LOW STOCK PRICES AND POISON PILLS

March 13, 2009

To Our Clients and Friends:

Companies throughout the world have had to grapple with falling stock prices. The problem is sufficiently widespread that the New York Stock Exchange announced on March 4 that it proposed to suspend its $1 minimum share price requirement and to lower from $25 million to $15 million its minimum average market capitalization requirement, until June 30, 2009.

The current market climate has led many companies to take another look at their charter, by-law and other provisions relating to potential takeover attempts. Interestingly, adoptions of shareholder rights plans (or "poison pills") increased in 2008, reversing a pronounced multi-year trend that saw many companies terminate their rights plans or allow them to expire. In 2001, 60% of S&P 500 companies had poison pills; today, only 21% do – a trend largely driven by the 2005 announcement by ISS (now RiskMetrics Group) that it would recommend "withhold" votes for directors of companies adopting pills that were not subject to a shareholder vote.

Companies considering whether to adopt, renew or maintain a shareholder rights plan should bear in mind two phenomena caused by rapidly falling stock prices.

First, one reason many companies felt comfortable allowing their pills to lapse was that the Hart-Scott-Rodino antitrust reporting regime provided, in effect, a distant early warning system that would alert companies before a bidder could accumulate a large stake as part of an effort to seek control. For a large company, the HSR notification would be required before a bidder reached even a 5% position, and a bidder cannot complete a purchase above the reporting threshold until the waiting period expires or is terminated. However, as the HSR reporting threshold has risen (it is now $65.2 million) and the market capitalizations of many companies have fallen dramatically, companies may find that a bidder could now amass a substantial percentage stake before any disclosure to the company is required – particularly since a Schedule 13D, which must be filed by a bidder crossing the 5% ownership threshold, need not be filed until 10 days after that threshold is crossed.

Second, rapid decreases in stock price can have aberrational effects on the operation of a shareholder rights plan. The deterrent effect of a poison pill derives from its "flip-in" feature: if a bidder crosses a triggering threshold (often 15%) without board approval, the rights "flip in" and allow their holders – other than the bidder, whose rights become void –

to buy company stock at half price. How much stock can be purchased – and, therefore, how dilutive the pill is – is a function of the rights' exercise price (typically a multiple of the stock price when the pill was adopted) and the company's stock price (typically calculated based on the company's trailing 30-day stock price).

In ordinary times, if a company had a steady $20 stock price, the rights had an $80 exercise price, and a bidder acquired 20% of the Company's stock, the rights would each become exercisable to buy eight shares for $10 each (the flip-in math is that the holder of each right can buy, for the $80 exercise, a number of shares equal to the exercise price divided by 50% of the 30-day average stock price). If there were initially 100 shares and the bidder owned 20 of them, the holders of the other 80 shares could buy a total of 640 shares for $6,400. As a result, the bidder would go from owning 20% of a company worth $2,000 (a $400 interest) to owning 2.7% (20/740) of a company worth $8,400 (a $227 interest). This kind of dilution has made pills effective deterrents.

But take the same example and assume the company's stock price has fallen to $10, half its 30-day average. The rights (other than the bidder's) would still be exercisable to buy 640 shares for $6,400 – but that means the rights would be exercisable to buy shares at an at-market price, and likely most rights would not be exercised at all. Even assuming full exercise, the bidder would go from owning 20% of a company worth $1,000 (a $200 interest) to owning 2.7% of a company worth $7,400 (still a $200 interest). The bidder's percentage interest is diluted, but the value of its interest remains the same.

Does this mean the pill is useless? Not really. Most pills have an exchange feature that allows the board to exchange one share for each right and avoid the rights exercise mechanics entirely. On the second set of facts above, such an exchange would take the bidder's percentage and economic interests from 20% to 11%. But given that in at least one situation (at Selectica, Inc.), a bidder apparently was willing to cross a pill threshold and absorb the dilution caused by such an exchange, companies may want to consider their own flip-in math – before a bidder does.

Please feel free to contact us if you have any questions.

William D. Regner
+1 212 909 6698
wdregner@debevoise.com

Jeffrey J. Rosen
+1 212 909 6281
jrosen@debevoise.com