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# Adopting a Poison Pill in Response to Shareholder Activism

In his regular column, Frank Aquila drafts a memo to a board explaining the considerations it should evaluate when deciding whether to adopt a poison pill.



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### MEMORANDUM

**TO:** The Board of Directors

**FROM:** Frank Aquila

**RE:** Considerations When Adopting a Poison Pill in Response to Shareholder Activism

As we have discussed, the Investor has just filed a Schedule 13D with the Securities and Exchange Commission disclosing equity holdings in the Company equal to 8.8% of the Company's common stock. The Investor has also disclosed its intentions to increase its stake to approximately 15%, seek representation on the Company's Board, and then advocate for either a spin-off of certain business units or a sale of the Company.

To strengthen the Board's negotiating leverage and provide adequate time to evaluate what alternatives would be in the best interests of the Company and its shareholders, the Board is considering adopting a shareholder rights plan, commonly known as a poison pill, with a 10% threshold. Correctly implemented, the triggering of this poison pill would massively dilute the Investor's voting and equity stake as soon as the Investor acquires 10% of the Company's outstanding common stock by allowing all other shareholders to purchase additional shares at a steep discount. Historically, the severity of the consequences to a shareholder of triggering a poison pill have been sufficient to deter investors from acquiring shares above the threshold without board approval.

The Board should be aware that a poison pill is not always a perfect defense or the proper antidote to address an activist's actions. Although unlikely, there is also a risk that an activist could convince a court that the company adopted the poison pill for improper reasons. Even if a board successfully blocks an activist campaign, the company might ultimately lose in the market. For example, the adoption of a poison pill under these circumstances could negatively affect the institutional investor community's perception of the company, particularly with institutional investors and proxy advisory firms. This memo highlights some of the primary issues the Board should consider before adopting a poison pill, including:

- Whether adopting a poison pill is legally permissible and appropriate under the circumstances.
- The message that adopting a poison pill will send to the Company's shareholders and to the market.
- Customized changes to the terms of a standard poison pill that could make it a more effective response to the Investor, taking into consideration the Company's facts and circumstances.
- Options other than a poison pill, including alternative and supplemental defenses available to the Company.

Time is of the essence in this situation regardless of whether the Board ultimately decides to adopt a poison pill. Compared to the activist campaigns of just five years ago, recent activist campaigns typically have a much shorter timeline. In some recent instances, investors have been able to amass significant stakes before a board could put a poison pill in place. Activists have accomplished this either by taking advantage of the ten-day window before their Schedule 13D is due to acquire additional stock, or by collaborating with other investors through informal arrangements that do not trigger Schedule 13D disclosure requirements. At this stage, it is especially important for the Board to stay informed so that it is well positioned to take swift, targeted action that will benefit the Company and all of its shareholders.



Search [Shareholder Activism: Rethinking the Approach](#) for more on shareholder activism, an assessment of company approaches to dealing with activists, and a discussion of effective responses to activist campaigns.

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## **1. LEGAL SUPPORT FOR POISON PILL ADOPTION**

Since the Company is a Delaware corporation, the Board's ability to adopt a poison pill is governed by Delaware law. Generally, the board of a Delaware corporation enjoys broad judicial deference with respect to its corporate decisions. Under the business judgment rule, a court applying Delaware law will presume that directors have discharged their fiduciary duties to act in the best interests of the corporation and its shareholders unless the plaintiff is able to show that the directors breached their fiduciary duties. If a court determines that a board has adopted a poison pill to avoid an unsolicited change in control, then the court applies the more nuanced test set forth in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). Adopting a poison pill is valid under *Unocal* if:

- The board has an objectively reasonable belief of a threat to the corporate policy and effectiveness of the company (a reasonableness test).
- The terms of the pill are a proportional response to the threat (a proportionality test).

As the Delaware Supreme Court clarified in *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995), a proportional response:

- Cannot be preclusive or coercive.
- Must be within the range of reasonable responses to the threat.

Although the original poison pills were used as anti-takeover defenses, Delaware courts have continued to apply *Unocal* and *Unitrin* to poison pills that companies have adopted to limit activists' additional accumulation of shares. Notably, the Delaware Court of Chancery has specifically found that a shareholder's creeping accumulation of control ("creeping control") by acquiring a company's stock is an objectively reasonable and legally cognizable threat that justifies the adoption of a poison pill (*Third Point LLC v. Ruprecht*, 2014 WL 1922029 (Del. Ch. May 2, 2014)).

