

# Shareholder Activism Against Poison Pills: An Effective Antidote?

by Soren Lindstrom\*

Today shareholders increasingly are exercising their right to vote for proposals to eliminate shareholder rights plans—commonly known as “poison pills”—and to withhold votes for directors. This makes it critical for directors to consider how important it really is to have a rights plan in place before there is a specific takeover threat.

Shareholder rights plans have been around since the early 1980s, and provide a defense against unwelcome takeover offers. A shareholder rights plan is designed to shift negotiating leverage to the target company’s board of directors and to give the board more control over the timing of the response to an unsolicited bid. A shareholder rights plan also is designed to protect the company’s shareholders from coercive or abusive takeover tactics and to ensure that shareholders will receive a fair price if the company is sold.

Shareholder rights plans seek to accomplish these goals by threatening to inflict a substantial economic loss, in the form of an unacceptable level of dilution, on a bidder that takes certain actions involving a company without the approval of the target’s board. Under a typical shareholder rights plan, shareholders are issued rights to buy stock at a significant discount (generally 50%) from the market price. The rights become exercisable when a hostile bidder buys a certain percentage of the target company’s stock (generally between 10 and 20%). Due to the potential significant dilution, the bidder is more likely to negotiate with the board, which has the ability to eliminate the rights plan or to exempt the bidder from the rights plan’s dilutive effect. No poison pill has ever been triggered.

## Potent Shareholder Activism

Despite the seemingly obvious advantages, poison pills lately have become the target of increasingly potent shareholder activism. The primary shareholder complaints against poison

pills are that they entrench management and the board and discourage legitimate tender offers. Typically, shareholder proposals addressing poison pills have taken the form of a request that the company submit its poison pill or any future pills to a shareholder vote, or redeem a pill already in effect. The numbers speak for themselves:

- In 2003, there were 107 shareholder proposals related to poison pills—a record high.<sup>1</sup>
- The number fell in 2004, but at the same time more than 40 companies took proactive action on their poison pills, including terminating a pill or adopting a board policy (described below) on poison pills.
- In 2003, anti-pill shareholder proposals won an average of 60% of shares voted. Thus, shareholder proposals requesting a company to terminate its poison pill or to not adopt a new pill without shareholder approval have, in a vast majority of cases, gained approving support. Such support, when proposals have been repeated, has generally increased year-over-year.

The primary reason for the increased shareholder activism is that powerful institutional shareholder groups generally do not like rights plans. Institutional Shareholder Services (ISS), an influential provider of proxy voting and corporate governance services, recommends that institutions vote in favor of shareholder proposals requesting that the company submit its poison pill or any future pills to a shareholder vote, or redeem poison pills already in existence. In addition, a company that has a poison pill in place that has not been approved by shareholders will suffer a



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significant downgrading in ISS' ratings system (Corporate Governance Quotient). Similarly, Fidelity dislikes poison pills. Fidelity recommends that portfolio shares should generally be voted against anti-takeover proposals. Moreover, the introduction of a poison pill without shareholder approval will cause Fidelity to withhold authority in the concurrent or next following vote on the election of directors.

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These statistics do not mean that poison pills are no longer a popular takeover defense. As of early 2004, 33 of the Fortune 100 companies had a poison pill in place, and among S&P 500 companies, 57.6% had poison pills at the end of 2003. Based on current trends, it appears likely that this number will be below 50% at the end of 2005. Still, although a majority of the major public companies continue to have poison pills, there has over the last few years clearly been a significant increase in shareholder activism in opposition to poison pills.

Shareholder proposals requesting the company to submit its poison pill or any future pills to a shareholder vote, or to terminate an existing poison pill, are precatory (not binding)—even if overwhelmingly approved by the shareholders. However, if a company fails to implement a proposal approved by the shareholders, there likely will be significant negative consequences for the company and its incumbent directors, including the perception that the company is not responsive to the wishes of its shareholders, substantial withholding of votes in director elections, and miserable corporate governance ratings.

### **Some Legal Considerations**

Delaware law embodies the business judgment rule, which is based on the fundamental principle that the management of the business and affairs of a Delaware corporation is entrusted to its directors as the duly authorized representatives of the shareholders. Under the business judgment rule, the decision of a board is generally not disturbed.

