

Poison Pills – Recent Developments

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Introduction

- The pill debuted in the early 1980's as a device boards of target companies could use to stop, or at least slow down, hostile tender offers.
- The original pill evolved in response to judicial and legislative developments during the 1980's. Most importantly, the permissibility of the "flip in" provision became clear during the late 1980's. Since then, the terms of the standard pill were generally stable until the last two years.
- Pill adoptions declined (and pill terminations/non-renewals increased) during the early 2000's as shareholder activism encouraged an "off-the-shelf" strategy.

Introduction

- Pills are now becoming more popular:
 - Lower equity values increase anxiety about hostile bids
 - HSR warning period less effective
 - Derivatives may allow a raider to emerge suddenly
 - Smaller companies have less reason to fear RMG-related backlash
 - Recession gives rise to NOLs, which can be protected by a pill
- Derivative issues are also causing pills to become more complicated.

Pill Mechanics – Rights

- In essence, the pill works by allowing all shareholders of Target other than Raider the opportunity to acquire additional Target shares at a discounted price in the event Raider crosses a specified ownership threshold (usually between 10% and 20%). In effect, Raider is discouraged from crossing the threshold while the pill is in place.
- From the recitals – *The Board of Directors of the Company has authorized and declared a dividend of one preferred share purchase right (a “Right”) for each Common Share of the Company, each Right representing the right to purchase one one-thousandth of a Preferred Share.*
- From Section 7, “Exercise of Rights” – *The Purchase Price for each one one-thousandth of a Preferred Share purchasable pursuant to the exercise of a Right shall initially be \$[] (a number equal to a multiple (e.g., 4X) of the company’s stock price).*

Pill Mechanics – The Flip-In

- From Section 11, “Adjustment of Purchase Price”:

In the event any Person becomes an Acquiring Person [i.e., the beneficial owner of [15]% or more of the company’s stock], each holder of a Right shall thereafter have a right to receive, upon exercise thereof at a price equal to the then current Purchase Price, in lieu of Preferred Shares ... such number of Common Shares of the Company as shall equal the result obtained by (A) multiplying the Purchase Price by the number of one one-thousandths of a Preferred Share for which a Right is then exercisable and dividing that product by (B) 50% of the then current per share market price of the Common Shares of the Company... From and after the occurrence of such event, any Rights that are or were acquired or beneficially owned by any Acquiring Person shall be null and void.

Pill Mechanics – Exchange

- From Section 24, “Exchange”:
- *The Board of Directors of the Company may, at its option, at any time after any Person becomes an Acquiring Person, exchange all or part of the then outstanding and exercisable Rights (which shall not include Rights that have become null and void pursuant to the [flip in provision]) for Common Shares at an exchange ratio of one Common Share per Right....*

Impact of Equity Derivatives

- Total Return Swap (TRS) – the “long” party pays the “short” party a fixed rate of interest in return for the cash flows associated with a share of Company X’s stock.
- The long party thus has economic exposure to Company X without owning X’s stock.
- Also, the short party is likely to buy X stock to hedge its exposure to the long party
 - Short party will likely be willing to unwind the transaction by selling its X stock to the long party at any time.
 - Short party may be willing to vote its X stock in the way the long party would prefer.
- If the long party does not disclose its TRS position under 13D, it may be able to suddenly acquire a large position in X stock without advance notice to the market or X.

How Will the Pill Evolve?

- Two principal issues:
 - Are derivative positions taken into account in determining beneficial ownership for purposes of the “Acquiring Person” definition?
 - If so, what happens when the flip-in is triggered?

Full Derivative Ownership/No Flip-In Change

- One approach is to amend the definition of beneficial ownership to include economic exposure through derivative positions without changing the flip-in.
- However, the flip-in only dilutes the Acquiring Person to the extent of its actual (not derivative) stock ownership – which may be zero.

Full Derivative Ownership/Requirement of Actual Ownership

- Another approach is to include derivatives in the definition of beneficial ownership, but only if the potential Acquiring Person also holds a significant non-derivative position.
- This ensures that if the flip-in is triggered, the Acquiring Person will suffer at least some dilution (although it may not be much).
- It does not, however, prevent a raider from establishing a large derivative position and a small actual one.

Limited Derivative Ownership/Requirement of Actual Ownership

- A third approach is to include derivative positions in the definition of beneficial ownership, but only to the extent the derivative positions actually correspond to actual shares, and to dilute holders of all of those shares when the flip-in occurs.
- Can you determine the extent to which beneficial ownership corresponds to actual ownership through a chain of parties?
- Dilution of derivative counterparties prevents the pill from being evaded, but is it fair/reasonable to dilute “innocent” counterparties?

Unknown/Ambiguous Trigger Issues

- Any pill that includes derivative exposure in the concept of beneficial ownership creates an increased risk that a person could become an Acquiring Person without the knowledge of the company (and possibly the Acquiring Person itself).
- Consequences of having a disputed capital structure are unappealing, to say the least.
- Could provide some discretion to the board to determine what counts as beneficial ownership, but too much could undermine the pill's efficacy.
- Another alternative is to stick with the “tried and true” pre-derivatives pill.

NOL Pills

- Many companies have experienced major operating losses, and carry correspondingly large NOLs on their balance sheets.
- The value of NOLs may be limited or lost if the company experiences an “ownership change” – which will generally happen if a 5%+ holder’s ownership increases by a specified amount over a three-year period.
- Triggering threshold is set at 4.99% – freezes existing 5%+ shareholders and discourages new ones.
- Not adopted for defensive purposes.

Selectica Pill Triggering

- No flip-in had ever been triggered before December 2008, when Versata Enterprises, Inc. triggered an NOL pill adopted by Selectica, Inc.
- Selectica was a small public company with a large NOL; Versata was a competitor with a 5.1% position in Selectica.
- Selectica adopted an NOL pill with a flip in that would be triggered if a “grandfathered” shareholder acquired another 0.5%; Versata intentionally triggered the flip in.
- Selectica opted to use the pill’s exchange feature rather than the traditional rights exercise provision.

Selectica Pill Triggering

- Why the exchange? Less dilution, but no requirement for shareholders to exercise rights (or pay cash)/dilution is automatic.
- The exchange reduced Versata's position from 6.7% to 3.4%; the total cost to Versata was roughly \$1 million.
- Trading in Selectica's stock was suspended for almost a month while back-office aspects of the exchange were worked out.

Conclusion

- No satisfactory answer to the derivative issue yet – SEC action on derivatives may change the landscape.
- Will raiders be more willing to trigger pills? Will potential targets be more wary of possible adverse effects of a triggering event on them?
- Pills may continue to grow in popularity even as their effectiveness is less than previously thought.