

Poison Pills— Prescriptions on the Rise

**Dallas Bar Association
Securities Law Section**

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Agenda

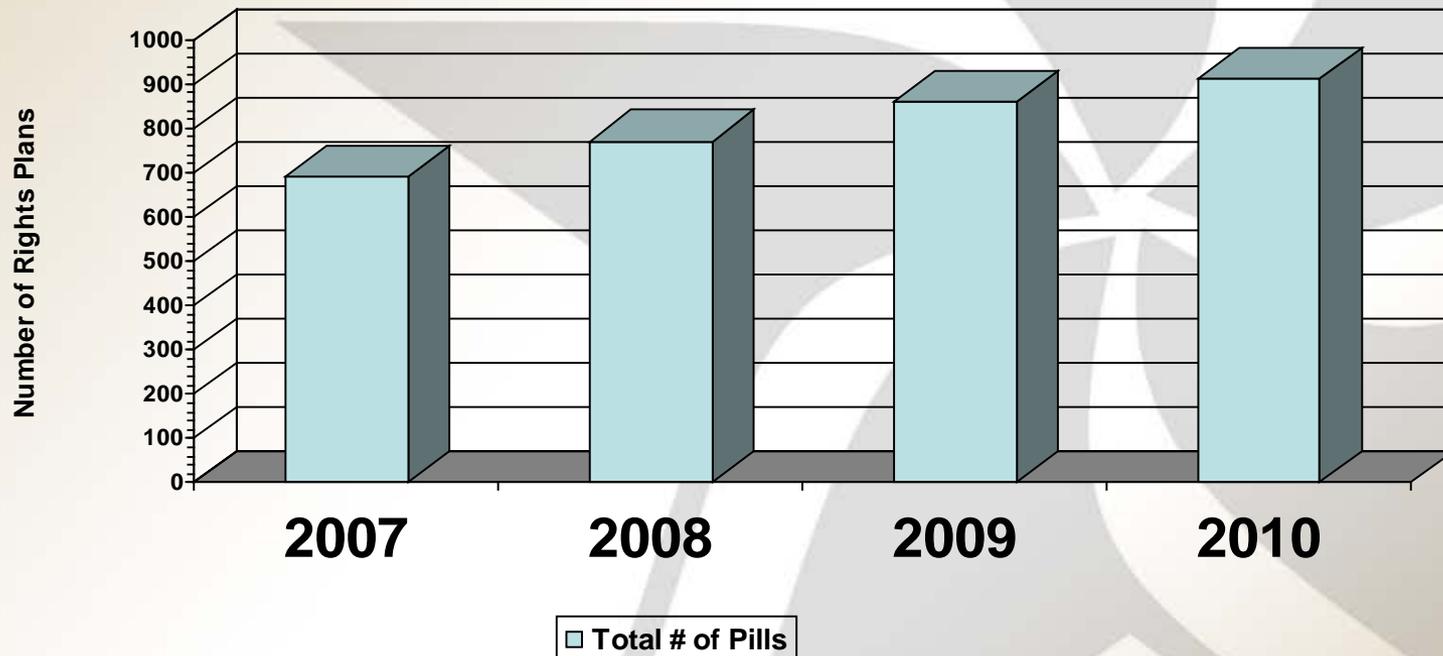
- What is a Rights Plan and What is its Purpose?
- Why the Recent Increase in Rights Plans?
- Advantages/Disadvantages
- NOL Rights Plans
- How It Works
- Other Pill Provisions
- Delaware Law

What is a Rights Plan and What is its Purpose?

- Rights Plans were created a little over two decades ago as a means to fend off hostile/abusive takeover attempts and today are an accepted part of the corporate landscape.
 - In *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985), the Delaware Supreme Court upheld the validity of Rights Plans.
 - Before the invention of the Rights Plan, the Board of a target company was largely defenseless against a hostile tender offer, even if it believed the offer was underpriced or coercive to stockholders.
- A Rights Plan is intended to act as a deterrent to any person or group of affiliated or associated persons becoming the beneficial owner of more than an established trigger amount without the prior approval of a company's Board.
 - The deterrent effect arises from the imposition of substantial economic and voting dilution upon any stockholder that accumulates shares exceeding the Rights Plan trigger amount.
 - This risk of dilution, combined with the authority of the Board to redeem Rights, gives potential acquirors a powerful incentive to negotiate with the Board rather than proceeding unilaterally.
- Generally, Rights Plans remain the single most effective device available to Boards of Directors and is one element of an overall strategy to maximize stockholder value.