Under *Unocal*, a board's reasonable belief of a threat is sufficient to justify its adoption of a defensive measure such as a poison pill. However, if a court finds that a board enacted a defensive measure for the primary purpose of obstructing the shareholders' right to vote, then the court will likely invalidate the defensive measure under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988), regardless of whether the board's belief in the threat was reasonable. In *Blasius*, the Delaware Court of Chancery found that the board violated its fiduciary duties by enacting anti-takeover measures (increasing the board size and packing the board with friendly directors) for the primary purpose of preventing the proper exercise of shareholder voting rights. The court held that these anti-takeover measures were invalid absent compelling justification. The much more probing standard under *Blasius* is consistent with the Delaware courts' repeated insistence that the validity of a poison pill turns on the shareholders' ability to have recourse to the ballot box. A poison pill, therefore, should never be used solely to prevent shareholders from voting in new directors who will support an activist's agenda (including eliminating a poison pill).

Activists often invoke *Blasius* to invalidate poison pills, but it is important to note that no court has ever applied the *Blasius* standard to a poison pill adopted by a public company. In two recent cases involving shareholder activism, the Delaware Court of Chancery considered the *Blasius* standard when reviewing the validity of poison pills, but rejected the heightened standard. In *Third Point LLC v. Ruprecht*, the court noted that Sotheby's refusal to waive its poison pill trigger would have been a very close call under *Blasius*, but declined to actually apply the standard. At a hearing regarding the impact of Allergan's poison pill on the ability of Pershing Square (as an Allergan shareholder) to call a special meeting, the court suggested that Allergan's board's decision not to waive the trigger requirement might have been primarily intended to chill the shareholders' vote (Transcript for Oral Argument on Plaintiff's Motion for Expedited Proceedings and Rulings of the Court, *PS Fund I LLC v. Allergan Inc.*, C.A. No. 9760-CB (Del. Ch. June 19, 2014) (settled before court action)).

In light of *Unocal*, *Unitrin*, and *Blasius*, it is imperative that the Board begin its deliberations about the poison pill with a discussion as to what a poison pill is and is not intended to accomplish. As a shareholder of the Company, the Investor has a right to make proposals on major corporate issues and to vote during director elections. The Board's primary purpose cannot be to obstruct the shareholders' right to vote. However, adopting a poison pill is a proper response to a perceived threat if the Board intends to use the poison pill to gain more time to exercise its fiduciary duties or to increase its leverage in future negotiations with the Investor so that it is able to resist demands that the Board concludes are not in the best interests of the Company and its shareholders.

## **2. THE MESSAGE SENT BY ADOPTING A POISON PILL**

Adopting a poison pill for the right reasons is vitally important. Adopting a poison pill to send the right message to the Company's shareholders and the market is just as important. Poison pill adoption can send a positive signal to the market that the Board will not merely acquiesce to the Investor's demands and is evaluating options that it believes to be in the best interests of the Company and its shareholders. However, institutional investors and proxy advisory firms are generally wary of corporate defenses such as poison pills because these defenses are

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generally perceived to be merely intended to achieve board entrenchment. The perceived abuses of the earliest poison pills also taint the image of the poison pill.

As a result of the substantial pressure from institutional investors and proxy advisory firms, most US companies have eliminated or watered down their poison pills. As of December 2015, only 19 of the companies in the S&P 500 maintained any poison pill at all. When adopting a poison pill in response to shareholder activism, in particular, the institutional investor community, prompted by the proxy advisory firms, could misconstrue the pill as a board's attempt to insulate itself from a shareholder vote.

Proxy advisory firms, such as Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. (Glass Lewis), do not favor the adoption of poison pills without shareholder approval. In general, ISS and Glass Lewis will recommend voting against each director on the board of a company that adopts a poison pill with a term longer than one year without obtaining shareholder approval. If a board adopts a pill with a term of less than one year without shareholder approval, ISS will recommend voting on directors on a case-by-case basis, taking into account:

- The time period between the pill's adoption and the next shareholders' meeting.
- The company's justification for the pill.
- The company's corporate governance track record.
- The company's past record of shareholder accountability.

Glass Lewis will consider recommending against the members of the governance committee, depending on the company's justification for adopting a poison pill with a term of less than one year.

It is hard to predict the market effects of adopting a poison pill. Some studies have drawn positive correlations between pill adoption and market performance. For instance, in November 2015, Airgas agreed to sell itself to Air Liquide at a price that more than doubled Air Products' 2010 unsolicited bid of \$5.1 billion. Airgas had previously successfully fought off Air Products' unsolicited bid by arming itself with a poison pill.

