

MEMO TO THE PARTNER

**ANTI-DILUTION PROVISIONS OF A PREFERRED STOCK
SHAREHOLDER RIGHTS AGREEMENT**

Philip F. Head*

TO: Law Firm Partner
FROM: Associate
RE: Proposed Anti-Dilution Provisions of a Preferred Stock Shareholder
Rights Agreement

You have asked me to draft one of the anti-dilution provisions that will be included in a Preferred Stock Shareholder Rights Agreement (“Rights Agreement”) that will be executed by our client, ABC Insurance Corporation (“ABC”). The following memorandum addresses the facts, issues, and law surrounding our work for ABC and should be read with the draft of the Rights Agreement attached for your review. This memorandum includes defined terms referenced in Section 1 of the Rights Agreement. Other members of the firm have drafted the other component parts of the Rights Agreement; my draft should be incorporated into the appropriate section of the Rights Agreement upon your approval.

I. TRANSACTIONAL CONTEXT.

ABC is a Delaware corporation with its principal place of business in Nashville, Tennessee. ABC’s sole class of outstanding stock is traded on the New York Stock Exchange (“NYSE”). ABC’s Certificate of Incorporation authorizes it to issue 110,000,000 shares of stock. 100,000,000 of the authorized shares are designated common stock, and the remaining 10,000,000 authorized shares are designated preferred stock. To date, ABC has issued 50,000,000 shares of common stock and 5,000,000 shares of Series A preferred stock. Pursuant to Delaware General Corporation Law (“DGCL”) § 151(a), ABC’s Certificate of Incorporation authorizes its Board of Directors to issue the preferred stock in one or more series and to fix by resolution the designation, powers, preferences, and relative,

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participating, optional, or other special rights of any series of preferred stock. The preferred stock authorized by ABC's Certificate of Incorporation is "blank check" stock in that the Certificate of Incorporation grants the Board of Directors complete discretion to fix the powers, preferences, and rights of any preferred stock issued by resolution. ABC has a twelve-member Board of Directors that consists of nine outside directors and three inside directors.

ABC's Board of Directors feels that the corporation is a likely target for a hostile takeover. ABC's worries begin with its stock price of twenty dollars a share, which many analysts consider undervalued. Furthermore, ABC has a large asset base but is hindered by a slow growth rate and declining profits. ABC's assets total \$4.6 billion, but its market share has fallen drastically in the past ten years. In 1993 ABC was the twenty-first largest insurer in the country, but currently it is the thirty-ninth. While ABC is consistently posting earnings and paying dividends to its shareholders, analysts have criticized management as being overly conservative and not amendable to change. Consequently, the Board is concerned that many companies may seek to acquire ABC because they believe that they can make greater profits by more aggressively utilizing ABC's sizable asset base and replacing the current management's conservative business model. Furthermore, ABC has valuable non-financial assets that increase ABC's "bust up" value and that an acquirer could sell off immediately after takeover to help finance the acquisition. These assets include Opryland U.S.A, the Grand Ole Opry, the Ryman Auditorium, a radio station, and a television station. Since ABC is such a likely target for hostile takeover, the Board of Directors seeks to implement a takeover defense plan that would force possible acquirers to negotiate directly with the Board.

ABC contacted our law firm to help implement a takeover defense strategy. Given the nature of ABC's concerns, we suggested the implementation of a Preferred Stock Shareholder Rights Plan. The Board adopted the Rights Plan at their last meeting. In forming the Plan, our firm has been working closely with ABC's investment bank, Morgan Stanley, to ascertain the appropriate Exercise Price to initially assign to the Preferred Stock issued as part of the Rights Plan. Morgan Stanley has suggested that the Exercise Price be \$50 per 1/100 of a share of the Preferred Stock, which is intended to reflect present estimates of the long-term value of ABC's common stock. ABC has also secured the services of American Stock Transfer Corporation to serve as Rights Agent for the Rights Agreement.

In initially formulating ABC's Shareholder Rights Plan, the firm has already taken into account several preliminary, background issues that are briefly discussed as follows:

- **Authority for the issuance of Rights by resolution of the Board of Directors**

A corporation may create and issue rights for the purchase of shares of the corporation's stock subject to the corporation's certificate of incorporation. DGCL § 157(a) (2001). The terms of the rights, including price and duration of the rights, will be determined by the certificate of incorporation or by the resolution of the board of directors that provides for the creation and issuance of the rights. DGCL § 157(b). Furthermore, since ABC's Board of Director's consists of nine outside directors unconcerned with entrenchment, adoption of the Rights Agreement will fall under the protection of the business judgment rule. *See Moran v. Household International, Inc.*, 500 A.2d 1346, 1347 (Del. 1985). *See generally, Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (applying the business judgment rule to the action taken by the board of directors in a takeover context).

