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Derivatives and Poison Pills

Hedge funds and other investors that use derivatives to enhance either their short or long positions in a company are well aware of the ongoing debate as to whether such transactions should be subject to further disclosure under the U.S. securities laws. Currently, Section 13(d) of the Exchange Act requires disclosure of derivative positions only in limited situations, e.g., if such derivative positions convey beneficial ownership within 60 days or if shareholders are otherwise required to file Schedule 13D. Now, companies may be opening another chapter in this debate by amending their corporate documents, most notably their poison pills or shareholder rights plans, to cover derivative positions. For example, we are aware of a recently adopted pill that includes in the calculation of shares beneficially owned by a person to determine whether the pill has been triggered, shares that are the subject of a derivative that creates the economic equivalent of ownership in such shares by explicitly tying the value of the derivative to the price or value of such shares, regardless of whether the derivative conveys any voting rights, is settled through physical delivery or has had its economic effect hedged away. Under such a definition, any significant derivative investment that surpasses the ownership threshold of a poison pill (typically between 10 – 20% of a company's outstanding stock) could trigger that pill. While we are not aware of a general trend by companies to adopt such broad pills, it is nevertheless more important than ever for investors who are considering building a stake (whether actual or derivative) in any company to review the company's poison pill before taking such action.

Companies considering such a provision for their shareholder rights plans should proceed with caution because of the possibility of inadvertent triggers and other considerations. Given the lack of reliable public disclosure on derivative positions, companies may find it difficult to monitor beneficial ownership to determine whether a broadly drafted pill has been or is about to be triggered. We also note that this type of poison pill is untested under Delaware law. For example, Delaware courts have not addressed whether this pill would satisfy the Unocal standard for anti-takeover provisions – i.e., that the company's adoption of such a pill was reasonable and proportionate to the threat posed.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning the issues addressed in this memorandum may be directed to Paul D. Ginsberg, 212-373-3131, Jeffrey D. Marell, 212-373-3105, Kelley D. Parker, 212-373-3136, or Frances F. Mi, 212-373-3185.

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