However, in the context of takeover defenses, Delaware courts have recognized that there is increased risk that a board may be acting primarily in its own interest rather than that of the corporation and its shareholders. Because of the potential for conflict of interest in this area, Delaware courts have imposed the additional requirement that a board show it had reasonable grounds for believing there was a threat to corporate policy and effectiveness. This burden may be satisfied by a showing of good faith and reasonable investigation on the part of a board. In addition, the defensive measure taken must be reasonable in relation to the threat posed. If these criteria are met, courts generally will defer to a board's actions.<sup>2</sup>

If a board adopts or extends a shareholder rights plan in advance of a specific threat, there is less risk that a court would determine that such action did not comport with the directors' fiduciary duties. However, some boards have adopted rights plans when they perceive specific threats. In those situations, court cases tend to focus on the decision of a board not to redeem the rights in the face of an unsolicited proposal, rather than on the timing of its adoption.<sup>3</sup> Accordingly, an extension of a rights plan in advance of any specific threat will not relieve a board of its fiduciary obligations if in the future it is faced with an unsolicited offer accompanied by a request to redeem the rights plan. So, while the law has not changed, potent shareholder activism has raised the "costs" of having a poison pill in place.

### **What Should the Board Do?**

A board facing a successful anti-poison pill proposal has four principal options:

- terminate the poison pill;
- keep the pill in place and try to ride out the storm;
- seek to adopt a "shareholder friendly" shareholder rights plan; or
- adopt a board policy on poison pills.

Before taking any action, the board should review its poison pill in light of its other takeover defenses and the current threat environment and seek advice from its investment bankers and legal advisers. If the company has other effective

takeover defenses in place, such as a classified board, it may be a less difficult choice for the board to terminate a poison pill. (Of course, the classified board may be the next shareholder target.)


Keeping the pill in place may very well not be a feasible option for the board: incumbent directors often cannot tolerate the withholding of significant votes in director elections. This leaves the company with the option of either adopting a “shareholder friendly” poison pill or a board policy on poison pills. “Shareholder friendly” poison pills typically contain so-called “TIDE” features (which stands for Three-Independent Director Evaluation of the plan) or “chewable” features (a qualifying offer clause requiring the pill to be redeemed, either automatically or by shareholder vote, if a bid is made for the company that meets certain criteria). It appears, however, that these “shareholder friendly” rights plans do not really get the job done; institutional investors still withhold votes for directors unless the plan is truly weakened. As a result, an unprecedented number of companies have opted to terminate poison pills and adopt board policies on poison pills.<sup>4</sup> Typically, a board pill policy covers two concepts:

- The board will seek prior shareholder approval before adopting a shareholder rights plan unless the directors determine that it would be in the best interests of the shareholders to adopt a plan without such approval. This is a “fiduciary out” in case the company faces a threat, and is probably required under Delaware law in order for the board to fulfill its fiduciary duties.
- If a rights plan is adopted without prior shareholder approval, the plan must either be ratified by shareholders or must expire within a certain period—typically, one year.

The termination of a poison pill and the adoption of a board poison pill policy likely will

have a number of advantages: fewer votes will be withheld in director elections; corporate governance ratings will improve; and, as an added benefit, the Securities and Exchange Commission generally will allow the company to exclude any future poison pill shareholder proposal from its proxy statement.<sup>5</sup>

One prudent step for the company and the board to take upon termination of a poison pill and adoption of a pill policy would be to have a new rights plan ready “on the shelf.” The board should review, but not formally adopt, a new rights plan and have it ready for use if needed. The new shelf plan should be reviewed by the board at reasonable intervals to ensure that its terms are appropriate in light of potential threats. This would add to the board’s reasonable investigation, and enhance the validity of any future adoption of the pill.

By terminating the poison pill, adopting a pill policy, and having a new poison pill ready on the shelf, the company would have gained the most of a tricky situation: It has responded to the request of the disgruntled shareholders (and done away with the resulting negative consequences), and yet it continues to have a strong takeover defense available to be deployed when needed. 

- 1 The statistics in this article are based on information from the “2004 Background Report on Poison Pills” issued by Investor Responsibility Research Center (available through links at <[www.irrc.org/index.html](http://www.irrc.org/index.html)>).
- 2 *See* *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Moran v. Household International Inc.*, 500 A.2d 1346 (Del. 1985); *Revlon v. MacAndrews*, 506 A.2d 173 (Del. 1986).
- 3 *See, e.g.*, *Facet Enterprises v. Prospect Group*, C.A. No. 9746 (Del. Ch. 1988).
- 4 Major companies that have adopted policy statements regarding poison pills include American Airlines, ExxonMobil, Intel, General Electric, 3M, Hewlett Packard, and ChevronTexaco.
- 5 *See, e.g.*, *Hewlett-Packard Company*, SEC No-Action Letter, 2003 WL 23148894 (Dec. 24, 2003); *Marathon Oil Company*, SEC No-Action Letter, 2004 WL 187664 (Jan. 16, 2004); *General Electric Company*, SEC No-Action Letter, 2004 WL 307447 (Feb. 10, 2004); *3M Company*, SEC No-Action Letter, 2004 WL 346065 (Feb. 17, 2004); and *Kimberly-Clark Corporation*, SEC No-Action Letter, 2004 WL 2997719 (Dec. 22, 2004).