Poison pills with a twist

Delaware decisions approve stockholder rights plans with unorthodox provisions

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Corporate and Business Law

This is the second installment of a two-part series on the return of the poison pill (stockholder rights plans) that addresses lessons learned in 2010 from the Selectica *and* Barnes & Noble *cases, new technologies and recent trends. Last week's installment described the nuts and bolts of poison pills.*

In 2010, Delaware courts upheld the use of stockholder rights plans, or poison pills, including features that had not previously been expressly sanctioned. In these cases, the Delaware courts reiterated that the *Unocal/Unitrim* standard applies to poison pills and held that the boards that adopted and applied the subject plans satisfied their burdens of demonstrating that their actions were reasonable in relation to the threats posed.

While activist institutional investors and proxy advisory firms continue to disfavor poison pills — particularly those adopted without stockholder approval — poison pills are a key defense mechanism to protect tax assets and against hostile bidders. Public companies with valuable tax loss carry forwards, or which find themselves attractive targets for hostile bidders, may either adopt poison pills or draft poison pills to be kept "on-the-shelf" for implementation when needed. Boards considering poison pills today will have new technologies at their disposal, and the 2010 Delaware court decisions allow them renewed confidence that the poison pill will be upheld when needed. In light of recent competitive processes for public company targets, watch for buyers to insist that targets implement poison pills to protect the deal upon signing the definitive agreement.

RECENT DELAWARE CHANCERY COURT DECISIONS

Two recent Delaware cases have addressed the enforceability of poison pills and are instructive as to their implementation going forward:

- On Feb. 26, 2010, in *Selectica Inc. v. Versata Enterprises Inc.*, the Delaware Chancery Court upheld Selectica's use of a poison pill designed to protect its net operating losses, or NOLs. This decision was reaffirmed on Oct. 4, 2010, by the Delaware Supreme Court.
- On Aug. 11, 2010, in *Yucaipa American Alliance Fund II, L.P. v. Riggio*, the Delaware Chancery Court upheld the validity of a stockholder rights plans adopted as a defense to hostile takeover maneuvers.

'SELECTICA'

In December 2008, Versata Enterprises Inc. intentionally triggered an NOL poison pill adopted by Selectica Inc., marking the first intentional triggering of a modern poison pill. In response to share accumulations earlier in 2008 by Versata, a direct competitor of Selectica, Selectica's board reduced the trigger threshold of its existing rights plan from 15 percent to 4.99 percent. Stockholders owning more than 5 percent at the time of this action, including Versata, were grandfathered in under the poison pill, subject to a trigger threshold of half a percent above their then-current ownership.

Versata's intentional triggering of the poison pill in turn triggered a 10-day period during which the board of directors could negotiate, and if beneficial, waive the triggering acquisition, thereby avoiding the dilutive effects of the pill. Selectica declined to grant a waiver and instead decided to exercise the exchange feature in its poison pill, thereby avoiding potential threats to the use of its NOLs presented by a flip-in. Selectica then instated a new poison pill, again with a 4.99 percent threshold.

In the ensuing litigation, the Delaware Chancery Court determined that the poison pill was not preclusive, that the Selectica directors had shown that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership, and had acted reasonably in relation to the threat posed by Versata. The court upheld each of the initial poison pills, the adopted replacement poison pill and the exchange.

'BARNES & NOBLE'

In November 2009, following failed discussions regarding company strategy and policies between investor Ronald Burkle and Barnes & Noble's founder and largest stockholder, Leonard Riggio, Yucaipa and several other investment funds affiliated with Burkle increased their 8 percent ownership stake in Barnes & Noble to 17.8 percent and indicated in a Schedule 13D filing the possibility of Yucaipa acquiring Barnes & Noble. In response to the rapid accumulation of shares by Yucaipa, the board of directors of Barnes & Noble adopted a stockholder rights plan. The rights plan had a 20 percent trigger, but grandfathered Riggio's significantly higher stake from triggering the plan, which, together with family members, equaled almost 30 percent. In the ensuing lawsuit brought by Burkle, the Delaware Court of Chancery applied the *Unocal* standard and upheld the Barnes & Noble rights plan as a reasonable and proportionate response to the threat posed by Yucaipa. On Nov. 17, 2010, the stockholders of Barnes & Noble overwhelmingly approved the poison pill at the 20 percent threshold.

TAKEAWAYS FOR BOARDS

In *Selectica* and *Barnes & Noble*, the courts painstakingly reviewed the board's decision-making processes that resulted in the determination that an identifiable threat to a legitimate corporate purpose warranted the adoption of a poison pill, including the involvement of independent and interested directors in the decision-making process and the board's reliance on outside experts. Despite ultimately upholding the decisions of the Barnes & Noble board, the court faulted the board and its advisers for failing to exclude Riggio from the boardroom when discussing Riggio's motivations and interests, and for the selection of outside experts to advise the board (certain of the advisers selected had previously advised Riggio on business and personal matters). The court in *Selectica* affirmed the board's determination that the NOLs had potential value, despite noted skepticism, because the board reasonably relied on outside experts to analyze the potential value of the NOLs and the potential threat that an ownership change presented to the NOL asset. These decisions reiterate the importance of independent directors, outside advisers that are free of relationships with interested directors and thorough documentation of the board process.

