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The Resurgent Rights Plan:
Recent Poison Pill Developments and Trends

April 2009

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Table of Contents

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Recent Poison Pill Developments and Trends

INTRODUCTION

Shareholder rights plans were developed more than 25 years ago to fend off opportunistic hostile offers and other abusive takeover transactions. Rights plans deter unauthorized stock accumulations by imposing substantial dilution upon any shareholder who acquires shares in excess of a specified ownership threshold (typically ten to twenty percent) without prior board approval. Although the freewheeling takeover environment of the 1980s is now a distant memory, corporations today face continued threats of abusive takeover transactions, as well as threats from activist and other "event-driven" investors. The credit crunch and the resulting recession, accompanied by substantial deterioration in U.S. equity markets, has exacerbated these vulnerabilities. Perhaps predictably in light of these events, there was a resurgence in the adoption and use of rights plans in 2008 and the first quarter of 2009. This paper documents and analyzes these trends.

The past year also brought a number of important developments related to the next generation of rights plans:

- Following the well-publicized case involving CSX Corporation,[1] and in light of the changing nature of equity ownership in the U.S., corporations have modified their rights plans to include derivatives, swaps and other synthetic equity positions within the definition of "beneficial ownership."

- To address coordinated "wolf-pack" campaigns by activist and other event-driven investors, who may seek to execute their strategies without disclosure of their coordinated activities, one corporation has modified its rights plan to treat parties acting in concert as having formed a group for purposes of determining beneficial ownership.

- NOL rights plans gained prominence due to the recession, in which many corporations are generating significant net operating losses ("NOLs"). NOLs may be used to reduce future income tax payments and have become valuable assets to many corporations.

Ŧ Mr. Gerstein and Mr. Faris are partners in Latham & Watkins' M&A Practice Group, of which Mr. Gerstein is a Global Chair, and Mr. Drewry is an associate at Latham & Watkins. The authors extend our gratitude to partners Charles M. Nathan, Diana S. Doyle and Joseph M. Kronsnoble, associates Puja Seam, Euler K. Bropleh and Enrique Rene De Vera and the M&A Practice Group's Knowledge Management Lawyer, Kaitlin R. Verber, for their additional assistance with this paper. The views expressed in this paper are those of the authors alone and do not necessarily represent the views of Latham & Watkins or its clients.

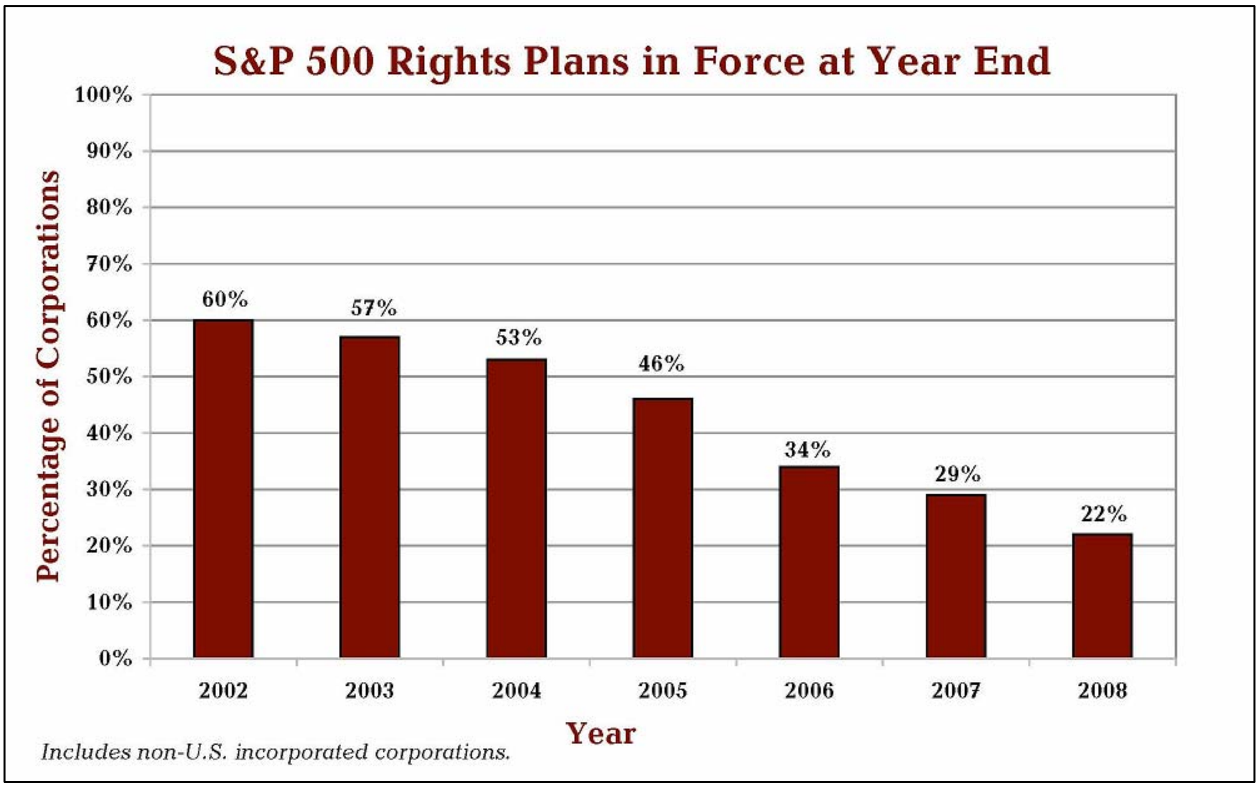
[1] *See CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd* 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

- Selectica's NOL rights plan was triggered in December 2008 by Versata Enterprises, which became the first shareholder to have swallowed a modern rights plan by intentionally buying shares in excess of a rights plan's trigger amount. This situation has provided lessons applicable to all rights plans.

I. RIGHTS PLAN TRENDS

A. Rights Plan Utilization and Terms.

The use of rights plans spread widely after their introduction in the 1980s. Indeed, in 2002, approximately 60 percent of Standard & Poor's 500 corporations had rights plans in place. However, usage of rights plans declined beginning in 2001, as illustrated in the following chart.



Factors that drove the decline in usage of rights plans included:

- an increase in the number, and success of, shareholder proposals to redeem rights plans;

- proxy advisers, such as RiskMetrics Group, adopting policies recommending that shareholders vote "withhold/against" directors of corporations that adopted or renewed rights plans, unless the rights plan was submitted to a shareholder vote within 12 months of the adoption or renewal;[2]

- an increase in the prevalence of majority voting policies, which increased the impact of adverse advisory firm recommendations following implementation of a rights plan without shareholder approval or board failure to redeem a rights plan following shareholder approval of a resolution demanding termination;

- buoyant equity markets, which provided a sense of confidence generally and perhaps muted the anxiety of boards of directors over the threat of hostile bids; and

- wider acceptance of a strategy to put a rights plan "on the shelf" to be deployed quickly and only if necessary in response to a specific threat.

Much changed in 2008, however, as the credit crunch and the resulting recession, accompanied by substantial deterioration in U.S. equity markets, heightened the real and perceived threats of abusive takeover transactions. In light of these events, there was a resurgence in the adoption and extension of rights plans in 2008, although the overall number of S&P 500 corporations with rights plans continued to decline. The following statistics illustrate certain important trends in rights plans in 2008:[3]

- *Increased Adoption of New Rights Plans*. Sixty-nine corporations adopted rights plans for the first time in 2008, representing a 245-percent increase over the 20 first-time adoptions in 2007.

- *Rights Plans Adopted by Smaller Capitalization Corporations*. Fifty-five corporations with market capitalizations of less than $500 million adopted or renewed rights plans in 2008, representing a nearly three-fold increase over the new rights plans adopted by small-cap corporations in 2007. This reflects the heightened vulnerability to "low-ball" unsolicited offers for corporations that have experienced dramatic loss of equity value in the recent market collapse.

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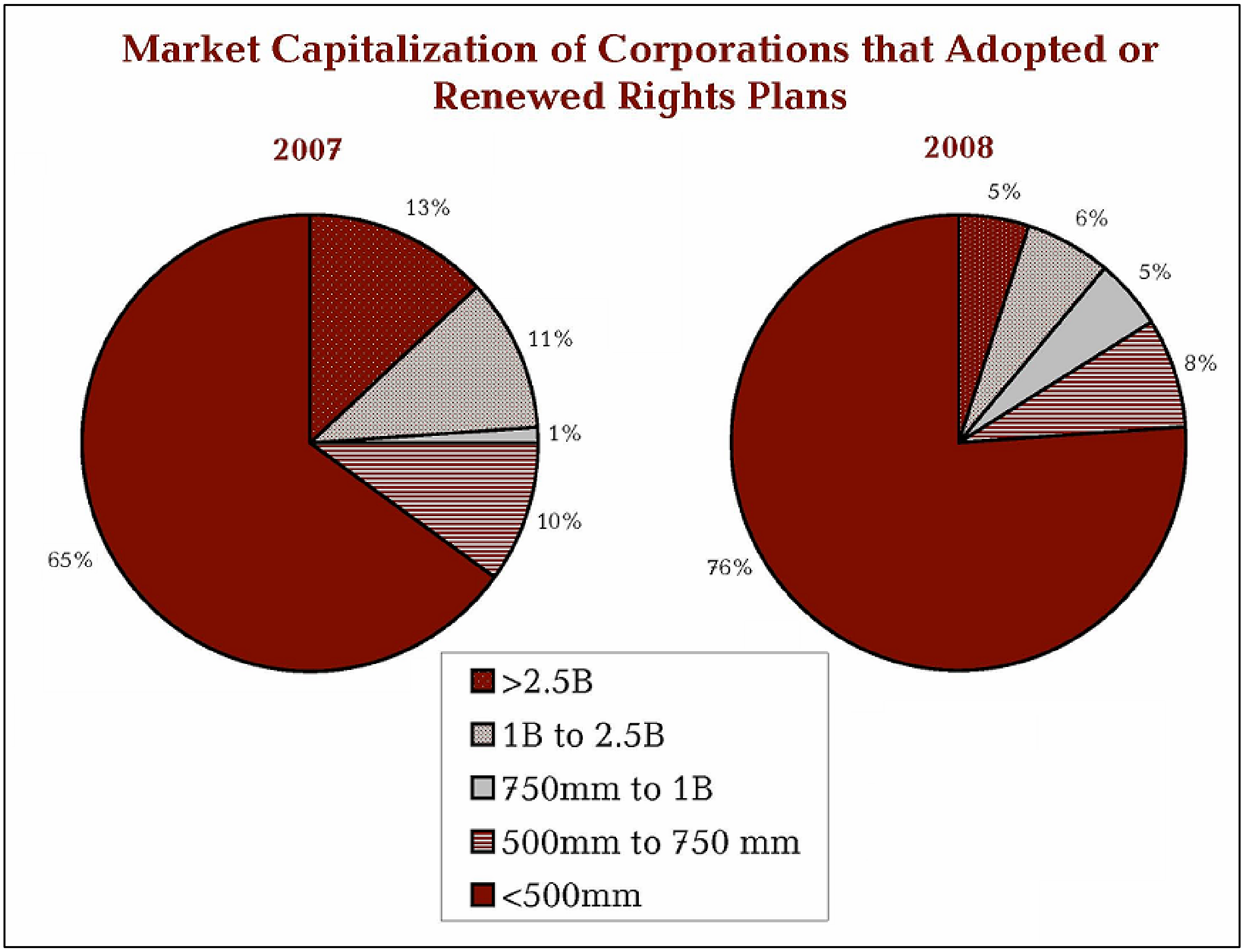
2 See 2009 RiskMetrics Group U.S. Proxy Voting Guidelines Summary, December 24, 2008. (November 25, 2008), *available at* http://www.riskmetrics.com/sites/default/files/RMG2009SummaryGuidelinesUnitedStates.pdf. Note that since 2005, it has been RMG's policy to recommend a withhold/against vote for the entire board of directors (except new nominees) if the board adopts or renews a rights plan without shareholder approval. In addition, RMG currently recommends a withhold/against vote for the entire board of directors (except new nominees, who will be considered on a case-by-case basis) if the board does not commit to putting a rights plan to a shareholder vote within 12 months of adoption or reneges on a commitment to put the poison pill to a vote, and has not yet received a withhold recommendation for the issue. The relevant factors for a RiskMetrics recommendation concerning an NOL rights plan differ from those for a traditional rights plan. *See infra* Part IV.B.4.

