KIRKLAND M&A UPDATE

March 22, 2010

Poison Pill Plumbing

With the recent uptick in implementation of poison pills, boards and their advisors should pay close attention to the details and mechanics of the pill that may prove decisive in whether the outcome will match the board's expectations.

Shareholder rights plans, or "poison pills," are back in focus following the recent Delaware decision in the *Selectica* case that generally validated the use of a so-called "NOL pill" even as it applied in a takeover context. After a prolonged decline following pressure from the governance community, there is a noticeable uptick in the implementation of pills. This reflects both the increasing prevalence of NOL pills (with a 5% trigger) designed to protect tax attributes that may be limited if there are certain ownership changes and the increased sensitivity of boards to exposure to opportunistic unsolicited offers in light of depressed valuations and vulnerability resulting from the dismantling of anti-takeover protections over the past decade. As such, many boards may be in the process of considering the adoption, renewal or amendment of an anti-takeover or NOL pill or, in many cases, at least putting such a pill "on the shelf" for future use. While much has been written about the doctrinal and academic arguments for and against rights plans, we suggest that boards and their advisors should not gloss over the details and mechanics of the pill, many of which will be decisive in whether the outcome will match the board's expectations. Below we discuss a few such "technical" issues that have recently garnered attention.

Derivatives, etc. Poison pills are triggered when a person acquires "beneficial ownership" of a fixed percentage of the target company's shares, typically 5% for NOL pills and 10% to 20% in anti-takeover pills. Following the widely-reported use by hedge funds in the CNET and CSX situations of cash-settled derivatives to take significant stakes in companies without having actual ownership of the underlying shares, many pills sought to expand the definition of "beneficial ownership" to capture cash-settled and other similar derivative positions. While such a broadening of the definitions may prove effective against this threat because of the fear factor it creates, it is also clear that such definitions present real obstacles and complications in practice, including the risk of legal challenge for being too vague (see the *Atmel* litigation that was ultimately settled) and the general inability of companies to monitor many such derivative positions. Similar difficulties apply to attempts to cast a wider net in rights plans by broadening such concepts as "acting in concert" to arguably capture certain hedge fund "wolfpack" activity and thereby snaring the aggregate beneficial ownership of those parties when determining whether the pill has been triggered; such language may also be effective in creating uncertainty among potential collaborating parties, but again is difficult to monitor and subject to challenge as potentially fatally vague.

Dilution Math. The premise of a poison pill's deterrent effect is the intolerable dilution and economic loss that the pill is meant to inflict on an acquiring person who triggers the pill. In a typical "flip in," the dilution results from the target's issuance, at a 50% discount to the current market price, of new shares to all stockholders other than the triggering party upon payment of a fixed exercise price. Traditionally, the exercise price is determined at the date the rights plan is implemented and is intended to represent the estimated share price at the end of the life of the plan (usually 3x to 5x times the price at adoption in a ten-year pill). The magnitude of the "flip in" dilution upon a triggering will be based on how many half-price shares can be acquired at that time upon payment of the exercise price. If the market price has moved significantly since the date of adoption, the dilutive effect may be exaggerated or undermined. This is particularly true if the exercise price is set during a period of lower stock prices, as the potency of the "flip in" dilution will be reduced following subsequent material price increases. Moreover, many rights plans contain an alternative dilution mechanism through an exchange feature that permits the board, in lieu of a "flip in," to exchange the rights held by all shareholders other than the triggering person for new shares of the target (almost universally on a one-for-one basis) in a cashless exercise. Despite the fact that such an exchange will generate substantially less dilution than a "flip in," it is quite likely that a board facing a triggered pill will select the exchange option as was the case with Selectica. The exchange obviates the necessity of shareholder action and avoids the need for shareholders to come up with the exercise

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price, which could be substantial. While the mere threat of a more dilutive "flip in" presumably continues to have prevention value, given the reality that an exchange is the more likely outcome boards should at least consider whether the 1:1 exchange ratio will be sufficient to generate the desired dilutive effect.

