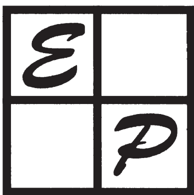

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Time to Install a Pill? Dealing With Rights Plans in a Down Market

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Despite an increase in hostile bids, shareholder activism and proxy fights over the past few years, the number of public companies with shareholder rights plans—poison pills—has been declining steadily.[1] One explanation is that, since the implementation of Sarbanes-Oxley in 2002, companies have focused on corporate governance and are reluctant to incur the triangulated wrath of institutional shareholders, activist hedge funds and proxy governance advisors.

Nevertheless, with the recent severe decline in stock prices, companies have been increasingly feeling vulnerable and reaching for the poison pill to ward off potential hostile threats. As of December 21, 2008, there were 73 public companies that adopted their first poison pill this year, compared to 42 in 2007 and 50 in 2006.[2] For companies contemplating a pill, and those with a pill already in place, there are difficult pill issues that need to be addressed. And in some cases, the current down market complicates these issues.

Could It Actually Happen? The Buy-Through Threat Looms

A typical pill provides that if an acquiror becomes the beneficial owner of a specified percentage of the target's outstanding shares (generally 10-25%), the pill "flips in" and grants all target shareholders—other than the acquiror—the right to purchase target shares for a discount (universally 50%) from the current market price of the target's shares. To achieve the 50% discount, a pill provides the right to purchase a number of target shares with a value that is 2x the exercise price of the pill rights.

The exercise price of the pill generally ranges from 3-5x the market price of the target shares at the time the pill is adopted. This multiple is supposed to approximate the long term growth of the target's profits over the life of the pill, typically ten years. Target management, often assisted by investment bankers, perform backup support to justify these target growth rates. The rates often exceed 17% per year compounded in order to hit the 3-5x exercise price bogey.[3] The higher the exercise price of the pill and the discount to the market price of the target shares purchasable upon exercise of the pill rights, the more dilution to the acquiror.

The views expressed herein are the authors' and do not necessarily represent the views of the authors' law firm or its other lawyers.

[1] According to data from SharkRepellent.net and MergerMetrics.com.

[2] According to data from SharkRepellent.net.

[3] Houlihan Lokey Howard & Zukin, Stockholder Rights Plan Study 4 (1999).

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Pills, of course, are designed so that the economic and voting dilution to a prospective acquiror are so massive that it will never attempt to buy through the share ownership trigger threshold. And so far, the pill's buy-through deterrent effect has been self-evident. In the late 1980s Sir James Goldsmith bought enough Crown Zellerbach stock to cause its pill to become non-redeemable, but the Crown Zellerbach pill was an early vintage which did not contain a "flip in" trigger based on mere share ownership in the target. Rather, it was a "flip over" pill which was only triggered if the target subsequently merged with an acquiror. Goldsmith did not trigger the Crown Zellerbach pill through a merger and, to date, a deliberate flip-in or flip-over trigger event has never happened in a conventional pill.[4]

But it may happen. In recent years, more than a few observers have commented on the inherent limitations of the buy-through dilutive deterrence of pills.[5] The fundamental problem is that a pill only dilutes an acquiror with respect to its investment in the target at the time the pill is triggered. If the acquiror's stake approximates the typical pill ownership trigger of 15-20%, that means that the acquiror only suffers dilution on 15-20% of the total shares of the target. Moreover, because the pill does not completely dilute the acquiror's position and the market discount formula is only 50%, the acquiror's dilution is often only a portion—albeit significant—of the acquiror's investment.

A Simple Illustration of Pill "Math":

Assume the target has 100 million shares outstanding and a pill with a 20% trigger and a 50% dilution factor. The pill was adopted when the target's shares were trading at $50 per share and a 4x multiple was used to set an exercise price of $200. The market price is now $100 per share yielding a market value of $10 billion ($100 x 100 million shares). The acquiror values the target at $12 billion or $120 per share and buys a 20% stake for $2.4 billion ($120 x 20 million shares).