Why the Recent Increase in Rights Plans?

Growing Number of Pill Prescriptions
as of October 31, 2010



Source: SharkRepellant.net



Why the Recent Increase in Rights Plans?

- Credit crunch and recession
- Low interest rate environment
- Substantial pool of un-invested capital
- Deterioration of equity values
 - Market-wide decline
 - Company-specific events due to impact of recession
- Reduced utility of “early warning” systems
 - HSR Act
 - Schedule 13D reporting
- Hostile activity
 - Traditional hostile takeover offers
 - Aggressive stockholder tactics, including synthetic equity positions
- Protection of NOLs

Advantages

- Flexibility & Time: Helps preserve the Board of Directors' flexibility, while simultaneously providing the necessary time to evaluate alternatives to maximize value for all stockholders
- Increased Likelihood of Full Price: Deters market accumulators seeking to acquire a position of substantial influence or control without paying to selling or remaining stockholders a full and fair price
- Reduced Risk of Coercion: Reduces the risk of coercive two-tiered, front-end loaded or partial offers which may not offer full and fair value to all stockholders
- Negotiation Encouraged: Encourages an otherwise hostile acquiror to negotiate with the company since the Rights would cause substantial dilution to the acquiror
- Self-dealing Restricted: Restricts self-dealing by a substantial stockholder

Disadvantages

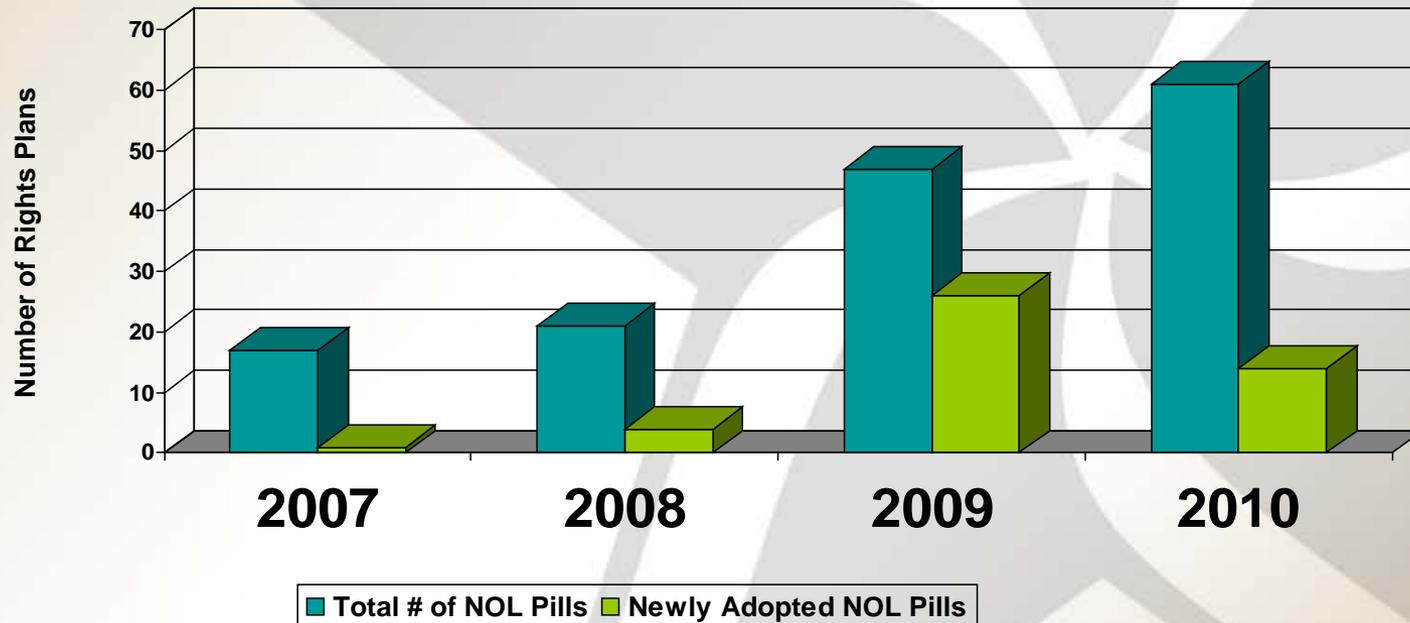
- RiskMetrics: RiskMetrics will generally recommend a withhold or against vote from all director nominees if the company has adopted or renewed a Rights Plan (non NOL protection) with a term longer than one year. However, RiskMetrics will generally support management proposals to adopt NOL Rights Plans as long as they are not intended primarily to serve as an anti-takeover device.
- Potential Stockholder Reaction: The adoption of a Rights Plan may be negatively viewed by certain institutional holders
 - Reaction likely to be more substantial and adverse when adopted in response to specific approach
 - Large institutional investors are typically opposed to Rights Plans, although they are increasingly taking a case-by-case approach
 - Institutional activism focus has shifted from Rights Plans to director-related issues (e.g., director pension and compensation plans, classified boards, etc.)