- **Authority for the issuance of the Preferred Stock underlying the Rights by Board resolution**

If a corporation desires to issue stock with associated rights, the corporation's board of directors may issue the stock with rights via a resolution if the certificate of incorporation allows. DGCL § 151(g) (2001). Since ABC's Board of Director's has "blank check" stock authority, the Board may issue the Preferred Stock underlying the Rights by resolution. ABC may issue Rights that are an option to purchase a fractional share of Preferred Stock. DGCL § 155 (2001) (stating that a corporation may issue fractional shares).

- **Authority for distribution of the Rights via a dividend on common stock**

A corporation may unilaterally adopt a shareholder rights plan that distributes the rights to shareholders via a dividend on the corporation's common stock. *Leonard Loventhal Account v. Hilton Hotels Corp.*, 780 A.2d 245, 249 (Del. 2001); *Moran*, 500 A.2d at 1357.

- **Whether the Rights will be tradeable on the New York Stock Exchange**

Rights are tradable on the NYSE if the beneficiary security to which the rights attach are listed on the Exchange. New York Stock Exchange Listed Company Manual 703.03(N). Furthermore, the Exchange considers it "highly desirable" that the rights are indeed traded on the Exchange, even though this is not explicitly required. *Id.*

- **Whether issuance of the Rights as a dividend on ABC's common stock constitutes a public offering**

The securities department of our firm assures me that ABC is not exempt from registration of the Right under Section 12(g)(1) of the Securities Exchange Act of 1934. Therefore, according to our securities attorneys, ABC must register the Rights Agreement with the Securities and Exchange Commission on Form 8-A or a voluntary filing under Form 8-K.

- **Whether a Shareholder Rights Plan is feasible given ABC's current capitalization**

ABC currently has 5,000,000 authorized and unissued shares of preferred stock and 5,000,000 outstanding shares of preferred stock, which is ample authorized and unissued shares of preferred stock to facilitate the Rights Agreement. Therefore, ABC will have no problem holding the number of shares of Preferred Stock in its treasury that will fully permit the exercise of all outstanding Rights. The large number of authorized and unissued shares of preferred stock was the impetus behind allowing one Right to be exercisable for one 1/100 of a share of Preferred Stock in the Rights Agreement.

II. ISSUE PRESENTED BY THE TRANSACTIONAL CONTEXT

- How should the Rights be protected from dilution? What transactions should trigger the anti-dilution provisions in the Rights Agreement? How should the anti-dilution provision state that the Exercise Price and the number of one-hundredths of a share of Preferred Stock for which a right is exercisable adjust to prevent dilution? Will Rights attach to ABC common stock issued after the Record Date?

ABC's Board wants to make certain that adoption of the Rights Agreement will not inhibit future corporate transactions, but at the same time, the Board desires certainty that the Rights Agreement will remain effective. Since the effectiveness of the Rights Agreement depends on maintaining the value relationship between the Rights and the underlying Preferred Stock, anti-dilution provisions are necessary.

III. ANALYSIS OF SPECIFIC DRAFTING CHOICES Authority for Anti-Dilution Provisions

Delaware General Corporation Law expressly recognizes anti-dilution adjustments. *See* DGCL § 151(e) (2001) (stating that any stock may be made convertible into the same or any other stock of the corporation upon the happening of a specified event at the applicable price or rate of exchange "with such

adjustments as shall be stated in” the certificate of incorporation or resolution of the board of directors providing for the convertible security’s issuance). *See also, Wood v. Coastal States Gas Corp.*, 401 A.2d 932, 937-38 (Del. 1979) (discussing anti-dilution provisions within the context of convertible preferred stock). The meaning and effect of anti-dilution provisions is determined by application of general contract interpretation principles. *See id.* at 937.

The anti-dilution provisions within the Rights Agreement are analogous to anti-dilution provisions in convertible securities generally. *See Moran*, 500 A.2d at 1352 (accepting the argument that a shareholder rights plan is analogous to anti-dilution and anti-dilution provisions in corporate securities). Anti-dilution provisions within preferred stock prevent dilution of the value relationship between the rights and the underlying preferred stock, while anti-dilution provisions within convertible securities protect the value relationship between holders of convertible securities and holders of common stock. Furthermore, since rights are securities under the Securities and Exchange Act of 1934, rights should be able to incorporate anti-dilution provisions in the same manner as other securities.

