MERGERS AND ACQUISITIONS

The Return of the Poison Pill—Lessons Learned in 2010 from the *Selectica* and *Barnes & Noble* Cases

With recent validation from Delaware courts that directors will receive the protection of the business judgment rule if it can be demonstrated that a poison pill was reasonable in relation to the threat posed, and with stock prices stagnant below highs reached in the prior decade, this previously defanged shark repellent may be growing new teeth. In 2011, poison pills are poised to regain their position as a key defensive measure to protect tax assets and against corporate raiders.

By Louis Lehot, Kevin Rooney, John Tishler, and Camille Formosa

In 2010, Delaware courts upheld the use of stockholder rights plans, or poison pills, including with 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 if and 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.

Background

Stockholder rights plans were born in the 1980s in response to the proliferation of corporate raiders making hostile bids for public companies, and were designed to provide public company boards of directors with a "poison pill" with which to defend themselves against hostile takeover bids. Stockholder rights plans allow the target board of directors time and leverage to negotiate for a control premium or other alternatives to hostile bids. Typically, a stockholder rights plan provides rights to all holders of common stock that, if fully activated, will give all stockholders, other than the hostile bidder, the right to buy additional stock at a substantial discount. The rights initially trade together with the common stock, do not have separate certificates and are not exercisable.

A poison pill typically has two triggers that will cause the rights to be distributed separately from the common stock and to become exercisable. The date this occurs is usually called the "distribution date."

One trigger occurs when a potential acquirer launches a tender offer for the purchase of at least a specified percentage of the stock of the target company. Upon this trigger, the rights are

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distributed and become exercisable. Upon a distribution for this trigger, one right is usually exercisable to purchase the equivalent of one share of common stock[1] at a fixed price (the "exercise price"), which is customarily set at a price representing the hypothetical appreciation of the stock over the duration of the plan. Often, a board seeks the advice of an investment bank on setting the exercise price.[2]

The second trigger occurs when someone actually acquires beneficial ownership of stock over a specified percentage. When this occurs, the holder is usually given some time to divest itself of excess holdings, and if it does not, the rights undergo what is called a "flip-in." On a flip-in, each right other than rights held by the holder that triggered the flip-in becomes exercisable for the number of shares equal to the exercise price divided by one-half the then-current trading price of the stock. For example, if a company's stock is trading at $15 per share at a time when someone triggers a flip-in by acquiring 25 percent of the outstanding shares, and the rights have a $30 per share exercise price, each right, other than those held by the triggering holder, will enable the purchase of 4 common stock equivalents for $30, which is an effective price per share of $7.50. Assuming all the rights are exercised, the holdings of the holder that triggered the rights will decrease from 25 percent to 6.25 percent. Typically, upon a flip-in event, the board can elect to exchange each right for one (or more) common stock equivalents in lieu of permitting the rights to be exercised for cash.

Later, poison pills were adopted outside the hostile takeover context to protect a corporate asset, such as a company's ability to offset future taxable income with net operating losses (NOLs). NOL plans typically trigger a flip-in at 4.99 percent of outstanding shares compared to more typical trigger percentages of 15 percent or more.

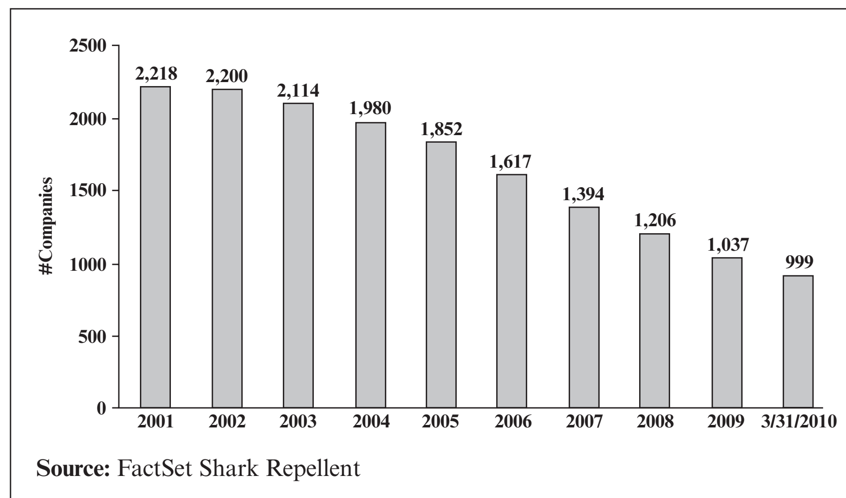
While a poison pill is not designed to thwart entirely any change of control, and it cannot do so, triggering a poison pill results, in theory, in unpalatable dilution to the potential acquirer's ownership interest and increased acquisition cost, thereby forcing a potential acquirer to negotiate with the target board of directors prior to completing any acquisition.

