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The Defensive and Offensive Use of "Poison Pills" Within the Business Judgment Rule

Wendy B. Gayle
University of Richmond

NOTES

THE DEFENSIVE AND OFFENSIVE USE OF "POISON PILLS" WITHIN THE BUSINESS JUDGMENT RULE

I. The Business Judgment Rule

A. *The Business Judgment Rule—In General*

Corporate directors owe fiduciary duties of care and loyalty to the corporation and its shareholders as a result of their position of control.[1] In general, the standard for the duty of care owed by a director is one of a prudent person in similar circumstances.[2] The duty of loyalty prohibits

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1. D. Block, N. Barton & S. Radin, The Business Judgment Rule: Fiduciary Duties of Corporate Directors & Officers (2d ed. 1988) [hereinafter D. Block].

2. *Id.* All states and the District of Columbia have enacted statutes prescribing a general standard of conduct for directors and/or authorizing reliance on outside professionals. *Id.* at 561. Thirty-six states have modeled their statutes after either the Model Business Corp. Act § 8.30 (1984) or § 35 of 1969 Model Act (amended in 1974). Section 8.30 of the Model Business Corp. Act reads as follows:

> (a) A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith;
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.
>
> (b) In discharging his duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:
>
> (1) one or more officers or employees of the corporation whom the director reasonably believes to be reliable and competent in the matters presented;
>
> (2) legal counsel, public accountants, or other persons as to matters the director reasonably believes are within the person's professional or expert competence; or
>
> (3) a committee of the board of directors of which he is not a member if the director reasonably believes the committee merits confidence.
>
> (c) A director is not acting in good faith if he has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (b) unwarranted.
>
> (d) A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.

Id. at 562-63.

Three states, Delaware, Kansas, and Oklahoma have statutes that protect directors if they directors from engaging in self-dealing transactions and acts of bad faith.[3]

The business judgment rule operates as a presumption that directors will act in good faith, on an informed basis, and in the best interest of the corporation in rendering corporate decisions.[4] As long as directors do not abuse their discretion, the merits of a decision will be respected by the court, which will not interfere by substituting its own judgment.[5] The business judgment rule acts as a method of judicial review whereby a court will verify that a business decision was made by disinterested directors with due care, good faith, and no abuse of discretion.[6]

The effect of the business judgment rule is to protect directors from personal liability to the corporation or its shareholders. This protection exists because directors, as a result of their capabilities and experience, are in the best position to make corporate decisions.[7] Business decisions are complex and often require quick action, thus courts are ill-equipped

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rely in good faith upon records or information provided by certain individuals, however, a general standard of care is not included in the statute. *Id.* at 570. Section 141(e) of the Delaware General Corporation Law reads as follows:

> (e) A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of his duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.

Id.

Virginia has a unique statute that requires a director to act "in accordance with his good faith business judgment." VA. CODE ANN. § 13.1-690 (Repl. Vol. 1989). Section 13.1-690 reads as follows:

> A. A director shall discharge his duties as a director, including his duties as a member of a committee, in accordance with his good faith business judgment of the best interests of the corporation.
>
> . . .
>
> C. A director is not liable for any action taken as a director, or any failure to take any action, if he performed the duties of his office in compliance with this section.
>
> D. A person alleging a violation of this section has a burden of proving the violation.

Id.

For reference to all state provisions imposing a general standard of directorial conduct, see D. BLOCK, supra note 1, at 561-72 app.

For a discussion of the law in Virginia, see Murphy, *The New Virginia Stock Corporation Act: A Primer*, 20 U. RICH. L. REV. 67 (1985).

3. *See* D. BLOCK, *supra* note 1, at 1.

4. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The burden of rebutting the presumption is on the party challenging the decision. *Id.*

5. *See* D. BLOCK, *supra* note 1, at 3.

6. *Id.*

7. W. KNEPPER & D. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 182-83 (4th ed. 1988).

to evaluate such decisions.[8] After-the-fact litigation has the benefit of hindsight and is thus an imperfect device with which to evaluate corporate decisions.[9] The policy underlying the business judgment rule is to encourage qualified persons to become directors and to encourage innovative decision making without the constant threat of liability.[10]

B. *The Business Judgment Rule—In the Corporate Takeover Context*

In 1984, the Delaware Supreme Court in *Pogostin v. Rice*[11] held that the business judgment rule was applicable in the context of a takeover.[12] Whenever a board of directors evaluates a pending takeover bid, they are required to determine what is in the best interest of the corporation and its shareholders.[13] One year later, in *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court recognized that, due to the very nature of a takeover bid, there was the "omnipresent specter that a board may be acting primarily in its own interests. . . ."[14] Therefore, there was "an enhanced duty which call[ed] for judicial examination at the threshold" before the business judgment rule would provide protection.[15] The court in *Unocal* created a two-prong test which placed the initial burden on the directors to show: (1) reasonable grounds for believing that there was a danger to corporate policy and effectiveness;[16] and (2) that the defensive measure was reasonable in relation to the threat.[17] Once the directors satisfied this burden, the burden of proof shifted back to the challenging party.[18] The business judgment rule would protect the directors, unless the plaintiff showed by a preponderance of the evidence that the direc-

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8. *Id.* at 182.

9. *Id.* at 183.

10. *Id.*

11. 480 A.2d 619 (Del. 1984).

12. *Id.* at 627. A board's refusal to accept a premium from or to negotiate with a potential acquirer were not found to be prima facie breaches of fiduciary duty. Such a principle would present directors with a "Hobson's choice" of either having to accept a tender offer/ merger proposal above market value or face liability if they did not. *Id.*

13. Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985).

14. *Id.*

15. *Id.*

16. *Id.* at 955. This can be satisfied by proof of good faith, reasonable investigation, and materiality enhanced when a majority of independent directors approves it. *Id.*

17. *Id.* Proper concerns for this factor included "inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on 'constituencies' other than shareholders . . . . the risk of nonconsummation, and the quality of securities being offered in the exchange." *Id.*

18. *Id.* at 958. *But see* D. Block, *supra* note 1, at 114-18. The Second Circuit has taken a different approach to evaluating takeover defenses and the business judgment rule which focuses more on issues of corporate governance.