3 Unless otherwise noted, empirical data regarding rights plans throughout this paper is provided by, or derived from data provided by, SharkRepellent.net.



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- *In-Play Rights Plans.* Sixteen corporations adopted rights plans in 2008 while they were the subject of specific or publicly announced threats (so-called "in-play" adoptions), representing a 433-percent increase over the three in-play rights plans adopted in 2007. This reflects the marked increase in hostile offers and hedge fund activity in 2008.[4]

- *NOL Rights Plans.* Seven NOL rights plans were implemented in 2008, nearly double the 2007 court. The increasing prevalence of NOL rights plans has continued into 2009, with 11 corporations implementing NOL rights plans in the first quarter of 2009, compared to one such rights plan in the same period during 2008.

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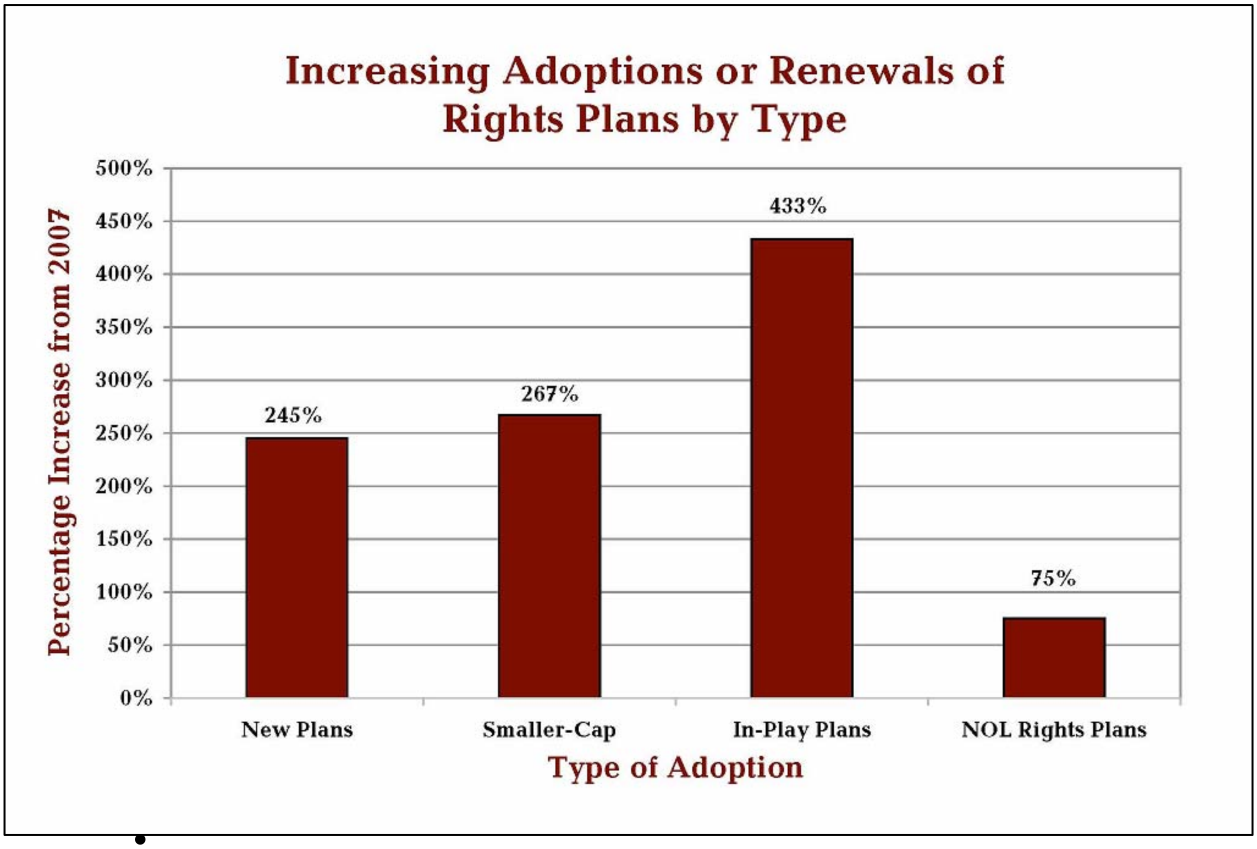
[4] For example, Dealogic reports that the number of announced unsolicited strategic offers increased by 87 percent in 2008 from 2007.



- *Expirations vs. Extensions of Existing Rights Plans*. Although the trend of corporations allowing their existing rights plans to expire continues (likely accompanied by a strategy of putting new rights plans on the shelf),[5] 76 corporations extended their existing rights plans in 2008, representing a 43-percent increase over 2007.

- *Synthetic Equity Provisions*. Thirty-three of the rights plans adopted or renewed during 2008 implemented provisions including synthetic equity positions for purposes of determining beneficial ownership. This feature was newly introduced in the spring of 2008, when Micrel, Incorporated and Clarus Corporation adopted rights plans aggregating synthetic equity. Each subsequent month saw an increase in the number of rights plans incorporating this feature.

[5] Most S&P 500 corporations faced with the decision of renewing rights plans adopted around the millennium are allowing them to expire. Of the S&P 500 corporations with rights plans scheduled to expire in 2007 and 2008, 78 percent and 91 percent, respectively, allowed their rights plans to expire.

- *Duration of New Rights Plans*. In 2008, an increasing number of corporations adopted rights plans with shorter durations; perhaps coordinating rights plan terms with an investor communication strategy that emphasized the temporary nature of the rights plan implementation. Forty-two percent of first time adoption rights plans were of five years or less in duration, versus 16 percent in 2007.

- *Trigger Threshold*. The most common trigger threshold for rights plans adopted or renewed in 2008 was 15%, representing fifty-five percent of all such rights plans. A trigger threshold of 20% was included in twenty-nine percent of adopted or renewed rights plans and a trigger threshold of 10% was included in nine percent of adopted or renewed rights plans. Seven percent of the adopted or renewed rights plans were NOL rights plans, with trigger thresholds at or near 5%.

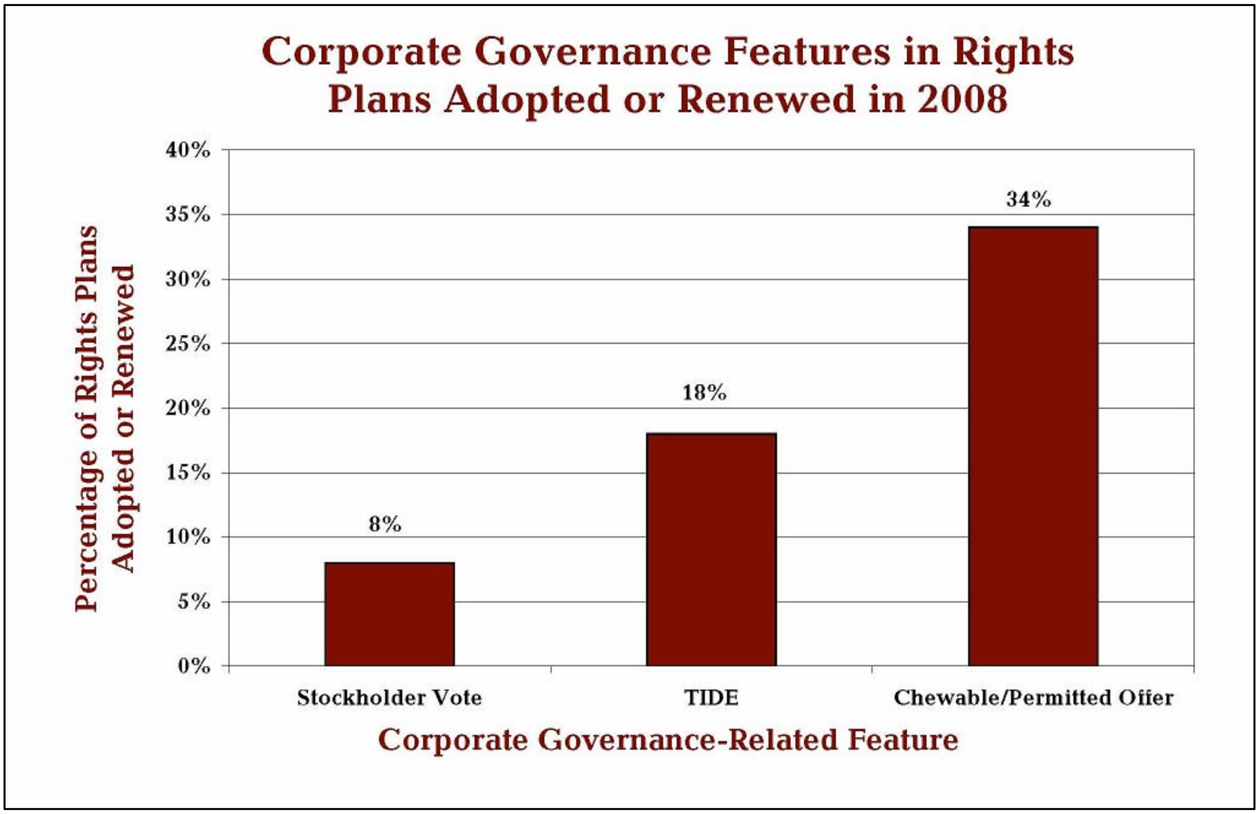
Corporations seeking to adopt new rights plans, or to extend the terms of existing rights plans, can submit the question to a shareholder vote, or include other provisions favored by corporate governance activists that require periodic review of rights plans by independent directors or permit certain qualified offers to go directly to the shareholders. The following statistics illustrate the prevalence of corporate governance–related features in rights plans in 2008:

- *Shareholder Vote*. Twelve rights plans were put to a shareholder vote in 2008, of which ten rights plans were approved by the shareholders.

- *Three-Year Independent Director Evaluation (TIDE)*. A TIDE feature requires independent director evaluation of rights plans every two to three years. Twenty-one rights plans adopted or renewed in 2008 contained this feature, representing 18 percent of the total number of adoptions and renewals.

- *Chewable Rights Plans and Permitted Offers*. The chewable feature and the permitted-offer feature provide exceptions to the trigger of a rights plan for a qualified offer for the corporation. Qualified offers are typically all cash, fully financed and open for a set time and may require a certain premium to the corporation's current or historical stock price. Forty rights plans adopted or renewed in 2008 contained either the chewable feature or the permitted-offer feature, representing 34 percent of the total number of adoptions and renewals.

We continue to question the strategic motivation for including these provisions, particularly those providing for chewable pills or permitted offers. It seems contrary to the interests of shareholders to constrain the discretion of a board of directors to use a rights plan to defer an offer or enable an auction, in an environment where equity values are relatively and absolutely low, through a provision exempting an ostensibly "premium" bid that the board does not believe reflects a corporation's full value.



B. <u>Reasons for Increased Adoption of Rights Plans</u>.

In 2008, the financial crisis changed a number of dynamics for boards of directors, including a heightening of the real and perceived threats of abusive takeover transactions. We believe that the following factors accounted in substantial part for the upward trends in the adoption of rights plans in 2008:

- *Deterioration of Equity Values.* There is little precedent for the precipitous declines in equity values experienced by corporations in virtually every sector and market in 2008. Time will tell whether these declines reflect deteriorating fundamental values or will ultimately be ascribed to fear and uncertainty. This much is clear—corporations trading at levels far below historical norms frequently believe their stock to be undervalued and, therefore, perceive a threat of an abusive transaction at an inadequate price. Observing this theme, SharkRepellent.net stated in its 2008 Year End Review that the "increase in poison pill adoptions was likely related to the precipitous drop in valuations and not a sea change in the current thinking on poison pills" and that "several of the corporations pointed to current market conditions as the impetus for the adoption [of a shareholder rights plan]."

