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Shareholder Rights Plans (Poison Pills)

A shareholder rights plan provides the shareholders of a target company with rights to purchase additional shares or to sell shares at very attractive prices, in the event of an unwanted offer (“hostile takeover”) for the company. These rights, when triggered, impose significant economic penalties on a hostile acquirer. Hence, they have been coined “Poison Pills”.

Takeover bids are attempts by a bidder to obtain control of a target company, either by soliciting proxies in a proxy fight to get elected to the board or to acquire a controlling block of shares and use the associated votes to get elected to the board. Once in control of the target’s board, the bidder then tries to select the target’s management.

How a Shareholder Rights Plan Works

The target company issues rights to existing shareholders to acquire a large number of new securities, usually common or preferred stock. The new rights typically allow holders (other than a bidder) to convert the right into a large number of common shares if anyone acquires more than a set amount of the target’s stock (typically 20-30%). This dilutes the percentage of the target owned by the bidder, and makes it more expensive for the bidder to acquire control of the target company.

History

The poison pill was invented by noted M&A lawyer Martin Lipton of Wachtell, Lipton, Rosen & Katz, in 1982, as a response to tender-based hostile takeovers. Poison pills became popular during the early 1980s, driven by the increasing trend of corporate raids by businessmen such as Carl Icahn.

The trend since the early 2000s has been for shareholders to initially vote against poison pill authorization, since, despite the above statistic, poison pills are designed to resist takeovers, whereas from the point of view of a shareholder, takeovers can in most cases, be financially rewarding.

There are five main types of Shareholder Rights Plans:

1. Preferred Stock Rights Plan

Occasionally companies use preferred shares as means of preventing hostile takeovers, creating preferred shares with a poison pill or forced exchange/conversion features that exercise upon a change in control of the Company.

2. Flip-over Rights Plan

A flip-over poison pills is a rights plan where shareholders of a targeted firm will have the option to purchase discounted stock after the potential takeover. This strategy gives a common stock dividend in the form of rights to acquire the hostile acquirer’s common stock or preferred stock below market value. Following a takeover, the rights would “flip over” and allow the current shareholder to purchase the unfriendly competitor’s shares at a discount. If this tool is exercised, the number of shares held by the unfriendly competitors will realize dilution and price devaluation.

3. Ownership Flip-in Rights Plan

The flip-in is a provision in the target company's corporate charter or bylaws. The provision gives current shareholders of a targeted company (other than the hostile acquiror) rights to purchase additional stocks in its own targeted company at a discount rate. These "flip-in" rights to purchase occur only 1) before a potential takeover, and 2) when the acquirer surpasses the "kick-in" or threshold point of obtaining outstanding shares (usually 20 - 50%).

4. Back-end Rights Plan

A "back-end plan" is when current shareholders of the targeted company receive a rights dividend, which allows for the exchange of a share (including voting rights) for senior securities or a cash equivalent to the "back-end" price established by the targeted firm. As a result of this strategy, the takeover bidder is unable to both 1) exercise this right, and 2) easily deter the rise in the acquisition price.

5. Voting Plan Rights Plan

A voting plan is implemented when a company puts a charter in place for its preferred stock allowing it to have superior voting rights over common shareholders. If an unfriendly bidder acquired a substantial quantity of the target firm's voting common stock, the acquiror would not be able to exercise control over its purchase due to the voting rights of the preferred stock.

In the **U.S.**, a shareholder vote on the enactment of a shareholder rights plan is **not** required and boards generally adopt these plans without shareholder approval. This has made the use of these plans quite contentious.

In **Canada**, corporations are required to submit shareholder rights plans to shareholders at a meeting no later than six months following the adoption of the plan by the board (TSX Company Manual Section – 636 (a)). These plans are still quite controversial in Canada, according to the Ontario Teachers' Pension Plan ("OTPP"), but shareholders have some comfort in knowing that any plan must be brought before shareholders for ratification.

As outlined on the OTPP website, www.otpp.com:

There are two legitimate purposes of a shareholder rights plan:

1. ensuring that all shareholders are treated equally in connection with a change of control of the company; and
2. allowing the board of the target company sufficient time to determine whether there is a course of action that will provide shareholders with a better alternative to the offer.

Many shareholder rights plans go much further than their two legitimate aims. In those circumstances they may become effective tools in the hands of boards and management to discourage a takeover bid, or to prevent shareholders from responding to a bid, or from determining the best course of action for the company.

For this reason, OTPP will look to support shareholder rights plans with all or substantially all of the following features:

- The plan provides that the minimum bid period is not longer than 60 days.
- The plan allows for partial bids.
- The plan does not authorize the board to waive the plan's application unless the plan is waived for all other subsequent bids.
- The plan does not allow for the redemption of rights without shareholder ratification.
- The plan does not contain exemptions for private placements.
- The plan exempts soft lock-up agreements.
- The plan requires shareholder ratification at least every three years.
- The plan places a modest limit on the granting of any "break fees."

Risk Metrics Group

Risk Metrics Group (www.riskmetrics.com) – the former Fairvest/ISS (ISS Governance Services) has published analyses of the corporate governance issues raised by Canadian rights plans in its Corporate Governance Review (CGR). Copies of the CSR are available to clients. These articles describe the development in recent years of a 'new generation' of shareholder rights plans in Canada. Over the course of the last several proxy seasons, the 'new generation' plan has become the widely accepted norm for rights plans that attempt to address corporate governance concerns.

Some of the features are:

Permitted bid: The 'new generation' rights plans have established a 60-day maximum period for a permitted bid. The acquirer may not take up any shares pursuant to the takeover bid unless more than 50 percent of the company's voting shares are deposited and tendered at the expiration of the bid. In addition, the bid must remain open for 10 days after expiration if all of the above conditions are met, affording disapproving shareholders the opportunity to tender their shares. Based on these criteria, the clause allows bids to proceed in spite of board opposition.

ISS's guidelines support a **three-year sunset** (term of the plan), allowing shareholders the opportunity to reconsider the plan in light of changing market conditions and to review management's use of the plan.

This ability of management to amend the plan without the approval of the holders of rights or shares is not acceptable from a corporate governance perspective.

Shareholder Rights plans issued for today's proxy season should meet the **new generation** shareholders rights guidelines.