Conceptually, the Right itself is analogous to an option—the option to purchase one 1/100 of a share of the Preferred Stock at the Exercise Price after the acquiring entity obtains a specified percentage of the target corporation’s stock. Thus, the anti-dilution provision for the Rights Agreement that I have drafted has the same effect as an anti-dilution provision within an option—it prevents specified events from diluting the power of the option or right. In other words, the anti-dilution provision that I have drafted maintains the ability of the flip-in and flip-over provisions to dilute the interests of any hostile acquirer, thus making the Rights Agreement an effective takeover defense mechanism. This idea, along with the fact that the anti-dilution provision would be strictly interpreted according to contract law, influenced my choice of anti-dilution provisions.

Drafting Choices

The attached anti-dilution provision will only adjust the Exercise Price and the number of one-hundredths of a share of Preferred Stock for which a Right is exercisable. Some precedent documents adjusted the number of Rights in lieu of adjusting the number of fractional shares of preferred stock for which a right was exercisable. I chose against this drafting because the actual number of Rights will never change under the terms of my draft. Since ABC has 50,000,000 shares outstanding at the execution of the Rights Agreement, 50,000,000 rights will be issued. Having a set number of Rights makes ascertaining the holders of the Rights easier in the highly improbable event that the Rights would become exercisable.

Adjustment of the Exercise Price and the number of one-hundredths of a share of Preferred Stock for which a right is exercisable will happen only upon the occurrence of any of these four events: (1) the declaration of a dividend on the Preferred Stock payable in Preferred Stock, (2) a subdivision of the outstanding Preferred Stock, (3) a combination of the outstanding Preferred Stock, or (4) the issuance of capital stock in a reclassification of the Preferred Stock. These same events triggered the anti-dilution provisions in all precedent documents reviewed. These four events are triggers for anti-dilution adjustment because each event either increases or decreases the number of shares of Preferred Stock. Any increase or decrease in the number of shares of Preferred Stock would disrupt the value relationship between the Rights and the Preferred Stock and thereby negate the Rights Agreement's effectiveness.

In trying to describe how the Exercise Price and number of one-hundredths of a share of Preferred Stock for which a right is exercisable would adjust, I was faced with many options. The precedent documents had a wide array of formulas by which the anti-dilution adjustments would be made. The majority of the precedent documents reviewed simply stated that after an event described in clauses (A)-(D) of Section 11(a)(i) occurred the Exercise Price:

shall be proportionately adjusted so that the holder of any Right exercised after such time shall be entitled to receive, upon payment of the Exercise Price then in effect, the aggregate number and kind of shares of capital stock which, if such Right had been exercised immediately prior to such date and at a time when the Preferred Shares transfer books of the Company were open, such holder would have owned upon such exercise and been entitled to receive by virtue of such dividend, subdivision, combination or reclassification¹

I chose not to use an anti-dilution adjustment similar to the one above, as most rights agreements did, for two reasons. First, because the provision did not specifically state a method or formula by which anti-dilution adjustments would be made, unnecessary ambiguity was created. While having proportionally the same right before an event as one has after an event does mandate an adjustment, it does not do so with the clarity desired. Second, the provision would seemingly only adjust the Exercise Price and would not adjust the number of one-hundredths of Preferred Stock for which a Right is exercisable since the provision does not expressly mention doing so. However, for the anti-dilution provision to work properly, the provision must adjust *both* the Exercise Price *and* the number of one-hundredths of a share of

¹ Stockholder Rights Agreement of Eprise Corporation dated December 18, 2000 (filed with the Securities and Exchange Commission on December 18, 2000 as exhibit to the Form 8-K of Eprise Corporation, available on EDGAR).

Preferred Stock for which a Right is exercisable. This is intended, but not explicitly stated, by the alternative anti-dilution provision quoted above.

I chose to draft the attached anti-dilution provision to explicitly state that both the Exercise Price and the number of one-hundredths of a share of Preferred Stock for which a Right is exercisable are adjusted upon the happening of an event described by clauses (A)-(D) of Section 11(a)(i) so that any ambiguity is alleviated. Furthermore, the formula within the attached anti-dilution provision is relatively easy to apply, and it accomplishes the ultimate goal of maintaining the value relationship between the Rights and the underlying Preferred Stock. Thus, the power of the Rights Agreement to dilute a possible acquirer's interest in ABC is maintained, and the Rights Agreement is ultimately effective.