- *Increased Hostile Activity*. 2008 saw a significant increase in the number of hostile offers, which represented 20 percent of announced deals by volume involving U.S. corporations, as compared to only five percent of announced deals by volume in 2007.[6] Twenty-three percent of the total number of negotiated deals involving U.S. corporations were initiated by "bear-hug" letters or other unsolicited offers that ultimately resulted in negotiated transactions.[7] In addition, activist hedge funds and other dissidents continued to mount campaigns in 2008, resulting in the initiation of 123 proxy fights versus 108 in 2007. Year to date in 2009, five percent of announced deals involving U.S. corporations by volume have been unsolicited or hostile[8] and 87 proxy fights have been initiated by activist hedge funds and other dissidents.

- *Proliferation of Activist Abuse of Synthetic Equity Positions.* The nature of equity ownership in U.S. corporations continues to evolve due to the proliferation of derivative, swap and other transactions in the marketplace. For example, a so-called "total return swap" allows an investor to create the economic equivalent of ownership of an equity security. Many investors take the position that this type of economic relationship does not confer beneficial ownership of the underlying equity security within the meaning of, and is not required to be disclosed under, the Williams Amendments (the "Williams Act") to the Securities Exchange Act of 1934 (the "Exchange Act").[9] When deployed for takeover purposes, these transactions permit investors to manipulate their economic interests in a manner that may deprive a corporation and other shareholders of sufficient time or ability to make informed voting and other decisions. The threats from these types of transactions are highlighted by the proxy contest involving CSX Corporation discussed below.

- *Coordinated Wolf-Pack Tactics.* The battle for CSX also highlighted the threat posed by activist and other event-driven investors executing their strategies in coordination with other like-minded investors without disclosing their coordinated activities. Many investors take the position that these coordinated activities are not conducted pursuant to any formal agreement, arrangement or understanding and thus are not required to be disclosed under the Williams Act as group action. These types of activities implicate many of the same concerns that validate rights plans (e.g., the acquisition of effective control without paying a control premium or the de facto neutralization of the board's role in transactions for corporate control), and in 2008 practitioners sought to implement new technologies to expand the definition of beneficial ownership in rights plans to capture and deter coordinated abusive activities.

[6] Thomson SDC/Thomson Financial, as of March 13, 2009.
[7] FactSet MergerMetrics' 2008 Year End Review.
[8] Thomson SDC/Thomson Financial, as of March 13, 2009.
[9] Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

- *Reduced Utility of HSR "Early Warning System."* Mid- and large-cap corporations have historically relied upon the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act"),[10] which requires a filing for acquisitions of approximately $65 million of voting securities, to provide advance notice of potential share accumulations and enable timely implementation of a rights plan. This early-warning system has an important defensive advantage over the applicable disclosure rules under the Williams Act—the HSR Act generally bars accumulations until expiration of a 30-day waiting period. This warning system is not effective for share accumulations at small-cap corporations, including those that have recently experienced substantial reductions in equity value due to the market collapse. Indeed, for a corporation with a market capitalization of $250 million, an HSR filing is not required until the stock accumulation exceeds 25 percent of outstanding shares, which is far above the 15 percent level at which a customary rights plan would cap a hostile bidder. The HSR warning system is also ineffective against the use of synthetic equity and can easily be avoided even with traditional "physical ownership" through the simple expedient of making purchases of target stock through multiple vehicles with different ultimate ownership as determined under the HSR rules.

- *Decline in Rights Plan Proposals.* A decreased corporate governance focus on rights plans in 2008 may have mitigated a previously significant damper on board enthusiasm for rights plans. Shareholder activism against rights plans was minimal in 2008, with the 2008 proxy season seeing only eight shareholder proposals to redeem rights plans. To date in 2009, there have been five shareholder proposals to redeem or require a shareholder vote with respect to a rights plan, which is consistent with the 2008 trend.

Considered together, these factors have lead many corporations to reconsider the widely accepted strategy of keeping a rights plan on the shelf to be deployed quickly in response to a specific threat. The premise for the on-the-shelf strategy—that a board will have sufficient time and opportunity to pull a rights plan "off the shelf" if necessary—has recently eroded due to the advent of synthetic equity abuses and wolf-pack strategies that may not trigger a filing under the Williams Act until an investor wants to make its campaign public. Additionally, the precipitous declines in market capitalization suffered by many corporations have enhanced a sense of vulnerability to hostile bids and resulted in the loss of efficacy of HSR as an early-warning mechanism. Boards of directors are concluding that the adoption of rights plans is necessary and prudent under the circumstances and that they will be less exposed to investor backlash for doing so. Indeed, many boards of directors are confident that they can effectively manage investor relations following the adoption of a rights plan given current market conditions.

[10] Pub. L. No. 94-435, 90 Stat. 1383 (1976) (codified as amended in scattered sections of 15, 18, 28 U.S.C.).

II. TREATMENT OF EQUITY DERIVATIVE POSITIONS AND "WOLF PACKS" AS NEW TRIGGERS

A new and significant trend in 2008 was corporations' efforts to develop new rights plan technology to defend against modern threats from the abuse of synthetic equity and "wolf-pack" attacks by activist investors. These broadly used strategies were revealed in detail and received widespread attention in the federal court decision addressing The Children's Investment Fund's and 3G Capital Partners' 2008 proxy insurgency against CSX Corporation.[11] We discuss these modern threats, provide a brief summary of the *CSX* case to illustrate how activist investors use these tactics in an abusive manner and then review the new rights plan technology that has been developed in response.

A. Modern Threats from Synthetic Equity Abuses and Wolf Packs.

1. Synthetic Equity

The increasing prevalence of equity derivatives in the public markets has provided a mechanism by which the economic, voting and other attributes of stock ownership can be divided and traded separately. This enables an investor to have an economic interest in a corporation's common stock that may be different from its beneficial ownership for purposes of the Williams Act and related Securities and Exchange Commission ("SEC") filings.[12] The best example of this is "total return swaps" ("TRSs"), which allow an investor to create the economic equivalent of ownership of an equity security without ever acquiring traditional (often called "physical") ownership of the equity security.

TRSs are one type of derivative contract in which the "short party" (usually a bank) agrees to pay the "long party" the cash flows associated with a stated number (often called the "notional number") of shares of a corporation—i.e., any distributions the corporation pays to shareholders and any market appreciation of the stock. In exchange, the long party agrees to pay the bank a "financing fee" (usually computed as a spread over LIBOR on the notional value of the reference security position at the outset of the TRS contract) and any decrease in the market value of the underlying notional or reference security position. Typically, short parties hedge their TRS exposure by purchasing the underlying security in amounts identical to the notional number referenced in their TRS agreements. Many investors take the position that the economic relationships created by TRSs, although essentially creating indirect ownership by the long party of the reference security, do not confer beneficial ownership of the underlying equity security to the long party, are not required to be disclosed under applicable federal securities laws and would not trigger traditional rights plans.

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[11] *See CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd* 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

[12] These SEC filings include Schedules 13D and 13G. A person who, directly or indirectly, is the beneficial owner of more than five percent of a corporation's stock must disclose certain information on either Schedule 13D or Schedule 13G. *See* 17 C.F.R. § 240.13d-1. Once the five percent threshold is reached, Schedule 13D requires the disclosure of contracts relating to the issuer's securities. In contrast, Schedule 13G (which relates to passive investments) has no similar requirement. *See* 17 C.F.R. § 240.13d-101, Item 6; 17 C.F.R. § 240.13d-102.

Despite this view by some investors, TRSs and other forms of synthetic equity pose a threat when used by activist investors in a destabilizing campaign. Fox example, in the TRS context, upon request of the long party, the short party is sometimes willing to unwind the TRS agreement by delivery of the hedge shares (even when the underlying agreement does not provide for physical settlement), allowing the long party to convert synthetic equity into physical equity very quickly. Even where this is not the case, the long party typically has the practical ability to terminate the swap whenever it chooses and can enter into the market to purchase shares at the very time the short party is liquidating its hedge position. Alternatively, since a fully hedged short party has no economic interest in the shares, it may be willing to vote the shares in accordance with the long party's preferences, even if not part of a formal arrangement. The likelihood of this increases when the long party is a valued customer of the short party.[13] Although this practice is no longer as common as it once was, many short parties have adopted a policy either to not vote the hedge shares or to vote the hedge shares in proportion to all other voted shares. Knowledge of these voting policies by the long party can easily affect the outcome of a shareholder vote and can be integrated by an investor into a proxy campaign against the target corporation. Under any of these approaches, the long party has the practical ability to quickly convert its synthetic equity position into a physical position or to direct or influence the voting of the hedge shares without acquiring conventional beneficial ownership until such time as it acquires the physical shares. This allows the long party to lay in wait undetected and to use its synthetic equity ownership to influence or determine a control contest at the time and in the manner of its choosing—a potent weapon for an investor seeking to gain or exert control or undertake a destabilizing campaign.

2. *Wolf Packs*

There are numerous examples of successful destabilization campaigns led by hedge funds with relatively small (often less than five percent) stakes in the target corporation and based in large part on parallel investing and seemingly coordinated activities by other hedge funds. Although the members of these so-called "wolf packs" rarely sign a formal agreement, and almost never do so at the onset of their relationship, they often communicate informally and share strategies and goals regarding the destabilization campaign. The members also quickly accumulate stock positions in the target that, although small individually, are significant in the aggregate. The market's knowledge of the formation of a wolf pack (either through word of mouth or public announcement of a destabilization campaign by the lead wolf pack member) often leads to additional activist funds entering the fray against the target corporation, resulting in a rapid (and often outcome determinative) change in composition of the target's shareholder base seemingly overnight. Many investors take the position that these coordinated activities are not conducted pursuant to any formal agreement, arrangement or understanding and thus are not required to be disclosed under applicable federal securities laws.

[13] The Panel on Takeovers and Mergers, *Dealings in Derivatives and Options*, Consultation Paper Issued by the Code Comm. of the Panel (2005) PCP 2005/1, p. 5; *see also*, The Panel on Takeovers and Mergers, *Dealings in Derivatives and Options*, Statement by the Code Comm. of the Panel Following the External Consultation Processes on Disclosure Issues in PCP 2005/1 and PCP 2005/2 (2005) RS 2005/2.

Much of the potency of a wolf pack stems from the fact that its members typically do not report the formation and members of the wolf pack (along with the pack's intentions and aggregate beneficial ownership of the target corporation) pursuant to the Williams Act unless they choose to do so for tactical reasons. This usually occurs only shortly before the wolf pack announces a proxy contest. By this point, key objectives of the Williams Act (affording timely notice to other investors), and rights plans (avoiding the accumulation of outcome determinative equity positions) can no longer be achieved. For traditional rights plans, the absence of an agreement among the wolf pack members has been viewed as insulation against rights plans because the traditional rights plan imports a Williams Act definition of beneficial ownership, together with its group concepts. The result is that a wolf pack under a traditional rights plan might control 20 percent, or even 30 percent, of a corporation's shares, effectively a dominant block, and the corporation is powerless to protect itself and its other shareholders. In these ways, wolf packs can circumvent the common early warning mechanisms upon which corporations have historically relied.

The potential concerns raised by wolf pack behavior have galvanized target corporations, and in many countries the political establishment, by the blatant but generally successful end-running of customary concepts such as the "group" definition under the 1934 Act and "acting in concert," "concert party" or similar concepts in the equivalent share ownership disclosure regimes in many of the developed equity markets around the world.[14] Moreover, unlike the use of equity derivatives to decouple attributes of share ownership, which was created in the context of, and driven by, trading strategies and economic considerations unrelated to change of control campaigns, the wolf pack has been used virtually exclusively by the activist investor community in campaigns against corporations, often culminating in successful proxy contests or other change-of-control events as documented in the CSX case described in the next section.

B. Illustrating the Threat: *CSX Corporation*.[15]

In *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*,[16] the United States District Court for the Southern District of New York considered two important issues. First, the District Court addressed whether and under what circumstances a long position under a TRS may be deemed beneficial ownership of the underlying stock requiring disclosure under the Williams Act. Second, the District Court considered whether and at what point investors' coordinated activities would cause them to be deemed a group for Williams Act purposes. The Court found that the two activist hedge funds violated the Williams Act disclosure requirements in the context of both the

[14] *See, e.g.*, Chapter 5 of the UK Disclosure and Transparency Rules, *available at* http://fsahandbook.info/FSA/html/handbook/DTR/5, or Chapter 6 of the Australian Corporations Act, *available at* http://www.comlaw.gov.au/ComLaw/Legislation/ActCompilation1.nsf/framelodgmentattachments/72A9C5AEACF895C3CA25756D007AA5A9.

