
Papa John's Board Adds Texas-Sized "Poison Pill" As New Topping on Its Menu

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(Sept. 27) – Last month, Papa John's announced that its board of directors voted to prevent the company's founder and majority owner, John Schnatter, from taking control. The board implemented what is known as a shareholder rights plan, or "poison pill," in an effort to block Schnatter from acquiring more than 31 percent of Papa John's stock.

The board took this step after Schnatter was accused of using a racial slur and resigned from his position as chairman. He remains on the board, however, and is now suing the company, alleging that the board staged a "coup" against him.

Effect of the "poison pill"

Under the poison pill, if Schnatter goes out and buys more shares of Papa John's stock and exceeds the 31 percent ownership threshold, all other Papa John's shareholders – but not Schnatter – will be offered the opportunity to purchase additional Papa John's shares at a 50% discount. The result would be a drastic dilution of Schnatter's interest in the company.

As Bloomberg News reports, this poison pill also prohibits Schnatter from "acquiring any allies in his fight against the board." The Papa John's poison pill may be triggered if a shareholder "acting in concert" with Schnatter acquires additional shares, even if Schnatter himself does not personally acquire any additional stock.

Shareholders vs. board

While poison pills have certainly been used by boards in the past, the Papa John's poison pill sharply highlights the tension between shareholders as the those who "own" the company and the board as the those who "oversee" its operation. Bloomberg News observes:

“*The shareholders have some claim to be the people who own and control the company. But the board has a lot of power to limit that control, not only by prohibiting the shareholders from buying more shares ... but also by prohibiting the shareholders from talking to each other about how disgruntled they are with the board. When the board liked him, Schnatter could meet with shareholders all he wanted; he was after all the public face ... of Papa John's. But now that he's on the outs, and he might want to meet with shareholders to force his way back in, the board can do what it likes to stop him.*

In his lawsuit, Schnatter alleges the board overstepped its authority by targeting him, and he contends it may amount to a breach of the board's fiduciary duty. The Delaware Chancery Court will seemingly have the last word.

Takeover protections for Texas corporations

Does the Papa John's dispute hold any lessons for Texas public corporations? Yes.

Texas has a statutory anti-takeover law that imposes a three-year moratorium on business combinations with any party that, together with its affiliates or associates, acquires beneficial ownership of more than twenty percent of a Texas public corporation's outstanding shares. The statute bars business combinations for three years after such acquirer first obtained its twenty percent stake, unless the transaction is approved by the board or by shareholders holding two-thirds of the corporation's outstanding shares (excluding the acquirer). The practical effect of the statute, like with a poison pill, is to require potential acquirers to negotiate with the corporation's board and executive officers. A Texas corporation can "opt out" of the statute's protections by doing so in its certificate of formation or bylaws.

The protections of Texas' anti-takeover statute, however, do not fit all circumstances. For example, as recognized in *Third Point LLC v. Ruprecht*, potential acquirers may work in "conscious parallelism" with other activist investors in a manner that falls short of an affiliate or associate relationship, or acquirers may obtain "negative controls," or effective veto rights, over corporate decisions at ownership levels less than the statute's twenty percent threshold. Further, as in the Papa John's scenario, the potential acquirer already may have held its twenty percent stake for the required three years. For these reasons, Texas public corporations may need to look beyond the statute and consider the protections of a poison pill.

A Texas poison pill

A Texas board's decision to implement a poison pill arguably is subject to the business judgment rule. As articulated by the Fifth Circuit applying Texas law in *Gearhart Industries, Inc. v. Smith International, Inc.*, courts will not substitute their business judgment for the board's judgment or question that judgment with the benefit of hindsight. That said, a Texas court likely will evaluate implementing a poison pill under the slightly more nuanced Unocal standard applied by Delaware courts, as the district court applying Texas law did in *A. Copeland Enterprises, Inc. v. Guste*. Under that Unocal standard, a board's adoption of a poison pill as a defensive measure is valid if both:

- The board has an objectively reasonable belief of a threat to the corporate policy and effectiveness of the company, and
- The terms of the poison pill are a proportional response to the threat, in that the terms are not preclusive or coercive and are within a range of reasonable responses to the threat.

Further, the Texas Business Organizations Code states that the board is "entitled to consider the long-term and short-term interests of the corporation and the shareholders of the corporation, including the possibility that those interests may be best served by the continued independence of the corporation." This express permission to consider long-term interests of the shareholders suggests that Texas courts should defer to a board's exercise of its business judgment, even in evaluating the reasonableness and the proportionality of implementing a poison pill.

Finally, a board should be mindful of how its decision to implement a poison pill will be evaluated by the market and proxy advisory firms. The market's response may be unpredictable, but the board should work to communicate its reasons for implementing the poison pill and how that protection will protect shareholder value by requiring the acquirer to negotiate with the company. These justifications also will allow proxy advisory firms, which typically oppose poison pills, to evaluate such protections on a case-by-case basis.

Considerations for Texas boards

The Papa John's story continues to develop. It was recently reported that Schnatter has filed a second lawsuit against Papa John's seeking books and records relating to his own dismissal. Consequently, it may be years before these disputes are resolved.

However, there are some immediate takeaways for the boards of Texas corporations faced with takeover situations and "threats" like that faced by the board of Papa John's:

- Understand that these situations arise quickly and require prompt action by a board.
- When those circumstances arise, determine whether Texas' statutory anti-takeover protections apply and, if so, whether they are sufficient for the particular circumstances faced by the board.
- Tailor the terms of a poison pill to the specific activity of the potential acquirer in order to protect the long-term and short-term interests of shareholders while not ultimately obstructing the ability of the corporation's shareholders to vote on material corporate matters.
- Work with financial and legal advisors in order to be informed of all aspects of the transaction and to evaluate viable alternatives.

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