For the sake of clarity, this Note will focus on Delaware case law which has been the most active on the issue.

tors tried to perpetuate themselves in office[19] or "some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed. . . ."[20]

In *Moran v. Household International, Inc.*,[21] the Delaware Supreme Court concluded that directors were entitled to formulate a takeover policy either in response to a specific threat or in anticipation of a general,

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19. *Unocal*, 493 A.2d at 958.

20. *Id.* A landmark decision concerning the informed decision element of the duty of care was Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). Van Gorkom was the chairman and CEO of Trans Union, a publicly-traded, diversified holding company with primary earnings stemming from its railcar leasing business. *Id.* at 864. The company had tremendous cash flow but had difficulty generating enough taxable income to offset investment tax credits (ITCs). *Id.* Van Gorkom lobbied in Washington to have the ITCs refunded in cash. In addition, Trans Union pursued the purchase of small companies in order to increase taxable income, yet their problems continued. *Id.* at 865. Management discussed the possibility of a leveraged buy-out, and a rough analysis was performed using values of Trans Union shares at $50 to $60. *Id.* at 865. Van Gorkom vetoed a leveraged buy-out. However, he proceeded to meet with a well-known corporate takeover specialist and structured a cash-out merger proposal that was later taken to the board for a vote. *Id.* at 866-68. There were ten directors on the Trans Union board, five inside and five outside. Four of the five outside directors were CEOs and the fifth was the former Dean of the University of Chicago Business School; all had knowledge of the company's financial condition and were well informed concerning company operations. *Id.* at 868. After a two hour board meeting, the proposal was approved based solely on a twenty minute presentation by Van Gorkom, an inside director's supporting representations, the chief financial officer's oral statement that $55 was in the fair range (albeit at the low end), legal counsel's advice (that the board could be sued if they failed to accept the offer and that as a matter of law, a fairness opinion was not required), and their own knowledge of the company's stock market history. *Id.* at 868-69. Senior management was not in favor of the merger so Van Gorkom negotiated several amendments to the merger agreement. These amendments were signed without being read by Van Gorkom or any of the directors. Van Gorkom then secured the board's approval. The amendments were executed with considerable variations from what Van Gorkom told the board. The amendments, as executed, placed serious constraints on Trans Union's ability to negotiate a better deal. *Id.* at 870. The merger was later approved by a clear majority of the stockholders. *Id.*

The Delaware Court of Chancery, in a class action brought by shareholders seeking rescission of the merger, or money damages in the alternative, concluded that the directors were protected by the business judgment rule. The court held that the board had given sufficient time and attention to the transaction and that their conduct was informed and not reckless. *Id.* at 870-71.

The Delaware Supreme Court in *Van Gorkom* held that the trial court committed reversible error by applying the business judgement rule and that the board had breached their fiduciary duty to stockholders by: (1) their failure to fully inform themselves as to all available information; and (2) their failure to disclose all material information that a reasonable stockholder would need to decide whether to vote in favor of the merger. *Id.* at 893. The directors were held liable for damages to the extent that the fair value of Trans Union stock exceeded the $55 per share price in the merger agreement. *Id.*

For a summary of the factors in *Smith v. Van Gorkom*, see D. BLOCK, *supra* note 1, at 48-52; *see also* Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985) (analysis of the rejection of the business judgment rule in the *Trans Union* case).

21. 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

prospective one.[22] Pre-planning did not result in the loss of business judgment rule protection, because pre-planning might reduce the risk that the directors would act unreasonably under the pressure of a hostile bid.[23] As long as a legitimate business purpose existed, defensive tactics could be implemented in anticipation of a takeover attempt.[24]

When faced with an unsolicited bid, directors should be aware of certain guidelines in order to retain their protection under the business judgment rule.[25] First, directors are not obligated to sell the company, undertake an auction in response to a bid, or negotiate with an offerer if they conclude in good faith that it is not in the best interest of the corporation or its shareholders to do so.[26] Second, the business judgment rule is not conclusive merely because an offer is received at a premium over market. The directors have a right and a duty to review the bid and accept or reject it on a good faith, informed basis.[27] Third, once it is determined that the company is for sale, the board's duty changes from preserving the corporate entity to maximizing the benefit to shareholders.[28]

C. *Scope*

In recent years, takeover battles have increased in number, scope, and intensity resulting in the development of takeover techniques that make many corporations vulnerable targets.[29] In response, target companies have developed sophisticated anti-takeover defenses and strategies,[30] which raise issues under the business judgment rule.

One popular takeover defense is the "poison pill."[31] Poison pills are im-

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22. 500 A.2d at 1350.

23. *Id.*

24. *See* Mirvis, *The Business Judgment Rule and Takeovers: Recent Developments in Takeover Defense*, in DIRECTORS' AND OFFICERS' LIABILITY 1986: A REVIEW OF THE BUSINESS JUDGEMENT RULE 489, 508 (1986).

25. *See* Fleischer, Lesser & Raymond, *Directors Obligations When Faced With an Unsolicited Bid*, in THE 'BUSINESS JUDGMENT' CONFERENCE: PROTECTING OFFICERS AND DIRECTORS FROM LIABILITY 24, 27 (1987) [hereinafter Fleischer].

26. *Id.* at 27-28.

27. *Id.* at 28. The directors in *Smith v. Van Gorkom* were held personally liable for accepting a bid that was at a premium over market. *See* Mirvis, *supra* note 24, at 513-14.

28. *See* Fleischer, *supra* note 25, at 28; *see also* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986), *aff'g* 501 A.2d 1239 (Del. Ch. 1985) (director's duty changes once the sale of the company is inevitable).