[15] This discussion draws from a Latham & Watkins LLP M&A Commentary. Blair Connelly et al., *CSX: Opportunities and Implications for Corporations and Activist Investors*, M&A Commentary (Latham & Watkins LLP, New York, N.Y.), June 2008, *available at* http://www.lw.com/upload/pubContent/_pdf/pub2238_1.pdf; see also *Use of Total Return Swaps in Control Contest Leads to Deemed Beneficial Ownership of Underlying Shares*, Client Alert (Latham & Watkins LLP, New York, N.Y.), June 25, 2008, *available at* http://www.lw.com/upload/pubContent/_pdf/pub2237_1.pdf.

[16] *See CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), *aff'd* 2008 WL 4222848 (2d Cir. Sept. 15, 2008).

holding of TRS positions and certain coordinated activities. However, the District Court determined that existing precedent prevented it from enjoining the two hedge funds from voting their shares at the upcoming annual meeting of CSX.

Set against the backdrop of two activist hedge funds running a destabilization campaign, this decision contains important lessons for both activist hedge funds and corporations in the current environment of widespread activist hedge fund destabilization campaigns, including how corporations might confront the issues of derivative share positions and coordinated wolf pack actions in a corporate control context.

1. Factual Background.

In *CSX,* two hedge funds, The Children's Investment Fund ("TCI") and 3G Capital Partners ("3G"), ran a proxy contest to capture five of the twelve board seats at CSX, a major railroad corporation, in order to facilitate their campaign to force CSX to revise its business strategies in accordance with the hedge funds' agenda. Beginning in October 2006, TCI had expressed interest in CSX in a number of ways, including meeting with CSX's financial advisers, exploring the possibility of a leveraged buyout and contacting other hedge funds about CSX. TCI, joined by 3G, eventually began preparing for a potential proxy fight and simultaneously began to vet potential directors.

During this period, TCI also increased its economic position with respect to CSX. TCI did so principally by acquiring TRSs. By using TRSs, and later conventional physical ownership of stock, TCI ultimately amassed a total economic exposure equivalent to roughly 14 percent of CSX's outstanding common stock. However, TCI's physical securities never exceeded five percent and TCI never filed a Schedule 13D based on its greater than five percent economic interest in CSX.

Unlike TCI, 3G directly purchased shares of CSX common stock, and at one point held roughly 4.4 percent of the outstanding shares. By mid-February 2007, TCI and 3G, having established their mutual interest in CSX, began direct discussions regarding each other's activity relating to CSX. Between February and December of 2007, TCI and 3G frequently discussed CSX and, according to the District Court, coordinated their acquisitions and dispositions of CSX common stock and TRSs, as well as their preparations for a proxy contest with CSX.

In April 2007, TCI unwound some of its TRSs and purchased roughly four percent of CSX's outstanding common stock. At that point, TCI and 3G held an aggregate physical position of roughly eight percent of CSX's outstanding common stock—above the five percent threshold for filing a Schedule 13D if they were acting as a group.[17] However, TCI and 3G did not enter into a formal agreement to work together until December 19, 2007, and then only in the context of their contemplated proxy contest. On that date, TCI and 3G filed a Schedule 13D in which they disclosed that they collectively owned 8.3 percent of CSX's outstanding common stock, that they intended to conduct a proxy fight and that TCI had TRSs with counterparties that gave it economic exposure to roughly an additional 11 percent of CSX's outstanding common stock.

[17] TCI also held at that time TRSs giving it economic exposure to roughly an additional ten percent of CSX's outstanding common stock.

In early 2008, TCI and 3G filed their notice of intent to nominate directors, and later attempted to negotiate a resolution with CSX. The parties were unable to reach a settlement, and both sides filed proxy statements. TCI and 3G's proxy statement supported the election of five dissident directors to the board and further proposed an amendment to CSX's bylaws to allow any investor holding at least 15 percent of CSX's outstanding common stock to call special meetings of shareholders for any purpose.

Following the filing of TCI and 3G's proxy statement, CSX brought suit alleging that TCI and 3G had failed to timely file a Schedule 13D, and that the Schedule 13D and proxy statement were false and misleading. CSX sought, among other things, to enjoin the defendants from voting their shares at CSX's 2008 annual meeting.

2. *The Decision.*

The District Court addressed two issues: (i) did TCI beneficially own more than five percent of CSX's common stock by virtue of its TRS holdings and (ii) at what point did TCI and 3G become a group for Williams Act purposes.

Synthetic Equity: The District Court, as a matter of first impression, considered whether a holder of cash-settled equity TRSs beneficially owns the referenced securities held by the short party within the meaning of Rule 13d-3(a).[18] The Court observed that there were persuasive arguments for concluding that TCI exercised the requisite voting power and investment power to be deemed a beneficial owner. The Court noted that by virtue of the customary purchases executed by the intermediary "short" party in a TRS transaction, TCI knew its execution of TRSs would cause the counterparty banks to purchase CSX shares of common stock to hedge against their TRS positions, and likewise knew that it had the ability to cause the banks to sell their hedge shares when it unwound the TRSs. In the Court's words, "TCI manifestly had the economic ability to cause its short counterparties to buy and sell the CSX shares." With respect to voting power, the Court noted that TCI had eventually shifted the majority of its TRSs (which had previously been spread among eight banks) to two banks which, the Court found, would be more subject to TCI's influence as a result of prior relationships and common interests. However, the Court ultimately found that it was not necessary to hold that TCI had beneficial ownership based solely on its TRS positions because it found that TCI clearly should be deemed a beneficial owner pursuant to Rule 13d-3(b), an anti-evasion rule.

Under Rule 13d-3(b), TCI would be deemed to beneficially own CSX shares if TCI entered into its TRSs for the "purpose of preventing the vesting of beneficial ownership" of CSX shares in TCI and "as part of a plan or scheme to evade the reporting requirements of [S]ection 13(d)." The District Court concluded that these elements would be present if it were demonstrated that TCI entered into the TRS transactions with the intent to create a false appearance that there was no accumulation of securities that might represent a potential shift in corporate control—or, in the words of the Court, to "conceal . . . precisely

[18] Rule 13d-3(a) promulgated under the Exchange Act provides that "a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares: (i) voting power which includes the power to vote, or to direct the voting of, such security; and/or (ii) investment power which includes the power to dispose, or to direct the disposition of, such security."

what Section 13(d) was intended to force into the open." The Court further noted that Rule 13d-3(b) was promulgated to prevent circumvention of the Williams Act's disclosure requirements "where there is an accumulation of securities by any means with a potential shift of corporate control, but no beneficial ownership."

The District Court found that TCI had, in fact, entered into the TRSs for the purpose of avoiding its reporting requirements under Section 13(d) of the Exchange Act and thus concealed its accumulation of CSX securities that might represent a potential shift in corporate control of CSX. The Court cited evidence that TCI's CFO had told its board that one of the reasons for using swaps was "the ability to purchase without disclosure to the market or the corporation." The Court also cited TCI emails discussing the need to make certain that each of its bank counterparties remained below the five-percent reporting threshold. Accordingly, TCI was deemed to be a beneficial owner of the shares of CSX common stock held by its counterparties to hedge their short exposures created by the TRSs. Based on this holding, the Court concluded that TCI had violated Section 13(d) by not filing a Schedule 13D when its TRS position in CSX first exceeded five percent of CSX's outstanding shares of common stock.

<u>Wolf Packs</u>: The District Court next considered whether TCI and 3G formed a group earlier than had been disclosed, and therefore had not timely filed a Schedule 13D reflecting that status. Section 13(d)(3) of the Exchange Act provides that "[w]hen two or more persons act as a partnership, limited partnership, syndicate, or other group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person'" subject to the disclosure requirements of Section 13(d). When two or more entities or individuals fall within Section 13(d)(3)'s definition of a collective person, they are commonly referred to as a group. A group is deemed to have acquired beneficial ownership of all the equity securities of the issuer beneficially owned by each member of the group as of the date of its members' agreement to act together. Courts have repeatedly held that in order to constitute a group under Section 13(d), the members "must agree to act together for the common purpose of acquiring, holding, or disposing of securities." The group's agreement to act need not be in writing or in any other way formalized—an informal agreement proven through circumstantial evidence is sufficient. As explained by the District Court:

> '[T]he touchstone of a group within the meaning of Section 13(d) is that the members combined in furtherance of a common objective.' In this respect, an allegation that persons have formed a group 'is analogous to a charge of conspiracy' in that 'both assert that two or more persons reached an understanding, explicit or tacit, to act in concert to achieve a common goal.' The requisite agreement 'may be formal or informal, and need not be expressed in writing.'[19]

The District Court determined that TCI and 3G, despite acting without an express, written agreement were, in fact, a 13D group based on the circumstantial evidence of concerted action. The Court noted "[t]he likelihood that any agreement in this case would be proved, if at all, only circumstantially is perhaps greater than usual because the parties

[19] *CSX Corp.*, 562 F. Supp. 2d. at 552–53 (quotation citations omitted).

went to considerable lengths to cover their tracks." In a revealing footnote, the Court stated that "[the defendant] testified that he was 'particularly sensitive to the issue of groups and knowledgeable about when a group is formed and when it is not formed,'... and claims often to have begun conversations with other hedge funds, including 3G, by saying that the two parties were not a group . . . . Furthermore, when TCI approached the line between non-group and group behavior as it viewed it, it sought to limit any paper trail." The Court went on to find that the circumstantial evidence quite convincingly implied that TCI and 3G acted in concert with each other from as early as February 13, 2007. Among other things noted by the Court: TCI and 3G had a close relationship for years and were known to regularly communicate with each other; TCI and 3G had multiple meetings and conversations in which they explicitly discussed CSX; 3G consummated rather sizeable trades in CSX TRSs and stock shortly after discussing CSX with TCI; and both funds had reduced their exposure in CSX (albeit by different percentages) during the same time period and later increased their positions and began looking for director nominees virtually simultaneously. Accordingly, the Court found that TCI and 3G should have filed a Schedule 13D as a group months earlier than they did.

Having found that the defendants had violated the Williams Act, the District Court then turned to the relief sought by CSX. The Court first found that there was a substantial likelihood of future violations and therefore permanently enjoined the defendants from committing any future violations of Section 13(d). With respect to CSX's request to enjoin defendants from voting their shares at CSX's June 2008 annual meeting, the Court found that CSX had not met its burden of showing irreparable injury, which was essential to the injunctive relief it sought. The Court noted that as a result of Second Circuit precedent requiring a defendant to acquire "a degree of effective control" of the outstanding shares of a corporation before it could show irreparable injury, it was unable as a matter of law to grant CSX's requested relief. However, the Court stated that if it were free to do so on the grounds of deterrence or another basis, it would have granted CSX's requested relief and enjoined the defendants from voting the shares acquired during the period in which they were in violation of their disclosure obligations.[20]

3. Implications for Rights Plans.

CSX did not have a rights plan in place. Had a traditional rights plan been in place, provisions would have been triggered by the Court's finding either as to the synthetic equity abuse or as to the existence of a group. This is yet another reason to implement a rights plan rapidly in response to unusual market activity. However, because activist shareholders may seek to use CSX as a road map for avoiding similar judicial findings as to synthetic equity or wolf pack abuses, practitioners have sought to address more directly those concerns with next-generation rights plan provisions.

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[20] The Second Circuit affirmed the Court's decision not to enjoin TCI and 3G from voting their shares at the 2008 CSX annual meeting. It also decided to address the remaining issues in a subsequent opinion. *See CSX Corp. v. The Children's Inv. Fund Mgmt. (UK) LLP*, 292 Fed. Appx. 133, 134 (2d Cir. Sep. 15, 2008). To date, the Second Circuit has not issued a full opinion on the matter.

C. Addressing the Abusive Use of Synthetic Equity Positions.

Although this year many activist hedge funds and "event-driven" investors are facing challenging markets, which require them to re-focus energy internally rather than on external takeover campaigns, the ability and willingness of such investors to utilize share accumulation strategies that leverage equity derivative positions to advance takeovers (or other activist agendas) is likely to remain a permanent feature in the takeover landscape. We describe below methods employed by boards of directors of public corporations in altering the traditional definition of beneficial ownership in rights plans to explicitly protect against a strategy of significant stock accumulation, based in part on equity derivative positions, to effect a change in corporate control.

