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To Let Expire or Not to Let Expire? Responding to an Expiring Rights Plan

Boards of directors are faced with a dilemma when addressing the expiration of a rights plan. Such plans are a valuable takeover defense, but shareholder activists uniformly oppose them. Keeping a plan "on-the-shelf" offers a viable option.

by Stephen I. Glover, Jennifer Boatwright, and Anthony Shoemaker

Shareholder rights plans have long been a "hot topic" in the area of corporate governance and will likely continue receiving attention in 2008. More rights plans were adopted or extended in 1998 than in any other year.[1] With a standard term of 10 years, this means that a record number of companies are now facing the impending expiration of their rights plan and must decide what action, if any, to take in response. At the same time, opposition from shareholder activists toward rights plans has perhaps never been more forceful.

This article examines the actions that a board of directors can take when it is faced with an expiring rights plan. It first describes the current rights plan landscape, which is important to know before assessing which potential response is the best alternative for a particular company. It then outlines the specific potential responses that a board can take to address an expiring rights plan and analyzes the benefits and risks of each potential response.

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The Current Rights Plan Landscape

Rights plans are widely acknowledged to be one of the most effective takeover defenses a public company can deploy. In fact, no US company has ever been acquired when the board of directors has opposed the transaction and kept a rights plan in place.[2] Rights plans are effective because they vest control of the acquisition process in the board of directors of the target company. As a practical matter, a potential acquirer has little choice but to negotiate directly with the board because triggering the rights plan would make an acquisition prohibitively expensive by significantly diluting the value and voting power of the acquirer's holdings. Should the board desire to pursue negotiations with the potential acquirer, it finds itself in a stronger position to dictate timing and terms, and perhaps even extract a higher takeover premium.

In addition to being an effective takeover defense, many studies have concluded that companies with a rights plan in place command higher takeover premiums and perhaps enjoy better overall firm performance. In 1997, proxy solicitation firm Georgeson Research studied 319 takeover transactions with a transaction size greater than $250 million completed between 1992 and 1996. Georgeson concluded that even after controlling for factors such as market capitalization and whether bids were hostile or friendly, companies with rights plans received takeover premiums that were on average 9 percent higher than takeover premiums received by companies without rights plans.[3] The study also found that the presence of a rights plan did not affect the likelihood of the eventual completion of an announced takeover bid. A similar study, published more recently, confirms that rights plans "are, on average, in the best interests of shareholders, since they prove effective as a tool for negotiating for more highly valued offers without entrenching incumbent management."[4] Even a study commissioned by Institutional Shareholder Services (ISS), one of the most vocal critics of shareholder rights plans, has found a positive correlation between strong takeover defenses such as rights plans and the company's financial performance, determining that "firms with poison pills have higher returns on equity, higher net profit margins, higher dividend yields, and more share repurchases."[5]

Companies Less Likely to Maintain a Rights Plan

Despite the data showing that shareholders benefit from rights plans, companies are much less likely to maintain them than they were in the 1980s and 1990s. Since 2002, the number of companies with a rights plan in place has steadily fallen, and in 2005, for the first time in over a decade, fewer than half of S&P 500 companies had a rights plan.[6] By the end of 2006, just 37 percent of companies included in the S&P 500 and only 17 percent of Fortune 100 companies had a rights plan.[7] Many boards have simply declined to renew their company's rights plan as the plan approaches its scheduled termination date and have let it expire naturally. Of all the companies that had rights plans scheduled to expire naturally in 2005, 2006, or 2007, 61 percent, 69 percent, and 70 percent, respectively, of such companies allowed their rights plans to expire without extending or replacing such plans.[8]

Shareholders Continue to Voice Opposition

The decisions of companies not to renew their rights plans reflects a shifting governance landscape where institutional and activist shareholders play an ever increasing role in the board's decisionmaking processes. ISS and the institutional shareholders it influences have strongly opposed rights plans in the belief that they entrench management and deprive shareholders of the ability to evaluate takeover opportunities.