29. Lederman, *Current Takeover Techniques*, in ANATOMY OF A TAKEOVER BATTLE: FROM INCEPTION TO CLIMAX 41, 42 (1986).

30. *Id.*

31. *See generally* R. WINTER, R. ROSENBAUM, M. STUMPF & L. PARKER, 3 SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER (1988) [hereinafter R. WINTER]; Helman & Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW. 771 (1987); Note, *Recent Developments in the Use of the Poison Pill Antitakeover Defense: Limiting the Business Judgment Rule*, 31 ST. LOUIS U.L.J. 1083 (1987).

plemented primarily as a means of protecting minority shareholders from inadequate takeover bids and to give directors negotiating power with potential acquirers.[32]

This Note will explore, within the context of the business judgment rule, the defensive tactic of implementing a poison pill to ward off hostile takeover bids and the offensive use of the pill in the negotiating process with potential acquirers.

II. Defensive Takeover Tactics: Implementation of Poison Pills

A. *Development of Poison Pills: An Overview*

The poison pill first appeared in 1983[33] and was considered a daring defensive tactic that few boards were willing to adopt until tested by the courts.[34] In 1985, the Delaware Supreme Court upheld the implementation of a poison pill in *Moran v. Household International, Inc.*[35] This decision opened the gate for other companies to implement their own versions. In January, 1988, at least 400 companies had poison pills and thirty percent of these companies were Fortune 500 companies.[36] By mid-1988, the number of companies with poison pills in place rose to 500.[37]

For an excellent overview of other takeover defense tactics with citations to applicable cases, see Note, *supra* at 1083 n.4. Included among these are the "Pac-Man" defense (where the target company makes a tender offer for the bidder's stock), the "scorched-earth" defense (where the target company liquidates itself), the "white-knight" defense (where the target company sells a significant portion to a friendly party to make control by an acquirer more difficult), the "crown-jewel" method (where the target company sells its most valuable asset or division to a friendly party), selective self-tender offers, "lock-up" and "leg-up" options (where the target company gives friendly parties favorable stock options), continuous litigation, and "greenmail" (where the target company self-tenders only the hostile bidder's shares). *Id.*

32. Helman & Junewicz, *supra* note 31, at 772.

33. *See* R. Winter, *supra* note 31, at 508.

The early versions of poison pills were called convertible preferred stock pills because they were based on the issuance of convertible preferred stock to common stockholders as dividends. Balotti & Abrams, *Directors' Fiduciary Duties in Corporate Control Contests*, in The 'Business Judgment' Conference, Protecting Officers and Directors From Liability, 85, 139 (1987). Redemption and conversion provisions were designed to compel a potential acquirer to purchase 100% of the stock at the same price. If an acquirer purchased a certain percentage, but no merger occurred, the holder could elect to have his stock redeemed at the highest price paid by the acquirer. *Id.* at 139-40. In the event of a merger, the preferred stock could be exchanged for an equivalent amount of the acquirer's preferred stock and converted into common stock at a value equal to the highest price paid by the acquirer. *Id.* at 140; *see also* Helman & Junewicz, *supra* note 31, at 772; Mirvis, *supra* note 24, at 568-70.

34. *See* Helman & Junewicz, *supra* note 31, at 771.

35. 500 A.2d 1346 (Del. 1985).

36. R. Winter, *supra* note 31, at 505.

37. D. Block, *supra* note 1, at 237.

The poison pill was more potent when it was first introduced than it is today. The device was given this venomous label because of the severe economic consequences an offerer/acquirer would have to "swallow" if certain types of transactions were completed with the target company.[38] Today, judicial decisions and economic factors have limited the device. The primary objectives of modern poison pills are to deter abusive takeover tactics[39] and to provide target company directors with some negotiating strength.[40]

The implementation of a poison pill is a business decision made by the board of directors which receives the protection of the business judgment rule if it meets the elevated standards of *Unocal*.[41]

While shareholder approval is required for certain defensive measures,[42] a poison pill can be adopted without shareholder approval.[43] Therefore, judicial scrutiny is heightened when a poison pill is involved because poison pills can have a significant impact on a shareholder's chances of receiving a lucrative takeover bid.[44]

The Securities & Exchange Commission ("SEC") released a study in March, 1986 which concluded that the adoption of a poison pill had an adverse economic impact on a corporation's shareholders.[45] The SEC's evidence of stock market returns suggested "that the effect of poison pills to deter prospective hostile takeover bids outweigh[ed] the beneficial effects that come from increased bargaining leverage of the target management."[46] Proponents of poison pills have criticized the SEC study, claim-

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38. R. WINTER, *supra* note 31, at 505. An example of such a transaction is a second-stage merger.

39. *Id.* at 507. Abusive takeover tactics include two-tiered, front-end loaded takeovers; self-dealing transactions between the offeror and the target company; partial offers; and "street-sweeps", a technique where an offeror makes a tender offer triggering accumulation by arbitrageurs of the target company's stock, then withdraws the offer, and negotiates with the arbitrageurs to buy a controlling block of the target company's stock. *Id.*

40. *Id.* The presence of a poison pill can make the offeror uncertain as to its ultimate success and the cost implications, which continue through what can be quite lengthy litigation. This gives the target company negotiating leverage because they have more time to respond and look for alternatives or it may interfere with the offeror's ability to get financing for the transaction. *Id.* at 507-08.

41. *See supra* notes 13-20 and accompanying text.

42. *See* Helman & Junewicz, *supra* note 31, at 777. For example, fair price provisions require shareholder approval. *Id.*

43. *Id.* "A board of directors may increase the legal safety of a poison pill plan by obtaining shareholder ratification." *Id.*

44. *Id.*

45. A Study on the Economics of Poison Pills, [1985-1986 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,971, at 88,043-44, (Mar. 5, 1986); *see also* R. WINTER, *supra* note 31, at 506-07.