The flip-in pill is triggered and, for each of the 80 million shares not owned by the acquiror, the target issues $400 ($200 exercise price x dilution factor of 50%) worth of new target shares. That's four shares each at the current market price of $100 per share ($400/$100) or 320 million new shares in the aggregate. Since the total number of target shares is now 420 million (100 million shares + 320 million shares), the acquiror's stake has been diluted from 20% down to 4.8% (20 million shares/420 million shares).[6]

If we take into account the $16 billion of cash received from the exercise of the pill rights (80 million shares x $200) and assume that the fully diluted share price is now $61.90 (($10 billion + $16 billion)/420 million shares), then the market value of the acquiror's stake has thus been reduced to $1.2 billion (20 million x $61.90). That is a loss of about $0.8 billion, or 40%, from the original market value of the acquiror's stake in the target ($0.8 billion/$2 billion).

However, we need to put this loss in context. If we assume the acquiror can buy the remaining target shares at the same 20% premium it paid to buy its initial stake and, for simplicity, we ignore the cash received from the exercise of the pill rights (which presumably only gets valued by an acquiror on a dollar for dollar basis in any event), then the remaining shares cost the acquiror about $11.4 billion in the aggregate (($26 billion – $16 billion)/420 million shares x 1.2 x 400 million shares) and the total purchase price paid by the acquiror for the target is about $13 billion ($2.4 billion + $11.4 billion less $0.8 billion for the acquiror's pro rata interest in cash received upon exercise). This means that the pill added only 8% to the cost of the acquisition using the acquiror's original value for the target of $12 billion ($1 billion/$12 billion).[7]

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[4] In December 2008, a group including Versata Enterprises, Inc. and Trilogy, Inc. and Trilogy's chief executive deliberately triggered Selectica, Inc.'s pill. A month earlier, Selectica had converted its pill from the conventional variety with a 15% ownership threshold trigger to a pill with a 4.99% trigger that is designed to protect the company's net operating losses. See discussion of net operating loss pills *infra* p. 4. Selectica is now seeking a declaratory judgment in Delaware Chancery Court as to the validity of its pill. According to the complaint, there are other disputes among these parties that may be at play here.

[5] See, *e.g.,* William J. Carney and Leonard A. Silverstein, "The Illusory Protections of the Poison Pill," 79 Notre Dame L. Rev. 179 (2003); Guhan Subramanian, "Bargaining in the Shadow of Peoplesoft's (Defective) Poison Pill," 12 Harv. Negot. L. Rev. 41 (Jan Session 2007).

[6] The dilution would be less if the target utilized the exchange feature typical of most pills, which allows for the cashless exercise of the pill rights.

[7] An acquiror might not stop at the ownership threshold trigger and instead attempt to buy even more of the target. In that case, the dilution su - fered will be even greater. For example, if the acquiror buys 40% instead of 20% the acquiror's dilution will be 28 percentage points instead of 15. However, eventually a tipping point will be reached where the effect of a decreasing number of non-acquiror shares to which the pill rights apply overtakes the effect of an increasing number of acquiror shares. In this example, that tipping point is 70%. If the acquiror buys more than 70%, its dilution will fall from 38 percentage points down to 32 at 85% and 16 at 95%. Of course it may be difficult for an acquiror to buy enough shares in the open market to get past the tipping point.

To be sure, it requires a lot of moxie for an acquiror to trigger a pill. Not only is the potential pill dilution significant, but there is no guarantee that the acquiror will be able to buy the target even after the buy-through unless the acquiror acquires a very substantial position in the target and thereby takes on even more dilution (in addition to dealing with the other usual takeover barriers such as state antitakeover statutes, supermajority vote charter provisions and the like).[8] Moreover, there is always the threat that the target could put in another, more potent, pill after the initial buy-through, although the likelihood of a target board implementing an effective one in this situation is questionable.[9]

This brings us to the heart of the problem. The current market dislocations elevate the risk of a buy-through, even though all else being equal a lower market price will result in greater dilution to the acquiror. In a down market, the gap between a target's current market price and the target's "true" or intrinsic value may expand. The result is an opportunity for an acquiror to make a premium bid and afford pill dilution if it can eventually buy the target for substantially less than the target's intrinsic value.