Ultimately, how the market and shareholders will respond to the Board's adoption of a poison pill turns on the specific circumstances surrounding the decision and any other related actions that the Board takes. The Board will not be able to shape some of the circumstances (such as general market conditions, the Company's past performance, and prevailing attitudes toward corporate defenses) between now and the time it adopts a poison pill. Nonetheless, the Board can increase the probability of a positive reception by thoughtfully designing the poison pill and managing the narrative it uses to announce the pill's adoption.

The design of a poison pill also sends a message about a board's attitude. For example, when Sotheby's responded to an activist by adopting a poison pill with a "qualifying offer" exception that exempted all-cash offers, commentators concluded that Sotheby's would rather sell the company than give the activist a voice inside the boardroom. In designing a poison pill, the Company should consult with its proxy solicitor to help the Board anticipate how shareholders are likely to react to certain terms.

Consulting the proxy advisory firms can also help improve shareholder and public reaction. For example, ISS recommends the following attributes for a poison pill:

- A trigger threshold of 20% or higher.
- A term of no more than three years.
- No limitations on a future board's ability to redeem the pill.
- Shareholder redemption rights after the announcement of certain offers (qualifying offer clause).

If the Board decides to adopt a poison pill, it should make a proactive effort to provide shareholders full disclosure. The Company should explain in press releases and other shareholder communications the reasons for, and the terms of, the poison pill so that the public's perception of the poison pill's adoption can be based on actual facts, rather than mere supposition.

In collaboration with its public relations team, the Board should craft a narrative that emphasizes the potential of the poison pill to increase shareholder value. For the narrative to be effective, management and the public relations team need to deliver a clear and coordinated message about the Company's position regarding the Investor's proposals. Furthermore, if the Board can fit its narrative about the poison pill into its overarching message about its business strategy, shareholders are more likely to support the Board's plans. Under these circumstances, the Investor will have a more difficult time convincing other shareholders to support its agenda.

### **3. CUSTOMIZATIONS TO INCREASE POISON PILL EFFECTIVENESS**

Activists come in all shapes and sizes, and so should poison pills. Instead of treating the poison pill as a one-size-fits-all solution, the Board can unlock greater leverage by tailoring the pill design to the specific activist activity that it intends to address. Certain design features will optimize a pill's efficacy against certain types of shareholder activism. The Board can put mechanisms in place that will allow it to respond rapidly to future threats. Some of the most common customizable pill features are described below.

#### **A. TRIGGER THRESHOLD**

Setting the proper trigger threshold is probably the most important decision that the Board needs to make in designing a poison pill. An activist does not need a very large stake in order to agitate for change. A pill with too high of a threshold will not offer the Company much protection from the Investor. A threshold that is too low will restrict other investors from making investments in the Company. The appropriateness of the trigger threshold is entirely context-dependent. For example, for a company that wishes to protect its net operating loss (NOL) carryforward, it is appropriate for a NOL pill to have a 4.9% to 5% threshold. However, in the shareholder activism context, a 10% threshold is generally suitable for checking activist accumulations without unduly interfering with other shareholders' investments.

#### **B. TERM AND RENEWAL**

A ten-year poison pill was the norm in the 1980s, but now most companies adopt short-term pills that expire within one year. The move towards a shorter pill term is, in part, a response to the pressure from the proxy advisory firms. Many companies responded to the pressure by adopting pills that automatically expire after one year, at which time shareholders can vote to extend the pill's term to three years. Considering the abbreviated timeline of today's activist campaigns, an extension will be unnecessary in most cases. Nevertheless, putting in an extension option will give the Board more time if the Investor's campaign escalates.

Giving shareholders the power to extend a short-term pill sends a positive message to shareholders. Not only does ISS recommend (and Glass Lewis may recommend under certain circumstances) voting against the entire board if a pill is renewed without shareholder approval, including a shareholder approval requirement conveys the Board's commitment to engaging shareholders in discussions related to ongoing threats against the Company. Additionally, if shareholders vote to renew a pill that does not comply with ISS or Glass Lewis recommendations, the Board is less likely to receive pushback about the pill in the next proxy season.

#### **C. SHAREHOLDERS ACTING IN CONCERT PROVISIONS**

Activists have also been able to build up significant stakes through voting agreements and informal "wolf packs." Standard poison pill drafting applies the trigger threshold to the ownership stake of a "group" of shareholders who form an agreement, arrangement, or understanding for the purpose of holding, voting, acquiring, or disposing of company stock.

