

The Ultimate Takeover Defense?

RiskMetrics' New View on Net Operating Loss Poison Pills

By Dante Deliso of Hogan & Hartson LLP

Tight credit markets and recessionary pressures have historically led to an increase in strategic M&A. Hardly anyone has been immune to the recent devastating effects on equity values and many companies have watched their share price drop more than 50% over the past year. These factors tend to lead companies with cash on hand and driven by the never ending pressure to find new growth and increase shareholder value, to take advantage of the depressed market conditions and acquire competitors or other strategic targets that can not weather the downturn. The current downturn, arguably the worst since the Great Depression, has paved a smooth road for companies in the enviable position of being cash rich to accomplish this goal.

To add to the plight of these distressed companies, many have given in to the overwhelming pressure from activists over past years to dismantle their takeover defenses.¹ Couple this with the drastic drop in share price and these companies are virtually defenseless against an unwanted takeover. This is a scary thought considering unsolicited takeover attempts more than doubled in 2008,² a development that is likely to grow exponentially once financing becomes available and companies start shopping the clearance aisle.

When confronted with a takeover bid, a board is forced to determine whether the recent decline in the company's stock price is a true reflection of the company's long-term prospects or just a temporary dislocation of valuation. A board, tasked with maximizing shareholder value, will fail at its duty if it allows the company to be taken over at a time when its share price reflects only a fraction of its true value. However, if the proper takeover defenses are not in place—even if a board decides an offer does not reflect the company's true value—it may be powerless to thwart the takeover.

The most effective takeover defense a board can implement is a shareholder rights plan. A shareholder rights plan—also known as a “poison pill”—effectively works as a dividend, that once triggered radically dilutes the acquirer's holdings making the acquisition prohibitively expensive. Boards love poison pills because they provide leverage at the bargaining table giving the board a stronger voice in the timing and terms of a takeover. Poison pills also provide time for a company unhappy with its current suitor to locate a more suitable acquirer (a so-called “white knight”) or to identify other value-enhancing alternatives. Shareholders benefit from poison pills because they have historically resulted in increased takeover premiums without diminishing the overall completion percentage of announced takeover bids.³

Pills and the Lack of Investor—and RiskMetrics—Support

While poison pills can provide great benefit to companies and their shareholders, they do not receive widespread support. Some view poison pills as an entrenchment tactic by management and believe that they take power away from the shareholders to consider potentially worthy takeover bids. RiskMetrics Group, the leader in providing proxy analysis and advice to investors maintains a poison pill policy that reflects such concerns. Many institutional investors look to RiskMetrics's voting advisory policies to determine how to vote and a negative recommendation by RiskMetrics can significantly impact the results of a shareholders' meeting.

RiskMetrics' current policy states that they will only consider supporting proposed pills that meet certain guidelines. These guidelines require proposed pills to have a trigger threshold of 20% or higher, contain a three year sunset provision, not include any features similar to a dead-hand, slow-hand or no-hand feature⁴, be submitted to shareholder vote within twelve months of adoption and have a shareholder

¹ Sharkrepellent.net, *2008 Year End Review*, https://www.sharkrepellent.net/pub/rs_20090122.html.

² *Id.*

³ Geogerson & Company, Inc., *Poison Pills and Shareholder Value 1992-1996*, M&A LAWYER, Sept. 1998.

⁴ A “dead-hand” provision restricts the right to amend or redeem the poison pill to the original directors who adopted it. This prevents an unwanted acquirer from ousting a majority of the incumbent directors and having the newly elected directors amend or redeem the pill to allow for the acquisition. A “slow-hand” provision prevents a poison pill from being amended or redeemed for a specified period of time after a change in a majority of directors. A “no-hand” provision prohibits the amendment or redemption of the poison pill by any board.

redemption feature allowing for ten percent of the shares to call a special meeting or seek written consent to vote on rescinding the pill if the board refuses to redeem the pill within 90 days after an offer is announced.⁵

While shareholder activism against poison pills has decreased over the past few years,⁶ poison pills are still viewed by many as an entrenchment device. The current market conditions however, have created an environment that may change many shareholders' view of poison pills. Even without shareholder support, the current economy may force companies to weather the repercussions of adopting a poison pill that is noncompliant with RiskMetrics' policy to ensure that their company is protected against being acquired at unreasonably low valuations. This may not be necessary, however, since there may be a way that companies can "have their cake and eat it too."

What is a "Net Operating Loss Poison Pill"?

The severe economic downturn is causing a need for stronger takeover defenses and may have opened a door allowing companies that have incurred net operating losses over the past few years to adopt poison pills with trigger thresholds far below RiskMetrics' current policy without receiving a negative recommendation from RiskMetrics. This can be accomplished by adopting a Net Operating Loss Poison Pill or "NOL Pill."

NOL Pills have a much lower trigger threshold than traditional poison pills, usually around 4.99%, since Internal Revenue Code Section 382 limits the extent to which net operating losses can be used if one or more of the company's 5% shareholders increase their ownership by greater than fifty percentage points within a three-year period.⁷ In the past, most companies would not even consider adopting a pill with such a low trigger because RiskMetrics' policy did not differentiate between traditional pills used as takeover defenses and NOL Pills which are implemented to safeguard a tax benefit.

RiskMetrics' Latest NOL Pill Position

RiskMetrics, however, has made it clear in the '09 update to their guidelines that they will consider this rationale for adopting a pill in their analysis by indicating a willingness to support NOL Pills under certain circumstances.⁸ RiskMetrics' 2009 policy states that they will consider NOL Pills on a case-by-case basis taking the trigger threshold, the value of the NOLs, the term of the pill, along with other existing shareholder protection mechanisms, into account when making their recommendation.⁹

While NOL Pills have generally been adopted by small companies with recurring losses or those in bankruptcy, with losses piling up over the past year or so, some companies may be able to provide a legitimate reason for adopting an NOL Pill. In turn, these companies may be able to receive a supportive recommendation from RiskMetrics, which would allow them to adopt a virtually impenetrable takeover defense with the added benefit of safeguarding tax benefits -without the usual repercussions of adopting a poison pill with such a low trigger threshold. For the countless number of companies who are increasingly vulnerable to unsolicited takeover attempts due to the recent drop in the price of their shares, the protections afforded by adopting an NOL Pill could prove invaluable.

The views expressed in this article are solely those of the author and should not be attributed to the author's firm or its clients.

⁵ RiskMetrics Group, *U.S. Proxy Voting Guidelines Concise Summary*, <http://www.riskmetrics.com/sites/default/files/RiskMetrics2009SummaryGuidelinesUnitedStates.pdf>.

⁶ Sharkrepellent.net, *Unfriendly First Quarter of 2008*, https://www.sharkrepellent.net/request?an=dt.getPage&st=1&pg=/pub/rs_20080402.html&rnd=766486.

⁷ I.R.C. § 382; RiskMetrics Group, *Net Operating Loss Poison Pills (U.S.) 2009 Draft Policy for Comment*, http://www.riskmetrics.com/policy/2009_nol.

⁸ RiskMetrics Group, *Voting Guidelines*, *supra* note 5.

⁹ *Id.*