CLEARY GOTTLIEB

ALERT MEMORANDUM

Rewriting the Poison Pill Prescription: Consider Active Defenses During COVID-19

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Amidst a market-wide sell-off of public equities in the face of coronavirus uncertainty, companies across nearly every industry have seen significant declines in stock prices over the past several weeks. With the timeline for recovery of financial markets and the broader global economy increasingly unclear, in many cases stock prices no longer reflect the intrinsic value of the business and have instead become increasingly correlated with each day's (often negative) news reports and indiscriminate selling across investment portfolios.

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The current crisis has created a risk that well-capitalized activist investors or acquirers will seek to take advantage of the situation by acquiring significant stakes in companies at depressed prices. In the midst of a sell-off, an aggressive buyer can amass beneficial ownership of a significant percentage of voting securities of a target company without making public disclosure, particularly in light of its ability to continue buying during the 10-day window after the 5% ownership threshold is crossed but before an initial Schedule 13D is required to be filed with the SEC. This risk is even more acute for small-capitalization companies, for whom the mandatory filing and waiting period regime of the Hart-Scott-Rodino Antitrust Improvements Act may provide little protection, since it does not apply to acquisitions of shares resulting in aggregate ownership of voting securities valued at less than $94 million. Moreover, in light of the dismantling of takeover defenses at most companies over the last decade (including the forced elimination of classified boards and supermajority voting provisions as well as bestowing upon stockholders the ability to act by written consent and call special meetings), there are fewer tools in the toolkit for responding to hostile attacks. Unwary companies may awaken one morning to find that they have a new active shareholder with a large ownership percentage—a stake acquired at a price not reflective of the company's long-term value, but one that will persist into an eventual recovery. Opportunistic buyers may also use equity derivatives to increase even further their economic investment in the target company.

In light of the unique threat posed by the current market, it may be time for companies to revisit the potential use of shareholder rights plans (or "poison pills") as a component of their corporate defenses. While many companies have drafted "on the shelf" plans—ready to be implemented when an unsolicited acquirer or activist shows up—for the reasons described above, the current market dislocation may warrant taking it off the shelf now.

Even in a changed market, the use of shareholder rights plans, like all defensive strategies, remains subject to fiduciary duty considerations. In the case of a Delaware corporation, the adoption of any takeover defense such as a rights plan is subject to enhanced scrutiny under *Unocal*, which requires that the defense be adopted in response to a threat to corporate policy or effectiveness, and that the defense fall within a "range of reasonableness" in proportion to the threat posed (*i.e.* the defense must be neither coercive or preclusive with respect to shareholder choice). The Delaware courts have consistently held that adoption of a rights plan on a "clear day" is permissible under the enhanced scrutiny standard.

Proxy advisors such as ISS and Glass Lewis have also provided guidance with respect to rights plans, generally requiring that they be limited in duration (one year or less unless otherwise approved by a shareholder vote) and that their percentage ownership triggers not be so low as to be unduly restrictive (recent precedents have tended to cluster in the 10-15% range, unless the shareholder rights plan is designed to protect tax attributes, in which case it will typically have a 4.9% trigger).

Given the potential for an eventual recovery to be relatively rapid, public companies—especially those with a market capitalization of less than $1 billion—should consider enacting a shareholder rights plan for a limited duration in response to the current market dislocation. A limited-duration rights plan might last for only 12 months, and be freely redeemable by the board of directors at any time should normal economic conditions return sooner. And while proxy advisory firms have yet to reassess the rights plan trigger levels they view as acceptable (and are unlikely to do so), in determining the appropriate trigger companies should consider the increased ability of hostile investors to quickly amass a larger toe-hold position due to the recent and expected volatility in stock prices. The board must also be prepared to explain the utility of adopting the rights plan to the market—that is, to protect the company and their investment in uncertain times.

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