Inside Track with Broc: Bill Lawlor on Poison Pill Developments (1/12/05)

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Broc: As an M&A attorney representing various public companies, what's on your front burner these days regarding poison pills?

Bill: The front burner is really cooking this proxy season. Let me give you a scenario that's being played out time and again: Public company X has received a shareholder proposal complying with Rule 14a-8 under the Exchange Act to put the company's rights plan to a non-binding shareholder vote at the company's spring meeting. X's lawyers deliver the bad news: the company must put the proposal in the annual meeting proxy statement. X's proxy solicitor delivers more bad news: based on the company's shareholder demographics and the cut-off of the broker non-votes, the shareholder proposal will likely obtain a majority of the votes cast at the meeting; in fact, the proposal may carry over a majority of the company's outstanding shares.

This is not at all atypical for public companies with significant institutional shareholders: rights plan rescission/shareholder vote proposals have received on average around 60% of the votes cast.

Broc: Faced with this, what are companies doing?

Bill: The responses have been all over the map, but there are three basic approaches: fight, compromise or fold the cards.

Some companies fight, try to win the vote, and ignore the results if the nonbinding vote is unfavorable to the company's position. These companies are willing to take the public relations hit for an unfavorable shareholder vote. In the aftermath, some companies lift their pills or go to the well again with shareholders with a restructured pill.

Broc: How is the proposed SEC shareholder access rule fitting into this approach?

Bill: The SEC shareholder access rule proposed in October 2003 - Rule 14a-11 - would allow shareholders to nominate director candidates in the company's proxy statement after a triggering event such as a negative vote on a shareholder proposal to rescind a pill. The proposal contained a reach-back provision which made the 2004 proxy results relevant for purposes of the triggers.

If some version of the rule is eventually adopted, it is expected to be watered down so that the rule achieves a broader consensus among the SEC's commissioners. It's anyone's guess as to whether the reach-back provisions will survive, which are controversial and viewed by some as

administrative gun-jumping. There is no doubt that the very existence of this reach-back provision in the current proposal has affected the calculus for some companies deciding whether or not to fight.

Broc: What other options does a company have?

Bill: Some companies that want to keep their pills in place have tried to reach compromises with the shareholder proponents so that they withdraw their proposals. For instance, a company might agree to a sunset provision that provides for a shareholder vote on the pill within twelve months.

Other common variations include a "chewable" pill, which permits a qualified hostile offer to proceed or triggers a shareholder vote on the pill, or a "tide" (three year independent director) pill, which contains three year sunset provisions unless the pill is reapproved by independent directors.

The problem with most chewable pills is that they provide a clear path to victory for a bidder with a premium bid. The problem with most tide pills is that shareholder proponents often find them toothless given the already existing stock exchange requirements for companies to have predominantly independent boards. One of the growth areas for M&A lawyers is devising pill structures that achieve the company's objectives and are acceptable to shareholders. Not always easy.

Broc: And what about the "fold the cards" approach?

Bill: More and more companies are redeeming or not renewing their pills in response to shareholder proposals or pressure--or even preemptively. Often in conjunction with this the company adopts a policy that it will not implement a pill without shareholder consent, but with an escape hatch if the majority of independent directors determine in the exercise of their fiduciary duties that under the circumstances a pill is in the best interests of the shareholders.

What this means in practice is that the company pulls its pill but reserves the right to unilaterally implement another one in the face of a hostile bid--a so-called "morning after" pill. If a target board undertakes a careful process in reviewing a hostile bid, this approach should generally be legal even under the heightened standard of judicial scrutiny, and arguably even for companies that have previously lost non-binding shareholder proposals to rescind pills.

But the morning after approach isn't always the right solution. Each company has to look at its own facts and circumstances. For instance, anti-takeover statutes and charter provisions often address only follow-on transactions between significant shareholders and the target, not the accumulation of shares per se. A company may want to use a pill to prevent a significant shareholder from buying up additional shares which could give it actual or "negative" control over the company.