Disadvantages

- Potential Stockholder Resolutions to Rescind: Could invite stockholder resolutions for consideration at annual or special stockholder meetings to require redemption of Rights Plans
- Potential Deterrent: Possibility of deterring some acquisition proposals or tender offers that might otherwise be forthcoming
- Weakness: A target without a staggered Board cannot rely on an ordinary Rights Plan to give much protection in the face of combined tender offer/proxy fight.

NOL Rights Plans

Growing Number of NOL Pills
as of October 31, 2010



Source: SharkRepellant.net

Why Implement an NOL Rights Plan?

- Due to the recession, NOLs are becoming a valuable corporate asset
- Companies with NOLs can generally carry those losses forward up to 20 years to reduce taxable income
- Section 382 of the Internal Revenue Code restricts a company's ability to use its NOLs if the company undergoes an "ownership change," which occurs when "5% stockholders" increase their ownership of stock by more than 50 percentage points in a three-year period
- Consequently, companies have begun to adopt (or modify existing) Rights Plans that are triggered when a stockholder becomes a 5% stockholder to forestall possible changes in ownership
- NOL Rights Plans are intended to protect against a possible limitation on a company's ability to use its NOL carryforwards to reduce potential future federal income tax liabilities.
- Limitations of NOL Rights Plans
 - Only a deterrent to an ownership change, not an absolute bar
 - Does not prevent sales by existing 5% stockholders
- It is more effective to embed ownership limitations in the certificate of incorporation, but:
 - Stockholder approval is required
 - Enforceability against non-consenting stockholders is uncertain

NOL Rights Plans vs. Traditional Rights Plans

An NOL Rights Plan differs from a traditional Rights Plan in a number of important respects:

- An NOL Rights Plan is intended to protect a corporation's NOL asset, while the traditional Rights Plan is intended to deter abusive takeover tactics.
- An NOL Rights Plan has a lower 4.9% trigger threshold, as compared to the 10%-20% trigger threshold typical in a traditional Rights Plan.
- An NOL Rights Plan has additional "safety valves" to avoid an unnecessary trigger if there is no threat to the NOL asset.
- An NOL Rights Plan is not an adequate substitute for traditional takeover defenses. The Delaware courts may view skeptically any attempt to adopt or use an NOL Rights Plan for traditional defensive purposes, where no bona fide threat to a corporation's NOL asset exists.
- NOL Rights Plans do not have Flip-Over provisions as with traditional Rights Plans.

How It Works

- A Rights Plan entitles each holder of a Right to buy a specified dollar amount of the Company's shares – at a substantial discount to market – upon the occurrence of certain “triggering” events
 - Until the occurrence of a “triggering” event, Rights are not exercisable
- Upon the occurrence of a “triggering” event, all stockholders except the Acquiror may exercise their Rights to acquire shares of the Company – up to a specified dollar amount – at a price which is substantially “in-the-money”
 - Typical “triggering” event is acquisition of 10% - 20% of the Company's stock
 - “in-the-money” price is typically half of the then-market price of the Company's shares
- Acquirors will stop short of creating a “triggering” event, as the exercise of a Rights Plan would cause economic and voting dilution
- A Rights Plan is not intended to prevent a hostile takeover, and does not eliminate the obligation of the Board of Directors to adhere to its fiduciary duties
- No tax or accounting consequences