However, there have been several recent examples of activists engaging in informal wolf-pack activity that stops short of meeting the group definition for purposes of triggering a poison pill or Schedule 13D filing or disclosure requirements. With this in mind, a board might consider including language that applies the pill threshold more broadly to "shareholders acting in concert," to prevent shareholders from cooperating with or acting parallel to each other in ways that fall short of an agreement, arrangement, or understanding. Since courts have not expressly blessed

these shareholders acting in concert provisions, if the Board decides to include such a provision, it should ensure that the provision, as drafted, does not unduly interfere with the valid exercise of shareholder rights, such as the right to meet and to communicate with other shareholders.

#### **D. GRANDFATHER CLAUSE**

If the Board decides to adopt a pill with a 10% trigger threshold, it needs to confirm whether any shareholders currently own a 10% or greater stake. If so, the Board should structure its pill to include a grandfather clause so that shareholders who already own stakes equal to or greater than the pill trigger can maintain their stake without immediately triggering the pill.

To do this, the poison pill would exclude any shareholder who owns a specified percentage of the Company's stock from the definition of acquiring person at the time the Company adopts or publicly announces the pill. This type of provision typically also places a cap on the grandfathered shareholders' ability to increase their ownership percentage. However, pills often give grandfathered shareholders some leeway, such as the ability to acquire another 1% of the company's stock.

The Board should note that, by taking advantage of the ten-day window for filing a Schedule 13D, or in connection with wolf-pack or other stealthy behavior, a grandfather clause could give an activist the opportunity to bypass the threshold. For example, even though American Apparel adopted a pill the day after former CEO Dov Charney disclosed his 27% stake, through a collaboration with hedge fund Standard General, Charney had managed to build a 43% stake before the pill adoption and the large stake was therefore grandfathered in. The Board needs to remain up to date on the Investor's buying activities, pay attention to any rumors, and monitor the Company's stock for unusual accumulations or trading between hedge funds.

#### **E. TWO-TIER PILL**

The Board should consider a two-tiered pill structure that would restrict further accumulations by activists while leaving the door open for passive investors. For example, the Delaware Court of Chancery upheld Sotheby's two-tier pill in *Third Point LLC v. Ruprecht*, which imposed a 10% trigger threshold on Schedule 13D filers and a 20% trigger threshold on Schedule 13G filers.

#### **F. DERIVATIVE POSITIONS**

The Board should customize its poison pill to prevent activists from accumulating stock under the radar in excess of the trigger threshold. Without acquiring stock in its own name, an activist can build up its stake through swaps or other derivative instruments. In 2010, LVMH Moët Hennessy–Louis Vuitton surprised Hermès International by announcing a 17% stake in Hermès, which LVMH had been building since 2008 through derivatives.

A simple way to prevent an activist from sneaking past the threshold through the use of derivative positions is by referencing the definition of "derivative security" under Rule 16a-1(c) under the Securities Exchange Act of 1934 and explicitly including derivative securities in the types of stock a shareholder is deemed to beneficially own for purposes of triggering the pill. Because the inclusion of derivative securities in pill triggers has not been definitively addressed by the Delaware courts, the Board should discuss with its advisors the best approach to address and define derivative securities, in light of the Company's circumstances and shareholder base.

#### **G. PILL ACTIVATION**

The Board should think ahead when it is designing a poison pill. However unlikely, there is always a possibility that an investor could trigger the pill. In 2008, Versata Enterprises intentionally triggered Selectica's NOL pill. Selectica had to suspend the trading of its common stock for over four weeks in order to transfer shares to the shareholders who were unaffiliated with Versata. Since then, it has become quite common for poison pills to include a flexible exchange feature, which gives a company additional time to distribute rights certificates without reducing the pill's immediate dilutive effect. Some types of flexible exchange features extend the timeline for distributing rights certificates. Other types allow independently managed trusts to exercise the rights of shareholders until the rights certificates can be distributed.

## H. SHELF PILLS AND SPECIAL COMMITTEES

In addition to drafting considerations that can increase a poison pill's effectiveness in the current situation, the Board should also consider taking preemptive steps to increase the speed of implementing a poison pill in the future. By having a "shelf pill" the Board would be prepared to immediately act in case of future threats. A shelf pill does not inspire the same market censure that accompanies a long-term pill. At the same time, when a threat arises, a shelf pill can be put into action within 24 hours. Without a shelf pill, the Board still has the ability to adopt a poison pill quickly and without the need for a shareholder vote. However, having a shelf pill increases a company's response time because it has prepared all the necessary paperwork in advance.

