While rights plans, or “poison pills” as they are commonly known, are a frequent subject of litigation, with the exception of the recent Selectica situation in Delaware, rights plans are virtually untested. The fact that rights plans have not been tested in the heat of a takeover battle attests to their being among the most effective takeover defense ever developed. As a consequence of the effectiveness of rights plans, U.S. public companies adopted rights plans in increasing numbers in the late 1980s and throughout the ‘90s. In spite of, or maybe because of, their effectiveness, corporate governance watchdogs and activist institutional investors have increasingly opposed rights plans in recent years and, as a result, the number of U.S. companies that have rights plans has declined from more than 2,200 in 2001 to approximately 1,000 today.

Whenever a rights plan is adopted, it generates a significant amount of discussion among directors and their advisors. A complete survey of directors’ fiduciary duties in relation to adopting a rights plan, or a detailed description of the mechanics of rights plans, would fill a much longer piece. Since fewer and fewer companies have rights plans in place, more boards will be faced with making decisions about adopting a rights plan in situations where a company may actually be facing an unwanted hostile bid. If presented with such a situation, anxiety levels will increase and “speed reading” will most certainly be required. This article focuses on ten key issues that any board should consider when making a decision relating to a rights plan.

1. **Structuring an Optimal Board Process.** A board’s decision to adopt or maintain a rights plan is governed by the law of the state of the company’s incorporation. If the company is a Delaware corporation, a board’s action in adopting or maintaining a rights plan is entitled to the protection of the business judgment rule, which establishes a presumption that in making a business decision, the directors acted with due care (i.e., on an informed basis), in good faith and with the honest belief that the action taken was in the best interest of the company. The burden is on a plaintiff to establish facts rebutting the presumption by a showing of fraud, bad faith, self-interest or lack of care on the part of the directors. The Delaware courts do, however, require that board actions that have antitakeover implications first satisfy an enhanced level of scrutiny before the courts apply the business judgment rule. Directors must first establish (i) that they had reason-
able grounds for believing that there was a danger to corporate policy and effectiveness and (ii) that the measures they adopted were reasonable in relation to the threat posed. Despite this “enhanced scrutiny” requirement, however, Delaware courts have regularly upheld rights plans as “reasonable” defensive measures (whether they were adopted before or after a hostile bid emerged).

The adoption or maintenance of a rights plan therefore requires that directors (1) inform themselves about the rights plan, using the degree of care that an ordinarily prudent person would exercise under similar circumstances and (2) act in a manner that they believe is in the best interest of the company. Directors are entitled to rely in good faith on officers and employees if the board believes they are reliable and competent, on committees of the board if the board believes the committee merits confidence and on outside advisors if the directors believe the advice provided is within their professional or expert competence.

Recently, the Delaware Chancery Court issued a decision in the Selectica case. Selectica v. Versata Enters., 2010 Del. Ch. LEXIS 39 (March 1, 2010). The court confirmed that the preservation of net operating losses (“NOLs”) was a proper purpose for a rights plan. Perhaps more important than this narrow reading, however, is that the court signaled that directors have some discretion to determine what constitutes a proper purpose for a rights plan and how the company can design a customized plan to address its purpose. Therefore, the import of Selectica for M&A transactions is that if directors follow appropriate procedures, Delaware corporations can adopt rights plans that are designed to meet specific needs, such as responding to a hedge-fund hold-ups or issues presented by a particular hostile bidder, and not just implemented as generic anti-takeover devices.