By the mid-1990s, poison pills had been widely adopted by public companies in the United States, and were a key structural defense, or "shark repellent" to hostile corporate raiders. By the end of 1993, approximately 1,375 companies had poison pills in place.[3] Adoptions and extensions of poison pills continued and by the end of 2001, approximately 2,200 companies had poison pills in force.[4]

The last decade saw major corporate scandals from Enron to WorldCom to Tyco, the adoption of the Sarbanes-Oxley Act of 2002 and the rise of organized institutional investor voting and corporate governance metrics. Stockholder activists and proxy advisory firms rallied against poison pills, arguing that they often resulted in the entrenchment of management and the loss of stockholder value. With these changes came declines in the annual number of pill adoptions and extensions, with annual decreased activity each year. By the end 2007, the number of companies with poison pills in place had declined to the levels seen in 1994.[5] By the third quarter of 2009, boards of directors of established public companies had largely allowed their stockholder rights plans to expire, companies in registration ceased adopting stockholder rights plans in the course of going public and less than a third of S&P 1,500 companies had a poison pill in place.[6]

The severe market correction of late 2008 and early 2009, the drop in M&A activity, combined with several high profile unsolicited takeover bids for large public company targets, including by other public company bidders, and the proliferation of synthetic derivatives, may hearken the potential rebirth of the modern poison pill.

US-Incorporated Poison Pills in Force at Year End



Source: FactSet Shark Repellent

What Are the Fiduciary Duties Associated with Poison Pills?

The "business judgment rule" is a presumption that directors acted consistently with their fiduciary duties, were disinterested, and carried out their functions in good faith, after sufficient investigation, and for acceptable reasons. A more rigorous level of judicial scrutiny is given to decisions of board of directors with respect to defensive measures taken in an attempt to block hostile takeover attempts. In determining whether to enforce a stockholder rights plan or poison pill, Delaware courts apply the enhanced *Unocal/Unitrin*[7] standard and accord directors the benefit of the business judgment rule only if (1) the plan was not preclusive or coercive and (2) it was a reasonable response to a specific articulated threat. The decision of whether or not to adopt a poison pill involves the consideration of the necessity of the poison pill and the impact its adoption will have on the company and its shareholders. Consideration will also be given to the effect of a poison pill's adoption on the relationship between the company and its shareholders and whether complimentary defensive measures were adopted concurrently with the pill.

The principal potential benefit of a poison pill is the preservation of the board of directors' ability to evaluate unsolicited bids and to solicit alternative bids in order to maximize stockholder value. A poison pill will also deter an unsolicited accumulation of a control position without the payment of a control premium to all stockholders. In sum, it encourages negotiation with the board of directors so that the board is in a position to command of a higher control premium payable to all stockholders.

What Does ISS Say About Poison Pills?

Institutional Stockholder Services (ISS), a nationally recognized proxy advisor, will recommend "withhold" or "against" votes for the entire board of directors (except new directors)[8] if:

- The company adopts a stockholder rights plan with a term longer than 12 months, or renews any stockholder rights plan, including any "short-term" pill (12 months or less), without prior stockholder approval. A commitment or policy that puts a newly-adopted pill to a binding shareholder vote may potentially offset an adverse vote recommendation.