Approximately 28 percent of rights plans adopted or renewed in 2008 contained language including derivatives or synthetic equity in the calculation of the beneficial ownership threshold that triggers a rights plan. As this new rights plan technology has been implemented by corporations, various formulations of the definition of "beneficial ownership" have emerged. Three formulations are discussed below. The first approach seeks to capture all synthetic equity within the defined term beneficial ownership, without regard to any other factors (the "Full-Ownership Approach"), but operates only with respect to the long party investor, not its counterparties. The second formulation similarly operates only on the long party investor, but unlike the Full-Ownership Approach, requires the investor to own a physical position before the beneficial ownership definition aggregates the investors' synthetic equity position (the "Double-Trigger Approach"). The third formulation captures synthetic equity only to the extent that a counterparty (or counterparties) holds physical shares as a hedge, but unlike the first two formulations, seems to operate against the counterparties, as well as the long party. This last formulation is currently under review in the pending *In re Atmel Corporation Shareholders Litigation*[21] (the "Atmel Approach"). Assuming *In re Atmel Corp.* culminates in an opinion, it may offer further insight on the relative merits and drawbacks of some or all of these approaches to defining beneficial ownership and applying rights plans to counterparties in the equity derivatives market.

1. The Full-Ownership Approach.

The Full-Ownership Approach contemplates that all equity derivative positions held by an investor will be included in the calculation of a shareholder's beneficial ownership for purposes of the rights plan trigger. The derivative ownership position is calculated based on the notional number of shares covered by each derivative contract to which an investor is party, as illustrated by the sample definition of "beneficial owner" below.

> A Person shall be deemed to be the "Beneficial Owner" of and shall be deemed to "Beneficially Own" and have "Beneficial Ownership" of any securities: . . . (iv) that are the subject of a derivative transaction entered into by such Person, or derivative security acquired by such Person, ***which gives such Person the economic equivalent of ownership of an amount***

[21] No. 4161-CC (Del. Ch. filed Mar. 11, 2009).

> ***of such securities due to the fact that the value of the derivative is explicitly determined by reference to the price or value of such securities***, without regard to whether (a) such derivative conveys any voting rights in such securities to such Person, (b) the derivative is required to be, or capable of being, settled through delivery of such securities, or (c) such Person may have entered into other transactions that hedge the economic effect of such derivative. In determining the number of Common Shares deemed Beneficially Owned by virtue [hereof], the subject Person shall be deemed to Beneficially Own (without duplication) the number of Common Shares that are synthetically owned pursuant to such derivative securities.[22]

Although the key threat from derivative ownership positions relates to the physical shares acquired by a counterparty for hedging purposes, this formulation calculates the derivative ownership position without regard to physical shares actually held by the counterparty as a hedge or, if the counterparty hedges through a derivative instrument, the physical position held by the counterparty's counterparty. This reflects an important simplifying assumption that counterparties to these types of derivatives contracts almost always hedge their exposure through ownership of physical securities or through ownership of matching derivatives that at the end of the "daisy chain" are ultimately hedged by physical securities. As such, this formulation could be viewed as over-counting beneficial ownership relative to the perceived threat where the counterparty (and its counterparties) do not actually hold as many physical shares as a hedge as the notional shares covered by the initial derivative contract. Boards of directors and their financial and legal advisors should consider whether this simplifying assumption is reasonable from a business perspective, in light of current market custom and practice, and in the context of the corporation's shareholder base as a whole. The Atmel Approach discussed below does not make this simplifying assumption, so it can be viewed as more narrowly tailored to the perceived threat, but it is more complex and arguably more difficult to administer because it requires tracking the physical shares held by direct and indirect counterparties.

A potentially significant limitation of the Full-Ownership Approach is that, if and when a rights plan is triggered, economic dilution would not necessarily be suffered by the triggering investor with respect to its synthetic ownership position. Rights are only associated with physical shares, and thus would only be issued to holders of physical shares following a trigger event. Unless the counterparty to a derivative ownership position is deemed to be acting as a group with the triggering shareholder (which ordinarily would not be the case), such that physical shares held by the counterparty would be deemed to be held by the triggering investor, rights issuable to the counterparty with respect to its physical shares would be fully exercisable and the counterparty would not suffer dilution from triggering the rights plan. Moreover, under the standard TRS contract, the counterparty would be obligated to make the triggering investor "whole" with respect to the counterparty's exercise of the triggered rights. Thus, the economic

[22] Rights Agreement, dated as of March 24, 2008, between Micrel, Incorporated and Mellon Investor Services LLC, as Rights Agent. Micrel, Incorporated, Current Report (Form 8-K), ex. 4.2 (Mar. 24, 2008), *available at* http://www.sec.gov/Archives/edgar/data/932111/000119312508069421/dex42.htm.

deterrent that underpins the effectiveness of a rights plan would not deter accumulation of a derivative ownership position unless the triggering investor also holds a sizable physical ownership position that would be diluted upon the triggering of the rights plan.

2. *The Double-Trigger Approach.*

To address concerns that the Full-Ownership Approach does not deter accumulation of a derivative ownership position, unless accompanied by a sizable physical ownership position that is subject to dilution, the Double-Trigger Approach requires that a triggering shareholder first hold a minimum physical ownership position before any equity derivative positions the triggering shareholder may hold are included in the calculation of beneficial ownership for purposes of the rights plan. Accordingly, pursuant to a rights plan with this Double-Trigger Approach, only an investor owning, for example, five percent or more of the common stock would also be deemed to beneficially own any shares that are synthetically owned pursuant to derivative contracts. If an investor holds only derivative positions in a corporation's common stock, or less than the specified percentage of common stock set for the physical ownership, the equity derivative positions would *not* be imputed to the investor's percentage of beneficial ownership.[23]

The Double-Trigger Approach addresses in a practical way the concerns that the Full-Ownership Approach does not deter accumulation of a derivative ownership position unless accompanied by a sizable physical ownership position. Perversely, however, this may invite activists to accumulate wholly synthetic equity positions to advance a disruptive agenda, such as deliberately triggering a rights plan knowing it will suffer no dilution but will likely embarrass and perhaps discredit management and the board for getting itself into such a situation.

3. *The Atmel Approach.*

A third formulation of the definition of beneficial ownership is under review before Chancellor Chandler in the Delaware Court of Chancery. In this case, *In re Atmel Corp.*, defendant Atmel Corporation ("Atmel") received an unsolicited joint takeover bid from Microchip Technology, Inc. ("Microchip") and ON Semiconductor Corporation ("ON Semiconductor") to acquire Atmel for five dollars per share or a 52.4 percent premium to Atmel's closing share price as of the prior day. Shortly thereafter, Microchip received regulatory clearance to move forward on acquiring 50 percent of Atmel's shares. At this time, Microchip held approximately four percent of Atmel's outstanding shares. Faced with the acquisition proposal, but believing it not to be in the best interests of its shareholders, Atmel's board of directors adopted an amendment to its existing rights plan to lower the trigger threshold from 20 percent to ten percent and to expand the definition of beneficial ownership to capture synthetic equity positions.

The amendment in Atmel expanded the definition of "beneficial ownership" used in the rights plan to include derivative contracts to which a shareholder is party, but only to the

[23] In addition, as with the Full-Ownership Approach, the Double-Trigger Approach calculates ownership of synthetic equity based on the number of notional shares covered by all derivative contracts, without regard to whether or how many physical shares are held as hedges by the relevant counterparties.

extent of the physical shares held by a direct or indirect counterparty. The definition of beneficial ownership in Atmel's rights plan provides, in relevant part:

> A Person shall be deemed the "BENEFICIAL OWNER" of and shall be deemed to "BENEFICIALLY OWN" any securities:
>
> * * *
>
> (iv) which are ***beneficially owned, directly or indirectly, by a Counterparty under any Derivatives Contract*** (without regard to any short or similar position under the same or any other Derivatives Contract) to which such Person or any of such Person's Affiliates or Associates is a Receiving Party (as such terms are defined in the immediately following paragraph); provided, however, that the ***number of Common Shares that a Person is deemed to Beneficially Own pursuant to this clause (iv) in connection with a particular Derivatives Contract shall not exceed the number of Notional Common Shares that are subject to such Derivatives Contract***; provided, further, that the number of securities beneficially owned by each Counterparty ("Counterparty A") under a Derivatives Contract shall for purposes of this clause (iv) be deemed to include all securities that are beneficially owned, directly or indirectly, by a Counterparty ("Counterparty B") under any Derivatives Contract to which such Counterparty A is a Receiving Party, with this proviso being applied to successive Counterparties as appropriate.
>
> A "Derivatives Contract" is a contract between two parties (the "Receiving Party" and the "Counterparty") that is ***designed to produce the economic benefits and risks to the Receiving Party and that correspond substantially to the ownership by the Receiving Party of a number of Common Shares (the number corresponding to such economic benefits and risks, the "Notional Common Shares"), regardless of whether obligations under such contract are settled through the delivery of cash, Common Shares or other property,*** without regard to any short position under the same or any other Derivative Contract.[24]

The plaintiff, Louisiana Municipal Police Employees' Retirement System, on behalf of itself and other shareholders, filed suit on November 14, 2008, alleging that the directors of Atmel breached their fiduciary duties by amending the pre-existing rights plan to make it "significantly more onerous and potentially preclusive and destructive of stockholder value."[25] More specifically, the plaintiff claimed the inclusion of derivative interests in the definition of "beneficial ownership" is "overly broad and fatally vague,"[26] such that it

24 McIntrye Aff. Ex. H at Para. D (emphasis added).

25 Compl. Para 1.

26 Compl. Para 7.

would be difficult for shareholders and the corporation to determine how many notional shares covered by an equity derivative position should be included in the calculation of beneficial ownership.[27] In response, Atmel maintained that the amendment is clearly written and that it is not difficult for a party to ascertain the number of notional shares covered by a derivatives contract in order to calculate beneficial ownership.[28] Oral arguments in the case are currently expected to occur in mid-May.

As described in Atmel's rights plan, the target corporation and an investor accumulating synthetic equity must calculate both the notional shares covered by a derivatives contract (which the investor can easily do) and the number of physical shares being used to hedge, directly or indirectly, each derivatives contract (which almost certainly requires inquiry to the investor's direct counterparty and potentially further inquiry by that counterparty to the next counterparty if there is a daisy chain of offsetting derivatives, back to the ultimate counterparty in such a chain) in order to calculate the number of physical shares to be included in beneficial ownership. In this way, the Atmel approach attempts to address the perceived oversimplification of the Full-Ownership Approach. However, the required inquiry would be potentially complex and could well be unworkable as a practical matter, either for the investor or for the corporation seeking to administer its rights plan at the appropriate time, particularly if counterparties declined to provide details on their hedge positions and/or strategy.

Moreover, unlike the Full-Ownership Approach and the Double-Trigger Approach, which do not seek to impose economic dilution upon the counterparty to a derivatives contract upon the triggering of a rights plan, the Atmel Approach would also seem to dilute the counterparty with respect to the physical shares held as a hedge. Under the Atmel Approach, the physical shares held by the counterparty are deemed to be beneficially owned by the triggering shareholder, so that the rights issuable to the counterparty with respect to their physical shares would be void and not exercisable following a triggering event. We wonder whether it is reasonable or appropriate to impose the economic dilution attendant to the triggering of a rights plan on an investment banking firm or other financial services company operating its derivatives trading business in the ordinary course of business. If the Atmel Approach passes judicial muster and becomes common, it will probably lead to revisions in how business is done in the equity derivatives market, possibly including revised contractual forms to protect swaps dealers from being caught up in the effects of triggered rights plans and changes in the economics to compensate swaps dealers for the additional risks they might be shouldering in those cases. While the Atmel Approach does address a concern of the Full-Ownership Approach and the Double-Trigger Approach—the fact that an investor triggering a rights plan will only suffer dilution with regard to its physical ownership of shares—it also could be viewed as an overreaction and lead to the invalidation of a rights plan with respect to its treatment of synthetic equity.