In addition, the Board may wish to designate a special committee of independent directors to make decisions regarding the customization and adoption of a pill. Having a well-informed special committee increases the efficiency of the Company's emergency response. Placing decision-making power in the hands of independent directors may also improve shareholders' perception of the Company's poison pill.



Search [Innovations in Poison Pill Drafting](#) for more on recent developments influencing poison pills and drafting innovations resulting from these developments.

## 4. OTHER DEFENSE OPTIONS

Even a well-constructed poison pill can still fail against an experienced and determined activist. Fortunately, the Board has other options when adopting a pill is insufficient or not possible under the circumstances. For example, the Board can engage in settlement negotiations with the Investor or rely on alternative takeover defenses, such as classified boards, standstill agreements, advance notice by-laws, prohibitions on shareholder action by written consent, and heightened voting requirements in director elections. Some of these defenses can amplify the potency of a poison pill.

### A. CLASSIFIED BOARDS

An activist can launch a proxy contest without triggering a poison pill. If an activist has a successful proxy season and places enough of its representatives on the board, the new board can eliminate the pill and clear the way for the activist to amass additional stock. If a company also has a classified board in place, it becomes much more difficult for the activist to gain enough seats in one election to vote out the poison pill. An activist's fight for board control can be further prolonged by implementing prohibitions on shareholder action by written consent and the shareholders' ability to call special meetings, ensuring that the activists can only remove or replace directors at an annual shareholders' meeting.

A combination of a poison pill and other takeover defenses can be a potent deterrent to activists. For example, the Delaware Court of Chancery upheld Airgas's use of a combined classified board and poison pill defense to block Air Products' hostile takeover bid (see *Air Prods. & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011)).

However, combining a classified board with a poison pill might not be the most attractive option from a logistical and messaging standpoint. The majority of the companies in the S&P 500 have eliminated classified boards due to intense shareholder criticism. Moreover, unlike a poison pill, a board of an existing Delaware corporation cannot implement a classified board unilaterally. Section 141(d) of the Delaware General Corporation Law requires a company to obtain shareholder approval for an amendment to either its certificate of incorporation or by-laws to adopt a classified board structure. Not only would it be time consuming and expensive to seek shareholder approval for the amendment, but both ISS and Glass Lewis recommend that shareholders vote against proposals to implement a classified board.

### B. STANDSTILL AGREEMENTS

Compared to a classified board, a standstill agreement is a means of prolonging the effectiveness of a poison pill that is much better received by shareholders and that a board can

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unilaterally implement without shareholder action. Under a standstill agreement, the activist typically agrees to limit its stake in the company, often in exchange for board seats. The Delaware Court of Chancery has upheld the combination of a standstill agreement with a poison pill in certain circumstances (*In re BioClinica, Inc. S'holder Litig.*, 2013 WL 673736 (Del. Ch. Feb. 25, 2013)).

### **C. SHAREHOLDER COMMUNICATION**

In most shareholder activism situations, the best supplement to a poison pill is simply communication. As soon as an activist declares its intention to push for certain corporate changes, a board should attempt to establish a line of communication with the activist. An activist might defer more expensive methods of attaining its goals if it feels that the board is willing to listen. Communicating with the activist therefore gives the board more time to line up its defenses and exercise its fiduciary duties. Sometimes a board is able to provide explanations or resolutions that address the activist's concerns and the activist will terminate its campaign.

Even if the Board is unable to dissuade the Investor, having made the effort to talk with the Investor will help the Board appear more responsive to other shareholders. These communications can make a subsequent pill adoption seem less pernicious. Furthermore, any additional information gathered about the Investor's plans during the initial discussions puts the Board in a better position to evaluate the nature of the potential threat and devise a more targeted response.

At this stage in its campaign, the Investor is probably communicating with other shareholders and institutional investors to drum up support for its causes. Right now, it is crucial for the Board to maintain an active dialogue with the Company's shareholders. If a shareholder has confidence in the Board's overall business strategy, it will be more inclined to perceive the Board's adoption of a poison pill as a necessary means of protecting shareholder interests, even if the shareholder has general misgivings about corporate defenses. Moreover, shareholders will stand with the Board if they believe in the Board's vision for the Company, increasing the Board's leverage in an activist campaign.

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I look forward to discussing this at your convenience.

**F.J.A.**