To see why, let's return to the illustration in the Box. But instead of $100 per share, let's assume the market price has declined 25% to $75 per share. If 20% remains the market clearing premium, the acquiror would pay about $1.8 billion (20 million shares x $90) for its initial stake. Ignoring the cash received from the exercise of the pill rights, it would then be able to buy the remaining target shares for about $8.7 billion (510 million shares x $17.09), yielding a total purchase price of $9.9 billion ($1.8 billion + $8.7 billion less $0.6 billion for the acquiror's pro rata interest in cash received upon exercise). That means that even with the exercise of the pill and the resulting 32% blended premium to the depressed market value of the target, the acquiror's total acquisition cost would be $2.1 billion, or 18%, less than the acquiror's original "intrinsic" value for the target of $12 billion.[10] And, even if the acquiror wanted to ensure that it would have more than 50% control of the target post-exercise of the pill, if it acquired at least 90% of the target its diluted ownership level would be about 59% and its total acquisition cost would be about $1.4 billion less than its original value for the target.

Of course if the target shareholders also view the target as undervalued then the market clearing premium might rise above 20%. However, if the gap between the acquiror's valuation of the target and the market's valuation of the target is wide enough, the acquiror may be able to absorb the cost of the pill and still end up with a target it values at more than the total acquisition cost. If the current market dislocation has increased the valuation gap, then the opportunity for a pill buy-through has similarly increased. Finally, we need to remember that as the market dislocation becomes more entrenched, more and more of the high basis shareholders bail out or become increasingly impatient for a market event. In this environment, market premium bids become even more enticing irrespective of the long term "intrinsic" value of the target.

Practice Pointers

This exercise raises practice points for both acquiror's and target's counsel. Acquiror's counsel too often reflexively assumes, without doing the math, that for a hostile bid to proceed a pill needs to be redeemed or invalidated. It may very well be that the dilution and threat of follow-on target defensive actions are so great that biting through a pill is still not worthwhile. However, that outcome is not foreordained and the threat of a buy-through remains an underutilized bargaining chip.

Target counsel needs to do the math too. Too often the lawyers just mark up the last pill. There is nothing inviolate or talismanic about a certain flip-in ownership threshold, 50% market discount or 3-5x market multiple. Adjusting these within legal restraint can possibly increase the dilution to an acquiror. Moreover, counsel needs to re-sensitize the target board to the potential limitations as well as strengths of pills.

Other Pill Limitations

For companies grappling with the decision to adopt or renew a pill, there are a number of issues to consider in addition to the inherent limitations on the typical pill's dilutive potency and the risk of a buy-through.

1. Developing Shareholder and Governance Issues—The adoption or renewal of a pill can draw the ire of institutional investors and the firms that advise them on proxy voting, such as RiskMetrics (ISS). Under its current policy, RiskMetrics will recommend shareholders vote withhold/against management's incumbent slate of directors if the directors adopt or renew a poison pill without shareholder approval and do not commit to put the pill to a shareholder vote within 12 months of adoption.

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[8] See *supra* note 7.

[9] See Subramanian at 54.

[10] We have assumed here, as in the illustration in the Box, that the acquiror must pay the same premium to buy its initial stake as it would have to pay to buy the whole target. If it were able to buy its initial stake at a price closer to the depressed market price, its total acquisition cost would be even lower than its original value for the target.

Even if the directors seek shareholder approval, RiskMetrics will only consider supporting the pill proposal if the terms of the pill meet certain guidelines, including a 20% or higher ownership threshold trigger, a two to three year sunset provision, a shareholder redemption feature (if the board does not redeem the pill, then 10% of the shares can force a vote on the redemption) and no dead-hand, slow-hand, no-hand or similar feature. However, under this policy a company looking for a short-term defense could possibly put in a pill without a shareholder vote but without putting its management slate in jeopardy if the company commits to putting the pill to a vote within 12 months.

