

Client Alert

April 2020

Using Rights Plans to Protect Stockholder Value During the COVID-19 Crisis: A Case-by-Case Analysis

Recent stock market volatility, sharp declines in trading prices, and an uncertain economic outlook may create opportunities for shareholder activists and hostile bidders. With many companies and sectors feeling particularly vulnerable, there has been a recent uptick in the adoption of stockholder rights plans (or “poison pills”). Between March 1 and April 1:

- At least 17 companies adopted takeover defense rights plans, of which:
 - 10 of the rights plans had a 10% trigger;
 - 8 of the rights plans were two-tiered, with a second, higher trigger for Schedule 13G filers; and
 - all of the rights plans had a term of one year or less; and
- at least 5 companies adopted NOL rights plans to protect net operating loss carryforwards (NOLs).

The decision to adopt a rights plan is, of course, subject to fiduciary duty considerations and depends on the circumstances. While institutional investors and proxy advisory firms may be supportive of short-term rights plans in some situations, they will evaluate them on a case-by-case basis. Even if circumstances do not warrant a rights plan at this time, however, companies should consider preparing (or updating existing) “shelf” rights plans so that they can be deployed quickly if needed.

Current Climate for Activism and Hostile Bids

It is unclear whether activists and hostile bidders will try to capitalize on the current crisis in the near-term. Anecdotally, several activists have abandoned their campaigns or revisited settlement terms, and many hedge funds are trying to manage the impact of the recent market volatility on existing positions. In addition, one high-profile hostile bid has been withdrawn due to the COVID-19 crisis.

Other activists may adhere to the adage, “never let a good crisis go to waste.” Several activists have engaged in rapid share accumulations in recent weeks, and some companies have received unsolicited proposals. There is also concern that activists will accumulate shares now at depressed prices and launch an activist campaign after the COVID-19 crisis lessens.

Right now, issuers face several heightened risks, which are greatest for small- and mid-cap companies:

- *Depressed Stock Prices Create Opportunities.* Severely depressed stock prices make it easier for activists and hostile bidders to accumulate large positions by lowering the overall cost of acquiring a significant voting bloc. Moreover, activists or hostile bidders can acquire shares at prices that the board believes do not reflect the long-term value of the corporation.
- *Downward Pressure from Short-Sellers.* Short-selling is adding further downward pressure on some stocks. In some cases, certain companies may be targeted for short-selling and, therefore, disproportionately affected relative to their peers.

- *No or Ineffective Early Warnings.* The filing threshold under the Hart-Scott-Rodino Act may not serve as an effective warning to companies because the filing threshold (\$94 million) is based on absolute dollars rather than a percentage of the company's voting securities. Companies should also keep in mind that an activist or hostile bidder has ten days before it must report the acquisition of more than 5% of a class of a company's shares on Schedule 13D, thereby creating the opportunity to accumulate a position far in excess of 5% before the company can react and adopt a rights plan.
- *Market Volatility and Increased Trading Volume Can Mask Share Accumulations.* Market volatility and increased trading volume may make it harder to identify share accumulations, even for companies using stock monitoring services, and also allow activists or hostile bidders to more quickly acquire a large position in the company's stock.
- *Dismantling of Takeover Defenses.* Over the years, many US public companies have dismantled their takeover defenses, making them more vulnerable to opportunistic and abusive tactics of gaining control over the corporation without paying a fair price.

Recent Adoption of Rights Plans During the COVID-19 Crisis

Between March 1 and April 1, 2020, at least 17 public companies adopted takeover defense rights plans. These plans had the following terms:

- Triggering Threshold: Ten had a triggering threshold of 10%, four had a triggering threshold of 15%, one had a triggering threshold of 5%, and one had a triggering threshold of 20%.
- Two-Tiered Trigger for Schedule 13G Filers: Eight had a second, higher trigger for Schedule 13G filers, all of which were set at 20%. For non-Schedule 13G filers, the trigger was 15% (two plans) or 10% (six plans).
- Qualifying Offer Exceptions: Two had qualifying offer provisions (i.e., "chewable pills") that generally permit all-cash, fully financed tender offers for all shares of common stock that remain open for a specified minimum period.
- Term: All of the rights plans had a term of one year or less (e.g., until the next annual stockholders meeting).

Another five public companies adopted "NOL rights plans" to protect the companies' ability to use their NOLs. Under the tax code, certain changes in share ownership can limit a corporation's ability to use its NOLs and, as a result, NOL rights plans generally have different provisions (e.g., a lower trigger percentage of 4.9% and a longer term) than takeover defense rights plans.

New ISS Policy Guidance on Rights Plans During the COVID-19 Crisis

On April 8, 2020, Institutional Shareholder Services (ISS) provided policy guidance in response to the COVID-19 crisis. Importantly, ISS signaled 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 pill of less than one year in duration.*" ISS's policy guidance continued: "*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. The triggers for such plans will continue to be closely assessed within the context of the rationale provided and the length of the plan adopted, among other factors.*"

ISS's policy guidance should not be read to support widespread adoption of rights plans. Rather, a company that adopts a rights plan should expect ISS to review it on a case-by-case basis, and the terms of the rights plan will be important. Although some commentators have suggested that the COVID-19 crisis justifies new approaches in takeover defense strategies, it may be difficult to obtain ISS's support

with non-traditional terms. In particular, ISS can be expected to focus on the duration of the plan and the triggering threshold. For example, ISS recently recommended that shareholders vote against the chairman of a board of directors that adopted a takeover defense rights plan with a 5% trigger.

Take-Aways

While rights plans historically have drawn criticism from investors, the unprecedented COVID-19 crisis may require boards to be proactive in preserving stockholder value. For some companies, this means preparing or updating existing “shelf” rights plans. For other companies, the situation may justify adoption of a rights plan. In that case, the board of directors may consider such factors as the company’s recent stock price performance, both on a standalone basis and relative to peers; the board’s view of the company’s intrinsic value; trading volume and market volatility; specific industry challenges; projected financial performance; the existing shareholder base; change-of-control triggers in debt instruments; and existing takeover defenses (including whether stockholders can call special meetings or act by written consent).

Importantly, boards should determine that a rights plan is in the best interests of stockholders and should tailor the plan to the situation. As noted above, all of the rights plans adopted between March 1 and April 1, 2020, had a term of one year or less (other than the NOL rights plans). In addition, the board should disclose the rationale of the rights plan and engage with their stockholders in explaining the threat to the corporation and how the rights plan addresses it. We would expect most disclosures to specifically reference the COVID-19 crisis.

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