- The stockholder rights plan has a dead-hand or modified dead-hand feature. A dead-hand or modified dead-hand feature attempts to limit the discretion of a future board to amend or redeem the rights. Such features attempt to attack the vulnerability of a poison pill to the replacement of a majority of the board by a hostile acquirer through a proxy contest. These features generally are not enforceable under Delaware law.
- The board makes a material adverse change to an existing poison pill without stockholder approval.[9]

ISS will review companies with classified boards every year, and companies with annually-elected boards at least once every three years, and recommend "withhold" or "against" votes for all nominees if the company still maintains a non-shareholder-approved poison pill upon such review. ISS will issue the "withhold" or "against" recommendation every year that a poison pill is in place with a dead-hand or modified dead hand feature.

ISS's influence is felt mainly in the decision to adopt a poison pill.

ISS will consider on a case-by-case basis the recommendations for all nominees if the board adopts a poison pill with a term of 12 months or less without stockholder approval, taking into account the following factors:

- The date of the poison pill's adoption relative to the date of the next meeting of shareholders—*i.e.*, whether the company had time to put the poison pill on the ballot for shareholder ratification given the circumstances;
- The company's rationale for adopting the poison pill;
- The company's governance structure and practices; and
- The company's track record of accountability to shareholders.

ISS makes voting recommendations for poison pills put up for shareholder vote on a case-by-case basis, considering the plan features. ISS states that poison pills should have the following features:

- no lower than a 20 percent ownership trigger for the flip-in;
- a term of no more than three years;
- no dead-hand, slow-hand or no-hand feature that limits the ability of a future board to redeem the pill; and
- a stockholder redemption feature whereby if the board refuses to redeem the poison pill 90 days after an offer is announced, the holders of 10 percent of the shares may call a special meeting or seek a written consent to vote on rescinding the pill.[10]

Out of the top S&P 1,500 companies, 284 (less than 20 percent) currently have a poison pill in force and, out of those 284 poison pills:

- 5 have a "dead-hand" provision;
- 4 have a "no-hand" provision; and
- 10 have an "adverse person" provision, which gives the board power to reduce the triggering percentage where the potential acquirer is deemed adverse to the interests of the company.[11]

ISS's influence is felt mainly in the decision to adopt a poison pill. Only about a quarter of companies that adopted, renewed or extended poison pills in 2010 publicly disclosed that those actions would be subsequently put to a stockholder vote.[12] A board that neither wishes to neither subject its poison pill to stockholder approval nor face annual or triennial adverse vote recommendations will normally allow an existing poison pill to expire without renewal and/or hold off implementing a new poison pill until a specific need arises. When the need does arise, ISS's view of appropriate plan features appears to have

limited influence. For example, only approximately 20 percent of poison pills have a trigger at 20 percent or more, with approximately 69 percent having a 15 percent trigger.[13]

On November 19, 2010, ISS announced the publication of its 2011 global proxy voting guidelines. The 2011 guidelines will add a policy to recommend voting against new stockholder rights plans or amendments designed to protect against NOLs if the effective term of the protective amendment would exceed the shorter of three years and the exhaustion of the NOLs. If the term of the proposed protective or poison pill is shorter than three years or the exhaustion of the NOLs, ISS will base its recommendation on a case-by-case analysis.[14]

What if a Poison Pill Is Not Advisable?

As noted above, ISS's voting policies create a disincentive to adopt a poison pill that does not meet ISS's specifications and that is not submitted for stockholder ratification. Poison pills may be adopted once a particular threat has emerged, and at such a time, the board may be less concerned with ISS voting policies. Because a hostile bidder may emerge without warning and may quickly seek to take control through a hostile tender offer, boards should consider having a "pill-on-the-shelf" that will be ready to be implemented quickly in response to a specific threat. The work involved in drafting and implementing a poison pill is not trivial, and the need to do so "from scratch" in the face of an actual threat can distract the board and its advisors at a time when resources are already under pressure from the threat itself.

Poison pills work best when the company has authorized blank-check preferred stock.[15] Any company that does not have authorized blank-check preferred stock should consider amending its charter to add such a class. Boards should note however that ISS will consider proposals to add a class of preferred stock on a case-by-case basis, and will often recommend against a class of blank-check preferred stock unless it is "declawed," meaning that the board has committed that the preferred stock will not be used for anti-takeover purposes.