Boards of directors do not need shareholder approval to adopt a rights plan, but ISS has made it increasingly difficult for boards to move forward on a rights plan without consulting its shareholders. The significance of ISS voting recommendations on a particular company will depend on whether that company's shareholders typically vote in line with ISS voting recommendations. As is discussed further, ISS has developed voting guidelines in three areas that have influenced the rights plan strategies of public companies.

First, ISS will recommend "withhold" votes for all incumbent directors of a company if the company's board adopts or renews a rights plan without shareholder approval and either does not commit to submitting the rights plan to a shareholder vote within 12 months of adoption or reneges on a commitment to do so. If a company uses plurality voting standards, incumbent directors can still be reelected even if they receive a substantial number of withhold votes. Nonetheless, a substantial number of "withhold" votes can be embarrassing and may put pressure on the company to change its rights plan policy and submit its rights plan to a shareholder vote. If a company has adopted a majority voting standard or a director resignation policy, a substantial number of "against" votes could result in the Board having to make difficult decisions about accepting director resignations. According to a study released in November 2007, 66 percent of S&P 500 companies and 57 percent of Fortune 500 companies have adopted either a majority voting standard or a director resignation policy, or both.[9]

The second area in which ISS has developed voting recommendations for rights plans is with regard to rights plans submitted to a shareholder vote. Although a board can adopt a rights plan without shareholder approval, some boards choose to submit proposed rights plans to a shareholder vote. ISS evaluates rights plans on a case-by-case basis, but it only will generally recommend that shareholders vote for a rights plan if the plan contains all of the following: (1) a 20 percent or higher trigger threshold, (2) a term of no more than three years, (3) no dead-hand, slow-hand, or no-hand provisions that limit the ability of a future board to redeem the plan,[10] and (4) a stockholder redemption provision whereby holders of 10 percent of the shares of the company could call a meeting if the board fails to redeem the rights plan after a "qualifying offer" is made.[11]

Finally, ISS has developed voting recommendations with respect to rights plan shareholder proposals submitted by shareholders under the federal proxy rules.[12] Such proposals typically call for a company's board to eliminate an existing rights plan, if the company has one, and to require that any future rights plans be submitted to a shareholder vote. ISS will recommend a "yes" vote on any such proposal unless either (1) the company's rights plan has been previously approved by its shareholders or (2) the company does not have an existing rights plan and has adopted a rights plan policy (described in more detail below). From 1999 to 2006, rights plan shareholder proposals on average received majority support over 72 percent of the time.[13] Stated another way, when shareholders have the opportunity to vote, they generally vote in favor of terminating existing rights plans and requiring shareholder approval of any new rights plans. A board is not bound by a rights plan shareholder proposal, even if the proposal receives majority support, but ISS will recommend "withhold" or "against" votes from all incumbent directors if the board does not act on a shareholder proposal that was approved by a majority of the *shares outstanding* the previous year or by a majority of the *shares cast* for the previous two consecutive years.

Many companies that have received rights plan shareholder proposals have decided to terminate their rights plan early instead of giving shareholders an opportunity to vote on the proposal. The boards of these companies have often coupled the early termination of the rights plan with the adoption of a rights plan policy, which is a board policy that generally states that the board will seek shareholder approval prior to adopting any future rights plan.

A rights plan policy commonly includes a "fiduciary out" exception, which permits the board to adopt a rights plan without shareholder approval if the board determines, in the exercise of its fiduciary duties, that it is in the best interests of the company and the company's shareholders to adopt a plan without the delay required to hold a shareholder vote. In such a situation, the rights plan would then either have to be ratified by the company's shareholders within one year of its effective date or expire automatically on the first anniversary of its effective date. The SEC has taken the position that if a company terminates its rights plan and adopts a right plan policy that includes a fiduciary out, it can exclude the rights plan shareholder proposal from its proxy materials on the basis that the company has "substantially implemented" the proposal.[14]

The cumulative effect of the development of voting guidelines by ISS and shareholder activism helps explain the slowdown in renewal or adoption of right plans. In short, companies want to avoid the public conflict that can arise when ISS or activist shareholders oppose them. And so, as literally hundreds of boards in the coming months prepare to address impending rights plan expirations, it is worth examining more closely the options available to them.

