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Poison Pills In the Wake of COVID-19: A Refresher on Terms and Variations of Shareholder Rights Plans

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Shareholder rights plans, commonly known as “poison pills,” are arrangements that can be used by companies to stave off hostile takeovers or activist investors seeking to exert control over a company without paying a control premium. A typical rights plan, if triggered, would allow all shareholders except the triggering person to purchase additional shares in the company at a substantial discount. The resulting share dilution makes it significantly more expensive for the triggering person to purchase a controlling stake in the company. Because of this, it is extremely rare for a rights plan to be triggered; instead, rights plans can have the effect of encouraging hostile bidders or activist investors to negotiate directly with a company’s board of directors.

While rights plans were widely used in the 1980s, they largely fell out of favor in the early 2000s as institutional investors and proxy advisory firms advocated against their use. But following the financial crisis in 2008, companies suffering from reduced market capitalization again turned to rights plans as a means to prevent share accumulations by hostile acquirers and activist investors. And now, in the wake of the COVID-19 pandemic and consequent market volatility, a similar script is playing out—rights plan adoption has risen markedly, and proxy advisory firms have eased their guidance regarding rights plans.

In light of this resurgence, investors and companies alike may want to reacquaint themselves with the mechanics of rights plans. Typical terms and variations are discussed below, as well as new proxy advisory guidance in light of the effects of COVID-19. Additionally, interested parties should be aware of (1) the law governing rights plans in the state or jurisdiction in which the company is organized, as state law applicable to these arrangements can vary significantly, (2) the company's charter, bylaws and other governing documents, as well as its material contracts, as they may contain restrictions or impediments on the company adopting a rights plan, and (3) the requirements of the applicable securities exchange.

Key Terms

Threshold: This is the percentage of a company's shares that must be acquired for a rights plan to be triggered. Thresholds between 10-20% are common, although some companies have adopted 5% thresholds for traditional rights plans in the current environment. A trend in recent years has been to impose different thresholds for different types of investors—for example, a lower threshold might apply for activist investors rather than passive investors (sometimes defined as investors eligible to file a Schedule 13G with the SEC). Net operating loss (or "NOL") rights plans typically have thresholds under 5%. Unlike typical rights plans, NOL rights plans are designed not to deter takeovers, but to preserve tax treatment like NOLs, which can be lost if a stockholder acquires 5% or more of the company.

Beneficial Ownership: A rights plan will typically define beneficial ownership broadly, so that the definition includes shares held by affiliated entities of the investor, as well as swaps and other derivatives that might not give the investor beneficial ownership under the federal securities laws. Beneficial ownership typically is defined to include the ownership of the shares of any investors acting together as a "group," as such term is defined in the rules adopted under the Williams Act, and a minority of rights plans also include "wolf pack" provisions that aggregate the holdings of different investors that act in conscious parallelism, even if such activity would not form a "group" under the securities laws.

Exercise Price: The discounted price at which shareholders can purchase shares if the plan is triggered. This is typically determined in consultation with the company's financial advisors, and typically reflects the company's long-term view of market value.

“Flip-in” and “flip-over” provisions: A “flip-in” provision allows a shareholder to acquire additional shares of the company in which that shareholder already owns shares; a “flip-over” provision allows a shareholder to acquire shares of the acquiring company (at a discount), if there is one. All rights plans include a flip-in provision, and the vast majority of rights plans include both flip-in and flip-over provisions.

Duration: Rights plans will expire (or “sunset”) after a certain period. Though a 10-year duration was typical when rights plans first appeared, terms of one-to-three years have become the standard. Almost all of the plans that have been adopted in 2020 will only last for one year or less, in alignment with the views of proxy advisory firms (discussed below).

“Chewability”: Some plans allow shareholders to vote to cancel the rights plan depending on the offer. When shareholders must vote on a rights plan in response to any offer, the plan is referred to as “chewable.” But more often, rights plans with chewability provisions require that an offer must meet certain requirements in order to trigger a shareholder vote. Almost none of the plans that have been adopted in 2020 include a chewability provision. Plans that last for more than one year also frequently require annual evaluation by independent directors to determine if the plan is still advisable.

Duration: Generally, a board of directors can redeem a rights plan (i.e., terminate the rights plan) in its discretion. But some plans include a “dead hand” provision that only allows incumbent directors, and not newly elected directors, to redeem the plan. This becomes relevant in the situation where a potential investor launches a successful proxy contest to replace directors. However, dead-hand provisions are of questionable enforceability and have been struck down in New York and Delaware. Accordingly, they are not included in most rights plans.

Grandfather Clauses: Typically, current shareholders who exceed the ownership threshold need not worry when a plan is adopted. Most plans provide that shareholders who exceed that threshold prior to the plan’s implementation do not trigger the plan, unless they acquire additional shares after the rights plan is adopted.

Current Climate

As of the date of publication, at least 70 rights plans have been adopted this year, including more than 40 just in the months of March and April. The majority of these plans will be effective for one year or less, likely signaling that they were implemented in response to COVID-19 concerns, but meaning that most of these plans will remain in place through the end of 2020. And while the rate of adoption has slowed as markets have calmed, any renewed turmoil could lead to another wave of rights plans.

Notably, the increase in rights plan adoption this year has been met with some shareholder acceptance. While the influential proxy advisory firms Institutional Shareholder Services Inc. ("ISS") and Glass, Lewis & Co. ("Glass Lewis") generally oppose adoption of rights plans that are not subject to shareholder votes, they have issued further guidance on rights plans in light of the COVID-19 pandemic. Both appear more open to rights plans that are relatively short in duration. In April, ISS advised that: "A severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a plan of less than one year in duration; however, boards should provide detailed disclosure regarding their choice of duration, or on any decisions to delay or avoid putting plans to a shareholder vote beyond that period." Meanwhile, Glass Lewis has stated that while it still "generally opposes" rights plans, valid rationales can include "the closing of an important merger, managing a clear and present hostile takeover threat, or other contextual factors like a severe drop in stock price due to a widespread industry or market downturn."

In light of this guidance and continued economic uncertainty, companies may view rights plans as practical options to protect against share accumulation by hostile acquirers and activist investors. Even if not formally implemented, many companies keep plans "on the shelf" and available for swift implementation should the need arise in the future. Thus, at least in the short term, rights plans are likely to remain a go-to corporate tool.

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