How It Works

Adoption	Initial Trigger	Effect of Initial Trigger	Flip-In Trigger	Flip-Over Trigger	Exchange Right	Redemption or Expiration of Rights
<p>Company's Board of Directors declares a dividend distribution of 1 Right for each outstanding share of common stock of the Company</p> <p>Rights are initially redeemable, trade with the Company's common stock and are not exercisable.</p> <p>Rights remain outstanding for the term, absent any earlier exercise, redemption or cancellation</p>	<p>Person or Group ("Acquiror") acquires or announces intention to commence tender offer for beneficial ownership of 4.9% or 10-20% of Company's common stock</p>	<p>Rights detach from the common stock, trade separately and become exercisable, entitling stockholders to purchase 1 share of the Company's common stock or a common stock equivalent.</p>	<p>Acquiror purchases 4.9% or 10%-20% of the total outstanding shares of the Company</p> <p>Each Right except those held by the Acquiror, "flips in" and becomes a right to buy common stock of the Company at 50% of the market value</p> <p>The Acquiror's voting power and investment in the Company are greatly diluted if the Rights are thus exercised</p>	<p>Upon a Flip-Over Event, Right holders other than the Acquiring Person may purchase common stock of the acquiring company at a 50% discount to the then market price.</p>	<p>In lieu of the Flip-in Right, Board of Directors has option to exchange 1 common share for each Right upon a Trigger Event</p>	<p>Rights are initially redeemable by the Company's Board for \$0.01 per Right.</p> <p>Immediately upon the public announcement that the Acquiror has triggered the Rights Plan, the Rights can no longer be redeemed.</p>

How It Works – Flip-In

- **Flip-in**

Each holder of a Right (other than any Acquiring Person and certain related parties, whose Right automatically become null and void) will have the right to receive, upon exercise, Common Stock having a then current value equal to two times the exercise price of the Right.

- Exercise Price should approximate value of the common stock at the end of the term—the higher the price the more the dilution.

- **Typical Rights Plan Flip-in Language**

“Subject to Section XX [EXCHANGE RIGHT], in the event any Person becomes an Acquiring Person, then each holder of a Right (except as provided below and in Section YY [ACQUIRING PERSON’S RIGHTS ARE NULL AND VOID]) shall thereafter have the right to receive, upon exercise thereof at a price equal to the then current Purchase Price in accordance with the terms of this Plan, such number of shares of Common Stock of the Company as shall equal the result obtained by (x) multiplying the then current Purchase Price by the then number of shares of Common Stock for which a Right was exercisable immediately prior to the first occurrence of a Triggering Event and (y) dividing that product (which, following such first occurrence shall thereafter be referred to as the “**Purchase Price**” for each Right and for all purposes of this Plan) by 50% of the then current market price (determined pursuant to Section ZZ) per share of Common Stock on the date of such first occurrence (such number of shares, the “**Adjustment Shares**”).”

How It Works – Flip-In

For example, at an exercise price of \$60,000 per Right, each Right not owned by an Acquiring Person (or by certain related parties) following a flip-in event would entitle its holder to purchase \$120,000 worth of Common Stock (or other consideration, as noted above) at the then current fair market value for \$60,000. Assuming that the Common Stock had a per share value of \$20,000 at that time, the holder of each valid Right would be entitled to purchase 6 shares of Common Stock for \$60,000 (or \$10,000 per share).

$$\begin{array}{l} \# \text{ shares} \\ \text{Purchasable} \\ \text{per Right} \end{array} = \frac{\text{Purchase Price} \times 1}{50\% \times \text{current market price per share}}$$

$$\text{Value Purchasable} = 2 \times \text{Purchase Price}$$

$$= (\$60,000 \times 1) / (50\% \times \$20,000) = \$60,000 / \$10,000 = 6;$$

so 6 x \$20,000 per share = each holder of a Right can buy
\$120,000 worth of stock

How it Works – Sample Dilution Calculation Upon Trigger

Hypothetical Economic and Voting Dilution Calculation

Authorized	1,000,000
Outstanding shares pre trigger	10,000
Assumed trigger percentage	15%
Assumed current value per share	\$20,000.00
Exercise Price per share	\$60,000.00

Shares held by Acquiring Person upon Trigger	1,500
Shares held by others	8,500

Flip-In Trigger Calculations

# of Shares Holders Entitled to Buy Upon Trigger	6.00
Company then must issue these shares	51,000
Post trigger o/s number	61,000

Voting power of Acquiring Person post trigger **2.5%**

Economic Dilution post trigger:

Pre-trigger capitalization	\$200,000,000.00
Trigger add cash to capitalization	\$510,000,000.00
Total Post-trigger capitalization	\$710,000,000.00

Post trigger value per share	\$11,639.34
Drop in value to Acquiring Person	\$8,360.66
Economic dilution to Acquiring Person	41.80%



Exchange Option Calculations

# of Shares Holder Entitle to Upon Exercise of Exchange Right	1.00
Company then must issue these shares	8,500
Post trigger o/s number	18,500

Voting power of Acquiring Person post trigger **8.1%**

Economic Dilution post trigger:

Pre-trigger capitalization	\$200,000,000.00
Trigger add cash to capitalization	\$0.00
Total Post-trigger capitalization	\$200,000,000.00

Post trigger value per share	\$10,810.81
Drop in value to Acquiring Person	\$9,189.19
Economic dilution to Acquiring Person	45.95%

How it Works – Flip Over

- Additionally, if at any time following the date on which a person becomes an Acquiring Person:
 - The corporation is acquired in a merger or other business combination transaction in which the corporation is not the surviving corporation;
 - The corporation is acquired in a merger or other business combination transaction in which it is the surviving entity and all or part of its common stock is converted into securities of another entity, cash or other property; or
 - 50% or more of the corporation’s assets, cash flow or earning power is sold or transferred,
- then each holder of a Right will have the right to receive, upon exercise, common stock of the acquiring company having a value equal to two times the exercise price of the Right. This is known as a “flip-over” event.

How it Works – Exchange Feature vs. Traditional Flip-In

Exchange Right—At any time after there is an Acquiring Person, the Board may exchange the Rights (other than Rights owned by the Acquiring Person which will have become void), in whole or in part, for Common Stock at an exchange ratio of 1 to 1.

- *Dilution is Certain and Automatic with the Exchange Feature.* The exchange provision is effective immediately, requires no action by stockholders and eliminates any overhang issues.
- *No Cash Required for Exercise with the Exchange Feature.* To exercise following a traditional flip-in, the holder must deliver the exercise price in cash, making a decision to invest additional capital in the corporation. As a result, exercise is not certain.
- *Exchange Feature May Have Less Impact on the NOL Asset.* Unexercised Rights may not be deemed to create beneficial ownership of the underlying common stock for tax law purposes. As a result, exercises of the Rights after the traditional flip-in could change the stockholders' relative ownership percentages in the corporation, which could impact the ownership change calculation and itself threaten the value of the corporation's NOL asset.
- *Exchange Feature Results in Less Dilution.* Unless a Rights Plan's exercise price is very low in relation to the underlying stock's trading value, a one-for-one exchange is likely to be less dilutive than the traditional flip-in. (See sample dilution calculation)

Other Pill Provisions – Alternative Responses to Stockholder Opposition

The following variants to the standard Rights Plan can act to alleviate some stockholder concerns. Companies should work with their institutional stockholders and groups such as RiskMetrics to determine which provisions would gain support.

- Chewable Pill/Qualified Offer Provision
 - A company could implement a qualified offer provision—a so-called “chewable pill.” Chewable pills provide that an acquiror making certain types of offers, such as an all cash offer (or possibly as little as 80 percent cash), to acquire at least a certain percentage of the company’s shares at a specified premium over the market price can require the Board to hold a special stockholders meeting to consider the offer. If the stockholders request the Board to consider the offer, the Rights are automatically redeemed to allow the acquiror to proceed with the tender offer.
- Permitted Offer Exception
 - A company could implement a “permitted bid” feature which carves out certain types of transactions from the standard chewable pill’s limitations on which potential acquirors can force a stockholder redemption referendum.

Other Pill Provisions – Alternative Responses to Stockholder Opposition

- Term
 - Typically, Rights Plans have a term of 10 years, but some Rights Plans have terms as short as three to five years.
 - The Purchase Price is typically set to reflect the Board’s judgment, based upon the advice of management and financial advisers, as to the projected market price of the company’s shares at the end of the Rights Plan’s term
 - A Rights Plan with a large spread between the exercise price of the Rights and the market price provides a greater deterrent than one with a smaller spread.
 - Shortening the term of the Rights Plan tends to decrease the difference between the market price of the company’s shares and a reasonable determination of the exercise price of the Rights, which results in less potential dilution and less deterrence to a hostile bidder.
 - The amendment provision of most Rights Plans allows a company and its Board of Directors to unilaterally amend the Rights Plan including adjusting the exercise price of the Rights. As a result, implementing more frequent reviews of the exercise price of the Rights Plan’s Rights, such as through the implementation of a TIDE feature, can help address some of the concerns raised by shortening the term of a Rights Plan.

