WHITHER THE POISON PILL?

Neil Henderson – August 2009

The poison pill is a corporate strategy employed by a public company's Board of directors against potential hostile takeovers. The term "poison pill" has come to mean any method employed by a target company which acts as a deterrent to a potential purchaser. In its most common form, however, the poison pill is essentially the putting into place of a shareholder-rights plan, as a result of which a successful hostile bidder is then faced with the prospect of substantially inflated acquisition costs. Having fallen from fashion for a time, poison pills are increasingly being re-examined by Bermuda public companies.

In its most simple form, the poison pill is usually employed in the following manner: prior to, or upon, the launch of a takeover bid, the target company enters into arrangements with existing shareholders whereby the shareholders are able to acquire a form of preference shares at a discount to the market price, the so-called "flip-in" plan, a form of which was employed recently by Yahoo! in its defence against Microsoft's proposed takeover. The poison pill takes effect once an investor acquires a certain percentage (usually 15% or 20%) of the target company's voting shares. Once that threshold is breached, unless the rights are redeemed by the company's board the existing shareholders (other than that investor) may take advantage of the shareholder-rights plan to acquire additional preference shares at the discounted price, resulting in an increase in the number of shares which the bidder must purchase, thus making the takeover a less attractive proposition.

Alternative poison pill defences are the "flip-over", whereby a company's existing shareholders are given the right to buy discounted shares in the merged company, and the "macaroni defence", by which the target company issues bonds to existing shareholders which are liable to be redeemed at a higher price in the event of a takeover.

The attraction of the poison pill is that it acts as an immediate deterrent to unwelcome corporate advances. The effect is to centralize power in the Board, buying time for the target company to consider the offer, fight the takeover, prepare other defences, or to attract the attention of more appealing suitors.

Poison pill defences reached the height of their popularity in the 1980s and 1990s, falling somewhat out of vogue after the turn of the millennium in the face of increasing challenges from activist investors and proxy advisory services. As a result, many public companies have allowed their shareholder-rights plans to lapse in the last decade.

However, the current international economic crisis has resulted in a genuine concern amongst public companies that their shares are undervalued, leaving them vulnerable to become acquisition targets at prices which do not fully reflect their potential.

In addition, the character of hostile takeover activity has diversified such that specific poison pill defences require to be employed in response. By way of example, the widespread use of derivative and swap transactions in U.S. public companies has given rise to uncertainty regarding the ultimate beneficial ownership of such securities. This uncertainty - known as abuse of synthetic equity positions - has been exploited for takeover purposes with hostile bidders manipulating their economic interests to avoid disclosing beneficial ownership under U.S. securities requirements, thus depriving the target company sufficient time to prepare its defences.

In addition, wolf-pack tactics are being employed whereby like-minded investors are co-ordinating their efforts to acquire shares in a target without disclosing to authorities that they are acting in concert, on the basis that the requirement is obviated due to the 'arrangements' not being formally documented.

According to some commentators, these changing circumstances - of which synthetic equity positions and wolf-pack tactics are but two examples - contributed to a significant 2008 decline in shareholder activism against poison pill strategies, and a renewed enthusiasm for the poison pill amongst potential target companies themselves. By way of illustration, it has been noted that the 28 poison pill adoptions in December 2008 were the most in any month since October 2001; and 2008's full year total of 127 adoptions was the most in any year since 2002.

This trend looks likely to continue in the U.S. following the 19 May 2009 decision of the Delaware courts in relation to microchip-maker Atmel Corp., whose Board, in response to a takeover offer, amended the company’s poison-pill plan to make it harder for potential suitors to use derivative contracts to amass shares. Delaware Chancery Court Judge Chandler III concluded that Atmel’s changes to its takeover defence were properly designed to help protect the company from unwanted suitors, and the investor challenge that these changes were overly broad was rejected.

Specific poison pill defences to counteract the wolf-pack tactics also exist. Most commonly, these are dealt with under a shareholder rights plan which deems a shareholder to beneficially own the stock of any fellow investor with whom that shareholder is "acting in concert" relating to the change of control of a company. These provisions would be drafted broadly and offer a holistic view of the activities of a company's members.

Turning to Bermuda, the validity of poison pills was considered by the Supreme Court in *Stena Finance v Sea Containers (1989) 39 WIR 83*, which held that the adoption of a poison pill shareholder rights plan by the Board of a Bermuda company could constitute the proper and constitutional exercise of the Board's power. In that case, it appeared, however, that the fact that the shareholder rights plan in question was already in existence prior to the initiation of the takeover was persuasive to the Court.

Although *Stena* appears to be the only decision of a Commonwealth court directly in relation to the adoption of a shareholder rights plan, due to the increasing number of Bermuda companies listed on U.S. exchanges, it is commonplace for Bermuda public companies to consider the adoption of poison pill provisions. The House of Lords in England (the decisions of which would be highly persuasive in Bermuda's courts) has, in relation to a different type of poison pill, also indicated that the adoption of a poison pill may be a valid act by a company's board if it did so within the actual or apparent scope of its authority.

In the current economic climate, those Bermuda companies listed on U.S. exchanges with existing shareholder-rights plans that have not recently done so should take the opportunity to re-examine the terms of their current poison pill provisions to ensure that they are sufficient to defend the types of hostile takeover attacks described above. For those Bermuda public companies that consider themselves vulnerable to a hostile takeover and that are yet to implement a shareholder rights plan, it may be opportune to consider the merits of preparing suitable poison pill defences.

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