SIMPSON THACHER

CLIENT MEMORANDUM

Rights Plans Offer Special Benefits for Companies Whose Market Capitalization Has Declined to $500 Million or Below

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INTRODUCTION

The decline in the market capitalization of many companies has increased the number of pill adoptions, replacements and extensions. FactSet SharkRepellent's data show that rights plan activity (i.e., adoptions, replacements and extensions) in 2008 was at the highest level since 2002 and more than 64% higher than 2007. A major reason for this uptick in activity has been the severe decline in market capitalizations resulting in an increased risk of opportunistic takeover threats, particularly for small cap companies.

OFF-THE-SHELF STRATEGY PROBLEMATIC FOR SMALL CAPITALIZATION COMPANIES

In recent years, most companies have not been adopting (or renewing) rights plans because of (i) diminished legal concern with respect to adopting plans in the "heat of the battle" and (ii) the RiskMetrics Group ("RMG") policy, adopted in 2005, that generally recommends "withhold" or "against" votes with respect to directors who adopt a rights plan that is not subject to stockholder approval. Many companies have, therefore, refrained from adopting a pill with the knowledge that they could adopt a rights plan if and when a specific takeover threat emerged.

This "off-the-shelf" strategy is, however, not well suited to a company with a market capitalization that has fallen below roughly $500 million given the threat of an accumulation of control by an acquiror. The key warning signs of an accumulation—an antitrust filing under the Hart-Scott-Rodino Act ($65 million threshold) and a filing of a Schedule 13D (5% of the company's outstanding common stock)--may not occur until after a substantial accumulation has already taken place. For example, if a company has a market capitalization of $250 million, then an HSR filing would not be required until the accumulation was at the 26% ownership

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level. While a Schedule 13D is required to be filed once the 5% threshold is crossed, there is a ten-day window before the filing is required. In addition, although Delaware's "business combination" statute and similar statutes in other states limit the ability of stockholders who exceed specified ownership levels from engaging in certain business combinations for a prescribed period of time (e.g., three years following the threshold crossing in Delaware), these statutes do not prevent the actual accumulation of shares and the attendant implications of having a meaningful block of shares in the hands of an activist investor.

IMPLICATIONS OF ADOPTION OF RIGHTS PLAN UNDER RMG POLICIES

RMG's general policy with respect to the implementation of rights plans is to recommend to "withhold" from or vote "against" the entire board of directors if the board "adopts or renews a poison pill without stockholder approval, does not commit to putting it to stockholder vote within 12 months of adoption…or reneges on a commitment to put the pill to a vote, and has not yet received a withhold/against recommendation for this issue."[1]

RMG voting guidelines recommend that stockholders vote on a case-by-case basis on management proposals to ratify rights plans, focusing on specific features of the rights plans. In making a determination, RMG advises stockholders that "rights plans should contain the following attributes:

- No lower than a 20% trigger, flip-in or flip-over;
- A term of no more than three years;
- No dead-hand, slow-hand, no-hand, or similar feature that limits the ability of a future board to redeem the pill; [and]
- Stockholder redemption feature (qualifying offer clause); if the board refuses to redeem the pill 90 days after a qualifying offer is announced, 10 percent or more of the shares may call a special meeting, or seek a written consent to vote on rescinding the pill."[2]

Most of the plans that have been adopted, both recently and historically, do not satisfy RMG guidelines either because they are below the 20% threshold and/or lack the qualifying offer clause. For example, based upon information derived from FactSet SharkRepellent's data, of 192 rights plan adoptions, replacements and extensions in 2008, only a de minimis number was fully RMG compliant. It is possible that the volatility and almost unprecedented decline in the markets may lead RMG to revisit their approach and make more accommodations (e.g., refrain from making a withhold/against recommendation if a pill were only adopted or extended for a year).[3] While not quite analogous, we note that RMG now will support rights plans with a trigger below 5% if adopted for the stated purpose of preserving a company's net operating losses. Nonetheless, there is scant evidence to date that RMG will relax their standards with respect to a stockholder vote for rights plans.

NEXT STEPS

Any company with a market capitalization that has dropped below roughly $500 million that lacks a rights plan should consider its adoption in order to address the threat of an accumulation. If a plan is to be adopted or extended, the most significant decision will be whether to make the plan RMG compliant and submit the plan to stockholders for a vote. The biggest downsides of an RMG compliant plan are that the trigger needs to be 20% and include a stockholder redemption feature (which can

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[1] See RiskMetrics Group, 2009 U.S. Proxy Voting Guidelines – Concise Summary (December 2008).

[2] *See Id.*

[3] In a publication dated September 2, 2008, RMG praised Alpharma for the "shareholder-friendly aspects" of a limited duration stockholder rights plan it adopted in response to King Pharmaceutical's unsolicited takeover offer even though the Alpharma plan was not 100% "ISS [RMG] compliant". Unlike the adoption and extension of a rights plan to address a potential accumulation strategy, Alpharma's plan was adopted in the face of a hostile offer where there was a specific and imminent threat.

undermine the board's negotiating leverage). The downside of putting it to a vote is that a loss may inhibit the board's flexibility to adopt a plan going forward or suggest the company is in "play". It is too early to measure the extent to which plans will be submitted to stockholders for approval in 2009, but in 2008 less than one in ten rights plans were submitted for a vote. There is no one size fits all in these decisions and a board needs to consider its stockholder makeup, governance record, the extent of any threat and other individual matters.

For those companies that do not submit the rights plan to stockholders for approval, the decision often reflects a judgment that the board can consider how to deal with the plan if and when a significant "withhold" or "against" vote occurs. In the past few years, most companies that have adopted a rights plan that was not submitted to a stockholder vote did not suffer a majority "withhold" or "against" vote. While a majority of "withhold" or "against" votes could result in director resignations under a majority vote standard, the board typically has the discretion to reject a resignation. In connection with deciding how to address any resignation, the board could address the underlying reason for the lack of stockholder support, including redeeming the rights plan or adopting a compliant plan and submitting it for a vote. In sum, in these difficult times, we would be very cautious about failing to address a takeover vulnerability because of a concern about a possible withhold/against recommendation.

In order to mitigate the perception of entrenchment, a substantial number of recent rights plans have terms shorter than the standard ten-year term with one and three being the most popular alternatives. A one-year extension has the advantage of addressing the vulnerability to an accumulation while being the most stockholder friendly. The disadvantage is that a one-year rights plan will be subject to another extension decision at the same point next year (if the "off the shelf" strategy were still problematic because the issuer's price has not rebounded). An additional extension will also be subject to the heightened risk of a majority "withhold" or "against" vote at the annual meeting following such extension if not submitted to stockholders for approval. A three-year extension, although not as stockholder friendly as a one-year plan, is RMG compliant and avoids the need for additional extensions in the next couple of years with the attendant potential "withhold" or "against" votes. There is no right answer as to the term of a rights plan as it is inherently a fact and circumstances decision. This is reflected by the significant number of issuers that have adopted both three and one-year plans (as well as ten-year plans, which still constitute an overall majority of adoptions, replacements and extensions).

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