Other Pill Provisions – Alternative Responses to Stockholder Opposition

- Stockholder Approval
 - A company could agree to put its Rights Plan up for binding stockholder approval.
 - Given the risk of stockholder rejection, attention should be paid to (1) the particular provisions of the Rights Plan if stockholder approval is to be sought and (2) the other anti-takeover protections which may be available to the company.
- Sunset Provision
 - Shareholders are permitted to reaffirm or redeem the Rights Plan within one year of adoption
- TIDE Provision
 - A company could implement a Three-Year Independent Director Evaluation (TIDE) feature. This feature creates a corporate governance committee consisting of independent members of the Board who will review and evaluate the Rights Plan at least every three years to determine whether the Rights Plan continues to be in the interests of the company, its stockholders and other stakeholders.

Other Pill Provisions – Alternative Responses to Stockholder Opposition

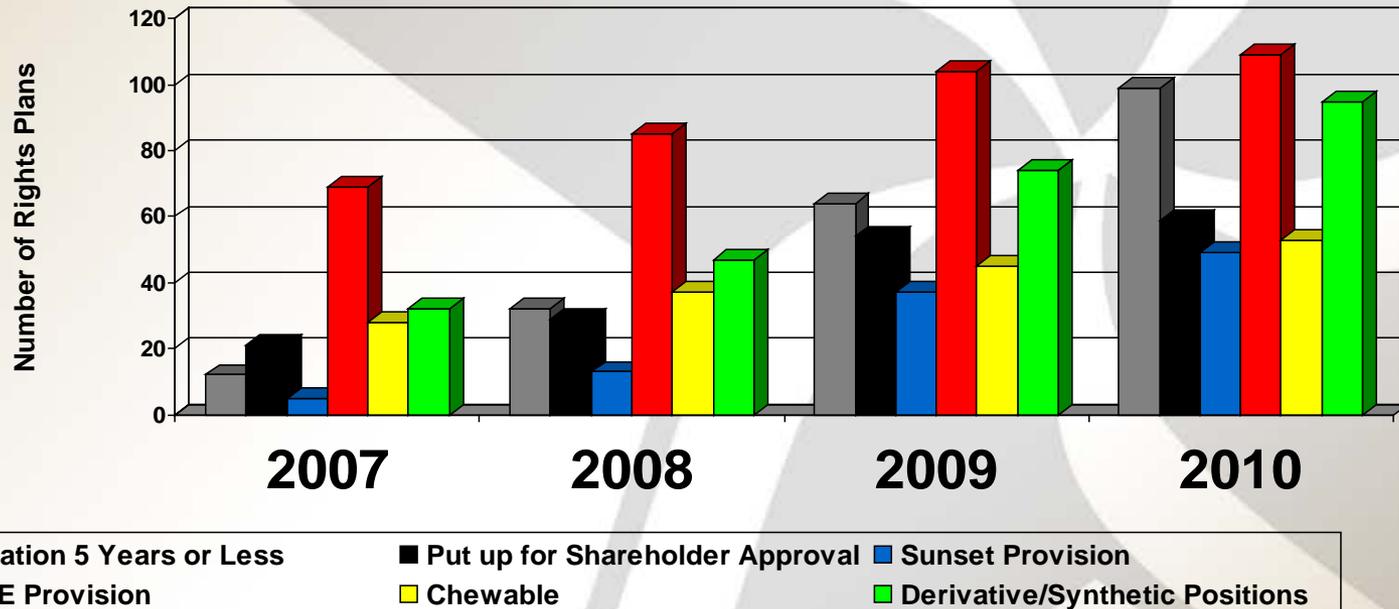
- Double Trigger
 - Stockholder Rights Plans typically have a flip-in trigger level of 10% - 20% with a great majority of Rights Plans today having a 15% trigger. If the trigger level is set too high, the deterrent effect against significant stock accumulations is decreased.
 - One variant is having two trigger levels.
 - The first trigger level, such as 10%, if exceeded would not activate the Rights Plan if, within a specified period of time prior to such stock accumulation, the acquiror discloses to the company its future Rights Plans and agrees that, for a specified period of time, such as two to four years, it will not (1) exceed a specified level of ownership, such as 20%, without Board approval, (2) deviate from its disclosed plans with respect to the company, (3) attempt a merger without Board approval, or (4) attempt to elect any or more than one director.
 - The second trigger level, the standard flip-in trigger, could be set at some level between 15% - 25%.