If a board is considering adopting a rights plan, or is considering whether to maintain a rights plan in the face of a specific hostile offer, the board should develop a process for consideration of the issues that will satisfy the applicable state law requirements. In practice, this usually means the following:

- Receiving presentations from outside counsel regarding directors’ fiduciary duties, the company’s existing takeover defenses (if the rights plan is being adopted for anti-takeover purposes; see Section 2 below), the potential reactions of corporate governance watchdogs to the rights plan, considerations relating to the selection of a record date and payment date for the plan, and the other mechanics of the rights plan;
To build a strong record, it is usually advisable for a board to meet more than once (and preferably at least one of the meetings should be “in person” rather than telephonic) in connection with its consideration of the rights plan. In some cases, the board may also want its corporate governance committee to analyze the desirability of adopting a rights plan before the full board is asked to consider the plan. Elements of the board’s “ordinary course” work will also be relevant to the board’s deliberations (e.g., whether the company has a strategic plan and whether the company has done a market check for a change of control transaction). As always, it is critical that the company secretary maintain accurate records at any board meeting at which the board discusses a rights plan.

**2. Types of Rights Plans: Takeover Defense v. NOL Preservation.** The first step in considering the adoption of a rights plan is to decide what type of rights plan the company needs. Most frequently, rights plans fall into one of two buckets (although we may start to see more variety in the wake of the Selectica decision): (1) anti-takeover pills and (2) NOL pills.

Antitakeover pills typically have 15% or 20% thresholds and are designed to (1) deter abusive takeover tactics, including “creeping” acquisitions of control, (2) enhance the board’s leverage to negotiate with a bidder and (3) buy the board some time to seek out alternatives if it does not think the unsolicited offer is in the company’s best interests.

Even an anti-takeover rights plan, however, will not prevent an acquisition of the company at a full and fair price in a transaction that is in the best interests of the company.

NOL pills typically have 4.99% thresholds and are designed to preserve a company’s NOLs by preventing shareholders from becoming “5% shareholders”. The tax rules relating to NOLs are complex, but, simply put, changes in ownership of the company’s stock by shareholders who own 5% or more of the company’s shares (including as a result of certain capital raising transactions by the company) can imperil the company’s ability to
use its NOLs. Some company’s NOLs are their most valuable asset and, in the Selectica case, the Delaware courts upheld the adoption of a rights plan to preserve NOLs.

3. Deciding Between Adopting a Pill Today or Putting a Pill “On the Shelf.” If a board decides a company needs an NOL pill, it should adopt it promptly. In contrast, if a company is considering adopting an antitakeover pill, it has two options: (1) it can adopt the pill immediately or (2) it can put a pill “on the shelf” (i.e., educate itself about the mechanics and other aspects of the rights plan and have all of the documentation drafted and ready to go in case an unsolicited bid emerges, but not actually adopt and announce a rights plan). There are pros and cons to each strategy, and in many ways the decision between these two options is very company-specific. However, some of the issues the board should consider include the following:

- How vulnerable is the company at this time (both in terms of its other available takeover defenses and in terms of where its stock is trading relative to its 52-week high and low trading prices)?

- Given the company’s stockholder composition and the typical trading volumes in the company’s stock, will the company be able to identify accumulations in its stock in time to implement a shelf pill effectively?

- Does the company have a predominantly institutional stockholder base that will be heavily influenced by RiskMetrics and other proxy advisory services that typically oppose the adoption of rights plans?

- Is the company likely to be a target of stockholder proposals requesting the termination of a poison pill?

- Is the company able to anticipate the exact kind of threat it is likely to receive? If not, it may be desirable to put a pill “on the shelf” that it can later customize to the particular facts and circumstances of a threat. This type of customization appears to be consistent with Selectica.

4. Stockholder Friendly Pill v. Traditional Pill. If a board decides to adopt a takeover defense pill immediately, rather than implementing a shelf pill, the board needs to decide whether the pill should be a so-called stockholder friendly pill. Stockholder friendly pills were developed in the decade in response to criticism of traditional pills by Risk-
Metrics and others. Certain of the key differences between stockholder friendly pills and traditional pills are as follows:

- Stockholder-friendly pills are typically required to be submitted to a stockholder vote within one year after adoption by the board. It is not always clear, in all cases, what impact the failure of the stockholders to approve the pill would have on its validity (in some cases, as a contractual matter, the rights plan provides that it expires automatically if the stockholders fail to approve it by a specified time).