The language of the attached anti-dilution provision which states "that in no event shall the consideration to be paid upon the exercise of one Right be less than the aggregate par value of the shares of capital stock of the Company issuable upon exercise of such Right" is included to comply with section 157(d) of Delaware General Corporation Law. Section 157(d) states: "In case the shares of stock of the corporation to be issued upon the exercise of such rights or options shall be shares having a par value, the price or prices so to be received therefor shall not be less than the par value thereof." Since the Preferred Stock has a par value of \$0.01 per share, I had to include this provision.

The last sentence of the attached anti-dilution provision allows for anti-dilution adjustment following any event described by clauses (A)-(D) of Section 11(a)(i) before the flip-in trigger of Section 11(a)(ii) is activated, which ensures that all diluting events are taken into account before the Rights become exercisable.

Less Significant Drafting Choices

The following less significant drafting choices were made in the attached anti-dilution provision in order to improve the clarity and presentation of the provision:

- "Preferred Stock" was chosen in lieu of "Preferred Shares."
- Portions of 11(a)(i) describing the adjustment of the Exercise Price and the adjustment of the number of one-hundredths of a share of Preferred Stock for which a right is exercisable were numbered and indented rather than being placed together in one large paragraph.
- Parenthetical information was added after some of the events described by clauses (A)-(D) of Section 11(a)(i).

ABC INSURANCE CORPORATION

and

AMERICAN STOCK TRANSFER CORPORATION
Rights Agent

PREFERRED STOCK SHAREHOLDER RIGHTS AGREEMENT

Dated as of November 13, 2003

[The Table of Contents, Preamble, Sections 2-10 and Sections 12-34 have been drafted by other associates. Additionally, portions of Section 11 that I did not draft are omitted. The portions of Section 1 included here, which I drafted, contain only the defined terms used within the portion of Section 11 that I drafted. Omitted portions of Section 1 have been drafted by other associates.]

Section 1. Certain Definitions. For purposes of this Agreement, the following terms have the meanings indicated:

(b) "Adjustment Fraction" shall have the meaning set forth in 11(a)(i) hereof.

(p) "Exercise Price" shall mean, as of any date, the price at which a holder may purchase one one-hundredth of a share of Preferred Stock pursuant to the exercise of a Right. The Exercise Price shall initially be \$50 and shall be subject to adjustment from time to time in accordance with the terms hereof.

(v) "Preferred Stock" shall mean shares of ABC Insurance Corporation Series B Participating Preferred Stock, par value \$0.01 per share.

(w) "Right" shall mean the option to purchase one one-hundredth of a share of Preferred Stock upon the terms and conditions set forth in this document.

Section 11. Adjustment of Exercise Price and Number of Shares. The Exercise Price, the number and kind of shares or other property covered by each Right, and the number of Rights outstanding are subject to adjustment from time to time as provided in this Section 11.

(a) (i) Anything in this Agreement to the contrary notwithstanding, in the event that the Company shall at any time after the date of this Agreement (A) declare

a dividend on the Preferred Stock payable in Preferred Stock, (B) subdivide the outstanding Preferred Stock, (C) combine the outstanding Preferred Stock (by reverse stock split or otherwise) into a smaller number of shares of Preferred Stock, or (D) issue any shares of its capital stock in a reclassification of the Preferred Stock (including any such reclassification in connection with a consolidation or merger in which the Company is the continuing or surviving corporation), then, in each such event, except as otherwise provided in this Section 11 and Section 7(e) hereof:

(1) the Exercise Price in effect at the time of the record date for such dividend or of the effective date of such subdivision, combination, or reclassification shall be adjusted so that the Exercise Price thereafter shall equal the result obtained by dividing the Exercise Price in effect immediately prior to such time by a fraction (the "Adjustment Fraction"), the numerator of which shall be the total number of shares of Preferred Stock (or shares of capital stock issued in such reclassification of the Preferred Stock) outstanding immediately following such time, and the denominator of which shall be the total number of shares of Preferred Stock outstanding immediately prior to such time; provided, however, that in no event shall the consideration to be paid upon the exercise of one Right be less than the aggregate par value of the shares of capital stock of the Company issuable upon exercise of such Right; and

(2) the number of one-hundredths of shares of Preferred Stock (or share of such other capital stock) issuable upon the exercise of each Right shall equal the number of one-hundredths of a share of Preferred Stock (or share of such other capital stock) as was issuable upon the exercise of a Right immediately prior to the occurrence of the event described in clauses (A)-(D) of this Section 11(a)(i), multiplied by the Adjustment Fraction.

If an event occurs which would require adjustment under both Section 11(a)(i) and Section 11(a)(ii) hereof, the adjustment provided for in this Section 11(a)(i) shall be in addition to, and shall be made prior to, any adjustment required by Section 11(a)(ii) hereof.