The SEC study found that a target company's stock price declined an average of 2.4% net of market price upon announcement that a pill would be implemented. *Id.*

46. *Id.*

ing that the pill benefits the shareholder in the long run.[47] A March, 1988 study by Georgeson & Co., Inc., an investor communication firm, revealed that shareholders in target companies with poison pills received an average final offer of 78.5% over the price of the stock six months before the control contest began. Target companies without pills received a gain of only 57%.[48]

B. *Structure of Modern Poison Pills*

The early convertible preferred stock pills[49] raised concerns of corporate procedure and excessive economic power that have been addressed by the more current forms of poison pills.[50] The typical pills today are in the form of "rights plans"[51] which involve the issuance of "rights" to purchase securities, whereas the original approach involved the immediate issuance of equity securities.[52] A rights plan is implemented by issuing, as dividends to shareholders, the right to purchase one share of common stock for every share held. The rights are attached to the stock[53] and do not separate or become exercisable until some triggering event occurs. A typical triggering event is the acquisition of twenty percent of the target company's common stock by any person or a tender offer for thirty percent or more of the common stock.[54] The exercise period is determined by the board,[55] and the exercise price is fixed according to what value the board and its financial advisors believe the stock will have by the end of the exercise period.[56] "Since the exercise price of the rights is 'out of the money' when issued, the rights will not dilute the [target] company's earnings per share and should not have any negative impact on the market price of the company's common stock."[57]

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47. R. WINTER, *supra* note 31, at 507.

48. *See* Fogg & Sterling, *Poison Pill Update*, in M. KATZ & R. LOEB, ACQUISITIONS AND MERGERS 1988 817, 844 (1988). Adjusted for the movement of the Standard & Poors 500 Index, companies with poison pills outperformed the S&P Index by 53% whereas those without pills were at 31% over the S&P Index. Only takeover contests of $100 million or more were included in Georgeson's study. *Id.* at 845; *see also* Lee, *Poison Pills' Benefit Shareholders by Forcing Raiders to Pay More for Targets, Study Says*, Wall. St. J., Mar. 31, 1988, at 55, col. 3 (giving details of the Georgeson study).

49. *See supra* note 33 and accompanying text.

50. *See* R. WINTER, *supra* note 31, at 571; Helman & Junewicz, *supra* note 31, at 771-72.

51. Mirvis, *supra* note 24, at 571.

52. *See* R. WINTER, *supra* note 31, at 571.

53. *See* Balotti & Abrams, *supra* note 33, at 141. "Initially, the rights are not exercisable, separate certificates are not issued, and the rights automatically trade with the issuing company's common stock . . . . Once the rights detach from the common stock, the rights trade independently from the common stock and are transferable."

54. R. WINTER, *supra* note 31, at 571.

55. Mirvis, *supra* note 24, at 571. (duration of the exercise period is typically 10 years).

56. *Id.*

57. Balotti & Abrams, *supra* note 33, at 141; R. WINTER, *supra* note 31 at 572 ("Out of the money" refers to the fact that the exercise price of the rights is "higher than the then-

Once the rights become exercisable, certain protective provisions allow the rights holders to purchase securities of the target company or the acquirer at a discount.[58] One such protective provision is the "flip-over" version[59] which allows rights holders, in the event that a merger or other business combination occurs, "to purchase at the exercise price that number of shares of common stock of the acquiring company which would have a market value of two times the exercise price."[60] The economic consequences to the acquirer can be avoided by the redemption of the rights by the board, at a nominal price, anytime prior to or within a specified time following the acquisition of twenty percent of the target company's stock.[61] This redemption feature allows the board of the target company to negotiate, thereby preventing the rights from interfering with a negotiated merger or a "white-knight" transaction prior to a twenty percent

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value of the securities").

Dilution will not occur because the rights do not have to be included in the number of outstanding shares used in the calculation to determine net earnings per share and book value. *See* Mirvis, *supra* note 24, at 571.

The SEC issued a study on the negative impact of poison pills on the market price of stock. This study has been confronted with studies showing opposite results. For a discussion of these, see *supra* note 45 and accompanying text.

58. *See* R. WINTER, *supra* note 31, at 572.

59. *Id.* "The variations between rights plans center primarily on the difference in treatment of the triggering event, the securities into which the rights are exercisable and the circumstances under which the rights may be redeemed." *Id.* Most rights plans have "flip-over" provisions, however other variations include the "flip-in" provisions and "back-end" plans. *Id.*

Whereas flip-over plans allow the rights holder to acquire securities in the acquirer's company, the flip-in provision allows the rights holder, except the acquirer/offeror, to purchase securities of the target company. *Id.* at 574. Flip-in rights were designed in response to the following concerns: (1) where there were no available securities in the acquiring company; (2) where there is an abusive takeover involving a first-stage tender offer and an avoidance of the second-stage business combination because the offeror was able to achieve effective control; and (3) the possibility of a self-dealing transaction between the target company and a significant shareholder. *Id.* at 574-76.

Back-end plans are designed to establish a minimum takeover price for the target company by insuring that non-tendering shareholders receive a specified value for their shares. A back-end price is established, equivalent to what the directors believe is a fair price for the target company. Once the rights are triggered, the rights holders (excluding the offeror) may exchange their rights (and sometimes their shares) for notes or cash equal to this back-end price. In addition to establishing a minimum takeover price, back-end plans discourage partial acquisitions of stock. *Id.* at 578.

See also Fogg & Sterling, *supra* note 48, at 819 (For recent variations of new "Poison Pill" technology).

60. Balotti & Abrams, *supra* note 33, at 142. (This provision is the devastating feature of the poison pill because of the dilution effect on the acquirer of the purchase of its stock at half price); *see* Mirvis, *supra* note 24, at 572 (the flip-over provision is effective regardless of who finally acquires the target company i.e., it does not have to be the same person who triggered the rights).

