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The Best Offense is a Good Defense – Considering a Rights Plan in Light of COVID-19

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Boards of directors of public companies have a lot on their minds today as they navigate the unprecedented circumstances resulting from the novel coronavirus ("COVID-19") pandemic—from precipitous drops in revenues as businesses are shuttered, to supply chain disruption, to difficulties in making debt payments, to labor challenges, among many others. On top of this, many companies have experienced significant declines in their market value since March 2020, and certain sectors, including airline, travel, hospitality, entertainment and energy, have been especially vulnerable to the recent downturn. During this time, boards of directors should consider the risk that opportunistic activist-investors and potential bidders, including hostile bidders, may be circling the waters as they consider acquiring a company, or a significant stake therein, at current market prices that may represent a fraction of what the company's market value was just a few months ago.

It is also worth noting that the enhanced risk of potential takeovers is not limited to the near future; the threat can linger in the wake of significant economic downturns. For example, the years following the 2008 global financial crisis witnessed significant activist activity, with 2009 representing a record year for proxy contests in the U.S. In the current economic landscape, we expect that many well-capitalized activists may seek to accumulate large positions of target company securities, relying on volatile prices and management distraction.

In light of the potentially enhanced risk of a hostile takeover or the emergence of a stockholder insurgent during these uncertain times, we are encouraging our clients to evaluate whether their existing slate of takeover defenses is sufficient. In particular, one of the key lines of defense to deter an unwanted acquisition of a large block of securities is the adoption of a stockholder rights plan, more commonly referred to as a "poison pill." One of the primary advantages of a rights plan is that, unlike many antitakeover provisions that typically require a stockholder-approved charter amendment to implement, a board of directors may adopt a stockholder rights plan without stockholder approval.

Recent Trends in Rights Plans

Since March 1, 2020, approximately 47 public companies have announced the adoption of a rights plan. Some of these rights plans have been adopted to protect net operating losses, but most have been traditional rights plans. In addition, several companies have recently adopted a rights plan in response to activism or a specific threat. For example, stock acquisitions by activist investors such as Carl Icahn, Kohlberg Kravis Roberts (KKR), Starboard, Outerbridge Capital, Bernhard Capital and Scion Asset Management preceded and prompted the adoption of rights plans by Delek US Holdings, Inc. (Icahn), Tenneco Inc. (Icahn), Dave & Buster's Entertainment, Inc. (KKR), Commvault Systems, Inc. (Starboard), Barnes & Noble Education (Outerbridge Capital), Fluor Corporation (Bernhard Capital) and Tailored Brands, Inc. (Scion Asset Management). In addition, HP Inc. adopted a rights plan following a hostile offer to acquire the company made by Xerox Holdings Corporation.

Below is an overview of the common terms included in rights plans adopted in March 2020[1]:

- a term of one year or less for traditional rights plans (100% of the recent traditional rights plans) and a term of approximately three years for NOL rights plans;
- a trigger threshold of between 5% to 15%, many with a two-tier trigger with one level for passive institutional investors filing a Schedule 13G and a separate trigger for other investors (approximately 48% of the recent rights plans have a two-tiered trigger);
- a definition of beneficial ownership that includes derivatives (approximately 90% of the recent rights plans); and
- "acting in concert" language to account for activists working together informally (approximately 38% of the recent traditional rights plans).

Although we have observed that some plans have been adopted with low trigger thresholds, including the rights plan adopted by The Williams Companies, Inc. (the "Williams Cos.") in March 2020 that featured a 5% trigger threshold, these low trigger thresholds can lead to unintended consequences. In the case of the Williams Cos., Institutional Shareholder Services, Inc. ("ISS") subsequently recommended voting against the company's Chairman principally due to the 5% trigger threshold included in the rights plan. From a practical standpoint, there was little risk the Chairman would not be reelected because he was running unopposed, but the company was the subject of a number of media articles once the recommendation was released by ISS.

