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Reconsidering Poison Pills

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The public health crisis caused by COVID-19 has had a dramatic economic impact on the trading prices of U.S. companies across all industries. As boards of directors and management teams work to stabilize their operations and deal with the myriad issues caused by the pandemic, we have witnessed a number of opportunistic shareholder activists accumulating stakes in publicly traded targets. In the current environment, boards and their advisors should take, and several already have taken, a fresh look at the implementation of a shareholder rights plan (aka "poison pill").

Rights plans were a permanent fixture in most public companies' defensive profile until the turn of century, when various governance and proxy advisory groups began an effective campaign to pressure companies into letting expire, or terminating, their rights plans. This is reflected in the fact that, according to SharkRepellent, only approximately 1% of companies in the S&P 500 had an active rights plan in place as of March 1, 2020, while around the year 2000 approximately 60% of the S&P 500 had one. Instead of maintaining standing long-term rights plans as a general defensive measure, many companies have kept rights plans in draft form "on the shelf"—ready for implementation if needed. Under the existing extraordinary market conditions, companies in particularly affected sectors should evaluate the advisability of activating on-the-shelf plans.

In assessing whether to activate a rights plan, companies should consider the following:

- **Presence of Activist:** Companies that already have an activist in their stock should closely monitor for potential accelerated accumulations. We recommend that boards take prompt action in the event there is a clear indication that the activist is proceeding with any aggressive accumulation of additional shares.
- **Schedule 13D:** Federal securities rules and regulations require an activist or hostile bidder to publicly file a Schedule 13D within ten days after crossing the 5% ownership threshold. However, after the initial threshold is crossed, accumulations can continue during the ten-day filing window, such that the buyer could launch its public campaign after having acquired an ownership stake well over the 5% threshold. This is particularly important to consider for companies that are seeing increased trading volumes that might facilitate rapid accumulations of large blocks of stock. Companies should also keep in mind that currently SEC rules do not require the aggregation of certain derivative instruments in computing whether the 5% threshold has been crossed, a loophole often used by professional activists to conceal their economic exposure to a target.

It is important to note that, following the filing of an initial Schedule 13D, an activist will be required to file an amendment within one or two business days after each time it acquires an additional one percent of the class of securities. For a company with an existing activist, this amendment might be a good early-warning indicator of when to activate a rights plan.

- **HSR Filing Obligation:** The Hart-Scott-Rodino Antitrust Improvements Act of 1976 generally requires a filing with the Federal Trade Commission and U.S. Department of Justice (with notice to the target company) and subsequent observation of the statutory waiting period before a person can acquire and, as a result of the acquisition, hold more than $94 million in shares for non-passive purposes. Although somewhat peculiar, for larger publicly traded companies, this antitrust rule generally establishes a more effective warning system against aggressive stock accumulations than Schedule 13D does under federal securities laws. However, the HSR filing obligations may not apply to groups of fund vehicles, as well as many derivative instruments, some of which are specifically designed with this purpose in mind. As a result, the HSR filings may not always provide the advance notice of an activist.
- **ISS Considerations:** One of the main deterrents against adoption of rights plans in recent years has been the fact that the proxy advisory firm Institutional Shareholder Services (ISS) will generally recommend votes against incumbent director nominees at annual meetings where the company has recently adopted a rights plan with a term of more than one year. However, for plans with a duration of less than a year, ISS will make its recommendations on a case-by-case basis taking into account the disclosed rationale for adopting the plan and other relevant factors (such as a commitment to put any renewal of the pill to a shareholder vote).

We believe that existing market conditions should be strongly considered and taken into account by ISS when reviewing cases, particularly where the board articulates a clear rationale for implementation of the rights plan. Companies should also consider whether they previously adopted a governance policy promising to seek stockholder approval prior to adopting a rights plan unless the board, in the exercise of its fiduciary duties, determines that it is in the best interests of the company and stockholders to do so before seeking approval. Such policies should not deter adoption but typically also provide that any rights plan adopted without shareholder approval will expire unless approved by shareholders within the next year.

- **Duration:** As a general matter, we believe that most companies that implement a plan in the coming weeks should consider an expiration date between six and nine months of adoption, and we have recently advised clients to adopt plans that expire on December 31, 2020. We believe that date strikes the right balance between adopting an instrument that protects shareholder value in this uncertain environment and mitigating against the potential criticism from governance groups. Of course, the board will always have the power to accelerate the term if it deems it in the best interests of the company and its shareholders.
- **Net Operating Losses ("NOLs"):** For companies with NOLs, a deemed "ownership change" under Internal Revenue Code Section 382 can materially impair or eliminate NOLs. The complex Section 382 test is dependent on shifts of ownership of 5% or greater holders over a rolling three-year period. NOL rights plans have acquisition triggers of 5%—much lower than the customary rights plans—but otherwise are substantially identical to a traditional rights plan. In light of ongoing market volatility and changes in investor positions, for companies with both material NOLs and demonstrable ownership shift percentage under Section 382, an NOL rights plan may make sense.

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Under the current extraordinary circumstances, companies in particularly vulnerable industries should actively assess the advantages and disadvantages of implementing a rights plan to ensure that all stockholders receive fair and equal treatment in the event of any proposed takeover of the company and to guard against creeping accumulations of control.

For more information, please contact the author Eduardo Gallardo. To view more insights regarding the COVID-19 pandemic, visit our COVID-19 Resource Center.

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