Moreover, RiskMetrics does not yet apply its adoption/renewal policy to a pill amendment that does not extend the term. Thus, a company could possibly amend its pill (for example, to change the exercise price or ownership threshold trigger) without drawing an automatic withhold/against recommendation for its directors. However, this approach is not free from doubt and in any event will hurt the company's governance ratings.

For the 2009 proxy season, RiskMetrics has revised its policy to include special consideration of pills that are adopted to preserve a company's net operating losses. Federal tax law can limit a company's ability to use its net operating losses to reduce taxes if the company undergoes a change of ownership. A "change of ownership" occurs if the percentage of a company's shares held by one or more of its "5% stockholders" increases by more than 50 percentage points over the lowest percentage of shares owned by those shareholders at any time during a three-year rolling look back period. As a result, some companies have adopted pills with an ownership threshold trigger below 5%. Under the new RiskMetrics policy, this lower threshold is not an automatic disqualifier.

2. Synthetic Equity—The typical pill tethers the ownership threshold trigger to the federal securities law concept of beneficial ownership, which only looks at voting or investment power. In recent years, however, so-called "synthetic equity" arrangements, such as total return swaps, have become more commonplace investments in the activist community. These arrangements provide the holder with economic exposure to a target's shares but not any contractual voting or investment power. As with traditional equity arrangements, companies have legitimate reasons for wanting to manage the acquisition of large blocks of synthetic equity.

For example, synthetic equity arrangements can put an acquiror in position to influence the voting of, and rapidly accumulate, target shares held by the derivative counterparties, without triggering Schedule 13D disclosure and, depending on the hedging activities of the counterparty, without driving up the share price.[11]

To date, a few companies seeking to address this vulnerability have made changes to the typical pill definitions and mechanics, such as expanding the definition of "beneficial ownership" and "outstanding shares."[12] Absent amendments to 13D reporting requirements, enforcing a pill trigger that extends beyond 13D beneficial ownership may be problematic, as an acquiror may quietly accumulate economic exposure to target equity without disclosing its holdings in a Schedule 13D.

3. "Morning After" Pill—Responding to immediate or potential shareholder pressure, many companies have decided against implementing a pill, or they have redeemed or not renewed existing pills. The principal justification for this is that the company avoids a conflict with shareholders and raises its governance rating profile while maintaining the flexibility to implement a "morning after" pill later if necessary. From a timing standpoint, this strategy can be effective in responding to a tender offer or bear hug by a hostile bidder, and if the target board undertakes a careful process in reviewing the hostile bid, this approach should generally be legal even under a heightened standard of judicial review.

Nevertheless, the morning after approach may not be suitable depending on the nature of the target and the specific facts and circumstances. Take creeping acquisitions or "toe hold" investments by hostile acquirors. If a target has a large enough market capitalization, an acquiror will trigger the Hart-Scott-Rodino Act antitrust filing threshold (set to become approximately $65 million) before it can buy too large a stake in the target.[13] This early warning gives larger companies time to put in place a pill. For smaller companies, on the other hand, especially those with battered share prices, the Hart-Scott filing threshold may not come into play until it is too late, if ever. Besides antitrust filing thresholds, there may be other potential early warning triggers applicable to companies

[11] But see *CSX Corporation v. The Children's Investment Fund Management (UK) LLP, et al.,* 562 F.Supp.2d 511 (S.D.N.Y. June 11, 2008) in which the court found that total return swaps constituted beneficial ownership under the anti-evasion prong of Rule 13d-3, *aff'd*, 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

[12] Companies recently adopting or amending a pill to cover synthetic equity include, among others, Atmel Corporation, Benchmark Electronics, Inc. and Cliffs Natural Resources Inc.

[13] Investors can purchase up to 10% of a target's shares without triggering a Hart-Scott filing if the shares are purchased for investment only, but the regulators interpret this exception very narrowly and it will be difficult for an acquiror to switch intentions from investment only to control. See *Chevron Corp. v. Pennzoil Co.*, 974 F.2d 1156 (9th Cir.1992).

based on their particular situation, including in regulated industries. Target counsel will need to examine these in determining whether the morning after approach is actually viable.