Brief Background to Rights Plans

Stockholder rights plans first became popular in the 1980s as a method to protect a company's stockholders from certain coercive takeover tactics and to ensure that the stockholders receive a fair and adequate price if the company is sold. Coercive takeover tactics may include: (i) partial or two-tiered tender offers, in which the acquirer acquires a majority of shares, and either offers the remaining holders a lower price or leaves the remaining as minority holders and (ii) rapid accumulations of a large percentage of stock by one or more hedge funds or activist investors acting as a "wolf pack" who may propose transactions aimed at realizing a short-term profit at the expense of creating long-term value.

A stockholder rights plan deters such takeover tactics through the risk of substantial dilution if a person acquires more than a specified percentage of the voting securities of the target without prior board approval. For example, assume there are approximately 50 million shares outstanding, a market price of $20.00 and an exercise price of $80.00, a raider could be diluted from 15% to approximately 2% with the triggering of the rights plan.

- In this example, assume that the acquiring person owns 7.5 million shares (15%).

[1] Data provided by Deal Point Data, LLC, *Observations on Recent Poison Pill Activity*, Deal Point Data (April 1, 2020), https://www.dealpointdata.com/res/dpd_pill_activit y_4_1_2020.pdf).

- When the rights plan is triggered, with respect to each of the remaining 42.5 million shares outstanding, the holders (other than the acquiring person) would have the right to buy an additional 8 shares of common stock for an aggregate of $80.00, or $10.00 per share (50% discount).

- If all holders exercised their rights, 340 million shares would be issued, resulting in total outstanding shares of 390 million.

- The acquiring person would continue to own 7.5 million shares, but these shares would represent only 2% of the outstanding shares.

As a result of this dilution risk, would-be acquirers are encouraged to negotiate with the board, which provides the board leverage in the negotiation process and creates time for the board to consider other proposals and alternatives.

Though the Delaware courts have long held that rights plans are enforceable,[2] beginning in the early 1990s rights plans fell out of favor as proxy advisory firms, institutional investors, and activist investors harshly criticized rights plans as a board entrenchment device. As a result, over the last few decades, the number of public companies that have a rights plan in effect has fallen significantly. In 2001, more than 2,200 U.S. companies had a stockholder rights plan in effect as compared to less than 200 U.S. companies at the end of 2019.[3]

Influence of Proxy Advisory Firms

When considering whether to adopt a rights plan, a board should consider the voting guidelines and influence of proxy advisory firms such as ISS and Glass Lewis. ISS and Glass Lewis have historically opposed the adoption of rights plans and, in certain circumstances, will recommend votes against or recommend withholding votes with respect to the entire board of directors following the adoption of a rights plan. However, ISS and Glass Lewis have both issued updated guidance concerning rights plans in light of the COVID-19 outbreak.

In its updated guidance, ISS reiterated that its policy is to consider a rights plan on a case-by-case basis in light of the disclosed rationale for adopting the plan and other relevant factors. The guidance goes on to state that "a severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a pill of less than one year in duration. . . . The triggers for such plans will continue to be closely assessed within the context of the rationale provided and the length of the plan adopted, among other factors."

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[2] See, e.g., Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245, 248 (Del. 2001) (holding that "[i]t is settled Delaware law that a corporation chartered under the laws of this State may adopt shareholder rights plans"); Bebchuk v. CA Inc., 902 A.2d 737, 743 (Del. Ch. 2006) ("It is clearly established that Section 157 of the DGCL empowers boards of directors to adopt rights plans.").

[3] These amounts include, in each case, stockholder rights plans adopted to protect net operating losses.

Following the emergence of the COVID-19 crisis, Glass Lewis clarified that while it generally opposes the adoption of poison pills it is "supportive of poison pills that meet certain conditions, particularly those that are limited in scope to accomplish a particular objective. This objective may include the closing of an important merger, managing a clear and present hostile takeover threat or other contextual factors like a severe drop in stock price due to a widespread industry or market downturn." Glass Lewis also explained that if a board adopts a rights plan that has a duration of greater than one year or if the company does not disclose a sound rationale for the adoption of the rights plan, Glass Lewis will recommend opposing the re-election of all board members who served at the time of the adoption of the rights plan.