Three Potential Responses of the Board

A board of directors of a company facing the impending expiration of the company's rights plan generally has three potential responses from which to choose: (1) extend the term of the existing rights plan or adopt a new rights plan, (2) allow the existing rights plan to expire without any further action, or (3) follow an "on-the-shelf" strategy.

Extend the Term of the Existing Rights Plan or Adopt a New Rights Plan

The first option for a board of directors is to stay the course with maintaining a rights plan in some form. As a mechanical matter, companies can accomplish this in different ways. The board could amend and restate the rights plan by changing the termination date and letting the plan continue unchanged or could change the termination date as well as other provisions. Alternatively, the board could adopt a new plan with modified terms that would go into effect immediately after the old plan expires. In either case, the board has the choice of whether or not to submit the rights plan to a shareholder vote.

The advantage of choosing this option is obvious—the company continues to benefit from a very effective takeover defense. The option does, however, have significant drawbacks. If the board extends the existing rights plan or adopts a new rights plan without the ISS-approved features and does not submit the extension or adoption to a shareholder vote, ISS will recommend "withhold" or "against" votes for all incumbent directors at the company's next annual meeting. In addition, the company becomes a more likely candidate to receive a rights plan shareholder proposal. If that happens, a board generally has two options: (1) submit the rights plan shareholder proposal to a vote by including the proposal in the company's proxy statement or (2) terminate the rights plan early, adopt a rights plan policy, and submit a no-action letter to the SEC to try to exclude the shareholder proposal on the basis that the company has "substantially implemented" the proposal. If the board chooses the first option of submitting the shareholder proposal to a shareholder vote and the proposal receives a majority vote, the board could ignore the proposal but then incumbent directors will face a "withhold" or "against" recommendation from ISS in upcoming director elections. If the board chooses the second option, it will find itself in nearly the same position it would have been in had it decided to allow the existing rights plan to expire without any further action in the first instance.

The board could, alternatively, extend the existing rights plan or adopt a new rights plan without the ISS-approved features but submit the extension or adoption to a shareholder vote. This alternative is not, however, much more appealing than the first alternative of extending the existing rights plan or adopting a new rights plan without a shareholder vote. Without the ISS-approved features, ISS almost will certainly recommend that shareholders vote "against" adoption of the plan. Although the company can try to make its case and attempt to persuade shareholders to ignore the ISS voting recommendation, the company may be wasting its corporate breath.

The remaining alternative under this option is for the board to adopt a new rights plan that includes the ISS-approved features, which should draw a recommendation "for" the plan from ISS, and submit the plan to a shareholder vote. The drawback of this alternative is that a rights plan with the ISS-approved features provides the board with less flexibility and less leverage than a traditional rights plan. For example, including a qualifying offer provision eliminates part of the board's negotiating leverage because it provides a clear blueprint to a potential acquirer for sidestepping the rights plan and bypassing the board. A qualifying offer provision also may set the stage for a difficult and expensive dispute regarding what does or does not constitute a qualifying offer.

Do Nothing

The second option for a board of directors is to allow the company's rights plan to expire and not take any further action. This option has the appeal of being the least time consuming of the three options, and it mitigates the risk of shareholder opposition to the company's rights plan strategy. Furthermore, the lack of a rights plan increases corporate governance scores published by services such as ISS, which take into account whether or not a company has a rights plan in place. The absence of a carefully considered rights plan strategy, however, leaves the company without a powerful and effective tool to control both the timing and the tactics used by a potential acquirer. While the board can wait until takeover activity begins and then begin drafting and considering a rights plan, doing so will increase the burdens on the board at a time when it is likely to have many other significant issues to address and thus may not be able to act quickly and respond effectively.