TRIGGERING THRESHOLD

In determining the reasonableness of the triggering threshold, courts have generally focused on whether it is so low that it would preclude a holder from undertaking and winning a proxy contest. Traditionally, the triggering threshold for poison pills has hovered between 10 and 20 percent. Delaware's anti-takeover statute has a 15 percent threshold, and as stated above, ISS policy has a minimum 20 percent trigger under its guidelines. Allowing accumulations up to a larger trigger make it easier for a bidder to win a proxy contest.

The *Selectica* pill's triggering threshold was 4.99 percent due to Internal Revenue Service regulations with respect to NOLs, which provide that if a 5 percent stockholder increases its ownership by more than 50 percent, an "ownership change" is triggered and a company's ability to use its NOLs following an "ownership change" is limited. The *Selectica* court examined evidence from proxy solicitors and others as to the feasibility of running a proxy contest against a company of Selectica's size from a 4.99 percent ownership position. The court found that there was evidence that bidders had succeeded in winning proxy contests from that position, and hence the threshold was not preclusive.

The court made this determination without reviewing whether running a proxy contest was possible in Versata's particular circumstances. Despite a range of acceptable thresholds from 10 to 20 percent, a threshold as low as 4.99 percent will be upheld, provided it meets the *Unocal/Unitrin* test. The new 2011 ISS guidelines regarding NOL poison pills acknowledge the general 5 percent threshold for NOL poison pills.

In *Barnes & Noble*, the threshold was 20 percent — in line with ISS guidelines. However, Burkle initially argued that the 20 percent trigger was preclusive, since Riggio, who was adverse to Burkle, already held 30 percent of the outstanding shares. The court found that, due to the make-up of the stockholders other than Riggio and the activity of proxy advisory firms, Burkle's fund Yucaipa could win a proxy contest (as it turned out, Burkle lost the proxy contest in September 2010).

These cases demonstrate the importance of the board keeping a record to show that the poison pill will not prevent someone from winning a proxy contest. With the proliferation of equity derivatives trading over-the-counter, boards should also consider the inclusion of synthetic equity positions, including derivatives and swaps, in the definition of beneficial ownership.

DELAYED TRIGGER

Many poison pills include a window of time, commonly 10 days, after a stockholder purchases above the triggering threshold and before the activation of the rights occurs. The window gives the board fiduciary flexibility to ensure the pill wasn't triggered inadvertently, or to negotiate with the triggering stockholder and potentially amend the rights plan or redeem the rights. However, the existence of a delay in triggering can create pressure for the board to amend the plan rather than allow the draconian result of allowing the rights to activate. Boards should carefully weigh the benefits and detriments of the delayed trigger for a particular company's situation.

EXCHANGE FEATURE

As discussed above, poison pills typically permit the board to exchange the rights for common stock equivalents upon a flip-in event. The exchange is most commonly one share of common stock or common stock equivalent for each right, but some poison pills provide for an exchange that equates to a cashless exercise of the flip-in option. That is, each holder of the right receives the net number of shares it would receive if it sold shares to pay the exercise price. For Selectica, the dilution that would have been caused by the flip-in posed potential threats to the company's use of its NOLs, which was the very corporate asset the poison pill was designed to protect. To avoid the threat, Selectica chose to use the exchange feature in its poison pill, exchanging each right for one share of common stock. The exchange feature may avoid the need to register under the Securities Act of 1933 the sale of securities upon exercise of the rights, and it may also avoid a situation where receipt of the exercise price would put unwanted cash on the company's balance sheet.

MORE POISON PILLS IN 2011

In 2010, HP's jumping of Dell's prior agreement to acquire 3Par may have spurred the adoption of poison pills and other defensive mechanisms to protect negotiated friendly transactions. On Dec. 16, 2010, three days after Compellent Technologies announced that it has agreed to be acquired by Dell, Compellent Technologies announced that it had adopted a poison pill (the terms of which did not apply to Dell). Compellent's pill has a 15 percent trigger, accounting for derivative interests (even cash-settled derivatives), for purposes of determining whether the 15 percent threshold has been triggered. This means that a shareholder's direct interests as well as derivative ones will be counted together for purposes of the pill trigger. The pill also expansively defines a group for purposes of lumping together shareholder interests. Compellent was required under the terms of the definitive agreement with Dell to adopt the pill within three days.

On Nov. 29, 2010, just after it had agreed to be acquired by the Carlyle Group, and in the midst of its go-shop process, CommScope amended its bylaws, giving the company more flexibility to delay or postpone a shareholder meeting, including calling a recess. This amendment allows CommScope to better manage any shareholder opposition through better timing of its meeting to approve the Carlyle deal.

CONCLUSION

In 2011, a combination of economic conditions, activist stockholders and unsolicited deal activity could cause many companies to reconsider the poison pill. Whether a company is renewing or restoring a poison pill or putting one in place for the first time, it can expect that:

- A poison pill adopted in good faith by independent directors advised by outside experts with the intention of maximizing shareholder value is a valid defensive measure.
- Delaware courts will review carefully the board's decision making and record keeping processes in the context of a challenged poison pill.
- Poison pills will be an available tool for protecting a company's NOLs.
- Design features will have a significant effect on the poison pill's effectiveness at achieving its desired goals.

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