

# The Future of Poison Pills

By Kevin Douglas

**Despite continued opposition from shareholder activists, poison pills made a comeback in 2008 after suffering through a decline in recent years. This resurgence was a reaction to the sharp drop in the stock market and the increase**

in hostile takeover activity that occurred in the United States during 2008.

Since they were originally developed in the early 1980s, shareholder rights plans have become recognized as a legal and effective way of deterring coercive or abusive takeover tactics and centralizing power in the board of directors in the event of a hostile takeover. Under the typical plan, “rights” are granted to shareholders to buy additional stock of the company at a substantial discount in the event that a party acquires a specified ownership percentage of the company.

Because of the massive dilution that a would-be acquiror would suffer if it triggered a plan, no modern form of rights plan had ever been deliberately triggered in the United States prior to December 2008.

Shareholder rights plans do not preclude unsolicited offers. The board of a target is required to comply with its fiduciary duties in considering any offer irrespective of whether a plan is in place. In addition, a

rights plan does not prevent a proxy contest that, if successful, could result in the election of acquiror-friendly directors who could terminate the plan.

Poison pills, along with classified boards, are widely regarded as the two most effective takeover defenses, especially when used in combination. Unlike classified boards, shareholder rights plans generally can be adopted by a board of directors without shareholder approval, often within a few days from the time a threat arises.

## **THE DECLINE OF POISON PILLS**

Once the current era of shareholder activism and focus on corporate governance “best practices” emerged, U.S. public companies came under significant pressure to dismantle takeover defenses, including shareholder rights plans.

For example, the proxy advisory service, RiskMetrics Group (formerly Institutional Shareholder Servic-

es), which wields significant influence among institutional shareholders, is opposed to the adoption of shareholder rights plans without shareholder approval. Under its proxy voting guidelines, RiskMetrics will recommend “withhold” or “against” votes for all directors (except new nominees) of any company that adopts or renews a poison pill without shareholder approval and does not commit to put the plan to a shareholder vote within 12 months of adoption (provided that the board has not yet received a withhold recommendation on this issue).

In this environment, a majority of companies whose plans have been expiring in recent years have elected not to renew their plan. In contrast, the renewal rate for pills was 85 percent in 2001. Other companies have elected to affirmatively terminate their rights plans prior to their expiration. In addition, first-time adoptions declined, and there were only 42 first-time plan adoptions in 2007, the lowest total since the early 1980s.

Overall, the percentage of S&P 500 companies with a shareholder rights plan fell from 60 percent at the end of 2002 to less than 25 percent by the end of 2008. While the trend of eliminating poison pills and other takeover defenses has been most prevalent among large-cap companies, the trend has been apparent among mid-cap and small-cap companies, as well.

As the market capitalization of U.S. public companies declined sharply in 2008, hostile takeover activity increased significantly compared to recent years,

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despite unfavorable financing conditions. The decline in takeover defenses that has occurred in recent years left many companies more vulnerable to unsolicited activity and may have been a contributing factor to the increase in hostile takeovers.

In this climate, the number of first-time poison pill adoptions increased to 76 in 2008 from 42 in 2007, the first year-over-year increase since 2004-2005. Of these first-time adoptions, approximately 22 percent were

adopted in response to a specific threat (based on data from SharkRepellent.net).

By comparison, in 2001 only two percent of all adoptions were in response to threats. As credit and

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stock market conditions worsened, the rate of adoption of first-time shareholder rights plans increased.

Although the number of first-time adoptions increased in 2008, the total number of U.S. public companies with shareholder rights plans in place continued to decline, as more companies allowed their existing plan to expire or terminated their plan early.

#### **THE FUTURE OF THE PILL**

The decision of more boards of directors to adopt shareholder rights plans in 2008 was an understandable reaction to circumstances. Many believed that the diminished market capitalization of their company created the potential for an acquiror to obtain control over their company without paying an adequate control premium. It appears likely that the factors that contributed to the increase in new poison pill adoptions in the United States last year – depressed stock market valuations and an active hostile takeover market – will continue in the near future. Nevertheless, the environment that has contributed to the decline of rights plans in recent years remains in place.

Companies reviewing whether or not to renew or adopt a rights plan will want to make this determination in conjunction with an analysis of their other takeover defenses and as part of a comprehensive advance preparedness approach. In this process, companies are advised to consider the following:

- Consistent with current trends, many companies whose rights plans are expiring will allow their plans to expire on schedule, while retaining the freedom to adopt one if a threat arises in the future. A benefit of this approach is that it will avoid (or, at least, defer) adverse shareholder reaction. A downside of deferring the adoption of a plan until a threat arises is that this approach will not deter rapid open market or block purchases, or concerted abusive activity by groups of shareholders, that might occur prior to the time at which a new plan can be adopted in response to a threat.

- It is likely that the percentage of adoptions in

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response to threats will continue to be significant. Companies that do not have plans in place will want to consider whether it is advisable to have a plan “on the shelf” that can be quickly adopted in the event a threat emerges.

- A shareholder rights plan adopted to fit the preferences of shareholder activists often will not provide the protections that a plan is intended to provide. Nevertheless, in some cases, companies will want to consider including certain provisions viewed more favorably by shareholder activists, such as a shorter term for a plan which may be intended to coincide with an anticipated short-term decline in the market price of the company’s stock or a short-term threat. (Plans traditionally have had a ten-year term, although terms of three years or less have become significantly more prevalent than they once were.)

- Companies that renew or adopt shareholder rights plans will want to carefully consider whether they voluntarily submit the plan to shareholders for their approval. The overwhelming majority of companies that have adopted a plan do not do so, even though that triggers a RiskMetrics withhold recommendation.

- In the event that a company elects to renew or adopt a shareholder rights plan, it is generally helpful for the company to maintain a dialogue with its significant investors and to communicate to these investors the board’s basis for its action (subject to the company’s obligation not to disclose material, non-public information under Regulation FD).

- Some companies include derivatives within the definition of ownership in shareholder rights plans. While it is beyond the scope of this article to discuss this development in detail, companies will want to be mindful of the risks of an inadvertent trigger and other considerations when deciding whether to include derivatives within the scope of a plan.

Even if the total number of U.S. public companies with shareholder rights plans continues to decline, the ability of companies to quickly adopt plans without shareholder approval will cause poison pills to remain a vital takeover defense mechanism in the foreseeable future.



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