Before proceeding to adopt a poison pill, the board of directors should consider:

- Is the adoption of the poison pill necessary to maximize shareholder value?
- How will institutional shareholders view the defensive measure, and how will they likely respond?
- Will adoption lead to votes against existing directors?
- Is stockholder approval of the stockholder rights plan achievable?

Recent Developments

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

On February 26, 2010, in *Selectica Inc. v. Versata Enterprises Inc.,*[16] the Delaware Chancery Court upheld Selectica's use of a poison pill designed to protect its NOLs. This decision was reaffirmed on October 4, 2010, by the Delaware Supreme Court.[17]

On August 11, 2010, in *Yucaipa American Alliance Fund II, L.P. v. Riggio et al.*,[18] 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 five 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 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 showed 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 pill, the adopted replacement poison pill and the exchange. The Delaware Supreme Court affirmed the lower court's decision on October 4, 2010.

Barnes & Noble

In November of 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 November 17, 2010, the stockholders of Barnes & Noble overwhelmingly approved the poison pill at the 20 percent threshold.

Take Aways for Boards

Board Decision-Making Process

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 advisors 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 advisors 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 advisors 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 percent and 20 percent. Delaware's anti-takeover statute has a 15 percent threshold percentage 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 five 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 percent 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 five percent threshold for NOL poison pills.

In the *Barnes & Noble* case, 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.

Conclusion

In 2011, a combination of economic conditions 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; and
- design features will have a significant effect on the poison pill's effectiveness at achieving its desired goals.

NOTES

1. Often, this will be a fraction of a share of preferred stock that is designated to have similar rights, preferences and privileges to the common stock.

2. No Delaware decision requires the exercise price to be set in this fashion, or the involvement of an investment bank. However, this is how it is customarily done and boards and their legal counsel are usually most comfortable with this process.

3. *Corporate Governance Background Report D: Poison Pills* (Investor Responsibility Research Center, Inc., Washington, D.C.), Feb. 8, 1994, at D-2.

4. Poison Pills in Force Year Over Year, FactSet SharkRepellent.

5. *Id.*

6. Chris Young, The M&A and Hedge Fund Activism Landscape (RiskMetrics Group, New York, N.Y.), Oct. 2009, *http://www.law.yale.edu/documents/pdf/cbl/Chris_Young.pdf*, at 6.

7. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

8. The recommendation for new directors will be determined on a case-by-case basis.

9. 2010 U.S. Proxy Voting Guidelines Summary, (RiskMetrics Group, New York, N.Y.), Feb. 25, 2010, *http://www.issgovernance.com/files/RMG_2010_US_SummaryGuidelines20100225.pdf*, at 10-11.

10. *Id.*

11. Poison Pills in Force US Incorporated Companies Summary Statistics, FactSet SharkRepellent.

12. *Id.*

13. *Id.*

14. U.S. Corporate Governance Policy, 2011 Updates (Institutional Shareholders Services Inc.), November 19, 2010, *http://www.issgovernance.com/files/ISS2011USPolicyUpdates20101119.pdf,* at 10.

15. Blank-check preferred stock is preferred stock that can be designated at a later time by the board, without further stockholder approval. The board then has discretion to determine the voting, dividend, liquidation, conversion and redemption rights of each series of preferred stock within the authorized class. Where a company has blank check preferred stock, the dilutive power of the rights is unlimited because a share of preferred stock may be designated to have voting, dividend and liquidation rights equal to a large number of common shares, and the rights will be for a fraction of that share. Rights plans for companies that do not have authorized blank-check preferred stock are limited in their dilutive effect to the available authorized and unissued common stock.

16. *Selectica Inc. v. Versata Enterprises Inc*., No. 4241-VCN, 2010 WL 703062 (Del. Ch. Feb. 26, 2010).

17. *Versata Enterprises v. Selectica, Inc*., No. 193-2010, 2010 WL 3839786 (Del. Oct. 4, 2010) (en banc).

18. *Yucaipa American Alliance Fund II, L.P. v. Riggio et al*., No. 5465-VCS, 2010 WL 3170806 (Del. Ch. Aug. 11, 2010).