61. *See* Balotti & Abrams, *supra* note 33, at 142; *see also* Mirvis, *supra* note 24, at 573 (Typically, rights can be redeemed for $.05 per right.).

acquisition.[62]

The major arguments in support of the flip-over rights plans are that they: (1) encourage negotiation between the potential acquirer and the target company in order to avoid the economic consequences of the pill; (2) deter an acquisition in excess of the triggering amount because this event makes the rights no longer redeemable; (3) discourage front-end loaded mergers; (4) preclude self-dealing by a significant shareholder; (5) preserve the option to sell the company; and (6) do not dilute the financial or earning position of the target company.[63] The major arguments in opposition to flip-over rights plans are that: (1) they may prevent shareholders from having an opportunity to receive a premium over market from an acquisition; (2) dissident shareholders claim these plans serve to entrench directors, and together with other shareholder discontent, could lead to a proxy fight; (3) directors must decide whether or not to redeem the rights, and failure to redeem the rights once triggered, will make the target company an unattractive acquisition candidate since the rights will remain in effect until the end of the exercise period; and (4) there is some evidence by the SEC that such plans have a negative impact on the price of the stock.[64]

C. *Rights Plans Upheld by the Courts*

1. *Moran v. Household International, Inc.*[65]

Shareholders of Household International, Inc. ("Household") sought to invalidate the rights plan adopted by a majority of its board of directors.[66] The shareholders claimed that the rights plan restricted the aliena-

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62. *See* Balotti & Abrams, *supra* note 33, at 142; Mirvis, *supra* note 24, at 573.

63. Mirvis, *supra* note 24, at 573-74.

64. *Id.* at 574. *But see supra* note 45 and accompanying text (the financial impact studies of other entities show that there is a favorable impact on the price of the stock).

65. 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

66. *Id.* at 1063. The original plaintiffs were John A. Moran and his company, the largest single shareholder of Household. Moran was a director on the board of Household and had voted against the rights plan. *Id.*

The Household board of directors had 16 members, 9 of whom were outside directors. *Id.* at 1064.

The Household rights plan issued one right to each common stock shareholder. The right had a ten-year exercise period and entitled the holder to buy one one-hundredth of a share of a new series of nonredeemable participating preferred stock. *Id.* at 1066. The rights detached and were exercisable upon one of two triggering events. The 20% triggering event occurred if a person acquired 20% of Household's common shares, achieved the right to purchase 20%, achieved the right to vote 20%, or formed a group holding 20%. The 30% triggering event occurred upon announcement of a tender or exchange offer of 30%. *Id.* Once the 30% triggering event occurred, the rights detached and were immediately exercisable to purchase one one-hundredth of a share of the new preferred stock for $100 and were redeemable at $.50 per right. *Id.* If the 20% triggering event occurred, the rights were issued and exercisable, but were no longer redeemable. *Id.* If a merger or consolidation occurred bility and marketability of their shares. In contrast, the directors maintained that the plan was an effective deterrent to hostile, abusive takeovers and was adopted in the best interests of both the corporation and its shareholders.[67]

The directors adopted the rights plan in response to their concerns about the company's vulnerability as a takeover target[68] rather than in response to a specific threat. While the flip-over provision was seen by the board as a "strong negotiating device" to use against a potential acquirer, it would not render the company takeover-proof.[69] Furthermore, the directors claimed their decision to implement the plan was protected by the business judgment rule because it was presumed that the board was willing to consider all takeover proposals and redeem the rights if necessary to permit an attractive bid to proceed.[70]

The Delaware Chancery Court upheld the rights plan as an "appropriate exercise of managerial judgment under the business judgment rule."[71] The Delaware Supreme Court affirmed the lower court's decision by applying the standard of *Unocal Corp. v. Mesa Petroleum Co.*[72] The court held that the board had the authority to enact the plan[73] and that the plan did not prevent the stockholders from receiving tender offers.[74] Then, the court proceeded to apply the *Unocal* test.[75] There were no alle-

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and in the agreement, Household shares were exchanged for securities of the acquirer, unexercised rights flip-over and the holder can purchase common stock of the acquirer at a price reflecting a market value of two times the exercise price. *Id.*

67. *Id.* at 1064.

68. *Id.*

69. *Id.* at 1066 (determined acquirer, willing to accept moderate dilution in the second step of a takeover or to condition an offer on surrender of a certain percentage of the rights, could still accomplish a takeover).

70. *Id.* at 1072.

71. *Id.* at 1083. The Chancery Court found that the plan had been properly adopted under Delaware law, was not intended to entrench management, and served a rational corporate purpose. *Id.* at 1082. While the plan may have restricted alienability indirectly, it was considered necessary to protect the corporation and its constituencies from hostile takeovers. *Id.* The plan did not represent an irreversible alternative like other takeover devices. While the board adopted a resolution indicating its interest to stay independent, the directors also claimed that acquisition proposals would be considered in good faith. *Id.* at 1083.

72. 493 A.2d 946 (Del. 1985). The Delaware Chancery Court heard *Moran* in January, 1985. The Delaware Supreme Court did not hear *Unocal* until May, 1985, and the appeal in *Moran* was heard in November, 1985.

73. *Moran*, 500 A.2d 1346, 1353 (Del.), *aff'g* 490 A.2d 1059 (Del. Ch. 1985) (court noted that the inherent powers conferred by DEL. CODE ANN. tit. 8, § 141(a) (Repl. Vol. 1983), provided the board with this authority).

74. *Id.* at 1354 (court described several methods by which Household could still be acquired, one of which was the famous takeover of Crown Zellerbach by Sir James Goldsmith).

75. Under *Unocal*, the directors have the initial burden of showing they had reasonable grounds for believing there was a danger to the corporation through good faith and reasonable investigation. *Id.* at 1356 (citing *Unocal*, 493 A.2d at 955). In addition, the directors must demonstrate that the defensive device was reasonable in relation to the threat posed.

gations of bad faith or entrenchment, and the board effectively demonstrated that the plan was adopted in reaction to what they perceived as the threat of a coercive tender offer.[76] The court also found that the directors' fear over the increased frequency of hostile takeovers and Household's vulnerability to coercive acquisition techniques made the plan a reasonable defense mechanism.[77]

2. *Horwitz v. Southwest Forest Industries, Inc.*[78]

The board of Southwest Forest Industries, Inc. ("SFI") adopted a poison pill "for the purpose of thwarting any competitive offers by outsiders to obtain control of SFI."[79] The rights plan adopted by the board was similar to that of Household, except that the acquiring company could avoid the flip-over provision by buying out the rights[80] at an exorbitant cash premium, an alternative, albeit a costly one, to dilution.[81]

The directors claimed the plan was implemented to protect the corporation and its shareholders from unfair, two-tiered tender offers.[82] Faced with two unsuccessful acquisition offers, the board[83] instructed management to concentrate on business operations.[84] The plan was recom-

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Proof is enhanced if a majority of the board consists of outside, independent directors. The burden then shifts back to the plaintiff, who has the ultimate burden of persuasion to show the directors breached their fiduciary duties. *Id.*

76. *Id.* at 1356. The appellants did claim that the directors were uninformed. The standard for determining whether a decision is informed and thus protected by the business judgment rule is gross negligence. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). The *Moran* court concluded that the directors were not grossly negligent. *Moran*, 500 A.2d at 1356.