Follow an "On-the-Shelf" Strategy

The third option for boards of directors facing an expiring rights plan is for the board of directors to allow the company's existing rights plan to expire without immediately adopting a new rights plan, while keeping a rights plan "on-the-shelf" so that the board can act quickly to adopt the plan in response to a specific takeover threat.

A principal benefit of an on-the-shelf strategy is that it allows a board to plan ahead by already having considered an appropriate rights plan before takeover activity begins, but minimizes the risk of ongoing shareholder conflict because the plan is not finalized and adopted until a specific takeover threat materializes. The board considers in advance most of the terms and conditions of an appropriate rights plan and defers decisions that are dependent on economic circumstances, such as the exercise price of the rights, until such time as the plan is pulled down from the shelf. With a rights plan on the shelf, a board can act to approve the plan quickly—in as little as 24 hours and generally not more than a few days—if a specific takeover threat arises, and can then work to control the negotiation process with the potential acquirer in order to maximize shareholder value.[15] A rights plan adopted in response to a specific takeover threat instead of as a general defensive measure does not generally weaken the effectiveness of the plan:

> [S]hareholders benefit from the enhanced bargaining power provided by poison pills regardless of whether they were in place before the takeover attempt or adopted as 'morning-after' pills once the firm has been targeted.[16]

One of the drawbacks of an on-the-shelf strategy is that if a board pulls the plan down from the shelf and adopts it, it may still face opposition from ISS and activist shareholders and thus directors will have to consider the possibility of receiving large numbers of "withhold" or "against" votes or a rights plan shareholder proposal. The board could, of course, decide to terminate the plan early if the specific takeover threat diminishes before the company's next annual meeting. In addition, it is possible that ISS and activist shareholders will not be opposed to the rights plan when evaluated in light of the specific takeover threat and the board's overall response to the takeover threat. But even if ISS and activist shareholders oppose pulling the plan down from the shelf, the company is not in any worse of a position than it would have been if the board had chosen the first option of maintaining a rights plan in some form following expiration of the existing plan.

A second drawback to the on-the-shelf strategy is the risk that a potential acquirer could accumulate a large percentage of a company's outstanding shares in open market purchases before the board of directors becomes aware of such fact and is able to respond by pulling the plan down from the shelf. There are limits, however, on an acquirer's ability to accumulate a large ownership position in a company without alerting the board, including the Hart-Scott-Rodino Act (HSR Act), Schedule 13D reporting requirements, and state business combination statutes. The HSR Act generally requires any person who, as a result of an acquisition of stock, holds more than $63.1 million of a company's stock to report such holdings.[17] Rule 13d-1 under the Securities Exchange Act of 1934 generally requires any person or group who acquires 5 percent or more of a company's common stock to file a Schedule 13G or 13D with the Securities and Exchange Commission within 10 days of becoming a 5 percent or more holder.[18] Moreover, when shares have been acquired or are held "with a purpose or effect of changing or influencing control," Rule 13d-1 imposes a "cooling off period" from the date of crossing the 5 percent threshold until the expiration of 10 days after the Schedule 13D filing is made. Delaware and other state business combination statutes prevent a person who acquires a threshold percentage of a company's outstanding voting stock, often 10 percent to 20 percent, from engaging in a "business combination" without prior board approval for three years following the date that the person crossed the ownership threshold.[19]

The alarm bells provided by the HSR Act, Schedule 13D reporting requirements, and state business combination statutes are not bulletproof.