Insurmountable Obstacle? Historically, it was assumed that a rights plan offered an almost impregnable defense because of the massive dilution an acquiring person would suffer if the pill was triggered, thereby forcing a hostile suitor to either negotiate with the board or undertake costly and time-consuming proxy contests (which could be multi-year with a staggered board). However, as evidenced in the Selectica situation, a poison pill may create a false sense of comfort in the face of a persistent suitor, especially one with significant resources and size relative to the target. This is particularly true given the sobering realities of the dilution math described above. An acquirer could make a strategic decision to intentionally trigger a pill, taking a temporary economic and dilution hit, but thereby gaining access to shareholders to make a direct offer—such a strategy could be more attractive economically to the suitor than significantly raising its bid to win over an intransigent board of the target. It bears mentioning that dilutive impact of pills upon an intentional triggering may be especially tolerable to an acquirer where the pill has a low trigger threshold (e.g., 5% in an NOL pill) and therefore the triggering stake subject to dilution is relatively small.

Board Discretion After Trigger. Some pills include a post-trigger period of time (usually the 10 days following the trigger date) during which the board of the target can decide if the pill should be amended or redeemed. This period during which the board is expected to exercise discretion before the dilution kicks in may put the board in a thorny predicament if a critical mass of stockholders, especially arbitrageurs, favor a premium takeover. The possibility that the board's hand may be forced could create another incentive for a hostile suitor to intentionally trigger the pill. While the board flexibility inherent in allowing for this discretionary period is appealing, due consideration should be given to whether the deterrent value of the pill may be enhanced by providing for "self-execution" of the dilution mechanisms upon a triggering event without further Board action or discretion.

Do the Mechanics Work? While the fifty or so pages of a rights plan are dense and appear to address even the smallest details, the actual implementation of the dilutive "flip in" or "exchange" under a modern pill had never been tested as no such pill had ever been triggered. The triggering of the Selectica pill using the exchange mechanism exposed certain challenges of implementing the pill's dilution mechanics. In fact, the trading of Selectica's shares on Nasdaq was halted for a month as the company and the rights agent struggled to resolve the practical implementation of the exchange, including ensuring that the correct shareholders (i.e., not the triggering party) receive exchange shares (not such a simple matter in a market environment where most shares are held in "street name"). In light of these difficulties, some recent poison pills (e.g., Ford's recent NOL pill) allow for the issuance of the exchange shares to a trust for the benefit of the entitled shareholders for subsequent distribution to such shareholders when the practical issues are resolved. This untested work-around only serves to highlight the practical difficulties associated with the implementation of a triggered pill, which we expect would be even more complicated in the event of a "flip in."

Pills for Dual Class Companies. Historically, companies with dual-class capitalization structures (i.e., high vote/low vote stock) have not needed poison pills as their voting structure offered sufficient protection against a hostile suitor. With the rising importance of protecting NOLs, such companies may, like Ford, for the first time need to consider enacting an NOL pill. In such cases, parties should be cognizant that the structure of the "flip in" or exchange mechanism (e.g., if all stockholders receive only low vote stock) may result in dilution to the super-voting power previously enjoyed by the high vote stock.

RiskMetrics. The governance community, most particularly the shareholder advisory services led by RiskMetrics (formerly ISS), has spread its influence into the area of rights plans. It is clear from the design of some recent pills that boards are often sensitive to the views of these constituencies. The voting policies of RiskMetrics (whether on the pill itself or in respect of the election of directors who adopt a pill) have led some boards to include higher trigger thresholds, "sunset" provisions (whereby the pill expires after a few years or the exhaustion of the NOLs, rather than the traditional ten-year duration) and shareholder ratification requirements for continuation. While the potential (and often knee-jerk) reaction of the governance community to a rights plan is a legitimate consideration, boards must remember that, especially when fac-

ing an imminent threat (whether of the takeover or loss of NOL variety), their primary obligation is to make an informed decision as to what is in the best interests of the company and its stockholders under the particular facts and circumstances facing them at the relevant time regardless of whether such outcome is in full conformity with a generic checklist issued by RiskMetrics or other governance advocate.

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The foregoing is obviously an overly-simplified presentation of very complex issues. However, we expect that rights plans will remain on the agenda for the foreseeable future given the recent increase in hostile M&A activity, perceived takeover vulnerability due to lower market valuations and the dismantling of other anti-takeover protections, and the value (and vulnerability) of NOLs resulting from the recent downturn. Boards and advisors would be well-advised to not lose sight of some of the "trees" described above while they focus on the more lofty "forest" of the wisdom and risks of adopting a poison pill.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland author or your regular Kirkland contact.

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