Smaller cap companies might be concerned that a morning after pill approach is too late if the company doesn't have an early warning system in place to identify destabilizing accumulations of stock. The Hart-Scott antitrust filing threshold is generally $50 million, and the Schedule 13D report for 5% shareholders still contains the 10 day filing loophole, so it might be a case of Katy bar the door when the target finally figures out what is going on. Some undervalued companies that have few other anti-takeover defenses are concerned with the perception problem of "flying

naked" without a pill.

Broc: Are the activist institutional shareholders and proxy consultant services ok with these escape hatches?

Bill: It depends on whom you speak with, but many, including Institutional Shareholder Services, will not accept an escape hatch without a built-in sunset provision or shareholder ratification within twelve months.

Broc: Do you see any change in the mood of institutional shareholders regarding their approach to pills?

Bill: Many have an ingrained, theological aversion to the concept. And the more prominent proxy consultant services have strong anti-pill policies. In fact, as noted in your recent interview with Pat McGurn of ISS, ISS amended its pill policy last December to include that it will recommend a withhold vote for the directors of a board which votes to adopt or renew a pill if the pill has not been approved by shareholders and there is no commitment to put the pill up for shareholder ratification within twelve months after the pill's adoption.

The prior policy had been to recommend a withhold vote only if the pill had provisions which effectively prevent or delay a hostile bidder from redeeming a pill after it has won a proxy contest (the so-called "dead hand," "no hand," "continuing director" or "slow hand" provisions; these types of provisions have been struck down in Delaware but are valid in some other states that statutorily authorize pills).

ISS's new policy is effective for the upcoming proxy season, but it will not be applied retroactively. Rights plans generally last for only ten years, so even companies with long-standing pills will have to face the music eventually if they wish to continue having a pill. In addition, the withhold vote tally may have trigger implications for any shareholder access rule that is adopted by the SEC.

Hopefully, shareholders will not take a “meat axe” approach to rights plans. Hostile bids and rights plans fundamentally revolve around director election cycles. If a target has an unstaggered board and a straightforward pill (which doesn't contain a "dead hand," etc. director provision), there is usually a limited, finite time in which a target board must act. Thankfully we do not have the European model in which a board is completely disintermediated in a hostile bid situation.

On the other hand, there are plenty of examples where a target's prolonged use of a pill did not result in a good shareholder result. The DNA of every company is different, and the conclusions of empirical research on pills are still debated. This is too important an area to adopt a "one size fits all" rule.

Broc: Where are the courts in all of this?

Bill: Many M&A lawyers were anxiously awaiting the Delaware chancery court's pill redemption decision in the PeopleSoft-Oracle takeover saga, but the case settled after the parties reached a deal. Since the late 1980's, the Delaware courts have not forced a target to redeem a pill, but by the same token they have not really clarified the limits on a target board's discretion to keep a pill outstanding as part of a "just say no" defense.

I would expect that the courts will continue to defer to a target board's discretion in this area, assuming there is a demonstrable record that the board exercised its good faith business judgment. This is especially the case where there is a clear path to redeem the pill via the ballot box, as was the situation in the PeopleSoft takeover. Does it matter that there is a staggered board and the bidder has to go through at least two annual election cycles in order to capture a majority of the board to redeem the pill? Arguably this shouldn't matter and there is Delaware federal district court precedent (Moore/Wallace Computer) to that effect.

However, this is a harder call from a policy perspective, and activist shareholders and their compatriots in academia are up in arms over the synergistic defensive effects of the pill and a staggered board. The Delaware state courts, esteemed as they are, are not immune from the winds of political correctness.

Broc: Final thoughts?

Bill: In the short term, the pressure on Corporate America to redeem its poison pills will continue apace. Longer term, it's hard to tell where this goes.

Will pills become extinct except during hostile bids? Will a new form of pill evolve which companies and activist shareholders reach some consensus on? Will the rising tide of shareholder animus against pills eventually moderate? If pills disappear, will new state anti-takeover laws fill the void? Will the Delaware courts throw a curve ball? Stay tuned.