Companies should recognize that the alarm bells provided by the HSR Act, Schedule 13D reporting requirements, and state business combination statutes are not bulletproof. For example, the HSR Act does not include a "group" concept, which means that several hedge funds could accumulate a large percentage of a company's stock but that no one hedge fund would own enough shares to trigger HSR reporting requirements. Similarly, although the Schedule 13D filing requirements do include a group concept, a handful of hedge funds or activist investors with similar interests that each own less than 5 percent of a company's common stock and that do not constitute a group under Rule 13d-1 may be able to exert significant pressure on a company without triggering a filing requirement. In addition, there have been media reports of hedge fund investors with large swap positions in a company not reporting such positions under the Schedule 13D reporting requirements on the theory that it is voting interests, and not simply economic interests, that trigger reporting obligations.[20]

Nonetheless, managing the risks associated with an on-the-shelf strategy often will be much more appealing than confronting the shareholder pressure and adverse publicity associated with maintaining a rights plan or the more limited flexibility provided by an ISS-approved rights plan. And an on-the-shelf strategy may be much more appealing than simply allowing the plan to expire and doing nothing further—an approach that will put the board under much more pressure if takeover activity arises in the future.

Conclusion

A record number of companies are facing the impending expiration of their rights plans in 2008 and the potential responses available to their boards of directors are not particularly appealing. Unless a company is fairly confident that only a small number of its shareholders follow ISS voting recommendations and that it does not have shareholders who are particularly active in corporate governance matters, the most appealing response appears to be following an on-the-shelf strategy. An on-the-shelf approach eliminates the need for companies to incur the costs that come with seeking to extend an existing rights plan or adopt a new rights plan, namely shareholder pressure and adverse publicity, and also avoids the drawbacks associated with adopting a rights plan with the ISS-approved features or doing nothing at all. At the same time, it leaves an effective takeover defense in a board of directors' toolkit, ready to be taken out and used when needed.

NOTES

1. Andrea Musalem, "2007 Background Report: Poison Pills," Institutional Shareholder Services, February 2007, at 15 (reporting that 546 rights plans were adopted in 1998). *SharkRepellent.net* reports that 620 plans were adopted in 1998. John Laide, *SharkRepellent.net*, "Research Spotlight: Poison Pill Renewal Rates," Sept. 20, 2007, *available at https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20070920.html&rnd=85956*.

2. Frank Aquila, "Shareholder Rights Plans: After 25 Years the Controversy Continues," *The M&A Lawyer*, July/August 2007, at 1; *see also* Musalem, *supra* n.1, at 10 ("GRS is not aware of any modern pill with flip-over, flip-in provisions ever being triggered").

3. Georgeson Shareholder, Mergers & Acquisitions: Poison Pills and Shareholder Value 1992–1996, November 1997.

4. Randall A. Heron and Erik Lie, "On the Use of Poison Pills and Defensive Payouts by Takeover Targets," 79 *The Journal of Business* 1783, 1803 (2006), available at *http://www.journals.uchicago.edu/doi/pdf/10.1086/503648*.

5. Lawrence D. Brown and Marcus L. Caylor, "Corporate Governance and Firm Performance," at 24, December 7, 2004, available at *http://www.issproxy.com/pdf/Corporate%20Governance%20Study%201.04.pdf* (study jointly conducted with researchers from Georgia State).

6. Musalem, *supra* n.1, at 10.

7. *Id*. at 5. In addition, *SharkRepellent.net* recently reported that during 2007, the percentage of S&P 500 companies with a rights plan in place dropped below 30 percent. John Laide, *SharkRepellent.net*, "2007 Year End Review: Shareholder Activism Continues to Increase While Takeover Defenses Decline," Jan. 7, 2008, available at *https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20080107.html&rnd=387359*.

8. *SharkRepellent.net*, "2005 Poison Pill Expiration Analysis," Laide, *supra* n.1; *SharkRepellent.net*, "2007 Poison Pill Expiration Analysis/Renewal Rates."

9. Claudia H. Allen, "Study of Majority Voting in Director Elections," November 12, 2007, available at *http://www.ngelaw.com/files/upload/majoritystudy111207.pdf*.