Another scenario to consider is where the potential acquiror is already an existing, significant shareholder of the target. Here, in the absence of an effective standstill agreement, the target may not have the luxury of deferring use of a pill. Targets facing anti-pill shareholder pressure may be able to justify a pill in this significant shareholder situation, especially if it is narrowly tailored to address any additional creeping purchases by the shareholder as opposed to bids to acquire all outstanding shares.

In all scenarios, companies considering the morning after approach should analyze whether it eliminates the immediate deterrent effect that a live pill may have on potential "wolf pack" investors. And companies adopting the morning after approach should still have a board-vetted pill on the shelf so it can be implemented quickly if needed.

4. Pills, the Board Election Cycle and the Courts—Ultimately, the effectiveness of a pill depends on the synergistic relationship of the pill and the company's other antitakeover features. If a company does not have an effective staggered board in its charter (*i.e.,* one that can't be unilaterally changed by the shareholders), or its charter allows removal of directors without cause or does not limit the number of directors, then in one election cycle an acquiror can wage a proxy contest to replace the board and redeem the company's pill. And while a proxy contest remains a threat even with a pill in place, the pill will prevent the acquiror from accumulating its own large block of shares and force the acquiror to win more proxies from the other, non-affiliated shareholders.

Since the late 1980s, the Delaware courts have not forced a target to redeem a pill. On the other hand, they have not specifically clarified the limits on a target board's discretion to keep a pill outstanding indefinitely as part of a "just say no" defense. The bidder's path to the board ballot box—and therefore redemption of the pill—has always been viewed by both shareholders and courts alike as a kind of safety valve for shareholder democracy.

It remains to be seen whether the courts will continue to defer to targets in this area, particularly where a bidder faces a target that has an effective staggered board. Here, a bidder would have to go through potentially two annual election cycles to force redemption. While there is Delaware district court precedent to uphold non-redemption of the pill even in such a context, this remains a difficult issue from a policy perspective and could create an opening for the courts to revisit their general pill non-disturbance posture.[14]

Companies and their counsel who are considering implementing or tightening pills in the current down market should be aware of other judicial uncertainties. While there is significant judicial precedent focusing on the redemption mechanics of pills, there is little precedent addressing other critical pill features, including the lowest level of flip-in tolerance (*e.g.,* 5%, 10%) and the exercise price of rights.[15]

5. The Use of Financial Advisors to Evaluate Pill Exercise Prices—The exercise price of a typical "flip in" pill approximates the board's view of the value of the company's shares at the end of a pill's ten-year duration. To set this estimated value, the board will typically consult with company management regarding the company's long-term strategy, prospects and financial projections. In addition, boards often, but not always, engage financial advisors to assist with setting this estimate of long-term value.

Setting the appropriate pill exercise price presents a difficult issue for companies in the midst of a down market. The 3-5x multiple to current market price typically used to set the exercise price in pills may very well understate the value of the target and produce too little dilution to a bidder. On the other hand, too high a market price might be unsupportable from a valuation perspective in such a volatile valuation setting. This issue underscores the need for companies and their counsel to consider the pill based on the particular situation at hand and not blindly rely on previous pill terms. Companies and their counsel will need to assess these pill valuations in relation to other company valuation studies and the ramifications for locking in target valuation.

Obtaining an investment banker analysis may also be particularly useful in this context. Nevertheless, there is no judicial requirement to engage outside financial advisors when implementing a pill. The board and management should carefully consider whether use of an advisor is warranted under the circumstances. For instance, when agreeing to a pill engagement an investment bank may insist on a right of first refusal on future financings, acquisitions, divestitures or other corporate assignments. Getting wedded to a particular advisor might be a steep price to pay for the advisor's valuation insights in the absence of any judicially-imposed obligation to do so.

[14] *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*, 907 F.Supp. 1545 (D.Del.1995).

[15] See, e.g., *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998); *Carmody v. Toll Bros.*, 723 A.2d 1180 (Del. Ch. 1998).