77. *Moran*, 500 A.2d at 1357. Earlier in the opinion, the court held that the directors did not lose the protection of the business judgment rule because they were not reacting to a specific threat. *Id.* at 1350. In fact, the court found that pre-planning might even reduce the risk of unreasonable action by the board because they were not under the pressure of a takeover bid. *Id.*

78. 604 F. Supp. 1130 (D. Nev. 1985).

79. *Id.* at 1132.

80. *Id.* The rights plan involved the issuance of poison pill warrants; *see* Comment, *"Poison Pill" Warrants and the Business Judgment Rule:* Moran v. Household International, Inc., 66 OR. L. REV. 373, 377 n.23 (1987) ("Poison pill warrants function as a 'put.' A put is a right to buy a certain amount of stock at a specific price within a stipulated time. The right may be sold separately or attached to stock as a warrant.").

81. *Horwitz*, 604 F. Supp. at 1132.

82. *Id.* at 1133. Under a two-tiered tender offer, the acquirer makes an attractive cash offer for a controlling position and offers less per share which often includes securities rather than all cash for the remaining stock. *Id.* This front-end loaded, two-tiered tender offer is coercive because stockholders feel compelled to tender their stock in the first tier, even if the offer is inadequate, for fear of receiving less in the second tier. *Id.*

83. The board consisted of twelve directors, eleven of whom were non-management. *Id.*

84. *Id.* One offer had come from inside but fell apart for lack of financing. *Id.* The second offer came from an outside group, but failed because they did not make a formal offer and did not demonstrate adequate financing. *Id.*

mended as part of a five-year management plan to develop and expand the company. The Nevada District Court found that the decision to "build the value of a company from within, rather than through merger or takeover may be a rational exercise of business judgment"[85] and upheld the board's decision due to the unlikelihood that the plaintiff could show that the directors breached their fiduciary duty.[86]

3. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[87]

The board of Revlon, Inc. ("Revlon") adopted a Notes Purchase Rights Plan in response to a hostile takeover bid by Pantry Pride, at what the board considered a grossly inadequate price.[88] Under the two-prong test of *Unocal*, the court held that the adoption of the plan was based on reasonable grounds.[89] In addition, the plan was reasonable in relation to the threat and was responsible for spurring the bidding to higher levels.[90] Due to subsequent actions by the board, the rights were redeemed, and the propriety of the plan became a moot issue.[91]

4. *Dynamics Corp. of America v. CTS Corp.* (The Second Poison Pill)[92]

CTS Corp. ("CTS") adopted its first poison pill plan to block a tender offer by Dynamics Corp. of America ("Dynamics"), regardless of the consequences to the shareholders.[93] The district court issued a preliminary injunction against this flip-over pill which was affirmed by the Seventh Circuit.[94] Then, CTS appointed a committee of outside directors who recommended a back-end rights plan that was subsequently adopted by the

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85. *Id.* at 1135 (citing Ponter v. Marshall Field & Co., 646 F.2d 271, 296 (7th Cir. 1981)).

86. *Id.* at 1136.

87. 506 A.2d 173 (Del. 1986).

88. *Id.* at 176-77.

89. *Id.* at 180-81. The plan was considered reasonable because it protected the shareholders from a hostile takeover bid at less than a fair price while maintaining the board's ability to consider acquisition proposals that might be in the shareholders' best interests.

90. *Id.* at 181.

91. *Id.* However, *Revlon* is still a significant case because the court held that once the break-up of a company was inevitable, the board's duty changed from one of protecting the corporation and its shareholders to one of maximizing the value to the shareholders. *Id.* at 182. The board's responsibilities under the *Unocal* standard were altered and the question of defensive measures became moot. *Id.*

The court finally held that Revlon's board, in granting an asset lock-up to a bidder in order to forestall Pantry Pride, was motivated by considerations other than the maximization of shareholder value, and that it entered into an agreement that was "to the ultimate detriment of its shareholders." *Id.* at 185.

92. 805 F.2d 705 (7th Cir. 1986).

93. *Id.* at 708; *see generally infra* pp. 141-43. (For the case history concerning the first pill see *Dynamics Corp. v. CTS Corp.*, 637 F. Supp. 406 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987)).

94. *CTS Corp.*, 794 F.2d at 259; *see also* Balotti & Adams, *supra* note 33, at 152.

entire board as part of their strategy to sell the company.[95] The district court found that the second pill was not devised solely to block a tender offer (an improper motive), but to maximize shareholders' profits once it was determined that the company was for sale.[96] In deciding the terms of the second pill, CTS expressed the following two concerns: (1) if Dynamics purchased enough shares it could obtain a "blocking position" that would deter other bidders; and (2) Dynamics could acquire the additional shares without first paying a premium for obtaining control of the company.[97] Even though the district court upheld the plan, the Seventh Circuit expressed doubt that the 28% trigger[98] could result in "blocking power"[99] and rejected the argument that the 28% trigger was necessary to insure shareholders a control premium.[100] Furthermore, the court questioned the reasonableness of the trigger price of $50 given the methods used in computing it.[101] Although the Seventh Circuit did not believe the district court clearly erred in its decision to uphold the plan, there were sufficient questions of fact to cause the court to remand for further findings.[102]

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95. *CTS Corp.*, 805 F.2d at 707. The board adopted the second pill on the same day that the Seventh Circuit upheld the preliminary injunction of the first pill. *Id.*

This second pill was devised by a special committee of outside directors with the help of its investment advisor, Smith Barney. *Id.* at 709. The Seventh Circuit was very suspicious of the fee arrangement between CTS and Smith Barney which was unclear in the trial record. *Id.* at 710-11. Although this alone was not enough to reverse or remand the case, it may have been a factor in the Seventh Circuit's decision to vacate and remand for further consideration. *Id.* at 711.

