POISON PILLS IN RESPONSE TO THE COVID-19 PANDEMIC

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In light of the precipitous decline in the stock market since the beginning of the coronavirus (COVID-19) pandemic, public companies should consider whether their existing corporate governance structures enable them to protect long-term shareholder interests from potential hostile acquirers. One of the strongest protections against unwanted hostile aggression is the shareholder rights plan, or so-called "poison pill."

Stock Market Decline/Be Prepared – During the current crisis, boards and management teams should be monitoring the company's shareholder base, along with trading activity in its stock, with a view toward recognizing unusual trading activity early and being in a position to react quickly. A comprehensive review of current defenses will help a board to determine whether it is prepared to react quickly, and whether it may be appropriate at this time to adopt a poison pill, or prepare an "on-the-shelf" one that the board can adopt quickly in response to stock accumulations or coercive tactics.

How Poison Pills Work – Poison pills protect against unwanted hostile aggression by deterring stock accumulations not authorized by the company. Once a company implements a poison pill, the effects of the pill are triggered if a party acquires more than a specified percentage of the company's outstanding stock, usually in the range of 10% to 20%. Triggering the poison pill would have the effect of massively diluting a hostile acquirer's equity stake in the company by allowing all other shareholders to exercise "rights" (comparable to stock options) to purchase additional shares of the company at a steep discount. As a result, poison pills deter would-be acquirers from bypassing the company's board of directors when attempting to gain control of the business. Historically, the severity of the consequences to an acquirer of triggering a poison pill have been sufficient to deter persons from acquiring shares above the ownership percentage threshold.

NOL Poison Pills – Since the 2008-2009 recession, companies have also begun to use poison pills to protect the future use of their net operating losses ("NOLs"). Under the Internal Revenue Code, changes in share ownership percentages can limit a company's ability to use NOLs in the future, so these poison pills are designed to restrict the relevant ownership changes (using ownership triggers just below 5%). While the purpose of these poison pills is different from the typical shareholder rights plan, the mechanics are largely the same (except for the lower ownership percentage trigger).

Negative Reaction of Proxy Advisory Firms – The main advantage of a poison pill is that it can be implemented without shareholder approval, unlike many other takeover defenses. However, proxy advisory firms, such as Institutional Shareholder Services ("ISS"), do not favor the adoption of poison pills without shareholder approval. In general, ISS will recommend voting against each director nominee of a company that maintains a poison pill with a term longer than one year without obtaining shareholder approval. If a board adopts a poison pill with a term of less than one year without shareholder approval, ISS will recommend voting against directors on a case-by-case basis, expecting poison pills to be adopted only in response to specific threats, and that they contain certain shareholder friendly features (*e.g.*, no limits on the board's ability to redeem a poison pill, a 20% ownership trigger, a term of one year or less (with longer terms, only if approved by shareholders) and the ability of a certain percentage of shareholders to terminate the poison pill in the face of certain qualifying offers).

<u>"On-the-Shelf" Strategy</u> – Because of the views of ISS and other proxy advisory firms, many companies have used an "on-the-shelf" strategy for a poison pill. This involves preparing the documentation and taking various other steps to prepare to launch the poison pill, but not actually launching it until a threat arises (*e.g.*, an accumulation of the company's stock or an unsolicited acquisition offer).

An "on-the-shelf" pill, however, does have an important disadvantage. In some instances, activist investors have been able to amass a significant stake in a company before the company could put a poison pill in place (even if one is "on-the-shelf"). Williams Act (Schedule 13D) and Hart-Scott-Rodino ("HSR") filings get triggered eventually, but the ten-day window before a Schedule 13D filing is due allows plenty of time for the acquisition of additional shares (in addition to informal collaborations which are often structured to avoid Schedule 13D filings), and the substantive limitations on the acquisition of shares under the HSR Act are not applicable in all situations, may be structured around and, even if applicable, currently permit acquisitions up to $94 million (which could represent a large percentage of a small cap company's overall market capitalization in a down market).

<u>Messaging</u> – During the current COVID-19 crisis, adoption of a poison pill can send a positive signal to the market (stock is undervalued and board is protecting interests of all shareholders). On the other hand, poison pills have historically been viewed by activists as devices used by boards looking to entrench themselves. Therefore, it is incumbent on boards to consider poison pills along with other existing takeover defenses (*e.g.*, Section 203 of the Delaware General Corporation Law and charter and bylaw provisions requiring super majority voting or classified board structures) and, if a poison pill is adopted, to consider a proactive communication plan with large shareholders and full disclosure regarding the reasons for (and terms of) the pill.

<u>Takeaways</u>

- Public companies should pay close attention to the composition of their shareholder base and trading activity and ensure that the board is ready and equipped to act;
- Companies with existing NOLs should consider the need for a poison pill to protect their future use;
- Public companies should consider whether to adopt a poison pill (or prepare one to be placed "on-the-shelf"), depending on stock price and trading activity;
- If a poison pill is adopted (or put "on-the-shelf"), consider tailoring terms for the current circumstances:
    - lower ownership trigger to avoid large percentage acquisitions for lower dollar amounts that are not reflective of the company's long-term value; or
    - shorter duration; and
- If adopting a poison pill, consider a proactive communication plan and full disclosure.

If you have any questions related to this alert, please do not hesitate to contact your regular Smith Anderson lawyer or any other member of our firm. Additionally, please visit and bookmark our firm's **Coronavirus (COVID-19) Business Resource Center**, which is continuously updated with useful materials, and resources related to COVID-19. This tool has been made available to ensure that our clients and the broader business community stay informed on key issues that may impact their operations and to navigate the related business and legal issues during these challenging times.

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