D. <u>Addressing "Wolf Pack" Abuses</u>.

The rights plan is intended to, and historically has, successfully deterred Section 13(d) groups from acquiring more than the trigger threshold. As described earlier and

[27] Pl. Br. 2.
[28] Def. Br. 2.

illustrated by *CSX*, however, activist and other "event-driven" investors have increasingly sought to execute their strategies in coordination with other like-minded investors, without disclosure of their coordinated activities or any material relationships or other interests they hold. These investors may attempt to subvert the trigger threshold by accumulating common stock through multiple unrelated entities working cooperatively. Many observers believe it is appropriate for rights plans to regulate excessive stock accumulation by a wolf pack, which economically and functionally poses most, if not all, of the same threats to the interests of the shareholders posed by a traditional group.

To mitigate against these strategies, a rights plan addressing wolf-pack strategies deems a shareholder to beneficially own the stock of any person with whom that shareholder is "acting in concert" relating to changing or influencing control of a corporation. Shareholders will be considered to be acting in concert where they are aware of one another's actions regarding the corporation and are influenced by, and act in parallel with, those actions, as indicated by the exchange of information, discussions, meetings or invitations to work cooperatively. The acting in concert concept offers corporations a more sophisticated approach to identifying and deterring potential wolf-pack threats. By taking into consideration a holistic view of a shareholder's activities in the public markets with regard to a corporation's stock, including its activities with other shareholders, the wolf pack feature provides corporations with a more tailored definition of beneficial ownership that better captures the strategies employed by activist and event-driven investors.

An analogous regulatory solution was the development of the concept of "conscious parallelism" to address the antitrust conundrum posed by industry trade associations or similar multi-corporation groups where pricing policies are openly disclosed, but where there is no vote or similar decision by the group to adopt or enforce them; yet, those prices are widely copied by most or all industry participants. Wolf-pack tactics by activist investors, hedge funds and arbitragers are not different in methodology or outcome. There are one or two wolf-pack leaders who drive the strategy and tactics and take a forward and public role. Through the use of telephone and internet communications, they seek to attract other activists to their cause. In doing so, they will communicate ideas and proposals for action, but not ask for or receive responses indicating agreement. Rather, self-selected members of the wolf pack will merely follow and support the leaders through such measures as accumulating equity positions below the five percent disclosure threshold, voicing support for the leaders' positions in separate one-on-one conversations with the corporation, voting in support of the leaders' proxy proposals and the like. The effect from the standpoint of the corporation and the truly non-aligned shareholders is the same as if a Williams Act group had been formed, but without the benefits of disclosure and accountability imposed on five percent or greater groups under the Williams Act.[29] For these reasons, boards of directors may be advised to consider addressing wolf-pack strategies in existing rights plans.

[29] The inclusion of a conscious parallelism concept in a rights plan has been challenged by a hostile bidder, which sued a target corporation claiming that the conscious parallelism provision was unduly vague and rendered the pill unenforceable. *In re CV Therapeutics, Inc. Sec. Litig.*, No. C-03-3709 SI(EMC) (N.D. Cal. filed Aug. 8, 2003). The issue was never resolved, however, because a white knight bidder appeared and the original hostile bid and lawsuit were withdrawn.

III. NOL RIGHTS PLANS

A. Protecting the NOL Asset.

Traditionally, rights plans have been adopted to protect corporations against abusive takeover transactions. The introduction of the NOL rights plan, designed to protect net operating loss carry-forwards and certain other tax attributes, has expanded the reach of rights plans. NOL rights plans have recently gained prominence due to the impact of the recession, as a result of which an increasing number of corporations are generating significant NOLs that may be used to reduce future income taxes. Particularly for a corporation in financial distress, its NOL asset may have value far in excess of the corporation's current market capitalization. In this context, and in other situations in which NOL assets may be at risk, more corporations are adopting NOL rights plans in an effort to protect their NOL assets against the threat that changes in share ownership could limit their ability to use NOLs in the future.

B. NOL Rights Plans.

1. The Threat Posed by an "Ownership Change."

Corporations that have experienced substantial operating losses may, for federal and state income tax purposes, "carry forward" net operating losses in certain circumstances to offset current and future taxable income, which will reduce federal and state income tax liability, subject to certain requirements and restrictions. These federal and state NOLs can be valuable assets, which may inure to the benefit of a corporation and its shareholders.

Section 382 of the Internal Revenue Code of 1986, as amended (the "Code"), and related Treasury regulations provide that if a corporation experiences an "ownership change" for tax purposes, its ability to use its pre-change NOLs in a post-change period could be substantially limited and delayed. These limitations can significantly impair the value of the NOL asset. An ownership change generally occurs if the percentage of the corporation's shares owned by one or more five-percent shareholders increases by more than 50 percentage points over the lowest percentage of stock owned by those shareholders at any time during the prior three-year period or, if more recent, since the date of the last ownership change. Determining who is a five-percent shareholder for these purposes may be complex, as various special rules may apply, including those that result in a "public group" or entities acting in concert be treated as five-percent shareholders if they own in the aggregate five percent or more of the shares. Corporations with significant NOL assets may engage advisers to review the trading records of those corporations to determine whether any ownership changes have occurred, or if there are any threats posed by the possibility of future shareholder action.

Only a change in ownership by five-percent shareholders will cause an ownership change. However, this may occur inadvertently as a result of normal trading activity. Therefore. corporations with significant NOL assets should implement systems to monitor share ownership changes with the assistance of qualified outside experts. This monitoring can identify whether their cumulative ownership change percentages are approaching the applicable 50-percentage-point threshold. In circumstances where a bona fide threat exists to a corporation's NOL asset, the board of directors and its advisers should consider whether it is prudent to seek protection for these tax assets.

2. The Protection Offered by an NOL Rights Plan.

One possible protection is the adoption of an NOL rights plan. An NOL rights plan has a lower trigger threshold (typically 4.99 percent), as compared to the ten-percent to 20-percent trigger threshold typical in a traditional rights plan. The 4.99-percent trigger threshold is required in an NOL rights plan for two reasons. First, it deters additional shareholders from becoming five-percent shareholders. This is intended to mitigate the threat that share ownership changes present to a corporation's NOL asset, because changes in ownership by a person owning less than five-percent of the corporation's stock are not included in the calculation of ownership change for purposes of Section 382 of the Code. Second, it deters existing five-percent shareholders (who will be grandfathered at their pre-adoption ownership) from acquiring additional shares, which limits purchases by five-percent shareholders that would be included in the ownership change calculation. The definition of beneficial ownership in an NOL rights plan customarily conforms to the definition used under applicable tax laws, to determine whether an ownership change has occurred.

Due to the specific focus of NOL rights plans on protecting NOL assets, there typically are additional "safety valves" to avoid unnecessary triggering if there is no threat to an NOL asset. For example, many NOL rights plans terminate automatically if the board of directors determines that an NOL has been fully used or is no longer available. Other NOL rights plans permit the board of directors to exercise discretion to waive a trigger *after* the applicable ownership threshold has been reached, if the board of directors determines that the share acquisition is not likely to impair or limit the value of the NOL asset. As is discussed below, however, it may be preferable that NOL rights plans be non-redeemable and contain a *pre-clearance* procedure.

3. Limitations of the NOL Rights Plan.

While NOL rights plans afford protection of corporations' NOL assets, they do suffer from certain limitations. An NOL rights plan does not offer complete protection for a corporation's NOL asset. It cannot prevent an ownership change for tax purposes or prevent a potential acquirer from purchasing more than the 4.99-percent trigger threshold. It merely serves as a deterrent. Even an inadvertent acquisition can cause an ownership change to occur, but it would not likely trigger the rights plan—as NOL rights plans, like most traditional rights plans, have an exception for inadvertent acquisitions. In addition, in certain circumstances, sales by existing shareholders who historically held a five-percent ownership position can result in an ownership change under applicable tax laws. An NOL rights plan will not prevent or restrict stock sales, so it will not protect against an ownership change due to stock sales. An alternative, more effective protection is to embed ownership limitations in the corporation's certificate of incorporation. This has become a fairly standard protection for corporations with significant NOL assets emerging from bankruptcy, as the bankruptcy process facilitates adoption of a certificate of incorporation that includes ownership restrictions. However, amendments to the certificate of incorporation to impose ownership restrictions are difficult to implement outside of bankruptcy because they require shareholder approval under Delaware law and may be enforceable only against shareholders who vote in favor of the ownership restrictions or who become shareholders after the ownership restrictions have been approved.

Nor is an NOL rights plan an adequate substitute for traditional takeover defenses. Under Delaware law, a board of directors' actions with respect to an NOL rights plan should be reasonable in relation to its expressed purpose: protecting against threats to a corporation's NOL asset. The Delaware courts may view skeptically any attempt to adopt or use an NOL rights plan for traditional defensive purposes where no bona fide threat to a corporation's NOL asset exists. A board of directors considering whether to adopt an NOL rights plan should inform itself as to the nature and extent of the threat to the corporation's NOL asset by considering, among other things, the financial value of the NOL asset, the potential loss of value that the corporation would suffer if an ownership change occurred and the likelihood of an ownership change. Where the board of directors also perceives a bona fide threat from abusive takeover transactions, it may consider adopting a "second-level" ten-percent to 20-percent trigger threshold in the NOL rights plan, which would allow the NOL rights plan also to serve as a traditional rights plan at the higher trigger threshold.

4. Investor Reaction to an NOL Rights Plan.

The potential merits of NOL rights plans have been recognized by a proxy advisory firm, RiskMetrics Group, which recently signaled acceptance of NOL rights plans from a corporate governance perspective when it revised its policy position to accommodate NOL rights plans on a case-by-case basis.[30] When a rights plan is adopted for the stated purpose of protecting the NOL asset, RiskMetrics will consider the following factors:

- the trigger threshold;
- the value of the NOL asset;
- the term of the NOL rights plan;
- the inclusion of shareholder protection mechanisms, such as sunset provisions, that cause the termination of the pill upon exhaustion or expiration of the NOL asset; and
- other applicable factors.

On the basis of this policy, RiskMetrics recommended a vote "For" Hovanian Enterprises, Inc.'s NOL rights plan when it was submitted for shareholder approval.

Notwithstanding RiskMetrics' willingness to consider whether to recommend that shareholders vote in favor of NOL rights plans on a case-by-case basis, a corporation may

[30] *See* RiskMetrics Group, *2009 Draft Policy for Comment: Net Operating Loss Poison Pills (U.S.)* (2008), *available at* http://www.riskmetrics.com/policy/2009_nol, and RiskMetrics Group, *U.S. Corporate Governance Policy: 2009 Updates* (Nov. 25, 2008), *available at* http://www.riskmetrics.com/sites/default/files/RMG2009PolicyUpdateUnitedStates.pdf.

still receive a recommendation from RiskMetrics that shareholders withhold votes for incumbent directors if the board of directors adopts an NOL rights plan without seeking shareholder approval. RiskMetrics has a policy of recommending that shareholders withhold votes for incumbent directors if: (i) the corporation has adopted or renewed a rights plan without shareholder approval since the corporation's last annual meeting; (ii) the corporation does not seek shareholder approval of the rights plan at the current annual meeting and (iii) there is no requirement for the corporation to seek shareholder approval of the rights plan within 12 months of the adoption or renewal of the rights plan.

5. Examining Board of Directors' Motivations in Adopting NOL Rights Plan.

No Delaware court has examined a board of directors' motivations in adopting an NOL rights plan, although these issues are squarely at issue in the *Selectica v. Versata Enterprises, Inc.* litigation.[31] The primary rationale for an NOL rights plan is to protect a valuable tax asset of the corporation, not to deter opportunistic "hostile" transactions. However, like a traditional rights plan, an NOL rights plan deters share accumulations above the trigger threshold and presents the same board of directors' entrenchment-related concerns as traditional rights plans.

While directors' actions on behalf of their corporation are generally protected by the "business judgment rule," the adoption of defensive provisions raises special concerns because such provisions may be deemed, among other things, to "perpetuate" the adopting directors in office. Accordingly, the Delaware courts have applied a heightened standard to boards' decisions implementing defensive measures. Because an NOL rights plan is likely to be viewed as a defensive measure, a Delaware court is likely to subject the board of directors' decision to adopt a traditional rights plan to heightened reasonableness scrutiny under the so-called *Unocal/Unitrin* standard.[32] Under this standard, a board of directors must demonstrate that (i) "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"[33] and (ii) a rights plan adopted is "reasonable in relation to the threat posed."[34] Measures that are otherwise inequitable, preclusive or coercive are not permissible.