10. A "dead-hand" provision, or "continuing director" provision, permits only incumbent directors to terminate, redeem, or amend a rights plan. This prevents a hostile acquirer from launching a proxy fight to take control of the board and then terminating the rights plan. A "slow-hand" provision prevents any board, whether composed of new or continuing directors, from terminating, redeeming, or amending a rights plan for a specified period of time ranging from 90 days to one year (with the most common time period being 180 days). A "no-hand" provision prevents any board, whether

comprised of new or continuing directors, from terminating, redeeming, or amending a rights plan.

11. ISS has not offered meaningful guidance on how a qualifying offer should be defined. In general, rights plans that include such a provision state that a bid will be treated as a qualifying offer if the bidder is not an affiliate and the bid is a fully financed cash offer or stock exchange offer in which all target stockholders may participate.

12. 17 CFR § 240.14a-8.

13. Musalem, *supra* n.1 at 51.

14. *See*, *e.g.*, *Hewlett-Packard Company*, SEC No-Action Letter, 2007 WL 4305672 (November 30, 2007); *RadioShack Corporation*, SEC No-Action Letter, 2006 WL 659550 (March 14, 2006); *Tiffany & Co*., SEC No-Action Letter, 2006 WL 659556 (March 14, 2006); and *Bristol-Myers Squibb Co*., SEC No-Action Letter, 2006 WL 3734555 (March 9, 2006).

15. A frequent concern voiced by directors is whether adopting a rights plan in the face of a specific takeover threat is a violation of a director's fiduciary duties. Delaware case law has supported the legality of rights plans since the landmark *Moran* decision in 1985. *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, (Del. 1985). Subsequent cases indicate that a board decision to adopt a rights plan, as well as a board's decision to maintain an already existing rights plan in the face of an actual takeover bid, will be measured against the standard set forth in Unocal Corp. v. Mesa Petroleum Co. 493 A.2d 946 (Del. 1985). That standard involves a dual test: first, is there a reasonable basis for concluding that the proposed takeover poses a threat to some legitimate corporate interest, and second, is the defensive action taken reasonable in relation to the threat perceived? In 1995, the Delaware Supreme Court applied the Unocal standard and upheld a rights plan adopted at the time of, and in response to, a hostile takeover bid. *Unitrin, Inc. v. American General Corp*., 651 A.2d 1361 (Del. 1995). Subsequent Delaware case law has refined the Unocal/Unitrin standard for determining the reasonableness of a response, but it remains clear that, under Delaware law, a board can choose to maintain an already existing rights plan or adopt a rights plan in the first instance in the face of a takeover bid provided that the board's actions are a "reasonable" response to a takeover threat.

16. Heron and Lie, *supra* n.4, at 1785. In this regard, it is also worth noting that in recent years an increasing percentage of new plans have been adopted in response to a specific takeover threat rather than as a general defensive measure; 19 percent of all rights plans adopted in 2005 were adopted in response to a specific takeover threat, whereas only 2 percent of all rights plan adopted in 2001 were adopted in response to a specific takeover threat. John Laide, *SharkRepellent.net*, "Research Spotlight: Record Year for Canadian Poison Pill Adoptions," Dec. 11, 2006, available at *https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20061211.html&rnd=323852*.

17. 15 U.S.C. § 18a(a)(2)(B)(i).

18. 17 C.F.R. § 240.13d-1(a).

19. For example, the Delaware business combination statute prevents a person who acquires 15 percent or more of a company's common stock from engaging in a "business combination," which includes mergers, asset sales and other transactions, with the company for three years following the date that person becomes a 15 percent or more shareholder unless (1) the business combination or share acquisition was pre-approved by the board of directors, (2) the holders of at least 2/3 of the company's voting stock (excluding shares held by the 15 percent or more shareholder) vote to approve the business combination on or following the date the person becomes a 15 percent or more shareholder, or (3) the person owns at least 85 percent of the company's voting stock upon completion of the acquisition that makes the person a 15 percent or more shareholder. 8 Del. C. § 203.

20 Andrew Ross Sorkin, "A Loophole Lets a Foot in the Door," *N.Y. Times*, Jan. 15, 2008.