To Our Clients and Friends

Memorandum

friedfrank.com

The Window Closing Pill – One Response to Stealth Stock Acquisitions

The recent announcement of accumulations of stock in J.C. Penney and Fortune Brands substantially in excess of the five percent Schedule 13D reporting threshold prior to any public disclosure has focused attention on possible inadequacies in the regulatory system in providing companies, their stockholders, and the trading markets with advance notice of significant ownership by activist investors or bidders. Although the reporting requirements of 13D, the ownership limitations of the Hart-Scott-Rodino Antitrust Improvements Act, state merger moratorium statutes, and traditional rights plans afford US companies some protections against rapid and secret stock acquisitions, the current state of law may provide opportunities for activists or raiders to obtain a sizable stake in a US company before they are obligated to make any disclosure:

- For non-passive investors, a Schedule 13D reporting ownership of more than five percent of a class of stock need not be filed with the SEC until ten days after ownership exceeds the five percent threshold. During this ten-day period, the acquirer may purchase additional stock without any restriction under the federal securities laws. Although there are no pending or proposed SEC rule changes to close or shorten this ten-day purchasing window, the recently adopted Dodd Frank Wall Street Reform and Consumer Protection Act authorizes the SEC to shorten the deadline for filing a Schedule 13D.
- In calculating whether a person beneficially owns five percent of a class of stock for purposes of 13D, a number of types of derivative securities may be excluded under current rules. Options, warrants and other securities which are not exercisable or convertible within 60 days do not give rise to beneficial ownership of the underlying stock. Similarly, the SEC staff has stated that securities futures contracts that provide for cash settlement do not result in beneficial ownership of the stock covered by the contract regardless of the ownership of the stock by the counterparty. (In certain circumstances in which there are actual or tacit understandings between the parties regarding voting or holding of the shares, futures contracts might create beneficial ownership, as was the case in the CSX/Children's Investment Fund litigation.) On the other hand, once a person is otherwise required to file a Schedule 13D, it must report contractual arrangements relating to stock, including derivatives.
- The Hart-Scott-Rodino Act generally requires a filing with the Department of Justice and Federal Trade Commission and the expiration or termination of waiting periods before non-passive investors may acquire more than approximately $63 million of voting stock. However, the HSR Act does not apply to the acquisition of options, warrants and other derivatives until they are exercised or converted into the underlying voting stock. Moreover, certain investment or hedge fund managers who oversee multiple funds may be able to acquire up to approximately $63 million of voting stock in each of the funds they manage without triggering the HSR thresholds because these funds often are treated under the HSR Act as separate, independent acquiring

Copyright © 2010 Fried, Frank, Harris, Shriver & Jacobson LLP
A Delaware Limited Liability Partnership

entities not under common control. Consequently, activist investors using multiple funds may be able to acquire stock greatly in excess of the HSR ownership limits.

- Many states, including Delaware, have so-called business combination or merger moratorium statutes which restrict the ability of parties acquiring a specified amount of stock, such as ten or fifteen percent, without prior approval of the issuer's board of directors from engaging in mergers and similar transactions with the issuer without waiting a number of years or, in some cases, complying with procedural or fair price requirements. These statutes, however, do not address the conduct of an activist investor seeking to force the sale or restructuring of a company without itself being the acquirer. Additionally, these statutes generally do not expressly include derivatives not providing investment or voting control over stock within the definition of beneficial ownership of stock and, as a result, may not restrict the ability of the holder of the derivatives to engage in transactions with the issuer.

- Traditional rights plans effectively impose maximum ownership levels on stockholders by means of 'flip-in" provisions. The ownership ceilings generally range from 10% to 20% (although so-called NOL plans, which seek to preserve the value of net operating losses, impose a five percent limit on ownership). Some plans include derivatives within the calculation of ownership and, therefore, attempt to address unorthodox ownership arrangements. However, these plans do not seek to compel public disclosure by acquirers. Moreover, many companies have responded to stockholder and proxy advisory service opposition to typical plans by not having plans in place; rather, they have a plan on the "shelf", ready to be adopted rapidly once a threat becomes known. Consequently, in many instances, traditional plans may not prove to be much of an obstacle to significant secretive stock acquisitions.