96. *Id.* at 709-10. The directors' duty, once the company was for sale, changed from one of acting in the best interests of the corporation to one of maximizing shareholder wealth. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

The second poison pill had a trigger of 28%. If any shareholder obtained 28%, all other shareholders could exchange their shares for a $50 debenture payable after one year, with 10% interest. The plan was effective for one year and could be cancelled by the board at any time, or automatically if anyone made a cash tender offer of $50 or more. *CTS Corp.*, 805 F.2d at 707.

97. *CTS Corp.*, 805 F.2d at 710.

The district court accepted as a "rational assumption" the advice given to CTS by Smith Barney that Dynamics, as a minority shareholder, could obtain blocking power by making a contrary bid at a higher price. *CTS Corp.*, 635 F. Supp. at 1179.

98. *See supra* note 94 and accompanying text.

99. *CTS Corp.*, 805 F.2d at 712 (court stated, "[d]espite much talk of 'blocking positions,' the record contains no evidence as to how Dynamics could use 28% or any other fractional ownership short of 50% to block anything.").

100. *Id.* at 712-13.

101. *Id.* at 714-15.

102. *Id.* at 716.

D. *Rights Plans Invalidated by the Courts*

1. *Dynamics Corp. of America v. CTS Corp.* (The First Poison Pill)[103]

CTS adopted the first poison pill plan for what the court determined was the express purpose of defeating the hostile tender offer by Dynamics Corp. of America ("Dynamics").[104] The court's major concern was the flip-in provision that would have caused Dynamics to suffer dilution[105] and severe economic loss.[106]

The District Court for the Northern District of Illinois recognized that Indiana law governed this case, and that Indiana looked to Delaware decisions for guidance.[107] The court reviewed the decisions in *Unocal Corp. v. Mesa Petroleum Co.*,[108] *Moran v. Household International, Inc.*,[109] and *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[110] before concluding that this case was distinguishable from the standards of director conduct upheld in the Delaware cases.[111]

First, the court found evidence that CTS directors had an entrenchment purpose in implementing the pill because of the almost immediate decision by management to oppose Dynamics' tender offer.[112] Since Dynamics openly threatened to engage in a proxy contest to put its own

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103. 637 F. Supp. 406 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

104. *Id.* at 407. Dynamics, a 9.7% shareholder in CTS, announced a tender offer for up to 1,000,000 shares at an eight dollar premium over market which would have given Dynamics a 27.7% interest. *Id.* Dynamics also announced its intention to wage a proxy contest to elect its own slate of directors to the CTS board. *Id.*

The pill had a flip-in provision that was triggered whenever anyone acquired 15% or more of CTS's common stock. When this occurred the rights became non-redeemable, and the holders, other than the acquirer, became entitled to purchase a unit of CTS securities at a price equal to 25% of current market value. *Id.* This provision caused the acquirer to suffer immediate economic loss, thereby forcing hostile bidders to negotiate with management. *Id.* The pill also had a flip-over provision which occurred upon the acquisition of CTS. The rights holder was entitled to purchase common stock of the acquiring company with a market value of $150 for the exercise price of $75. *Id.*

105. Once the flip-in provision was triggered and assuming all rights were exercised, Dynamics' interest decreased to 20.7%. *Id.* at 407. Also, when CTS issued rights to purchase securities (including debentures), the value of the company decreased because of the new debt. *Id.* at 407-08.

106. The dilution would cost Dynamics approximately $24 million if it completed the acquisition. *Id.* at 408.

107. *Id.* This action was filed seeking preliminary injunctive relief requiring the plaintiff to show probability of success on the merits, possibility of immediate and irreparable harm that outweighs possible harm to the defendant, and no harm to the public interest. *Id.*

108. 493 A.2d 946 (Del. 1985).

109. 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

110. 501 A.2d 1239 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

111. *CTS Corp.*, 637 F. Supp. at 411.

112. *Id.* at 416.

nominees on the board,[113] the court saw the flip-in plan, designed with a low acquisition level (15%), as a maneuver that would make mounting a proxy contest very difficult.[114] The court also found that the directors may not have made a reasonable investigation into the actual threat from Dynamics since there appeared to be conflicting testimony among the board members.[115] Finally, the court decided that CTS directors had not shown that this rights plan was a reasonable response to the threat of a takeover by Dynamics.[116] The directors knew that the plan would strengthen management in a proxy contest, which was not a legitimate purpose for enacting a defensive mechanism; and with no other reasons articulated, the plan was not reasonable in relation to the threat.[117]

On appeal, the Seventh Circuit expressed general misgivings about poison pills.[118] The court then affirmed the district court's invalidation of CTS's plan, on the basis that it violated the fiduciary obligations of CTS's management and directors.[119]

2. *Buckhorn, Inc. v. Ropak Corp.*[120]

The Buckhorn, Inc. ("Buckhorn") poison pill was a back-end plan implemented to protect shareholders from "Ropak's coercive, two-tiered, and inadequate tender offer and to assure for those shareholders on the 'back-end' a fair price for their stock."[121] The district court found the

113. *Id.* at 407.

114. *Id.* at 417. A 15% triggering event was lower than any plan known to have been adopted. The court could not see another reason, other than a proxy contest, for using this lower threshold. *Id.*

115. *Id.* Gross negligence is the standard to determine whether a board exercises informed judgment. *Id.* While there was some evidence of gross negligence, the conflicting testimony and a passive stance by the board as management shaped CTS's response to the tender offer, gross negligence had not been established. *Id.*

Earlier in the opinion, the court did say that management had a reason to fear Dynamics due to antagonistic relations in the past. *Id.* at 416. The problem was that the directors did not seem to focus on this in making their decision. *Id.*

116: *Id.* at 417.

