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Poison Pills — A Measured Prescription

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With the coronavirus pandemic creating unprecedented market disruption, and as stock prices have precipitously dropped to levels not seen in years, boards should consider implementing additional monitoring and protections against opportunistic stock accumulations.

Shareholder rights plans, or poison pills, can be adopted through board action without shareholder approval. By imposing significant dilution on an acquirer that exceeds specified thresholds (generally 10 to 15%), rights plans can provide a safety measure against substantial accumulations of shares that may be a prelude to an opportunistic takeover bid, creeping control or activist campaign.

> *In current market conditions, boards should consider preparing or implementing a shareholder rights plan to protect against opportunistic share accumulations or to protect tax NOLs.*

Rights plans can also be set at a lower threshold (generally just under 5%) as needed to protect net operating loss (or NOL) carryforwards and similar tax attributes — valuable tax assets which can be significantly impaired if a company undergoes a change of control as defined by the Internal Revenue Code.

Below are some key considerations related to rights plans in the current market.

Putting a Pill "On the Shelf"

All companies should be paying closer attention to the composition of their shareholder base and trading activity (especially because market volume and volatility may provide cover for rapid accumulations), and ensuring that the board is equipped to act quickly. Putting a rights plan "on the shelf" is simply doing the preparatory legal work and board consultation in advance so that, if it becomes necessary to deploy a rights plan quickly, the timeline to do so can be accelerated. This preparation generally involves drafting the shareholder rights plan and related documentation, discussing the plan and related fiduciary duties with the board, and conferring with advisors about potential terms. In contrast to the actual implementation of a rights plan, putting one on the shelf does not require any formal board action or public disclosure. Combined with an effective stock watch program, keeping a pill on the shelf is appropriate advance preparation for companies under most circumstances.

Adopting a Pill

But, for some companies, amidst the extreme volatility in the market today, it may make sense to actually adopt a rights plan if other risk factors are present. These include unusual or suspicious trading patterns or other specific evidence or concerns about opportunistic accumulation by an unsolicited acquirer or activist that could result in a substantial stake being accumulated before disclosure is required by securities or antitrust regulations, thereby reducing the board's leverage to protect the interests of all shareholders.

Where a rights plan is adopted, the exact terms and duration of the plan should be tailored to the specific risks being addressed, which we expect will often involve a short-term plan to address immediate concerns raised by the current crisis.

While during normal times the adoption of a shareholder rights plan on a "clear day" may garner negative reactions from a company's shareholder base as well as proxy advisory firms, shareholders today may be more likely to accept the rationale for a properly tailored rights plan and we would expect that the proxy advisory firms may be more open-minded to the implementation of short-term plans designed to address specific risks.

NOL Pills

During these times of market dislocation and low interest rates, the urgency for currently adopting a pill may be even greater for a company with meaningful NOL tax assets, particularly if it thinks it might otherwise generate taxable income in the medium term, including through liability management transactions or opportunistic debt repurchases.

As described in our previous *M&A Update*, Section 382 of the Internal Revenue Code applies a formulaic limitation (tied to equity value and a published interest rate) on the ability of a company to use its NOL carryforwards in future years if it undergoes an "ownership change" (i.e., if the ownership by 5% shareholders of the company changes by 50% or more during a rolling three-year period). Shareholder rights plans can be tailored to address NOL ownership changes by deterring accumulations in excess of this 5% threshold, thereby protecting a company's valuable tax assets.
