

The Purpose of Poison Pills

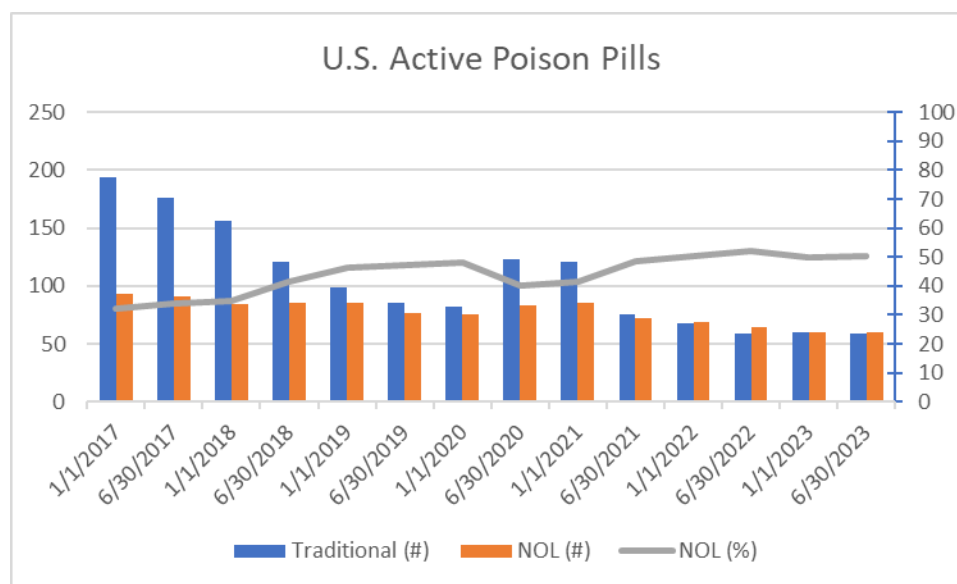
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Back in the News

Poison pills are back in the news with an increase in litigation surrounding the device, raising the question of what their proper use is. A Bloomberg Law article this week cited a “wave of recent lawsuits” related to poison pills that were specifically tailored to deal with activist investors and not the unfriendly acquisition offers for which they were originally designed. Against this backdrop, we examine why and for what purpose poison pills are being used. You may be surprised to learn that half of all active U.S. poison pills are not those to protect against raiders and activists but are instead to preserve valuable company tax assets.

Evolving Purpose

The first versions of the shareholder rights plan (which Wall Street quickly dubbed the “poison pill”) emerged in the early 1980s in response to the hostile takeovers being waged by the corporate raiders of the day. Over time, the threat of an activist campaign became much more likely than a hostile tender offer, and companies began to include provisions in rights plans specifically designed to deal with activists agitating for change (vs. a raider seeking to acquire the entire company). Starting around 2008, in response to the use of derivatives by activist hedge funds, companies began to specifically include derivatives in the trigger language, because an activist could amass a sizeable position and influence at a company without triggering any SEC reporting requirements. To account for activist “wolf packs” working together but not formally, trigger language also began to include shareholders “acting in concert”. Additionally, it became more common for companies to set a low 10% trigger versus the 15% or 20% triggers found in traditional anti-takeover plans in order to limit the influence of the activist.



Along the way, a new purpose was conceived for these plans: Protecting Tax Assets. The first company we are aware of that adopted a poison pill specifically designed to protect net operating loss carryforwards (NOLs) was Sterling Construction Company, Inc. in 1998. In the ensuing years, relatively few companies adopted NOL preservation poison pills, and these types of plans continued to represent a small subset of all active poison pills. The use of NOL plans gained in popularity following the financial crisis of 2007–2008 and has steadily increased over the years, representing half of all active poison pills today. The mechanics of an NOL poison pill

are similar to traditional anti-takeover poison pills with a few exceptions. In addition to the lower trigger threshold, another key difference is the definition of “Beneficial Owner”. An NOL preservation plan may reference Section 382 of the Code, whereas a traditional poison pill is based on the SEC definition of “Beneficial Ownership” and is focused generally on the right to vote or control disposition of the shares. While certainly less controversial than traditional poison pills, an NOL preservation plan adoption may nonetheless draw the attention of shareholders who may accuse the company of using the NOL rights plan as a disguised tool for Board entrenchment (e.g., in a letter to the Board of Directors of Mitek Systems, Inc., Elliott Management Corporation notes that “attempts to disguise this poison pill as a tax-asset-protection plan are thoroughly unconvincing”).

Recent Activity: Most Traditional Plans Adopted in Response to Activists

Over the three period since the 2020 spike in poison pill adoptions related to the Covid-19 pandemic, 54% of traditional adoptions (i.e., not net operating loss carryforwards protection plans “NOL plans”) were adopted while the company was being engaged by an activist shareholder or following the disclosure of a substantial stake purchase or increase (e.g., a 13D filing). Only 23% of the adoptions were in response to an unsolicited acquisition offer. Over the same three-year period, traditional adoptions have outnumbered NOL adoptions by two to one. However, traditional plans as a proportion of all active plans has remained steady, because NOL plans typically have a longer term than traditional plans (e.g., most commonly three years versus a one-year term for traditional). Traditional plans are also more likely to be terminated early (i.e., when the threat has passed, and the protection is no longer needed).