Putting a Rights Plan on the "Shelf"

As rights plans fell out of favor, many public companies began putting a rights plan "on the shelf," which means the board had reviewed the purposes and mechanics of rights plans generally and considered the value of a rights plan in the context of the company's other takeover defenses. However, because the company does not execute a rights plan when it puts one on the shelf, no public disclosure is required at that time. The primary advantages to having a rights plan on the shelf are (i) the time spent considering and discussing the benefits and mechanics of rights plans in advance of adopting one helps demonstrate that the directors acted on an informed basis and fulfilled their fiduciary duties if the board ultimately adopts a rights plan, (ii) the company can avoid stockholder criticism and negative voting recommendations from ISS and Glass Lewis, because no public disclosure is required, and (iii) if the company faces a hostile threat in the future, the board may adopt a rights plan very quickly, often in as little as 24 hours, because the board has already considered rights plans generally. However, the principle disadvantage of having a plan on the shelf is that by the time a company knows about a potential threat, the investor may have already accumulated a significant position in the company's common stock. In the midst of an economic downturn when stock prices are highly volatile, this threat may be intensified as an investor is able to capitalize on greater trading volumes.

Consider Practical Effect of HSR and 13D Thresholds

Certain federal laws effectively allow companies to receive notice of large stock acquisitions. However, when considering whether to adopt a rights plan, a company should consider whether these laws have practical utility in the company's specific facts and circumstances. For example, persons acquiring stock of a public company must notify the company if they propose to acquire common stock that exceeds the thresholds (with the lowest threshold being $94 million in 2020) under Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the "HSR Act"), unless an exemption applies. For smaller public companies or other companies that have experienced a significant drop in market price, this threshold may not trigger notice to the company until the person acquires a significant percentage of the common stock. In addition, a family of hedge funds may acquire common stock with an aggregate value well in excess of $94 million without triggering a filing under the HSR Act if the acquisitions are spread out among several hedge funds where each is its own "ultimate parent entity" for purposes of the HSR Act. Outside of notices required under the HSR Act, persons acquiring 5% or more of the common stock will be required to file a Schedule 13D with the SEC within 10 days after crossing a 5% ownership threshold. However, because a purchaser can continue buying stock during that 10-day window, it may acquire a substantial position in a target company's voting securities before the Schedule 13D is actually filed.

Key Takeaways

While the uncertain economic environment and downturn in stock prices should have boards considering whether adopting a rights plan is warranted, a rights plan may not be appropriate for every company. We expect that smaller companies in industries that have been disproportionately impacted by COVID-19 are the most likely targets for activists, who themselves may be unsure about putting up a substantial amount of their own capital, or who may struggle to obtain financing, for a substantial investment in a large-cap company.

If a board does decide to pursue the adoption of a stockholder rights plan, it should identify and articulate a clear rationale for adopting the plan and carefully consider the terms of the plan as well as the company's other existing takeover defenses to mitigate the adverse impact of ISS, Glass Lewis and institutional stockholder voting recommendations.

If a board determines not to adopt a rights plan today, the board may want to consider putting a plan on the "shelf," or, if the company has a rights plan on the shelf, the board may want to consider updating the draft rights plan to be ready to put it into place immediately and to incorporate some of the features of modern plans. In addition, having the proposed rights agent (typically the transfer agent) review a draft form of agreement is often helpful to ensure that the rights agent's comments are adequately addressed in the plan, and we are seeing that even rights agents may want a plan to include certain modern features, such as the inclusion of a force majeure provision that covers pandemics.

For additional information please contact any member of Haynes and Boone's Capital Markets and Securities Practice Group.