In light of the ability of activists or raiders to use the ten-day window for filing a Schedule 13D and to purchase shares before their stake in a company is required to be disclosed and the use of derivatives to defer or avoid a 13D reporting obligation, companies should consider a new form of rights plan the purpose of which is to compel disclosure by acquirers of stock and derivative ownership in excess of five percent and block acquisitions of stock until the disclosure is made. In essence, the plan would close the ten-day purchasing window that currently exists under Rule 13d-1 and include all derivatives in the definition of beneficial ownership of stock. Specifically, this rights plan would feature:

- *Transitory Five Plus Percent Flip-In Trigger*: If a person exceeds five percent ownership, including derivatives, and does not wait until ten days after it has filed a Schedule 13D with the SEC, regardless of whether the SEC rules require a filing, before it purchases additional shares or derivatives, then it would be an "acquiring person" under the plan, trigger the flip-in provision, and suffer the dilution caused by triggering the pill. (Persons who are eligible to file a Schedule 13G, passive investors, would be exempt from the plan.) However, after the tenth day following the filing of a Schedule 13D, the acquirer would be free to acquire additional shares or derivatives without triggering this pill. (Obviously, the ownership limitations of more traditional rights plans then in place would still apply.) This logistic is analogous to the SEC's rules prohibiting purchases of additional stock by a 13G filer that either no longer has a "passive intent" or exceeds 20% ownership until the expiration of the tenth day from the date of the filing of a Schedule 13D. The acquisition resulting in greater than five percent ownership would not trigger the pill; only subsequent purchases before a Schedule 13D is filed would be implicated. Accordingly, the trigger level for the flip-in would not be fixed at an absolute number: it could vary from slightly above five percent to much greater levels if an acquirer is able to purchase a large stake from a single source.

- *Expanded Definition of Beneficial Ownership*: The plan would attribute beneficial ownership of stock to a person who owns options, warrants, futures contracts or other arrangements which provide a "long" financial interest in the stock regardless of whether these securities or ownership arrangements give rise to beneficial ownership of the underlying stock under federal or state law. Derivative positions acquired as part of "ordinary course" market-making, hedging or trading activities could be excluded. As a result of this expanded definition of beneficial ownership, the

- plan could have the effect of requiring the filing of a Schedule 13D even if filing is not required by the SEC's rules.
- *Reload*: The plan would provide that it remains in effect after it has been triggered so that it continues to provide protection against the person that triggered the plan or others acquiring interests in the company.

This rights plan has a limited objective that of compelling disclosure so that a board of directors, stockholders and the trading markets can evaluate the ownership position of a substantial non-passive investor. The plan is benign because the acquirer is not precluded from acquiring more than a five percent voting or financial interest in a company and it would not create an impediment to purchasing shares pursuant to a tender offer. Nevertheless, the acquirer might no longer be able to acquire stock as cheaply as it would absent the rights plan because the accelerated disclosure obligation likely would result in an increase in the market price of the shares. Presumably, most would agree that this benefits stockholders who would otherwise have sold at a lower price while the acquirer was surreptitiously purchasing shares. (Arguably, the plan might deter some activists from undertaking an acquisition program because the expected profit from the program could be reduced.) The plan can stand alone or be incorporated into an existing plan.

As is the case with the adoption of any rights plan, the reaction of institutional shareholders and proxy advisory firms, such as ISS, is a consideration. Although this form of plan does not fit within the announced guidelines of these firms, the relatively modest impact of the plan on acquirers, due to its temporary applicability and no ownership restriction once appropriate disclosures have been made, suggests that these firms may not object to the plan as detrimental to shareholders.

If the SEC amends the 13d rules to close the ten-day purchasing window and to include derivatives within its definition of ownership, then this rights plan would no longer be necessary. Until then, it can provide notice to boards of directors and stockholders of aggressive stock acquisitions before being presented with a fait accompli. Consequently, we suggest that companies consider a plan of this type as a supplement to other elements of their preparedness planning.

Author and Contact:

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or the attorney listed below:

Peter S. Golden
Partner
+1.212.859.8112
peter.golden@friedfrank.com