While we believe that a target board could properly reach a conclusion that the threat of an orchestrated vote no campaign justifies implementation of a merger-related pill, we do not believe the conclusion is inevitable, nor should it be. As is true of all deal protection structures, adoption of a merger-related poison pill needs to be examined in the context of the facts and circumstances of the particular situation. Moreover, as is true of other deal protection structures, an important component of the target board's consideration is whether and how strenuously the acquirer pushed for the particular deal protection in question.

In sum, we would not be surprised to see adoption of merger-related pills by target companies becoming more commonplace, especially where acquirers make adoption a key deal point for targets. Although target adoption of a merger-related pill is not without its fiduciary duty concerns, on balance, we believe that they should pass legal muster, particularly in situations where they are strongly advocated by an acquirer.

Endnotes

- ¹ 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
- ² During the hey day of bank mergers of equals during the second half of the 1990 decade, merger partners without pre-existing poison pills sometimes adopted poison pills 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.
- ³ See *Yucaipa Am. Alliance Fund II, L.P. v. Riggio, C.A.* No. 5465-VCS, 2010 WL 3170806 (Del. Ch. Aug. 12, 2010) ("Yucaipa"); see also *Selectica, Inc. v. Versata Enters., Inc.*, C.A. No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010), aff'd 5A.3d 586 (Del. 2010). For our discussion of *Selectica*, see L&W M&A Commentary, "Lessons from the First Triggering of a Modern Poison Pill: *Selectica, Inc. v. Versata Enterprises, Inc.*," Mar. 2009, available at http://www.lw.com/upload/pubContent/pdf/pub2563_1.pdf.
- ⁴ See *Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985); see also *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995).
- ⁵ *Yucaipa*, 2010 WL 3170806. It is important to note that VC Strine explicitly rejected application of the more stringent review standard of *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).
- ⁶ We are not speaking to the more complicated fiduciary duty analysis that would arise if a participant in a merger of equals at or near market—that is without a premium—refused to redeem its pill in the face of an unsolicited bid offering higher value consideration but not the other asserted benefits of the proposed MOE.
- ⁷ 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 shareholder approval; and Crescendo Partners campaign against the merger between Computer Horizons Corp and Analysts International Corporation resulting in shareholder defeat.
- ⁸ See, e.g., *Moran v. Household Int'l, Inc.*, 500 A.2d 1361 (Del. 1985); *Omnicare, Inc. v. NCS Healthcare, Inc.* 818 A.2d 914 (Del. 2003); *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998).
- ⁹ See *Yucaipa* text at notes 244 and 254.
- ¹⁰ See *CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP, et al.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008); see also *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008).
- ¹¹ For a more complete analysis of the reasons to include derivatives in the definition of "beneficial ownership," as well as a discussion of different definitional approaches, see Mark Gerstein, Brad Faris and Christopher Drewry, "Resurgent Rights Plan: Recent Poison Pill Developments and Trends," Apr. 2009, available at http://www.lw.com/upload/pubContent/pdf/pub2628_1.pdf; Charles Nathan and Stephen Amdur, "Second Generation Advance Notice Bylaws and Poison Pills," Apr. 2009, available at http://www.lw.com/upload/pubContent/pdf/pub2604_1.pdf. The inclusion of derivatives in the definition of "beneficial ownership" was challenged as being impermissibly vague in *In re Atmel Corp. Shareholders' Litigation*, C.A. No. 4161-CC (Del. Ch. May 19, 2009) (Atmel and shareholders settled under an agreement requiring Atmel to clarify the definition of "beneficial owner").
- ¹² For a more complete analysis of the utilization of "conscious parallelism" to broaden the group concept in poison pills, see Gerstein et.al., *supra* note xi and Nathan et.al., *supra* note xi. In 2008, CVT Therapeutics adopted a poison pill which included "conscious parallelism" in its definition of person. This aspect of the pill was challenged by an unsolicited bidder as precluding solicitation of tenders by the bidder (notwithstanding a specific carve out of tender solicitations from the definition), but the case was settled without any judicial opinion. The initial Barnes & Noble pill expanded the traditional "beneficial ownership" definition to also include agreements, arrangements or understandings "to cooperate" with respect to a change of control. However, this branch of the definition was removed by amendment prior to the litigation and was not subjected to judicial scrutiny.
- ¹³ A countervailing observation is that expanding the definition of "person" or "beneficial ownership" in a merger-related pill to include language specifically aimed at wolf packs is about deterring conduct in the relatively short time frame

between announcement of a merger transaction and the record date for the target's shareholder vote—which could be as short as 30-45 days (even if closing will take far more time). While activist investors (or the plaintiffs' bar) could muster a judicial test of the expanded definition within this time frame, it seems unlikely that activist investors would indulge in wolf pack behavior prior to victory in the lawsuit.

¹⁴ The only nuances that would ordinarily require careful judgments would be whether to include derivatives in the definition of "beneficial" ownership and whether to expand the definition of "person" or "beneficial ownership" to deter wolf pack tactics.

If you have any questions about this *M&A Commentary*, please contact one of the authors listed below or the Latham attorney with whom you normally consult.

[Adel Aslani-Far](#)

[Charles Nathan](#)

[Barry Bryer](#)

[John Newell](#)

[Bradley C. Faris](#)

[Steven Stokdyk](#)

[Mark D. Gerstein](#)

[Paul Tosetti](#)

[Christopher Kaufman](#)

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