A board of directors considering whether to adopt an NOL rights plan should inform itself as to the nature and extent of the threat to the corporation's NOL asset by considering, among other things:

- the value of the corporation's NOLs, as analyzed by and discussed with the corporation's financial adviser, as well as the potential loss of value that would result from an ownership change under Section 382 of the Code;
- the risk that future acquisitions could impair the corporation's NOL asset, in light of the current ownership of the corporation and the status of the ownership change analysis under Section 382 of the Code; and

[31] No. 4241 (Del. Ch. filed Dec. 21, 2008).
[32] *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *see also Unitrin Inc. v. American Gen. Corp.*, 651 A.2d 1361 (Del. 1995).
[33] *Unocal Corp.*, 493 A.2d at 955.
[34] *Id.*

- that the NOL rights plan does not guarantee protection of the corporation's NOL asset because the sale of stock by significant shareholders may also result in an ownership change, thereby limiting the use of the corporation's NOLs to reduce future federal and state income tax obligations.

C. Testing the Technique: *Selectica, Inc. v. Versata Enterprises, Inc.*

1. *The First Triggering of a Modern Rights Plan.*

Until the end of 2008, the risk of economic dilution created by the rights plan had its intended deterrent effect. No shareholder had ever swallowed a modern rights plan,[35] and the mechanics of a rights plan trigger were purely an academic exercise.

This is no longer the case. In December 2008, Versata Enterprises, Inc. and certain affiliates triggered an NOL rights plan adopted by Selectica, Inc. in what appears to have been a calculated effort by Versata to obtain leverage in an unrelated business dispute. Selectica's board of directors used its rights plan to dilute Versata's position (exercising the feature that allows the board of directors to exchange rights held by shareholders other than Versata for common stock on a one-for-one basis). Due to uncertainty regarding the issuance and ownership of Selectica shares following the rights exchange, trading in Selectica's common stock was suspended for more than four weeks while the important "back-office" mechanics to implement the exchange were developed and implemented by Selectica and its advisers. In addition, *Selectica*, which is pending in the Delaware Court of Chancery, presents for the first time the question of the validity of an NOL rights plan and the board of directors' decision to use the rights plan against Versata. These events provide lessons applicable to all forms of rights plans.

Selectica is a California-based sales execution and contract management software provider that accrued an NOL asset valued at approximately $150 million. This value far exceeded Selectica's market capitalization. According to Selectica's complaint in the pending litigation, by November 2008, the acquisition of approximately ten percent of Selectica's common stock by new or existing five-percent shareholders would have resulted in an ownership change for applicable tax purposes and significantly impaired the value of Selectica's NOL asset.

On November 13, 2008, Versata and certain of its affiliates filed a Schedule 13D with the SEC disclosing that Versata had acquired 5.1 percent of Selectica's common stock and indicating that Versata was considering purchasing additional shares. Versata is one of Selectica's primary competitors. Since 2005, Versata had made periodic overtures indicating an interest in purchasing Selectica, all of which were declined by Selectica's board of directors. Selectica has alleged that Versata used its share acquisitions to seek leverage to force Selectica to accept a lower price for the corporation and to settle unrelated intellectual property disputes.

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[35] Sir James Goldsmith's takeover of Crown Zellerbach involved a first-generation poison pill with a flip-over feature, but did not include the now common flip-in feature. Stephen M. Bainbridge, *Dead Hand and No Hand Pills: Precommitment Strategies in Corporate Law* 13–14 (Law & Econ. Research Paper No. 02-02), *available at* http://ssrn.com/abstract=347089.

On November 17, 2008, in response to Versata's share accumulations, Selectica's board of directors implemented an NOL rights plan by reducing the trigger threshold of its existing rights plan from 15 percent to 4.99 percent. Selectica's existing five-percent shareholders, including Versata, were grandfathered under the NOL rights plan, subject to a trigger threshold of 0.5 percent above their pre-adoption ownership. Each existing shareholder was contacted and advised of the new trigger threshold. Selectica's board of directors also formed a committee of independent directors to monitor and administer the NOL rights plan.

On December 19, 2008, Versata notified Selectica that it had increased its position in Selectica to 6.7 percent, triggering the NOL rights plan. Selectica entered into discussions with Versata based upon the discretion available to Selectica's board of directors under the rights plan to determine whether to grant a waiver if Versata's share acquisitions would not jeopardize or endanger Selectica's NOL asset. The board of directors concluded that it could not grant a waiver because Versata was unwilling to agree to limit future purchases of Selectica's common stock as a condition for receiving a waiver.

Selectica had two options for using its NOL rights plan: allow a traditional flip-in event to occur; or exchange the rights held by all Selectica shareholders (other than Versata) for common stock. The flip-in event could have been substantially more dilutive to Versata, but relied upon holders paying cash to exercise the rights; could have resulted in a separate trading market in Selectica rights and may have further increased the risk of an ownership change (by increasing the percentage ownership of shareholders who exercised rights relative to other shareholders). On January 2, 2009, Selectica decided to exercise the exchange feature, declaring that all shareholders (other than Versata) would receive one share of Selectica common stock for each existing right. Because Versata and its affiliates were excluded from the exchange, Versata's ownership was diluted from 6.7 percent to approximately 3.4 percent. Selectica's board of directors also adopted a new NOL rights plan to maintain future protection for the NOL asset.

Selectica initially brought an action seeking a declaratory judgment to confirm that its rights plan was valid and that the board of directors acted appropriately in using the rights plan against Versata. In response, Versata asserted that Selectica's NOL rights plan is invalid on its face and that, even if the rights plan is facially valid, the manner in which Selectica's board of directors used the NOL rights plan constituted a breach of fiduciary duties.

Versata was not deterred by the cost of triggering Selectica's NOL rights plan; or, put another way, Versata may have valued the opportunity to gain leverage in an unrelated business dispute with Selectica more than these costs. Versata initiated purchases of Selectica's shares approximately three months prior to the trigger. During this time, Versata and its affiliates purchased 1,913,072 shares of Selectica's common stock at an average price of one dollar per share. Thus, the maximum loss Versata could sustain was just under $2,000,000.

Due to the uncertainty associated with implementing the share exchange, trading in Selectica's common stock on NASDAQ was suspended from January 5, 2009, until February 4, 2009. Besides this impact, Versata's trigger also caused Selectica to suffer the substantial equivalent of a two-for-one stock split (excluding shares held by Versata), legal and administrative expense and disruption to its board of directors, management and operations. The harm to Versata is more easily quantified. After the dilution caused by the share exchange, the value of Versata's holdings at the resumption of trading in Selectica's common stock on February 4, 2009 was approximately $920,000. Triggering Selectica's pill cost Versata just under $1,000,000 in lost value. This cost could have been substantially greater if Selectica had used the traditional flip-in, but it could never have been more than the approximately $1,900,000 Versata spent to acquire its position in Selectica.

2. The Potential Tax Implications of the Triggering of a Rights Plan.

The federal income tax consequences of shareholder rights plans, and NOL rights plans in particular, have not been definitively established by Congress or the courts. The Internal Revenue Service ("IRS") has issued one Revenue Ruling addressing the tax consequences of rights plans, but this ruling addressed only the adoption of a rights plan and did not address any later tax consequences.

Under Revenue Ruling 90-11, the adoption of a traditional rights plan—in response to a generalized takeover threat at a time when the exercise of the rights is remote and speculative—and the subsequent grant of the rights to shareholders is not a taxable event for the issuer or its shareholders. The adoption of such a rights plan and the grant of rights were held to be neither a distribution of stock or property, nor an exchange of stock or property.

Because Selectica's amendment was adopted in response to Versata's share accumulation, the tax treatment has not been specifically addressed by the IRS.[36] Revenue Ruling 90-11 does not technically cover the adoption of an in-play rights plan to ward off a specific threat, when it could be asserted that the exercise of the rights may not be as remote and speculative as compared to the adoption of a rights plan in response to a generalized threat. Although an in-play rights plan is adopted for the express purpose of deterring a specific share accumulation, the corporations adopting in-play rights plans generally do not expect that the rights will ever become exercisable or be exercised. The circumstances in which rights issued pursuant to an in-play plan would be exercised are generally considered by the corporations adopting them to be as remote and speculative as those existing in a plan adopted in response to a generalized takeover threat. Prior to Selectica, no one expected a hostile acquirer would actually suffer the economic dilution that occurs. Moreover, because a shareholder's ability to exercise the rights is subject to the actions of third parties, such rights issued pursuant to an in-play plan may be too contingent to be considered a distribution of property at all.[37]

Prior to being triggered, each Selectica right represented the right to purchase one one-thousandth of a share of preferred stock for the exercise price ($18.00), but were not separately traded from the common stock and were not exercisable. When the rights plan

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[36] The fact that Selectica amended its existing rights plan—rather than adopting a new rights plan—should not change the analysis of the plan for tax purposes.

[37] *See* Matthew A. Rosen, *Selected Defense Techniques, Including Leveraged Restructurings*, 8 Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 847, 858–59 (Louis S. Freeman, chair 2007).

was triggered, the rights plan provided for the separation of the rights from the common stock and the flip-in of the rights such that rights holders other than an "acquiring person" (Versata and its affiliates) would be entitled to exercise each right for that number of shares of common stock having a market value of two times the $18 exercise price. Although the flip-in provisions technically apply when the rights plan was triggered, as a practical matter the rights do not flip in until they are separated from the common stock and become exercisable. The applicability of the flip-in provisions upon a triggering event could be viewed as a non-taxable event to the rights holder because the change in the purchase price of the right is pursuant to the right's original terms. In situations like Selectica, in which the board decides to exchange the rights for common stock before they separate and become exercisable, there also is an argument that the shareholders never experienced any change in the terms of their rights upon the triggering of the rights plan, thus there is no taxable event.

If the flip-in were viewed as an exchange of the old rights for new rights, it generally would be viewed as a tax-free recapitalization. In certain circumstances, such a recapitalization could be treated as a taxable stock distribution under Code Section 305(b) if (i) the exchange was part of a plan to increase periodically the proportionate rights of a shareholder in the earnings of Selectica and (ii) Selectica had made cash distributions or paid interest on convertible debt within three years before or after the exchange. Even assuming that Selectica made such cash distributions, the flip-in arguably could still be a non-taxable recapitalization even though it has the effect—by design—of decreasing Versata's proportionate interests and increasing that of the other rights holders. The flip-in could instead be viewed as an isolated recapitalization, not pursuant to a prohibited periodic plan, since Selectica did not know in advance which shareholders' interests would increase.

The Selectica shareholders' exchange of rights for common stock in a cashless transaction should be a nontaxable recapitalization under Code Sections 368(a)(1)(E) and 354, subject to the same Code Section 305(b) concerns discussed above. In a recapitalization exchange of warrants for stock (rather than the actual exercise of the warrants for stock), there would be a tacking of holding periods under Code Section 1223(1). Consequently, a rights holder's holding period in the stock received in the exchange would include the time during which the right was held.

As the only U.S. rights plan ever triggered, Selectica's tax situation is unique. If the triggering of NOL rights plans becomes more prevalent, the need for IRS guidance clarifying the tax consequences of those events will increase.

Selectica's situation demonstrates that an NOL rights plan is a limited defense against impairment of the NOL asset. It can deter, but not prevent, share trades that may result in an ownership change. Even with its inherent limitations, however, in circumstances where a bona fide threat exists to a corporation's NOL asset, a board of directors and its advisers should consider whether it is prudent to seek protection for this asset by adopting an NOL rights plan. Thus, as the recession continues, the NOL rights plan will continue to merit attention.

IV. IMPROVING RIGHTS PLANS: LESSONS FROM THE FIRST TRIGGERING OF A MODERN RIGHTS PLAN

The triggering of exercisable rights under the Selectica rights plan provided the first opportunity to address the legal, economic and practical issues associated with rights becoming exercisable under a plan.