Other Pill Provisions – Alternative Responses to Stockholder Opposition

- Dead Hand Provision
 - Dead hand provisions permit only directors who were in place prior to a proxy fight or consent solicitation to redeem the Rights Plan. Courts have made clear that dead hand provisions are invalid.
- Equity Derivative Positions Trigger
 - Some companies have responded to the increasing use by activist investors of synthetic equity or equity derivative positions by amending their Rights Plan to address derivative positions in the calculation of beneficial ownership and resulting Rights Plan trigger.

Other Pill Provisions

Other Pill Provisions on the Rise
as of October 31, 2010



Source: SharkRepellant.net

Other Pill Provisions – Alternative Responses to Stockholder Opposition

Beyond adopting or renewing a Rights Plan with the alternative provisions discussed above, other alternative responses to stockholder opposition include the following:

- Adopt a Board Policy on Rights Plans
 - Policy that Board will (subject to an appropriate fiduciary out) seek stockholder approval prior to adopting a Rights Plan.
 - If a Rights Plan is adopted without stockholder approval, the Board will either eliminate the Rights Plan or submit it to the stockholders for ratification within a certain period of time such as one year.
- Put a Rights Plan “on-the-shelf”

Delaware Law

It is a settled principle of Delaware law that a Rights Plan, if drafted correctly, is valid. There is not a single state that does not permit their adoption. Only in extreme cases will a court invalidate the traditional flip-in/flip-over structure employed by a Rights Plan.

- At least one Court has suggested that a Board may even have an affirmative duty to adopt a Rights Plan where failure to do so would subject the corporation to an unfair transaction.

Typically, establishing that a Rights Plan is valid at the time of its adoption is no longer a major hurdle.

- The litigation concerning Rights Plans now focuses on whether or not a Board should be required to redeem the Rights in response to a particular bid.

Delaware Law

Unocal Corp. v. Mesa Petroleum Co. (1985)

- Because the adoption of a Rights Plan is likely to deter certain acquisitions, and can have the effect of entrenching directors and management, such Rights Plans are often subject to judicial scrutiny. Court will apply enhanced scrutiny even if there is no conflict of interest.
- The *Unocal* Court applied enhanced scrutiny and held that the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation) and (ii) the responsive action taken was “reasonable in relation to the threat posed” (established by showing that the response to the threat was not “coercive” or “preclusive” and then by demonstrating that the response was within a “range of reasonable responses” to the threat perceived).

Louisiana Municipal Employees' Retirement System v. Fertitta (July 2009)

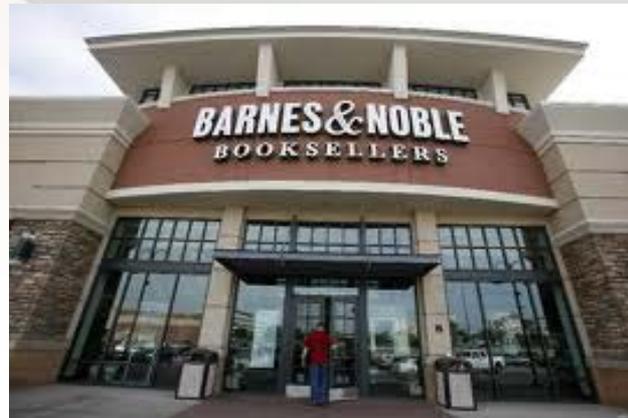
- This case involved an attempt by the CEO and 39% stockholder to acquire Landry's Restaurants. The Chancery Court commented in denying a motion to dismiss that given “the board's failure to employ a poison pill to prevent [the CEO and 39% stockholder] from obtaining control without paying a control premium, it is reasonable to infer fiduciary misconduct more serious than a breach of the duty of care.”

Delaware Law



Twenty-five years after *Household*, Rights Plans are common place and an accepted part of the corporate landscape.