- Stockholder friendly pills typically have much shorter terms (e.g., 3 years) than traditional pills (which often have ten-year or longer terms).

- Stockholder-friendly pills typically have a 20% trigger rather than a 15% trigger (the latter being the norm in the 1990s).

- Stockholder friendly pills typically have features that allow stockholders to vote to force a redemption of the pill if they favor an unsolicited takeover offer. These features can include, among other things, procedures for stockholders to compel the company’s board to call a stockholder meeting for purposes of voting on the redemption of the pill.

- Stockholder friendly pills often have so-called TIDE (“three-year independent director evaluation”) features that require independent directors to review the rationale for keeping the pill in place, even in the absence of a specific unsolicited proposal. Many stockholder friendly pills require annual TIDE reviews (rather than triennial reviews that the “TIDE” acronym suggests).

RiskMetrics is less likely to criticize a stockholder friendly pill. The downside of a stockholder friendly pill, of course, is that it does make a company more vulnerable to an unsolicited takeover as follows: If the board refuses to redeem the pill to permit an unsolicited offer to proceed, the offeror can solicit stockholders to vote in favor of redeeming the pill. If the company has a staggered board, getting a single stockholder vote to redeem the pill will be less costly for the offeror than soliciting proxies to replace directors in two separate annual meetings for the purpose of having the board redeem the pill.

5. Dealing with Derivatives. In designing a rights plan, many companies struggle with the question of whether ownership of economic or voting rights in the company’s stock
through derivative positions should trigger the rights plan. Total return equity swaps are agreements between investors and a counterparty that give the investor the economic equivalent of owning a company’s shares without actually transferring title to the shares. The parties have the ability to settle the swap in cash or shares. Accordingly, there was speculation for a time that an activist investor could enter into multiple total return swaps that could be settled on a single date in shares of the target without triggering any prior disclosure requirements. This would allow the activist investor to preserve the element of surprise, a powerful tool in any takeover battle.

The Selectica decision appears to clarify that directors can customize a rights plan to pick up derivative positions if the relevant legal standards are otherwise satisfied. For a number of reasons, however, it is usually not necessary to incorporate derivatives explicitly into the definition of beneficial ownership in a rights plan:

- The traditional broad definition of beneficial ownership that references Section 13(d) under the Exchange Act captures almost all situations that a company would ordinarily want to capture. After the CSX case and the SEC’s investigations that followed, many activist hedge funds became aware that the “scheme to evade” language in Section 13(d) can be made to capture even total return swaps, and they have become more cautious about trying to use total return swaps to evade Section 13(d) disclosure requirements.

- It is virtually impossible for a company to track derivative positions that relate to its securities. The positions can go through multiple layers of “ownership” in one form or another, which would make it very difficult to determine if the pill has been triggered. In addition, actually implementing the pill, once triggered, would be even more difficult to do given the complex nature of tracking derivatives.

- Even if a company could identify problematic derivative positions, would it really want to (and would the court allow it to) “punish” the “innocent” institutional counter-party to the swap by triggering the pill and voiding the stock? Keep in mind that the activist investor who is accumulating positions through total return swaps does not actually hold the target’s stock yet, so voiding the stock underlying the position only hurts the counter-party to the arrangement (and, to date, it does not appear that the “innocent” counterparties are negotiating for protection on this issue as part of
their swap contracts). This could raise validity issues under state law as to whether voiding the counterparty’s stock is a reasonable response to the threat posed (especially if an “innocent” institution is the plaintiff).

6. Working Through the Mechanics. As we said at the outset, the mechanics of rights plans are complex and a complete summary of how they work is beyond the scope of this article. Suffice it to say that it is important that the directors be well-informed concerning these mechanics. It is often helpful to supply a short term sheet or other summary of the rights plan’s principal features and to walk the directors through a hypothetical takeover scenario to demonstrate how the rights plan would work in practice. Among other things, the directors should understand the purpose and basic structure of the “flip-in” and “flip-over” and what impact triggering those events could have on the company’s stock.