A. The Exchange Feature Offers Advantages over a Traditional Flip-In.

Instead of allowing the traditional flip-in to occur, Selectica's board of directors exercised the exchange feature in its rights plan and exchanged the rights on a one-for-one basis for common stock. As a general matter, a corporation should not signal to the market in advance that it intends to use the exchange feature rather than the traditional flip-in (as this could reduce the deterrent effect of the rights plan). However, particularly in the context of an NOL rights plan, the exchange feature offers a number of practical and compelling advantages over the traditional flip-in.

First, the exchange feature provides certain and automatic dilution. After a traditional flip-in, rights would be in-the-money, trade separately from the common stock and be exercisable until the expiration of the rights plan. It is difficult to predict when the holders of rights would exercise. Standard options theory suggests that the rights might not be exercised until their expiration date,[38] although a holder's desire to vote or receive dividends on the common stock could create incentives to exercise sooner. The rights would create massive overhang until they were exercised, complicating the corporation's capital structure and impairing the corporation's ability to complete alternative transactions. In contrast, the exchange provision is effective immediately, requires no action by shareholders and eliminates any overhang issues.

Second, no cash is required to exercise. To exercise following a traditional flip-in, the holder must deliver the exercise price in cash, making a decision to invest additional capital in the corporation. Particularly in the current capital market environment, financing for the cash exercise price is uncertain. The holder's investment decision would be somewhat analogous to that in a conventional rights offering to raise equity capital in which not all investors will commit new money in order to avoid dilution in that context. Although the scale of dilution would be substantially larger in the rights-plan context, it is far from clear that all holders would recognize the difference, have the required cash and be willing to make the new investment decision. It is also unclear whether the corporation would need, or reasonably could deploy, the additional capital that it would receive. In contrast, the exchange feature does not require cash and instead exchanges each right for one share of common stock.

Third, the exchange feature may have less impact on the NOL asset. Unexercised rights may not be deemed to create beneficial ownership of the underlying common stock for tax law purposes. As a result, exercises of rights after the traditional flip-in could change the shareholders' relative ownership percentages in the corporation (by increasing the percentage ownership of shareholders who exercised rights relative to non-exercising shareholders), which could affect the ownership change calculation and itself threaten the

[38] John Hull, *Options, Futures, and Other Derivates* 211–12 (7th ed. 2009).

value of the corporation's NOL asset. The results of the exchange provision are predictable and should have less impact on the corporation's NOL asset.

However, the exchange feature results in less dilution. Unless a rights plan's exercise price is very low in relation to the underlying stock's trading value, a one-for-one exchange is likely to be significantly less dilutive than the traditional flip-in. A board of directors' determination to exercise this restraint by using the exchange provision instead of the traditional flip-in may bolster the argument that directors acted reasonably. We anticipate that the decision in the *Selectica* litigation may provide guidance on this specific question.

B. Adding the "Back-Office" Mechanics for the Exchange Feature.

When Selectica's board of directors determined to exercise the exchange feature, there was significant uncertainty as to important back-office mechanics to complete it.[39] The procedures in the modern rights plan for a traditional flip-in event, which require that holders certify their eligibility as a condition of exercising their rights, were not workable in the exchange initiated by Selectica. Due to this uncertainty, trading in Selectica's common stock on NASDAQ was suspended from January 5, 2009, until February 4, 2009, while mechanics were developed and implemented by Selectica and its advisers.

The most important of the back-office mechanics included a process to verify that rights being exchanged, including rights held in "street name" through The Depository Trust Corporation, were not beneficially owned by Versata or its affiliates. The process had two distinct procedures for verifying the beneficial owner of Selectica's shares. Shareholders holding shares registered in their names with Selectica's transfer agent were requested to verify that they each were not an "acquiring person" for purposes of the rights plan. Selectica then issued shares to shareholders who submitted the required verification. Alternatively, for shares held in "street name," The Depository Trust Corporation requested that its participating brokers electronically verify the number of shares held on behalf of clients who were not acquiring persons for purposes of the rights plan. Selectica then credited shares to the accounts of the participating brokers in the amounts covered by the verifications that were received. For shares for which the required verification was not received, Selectica issued exchange shares into a trust (representing approximately three percent of the exchange shares), to be held pending receipt of the required verification.

All rights plans should be revised to incorporate these or similar mechanics in order to expedite the implementation of an exchange and minimize (or even eliminate) the time during which trading would be suspended.

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[39] The standard poison pill already contains the legal mechanics to implement the distribution of the rights and the traditional flip-in, including determination of the equivalent of a record date for distribution and a verification procedure in the rights exercise process, so it should not raise comparable problems. The back-office procedures to give effect to these legal mechanics would need to be discussed with The Depository Trust Company, including the process to ensure that the requisite verifications are obtained each time a right is transferred in "book entry" form. These procedures would be consistent with the procedures used by The Depository Trust Company to implement transfer restrictions for shares that are restricted or held by affiliates.

C. Reconsidering a Board of Directors' Post-Trigger "Safety Valve" for NOL Pills.

Many NOL rights plans, such as the one in *Selectica*, permit a board of directors to exercise discretion to waive the trigger *after* the applicable ownership threshold has been exceeded, if the board of directors determines that the share acquisition does not impair or limit the value of the NOL asset. Under this post-trigger "safety valve," the board of directors must consider whether to dilute an acquirer who has already crossed the ownership threshold. The "after-the-fact" nature of the waiver may make the board of directors susceptible to increased pressure because its decision will result in an immediate detrimental impact to the acquirer, will cause disruption to the corporation when the rights plan is used, and likely will result in litigation challenging the board of directors' actions. Moreover, for an NOL rights plan, the corporation may suffer an ownership change when the rights plan threshold is crossed, in which case the corporation would already have suffered harm to its NOL asset. In this circumstance, the board of directors may find it difficult to justify the implementation of a rights plan to the detriment of the acquirer when no further threat to the corporation's NOL asset exists.

It is preferable that an NOL rights plan be non-redeemable after the ownership threshold has been crossed so that no post-trigger waivers can be granted.[40] As with traditional rights plans, this incentivizes a potential share purchaser to engage in a pre-purchase discussion to request a waiver from a board of directors. The board of directors can then consider the waiver in advance without undue pressure and grant it if the proposed share purchase does not threaten the value of the NOL asset.

To provide a formal procedure for pre-clearance, the board of directors could establish procedures for shareholders to submit requests for waivers (by way of a board-of-directors policy or in the NOL rights plan itself), which would encourage share purchasers to consult with the board of directors in advance and provide a process for the full board of directors or a committee of independent and disinterested directors to consider and evaluate waiver requests. Although not required by law, we believe that a waiver evaluation process led by independent and disinterested directors could provide additional protection for all of the directors. The procedures employed in the evaluation process could, for example, require share purchasers to notify the board of directors in writing and provide information about proposed purchases and rights plans with respect to future purchases. The procedures would provide a reasonable period of time for the board of directors or committee to evaluate and respond to the waiver request. The board of directors or committee could then grant or deny the request after considering all of the facts and circumstances, including, among other things, the potential current and future impacts on the NOL asset and the desire of other shareholders to purchase additional shares. A waiver approval could be subject to certain conditions, such as an agreement by the share purchaser to limit future share purchases that could threaten the NOL asset.

As discussed above, the board of directors' consideration of an advance waiver request is likely to be subject to the same fiduciary standards as consideration of a request for a post-trigger waiver, but a formal pre-clearance process may better position the directors to

[40] We believe that the customary exception for bona fide inadvertent share acquisitions is likely to remain in NOL poison pills, notwithstanding that even an inadvertent trigger can result in an ownership change for applicable tax purposes.

discharge their fiduciary responsibilities and subsequently defend their actions in litigation. Instituting a formal pre-clearance process helps demonstrate that the board of directors has adopted the NOL rights plan for the purpose of protecting the corporation's NOL asset, not for entrenchment or other improper motives, and frames the board of director's consideration of waiver requests in this context. This is particularly important in light of the lower 4.99-percent trigger threshold in an NOL rights plan. Assuming that the formal pre-clearance process is reasonable and not unduly burdensome, a share purchaser who does not pursue an advance waiver, but who instead seeks to invalidate the rights plan post-trigger, may carry a heavier burden in explaining its actions in litigation. Finally, the formal pre-clearance process also increases the likelihood that the board of directors will have advance notice of potential acquisitions, providing an opportunity for the board of directors to respond before the corporation has suffered harm.

D. The Deterrent Effect of a Rights Plan May Not Be Sufficient to Prevent a Trigger.

A rights plan is ultimately an economic deterrent, with the deterrent effect measured by the cost to the acquirer of economic dilution. The deterrent is less effective for corporations with low market capitalizations or in financial distress. With NOL rights plans, the deterrent effect is further impacted by the lower 4.99-percent trigger threshold, as the dilution is applied against a relatively small stake held by the acquirer. In the current economic environment, the deterrent effect of a rights plan will depend to an even greater extent on the specific facts and circumstances of the particular corporation.

The facts in *Selectica* are unique, and the uncertainty of implementing its response was in part a function of its being the first U.S. corporation ever to suffer the trigger of a modern rights plan. In the future, corporations will have the lessons of *Selectica* as a model for mechanics and implementation, with the result that there may not be a trading halt, or, if there is, it will be one of shorter duration and lower legal and administrative costs. It is probable that Versata concluded, as other future acquirers might conclude, that under certain circumstances the costs to the target corporation of a rights-plan trigger exceed the costs to the acquirer, and, therefore, the threat of triggering the rights plan could be used as leverage. This relative cost analysis is highly fact-specific, with outcomes that may be difficult to predict. Yet in situations involving corporations with low market capitalizations or in financial distress, one can imagine a rights-plan trigger being threatened by either strategic acquirers seeking leverage for a traditional hostile takeover, or activist shareholders or hedge funds seeking leverage in support of event-driven strategies. NOL rights plans are particularly susceptible to this relative cost analysis because of the lower 4.99-percent ownership threshold. In any event, if an acquirer decides to swallow another modern rights plan, the corporation's board of directors should be prepared to adopt a new rights plan, like Selectica's board of directors did, to maintain the protection sought to be obtained by the swallowed pill.

CONCLUSION

After years of decline, the rights plan experienced a resurgence in 2008. This may be a temporary result of the recession, as corporations buffeted by falling equity prices adopted measures to protect shareholders in a period of market volatility. However, the trend could outlive the recession. The *Atmel* and *Selectica* litigations likely will provide the Delaware courts with the opportunity to clarify the validity of the rights plan, including whether triggers can be expanded to include derivative and synthetic provisions and whether they can be employed not just to fend off hostile and abusive takeovers, but also to protect valuable assets of a corporation.

Whether the resurgence continues or abates, the increasing use of derivative and synthetic equity positions, coupled with the first trigger of a modern rights plan, dictates that increased attention be paid to the terms and mechanics of rights plans. No longer can advisers dredge up a stale rights plan and suggest that its terms sufficiently protect a corporation or that the complex procedures are unlikely to be tested. Instead, corporations and their advisers should evaluate rights plans to ensure that they contain customized state-of-the-art terms and mechanics that can offer fulsome protection against evolving threats.

#6 â€“ Voting Plans. Trends of poison pills adopted according to market cap. History of Poison Pills. Examples of Poison Pills.Â Advantages and Disadvantages of Poison Pill. Poison Pills: Always bitter or sometimes sweet? Conclusion.Â The latter responded by issuing a shareholderâ€™s right plan as a â€œPoison Pillâ€, a move which irked Carl Icahn to no end. A year later, he cut his holding to 4.5% and Netflix terminated its right issue plan in December 2013. source: money.cnn.com. A poison pill is a defense tactic companies use to deter or prevent hostile takeovers. These "shareholders rights plans" often threaten to dilute the price of stock enough to give the target company time to find alternative bids. It creates a cost that the purchasing company will have to pay after they've taken over. It also dilutes the value of the acquiring company's stock, to make taking over less appealing. A poison pill is a strategy that tries to create a shield against a takeover bid by another company by triggering a new, prohibitive cost that must be paid after the takeover.Â This could also make the takeover of the company prohibitively expensive the buyer had planned to replace the top management. Finally, one non-financial method of a poison pill is to stagger the election of the board of a company, causing the acquiring company to face a hostile board for a prolonged period of time. In some cases, this delay in gaining control of the board (and therefore the votes necesarry to approve certain key actions) is a sufficient deterrent for a takeover attempt. An extreme implementation of a poison pill is called a suicide pill. Why it matters