These cases demonstrate the continued vitality of the pill as a defense against threats to corporate policy and effectiveness.



 SELECTICA


versata

Delaware Law



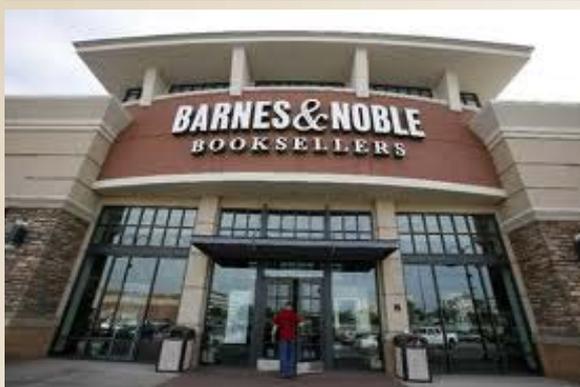
eBay Domestic Holdings, Inc. v. Craig Newmark, James Buckmaster and craigslist, Inc. (September 2010)

The Court struck down a Rights Plan that was:

- (a) designed solely to protect against a future threat to the company's corporate culture;
- (b) adopted in the context of several other protective (and potentially self-dealing transactions); and
- (c) essentially a retaliatory measure triggered by the targeted stockholder's choice to compete with the company in certain markets.

By contrast, a typical Rights Plan is considered in response to an immediate threat to actual stockholder value, rather than a distant threat against an amorphous concept of "corporate culture."

Delaware Law



Yucaipa American Alliance Fund II, L.P. v. Riggio et al. (August 2010)

In *Yucaipa*, the plaintiff alleged that the Board of Barnes & Noble, Inc. breached its fiduciary duties by adopting a Rights Plan that would be triggered if a stockholder became the beneficial owner of more than 20% of Barnes & Noble's voting stock. The Rights Plan—which included a definition of “beneficial owner” that effectively restricted two or more stockholders from joining together to control the company, but did not preclude a proxy contest—was adopted in response to the plaintiff's acquisition of an 18% stake in Barnes & Noble, which the Board felt threatened the possibility that stockholders' would have to “relinquish control through a creeping acquisition without the benefit of receiving a control premium.”

The Court questioned whether a Rights Plan should remain in place when a competitor “(1) won a proxy consent for a third of the seats of a classified board; (2) is not able to proceed with its tender offer for another year because the incumbent board majority will not redeem the Rights as to the offer; and (3) is required to take all the various economic risks that would come with maintaining the bid for another year.”

Delaware Law

The logo for Selectica, featuring a stylized circular icon to the left of the word "SELECTICA" in a bold, sans-serif font.The logo for Versata, featuring a large stylized "V" above the word "versata" in a lowercase, sans-serif font. A small graphic element resembling a person or a flame is positioned to the right of the "a".

Versata Enterprises, Inc. and Trilogy v. Selectica, Inc., et al. (October 2010)

The Delaware Supreme Court affirmed the Court of Chancery's decision in and, applying the *Unocal* two-part test, upheld (1) a Rights Plan with a 4.99% threshold adopted in an effort to prevent the loss of the company's NOLs which could result from changes in stock ownership, (2) the implementation of the exchange feature upon an acquiring person purchasing shares beyond the 4.99% threshold of the Rights Plan, and (3) the reloading of the Rights Plan.

The case was appealed by Versata and its parent, Trilogy to the Delaware Supreme Court on two issues: (i) whether the proper standard was applied to the Court of Chancery's review of the adoption of a NOL Rights Plan with a 4.99% trigger; and (ii) whether Selectica's NOL Rights Plan and its reloaded Rights Plan had a preclusive effect on its stockholders' ability to pursue a successful proxy contest for control of Selectica's Board of Directors.

Directors have broad latitude to draw reasonable conclusions about the value of a company's NOLs, the severity of the threat posed by a particular stockholder, and the appropriate defensive response under the circumstances.

- First judicial examination of an NOL Rights Plan
- First triggering of a Rights Plan
- "Common feature of the corporate landscape"
- "Legitimacy of the poison pill is settled law"
- Deference given to director's reasonable conclusions about the value of a company's NOLs. Directors may properly conclude that NOLs are worth protecting.
- The lowering of a Rights Plan's triggering threshold to 4.9% in response to an accumulation of shares is permissible under *Unocal* (adopting, amending, renewing and reloading are all supportable)

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