7. Flip-Overs Provisions Under State Law. Rights plans for Delaware corporations can include “flip-over” provisions (which have the effect of diluting the acquirer’s stock if the pill gets triggered but the acquirer takes a controlling stake in the target; in contrast, a “flip-in” provision only dilutes the acquirer’s ownership of the target, not the ownership by acquirer’s shareholders in the acquirer). Not all states, however, permit flip-overs. While all features of a rights plan should be vetted with local counsel, the “flip-over” feature deserves special attention to make sure it will work if the company is not incorporated in Delaware.

8. Exchange Features. The efficacy of a poison pill ultimately depends on the willingness and ability of stockholders to exercise the rights. To facilitate those exercises of the rights, many rights plans include provisions called the “exchange feature”. Under these provisions, the company’s board can allow rights holders to exchange rights for common stock on a one-for-one basis. This reduces the dilutive effect of the pill, but has the beneficial effect of eliminating the need for stockholders to pay the exercise price in cash. In addition, some rights plans include a concept that allows the exchange feature to be administered by an independent trustee in an orderly fashion. Ideally, the trustee concept obviates the potential market disruptions that could follow from stockholders trying to exercise rights. In the Selectica situation, for example, the target’s stock ceased trading for an extended period while its transfer agent attempted to sort out who was entitled to exercise rights at what time.

9. How to Set the Exercise Price. Customarily, exercise prices range from three times to five times the company’s current market price. However, an investment bank can
provide a more detailed rationale for the exercise price determination for any particular company. In particular, an investment bank could analyze comparable companies rights plans, comparable types of rights plans (even if the companies adopting the plans are not comparable companies), future share price analyses based on trading multiples, and a capital asset pricing model. An investment bank can also advise the board which methodologies are most appropriate given a company’s particular facts and circumstances and what the purchases of the rights plan are.

**10. Dealing with the Details: Overprinting, Stock Exchange Rules and SEC Filings.** The timeline for adoption of a rights plan needs to take account of a number of technical details, including the following:

- Rights initially trade with the common stock and are evidenced by a legend printed on the stock certificate. For companies that have few, if any, certificated shares, the stock certificates are typically held in a vault at the company’s transfer agent. If the company is adopting a rights plan for the first time, it needs to have the rights legend printed on its stock certificates for the first time. If it is adopting a second rights plan, it may be able to “over-silver” a new legend on top of the old rights legend on its stock certificates. If the Company is adopting a third rights plan, it may be necessary for the company to have all new stock certificates printed.

- The stock exchanges have certain requirements associated with the adoption of a rights plan. For example, the New York Stock Exchange requires that the company submit a listing application for the rights and give notice of the record date for the issuance of the rights. It is advisable to coordinate with a representative of the relevant exchange early in the process to ensure compliance with all of these technical requirements well in advance of the desired effective date for the rights plan.

- The rights issued pursuant to a rights plan also need to be registered under the Exchange Act, which can be accomplished by filing a Form 8-A with the SEC. If the company has an existing rights plan that is expiring, it will also be necessary to delist and deregister the company’s old, expiring rights.

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Mr. Frank Aquila and Ms. Melissa Sawyer on

Speed Reading: Top 10 Issues to Consider When Adopting a Rights Plan
Despite a decade in which pressure from corporate governance watchdog groups and institutional shareholders has dramatically reduced the number of rights plans currently in place at U.S. public companies, the rights plan remains the most effective takeover defense available to most companies. The recent Delaware Chancery Court Selectica decision validates rights plans as an appropriate tool available to boards of directors seeking to protect legitimate corporate interests in a manner that is consistent with their fiduciary duties. Rights plans may be under siege, but when the corporate bastion is under siege the rights plan continues to be one of the best defenses.

For more on D&O liability, see Chapter 14, "Liability in Takeovers, Mergers and Buyouts," in Liability of Corporate Officers and Directors

For more on takeovers and poison pills, see Chapter 5E, "Tender Offers and Takeovers," in Corporate Acquisitions and Mergers

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