117. *Id.* at 418. There was even evidence that the flip-in plan would deter all hostile acquisitions and did not spur a bidding contest, but in fact depressed the market for CTS stock. *Id.*

Legitimate purposes for enacting defensive mechanisms appeared in *Moran* and *Revlon.* In *Moran,* the concern was that a two-tiered merger would dilute shareholders' investment. *Id.* In *Revlon,* the goal was to preserve value for minority shareholders. In neither case was there specific regard to entrenchment as was evidenced here by the known effect on proxy contests. *Id.*

118. Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 255 (7th Cir. 1986), *rev'd on other grounds*, 481 U.S. 69 (1987).

119. *Id.* at 253, 259.

120. 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987) (decided without a published opinion).

121. *Id.* at 228.

directors had reasonable grounds to believe Ropak Corp.'s ("Ropak") tender offer was two-tiered because the directors were experienced and their opinion was supported by the professional advice of an investment banker.[122] In addition, the court believed the directors had "in good faith and after reasonable investigation" concluded that the price offered by Ropak was inadequate.[123]

However, the poison pill was enjoined because the directors failed to fully inform themselves of material information in setting the exercise price of the rights in the plan.[124] Since the pricing decision made by the directors essentially preempted the marketplace, an informed decision was imperative.[125] There were material deficiencies in the assumptions used to set the exercise price which the directors could have discovered upon reasonable inquiry.[126] Therefore, the directors could not satisfy either prong of the *Unocal* test since the pricing decision was not made on reasonable grounds and the prices set were not reasonably related to the interests of the shareholders.[127]

III. Offensive Takeover Tactics: Continued Use of the Pill

A. *Background for Current Litigation*

The implementation of a poison pill, essentially a device to resist hostile takeovers, may benefit the shareholders by raising their stock prices (through negotiation between the target company and acquirer) or by allowing the company to remain independent and build value from within.[128] There is no real dispute in the courts that defensive measures, including poison pills, are within the power of a target company's directors,[129] provided the directors meet their fiduciary burden under the two-prong *Unocal* test.[130] A key issue in recent litigation[131] concerns directors

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122. *Id.* at 229.

123. *Id.* (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)).

124. *Id.* at 231. If a poison pill is over-priced, it becomes a "show-stopper" preventing the shareholder from receiving a fair price. *Id.* at 230. Although this is a business decision, it is only protected by the business judgment rule if the directors show that they fully informed themselves. *Id.*

125. *Id.*

126. *Id.* at 231.

127. *Id.*

128. *See* Balotti & Abrams, *supra* note 33, at 107.

129. *See* Dynamics Corp. of America v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986); *accord* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986).

130. *See supra* notes 16-17.

131. Although this issue is the focus of more recent litigation, it is not a new issue. The Minnesota District Court in Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part and vacated in part*, 811 F.2d 414 (8th Cir. 1987), found that refusal to redeem rights was a reasonable response to a hostile bid that was contrary to the best interests of the corporation and its shareholders. *Id.* at 849. The court stated further that the

faced with a tender offer and a request to redeem the rights. In *Moran v. Household International, Inc.*,[132] the Delaware Supreme Court said in dicta that a board cannot arbitrarily reject an offer and will be held to the same fiduciary standards governing the implementation of a rights plan.[133]

B. *Refusal to Redeem Rights Plans Upheld by the Courts*

1. *CRTF Corp. v. Federated Department Stores, Inc.*[134]

In *Federated*, CRTF Corp. ("CRTF") made a cash tender offer for all the shares of Federated Department Stores ("Federated"). On the same day, CRTF filed suit for a preliminary injunction against Federated, claiming that the directors had breached their fiduciary duty in adopting a poison pill and refusing to redeem the rights.[135] Federated had agreed to redeem the rights with respect to a competing offer from R.H. Macy & Co.[136]

While Federated claimed the continued use of the pill was necessary to defend against CRTF's coercive offer and to increase bidding,[137] CRTF claimed that once an auction was underway, all defensive measures must be dropped.[138] The New York District Court, applying Delaware law, concluded that there was no evidence that Federated directors had acted for

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mere fact that a bid represents a premium above market value does not require the target company to submit to a merger. *Id.* at 849-50.

132. 500 A.2d 1346 (Del. 1985).

133. *Id.* at 1354. Specifically, the court concluded its opinion by stating:

> While we conclude for present purposes that the Household Directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its shareholders (citations omitted). Their use of the Plan will be evaluated when and if the issue arises.

Id. at 1357 (citations omitted).

134. 683 F. Supp. 422 (S.D.N.Y. 1988).

135. *Id.* at 433.

136. *Id.* The parties were in agreement that an auction, of the sort described in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986), was underway. Under this type of auction, the directors duty becomes one of maximizing value to the shareholders. 683 F. Supp. at 443.

137. *Id.*

138. *Id.* at 439. *Federated* cited language from the *Revlon* case:

> Favoritism for a white knight to the total exclusion of a hostile bidder might be justifiable when the latter's offer adversely affects shareholder interest, but when bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions.

Id. (quoting Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. 506 A.2d 173, 184 (Del. 1986)).

reasons other than shareholder interest.[139] The court interpreted the language in *Revlon*, which required that market forces be allowed to bring the best price available to shareholders, as demanding that directors do what was necessary to sell the company at the highest possible price.[140] It was clear to the court that Delaware law did not require the directors to be a "passive observer" and that directors had "the right to use [their] powers to defeat a coercive, two-tiered, front-end loaded bid . . . where the Board believe[d] the offer would not be in the best interests of the shareholders."[141]

The court held that, as part of the duty to auction, the directors "may selectively invoke or waive rights under a previously adopted 'Poison Pill' in order to further the auction and to raise the bidding."[142] If selective invocation of rights becomes an issue at the end of an auction,[143] the court said it must then carefully scrutinize the board's actions to determine if improper considerations such as conflicts or insider preferences were present.[144]

2. *BNS, Inc. v. Koppers Co., Inc.*[145]

BNS, Inc. ("BNS") challenged the reasonableness of the Koppers Co., Inc. ("Koppers") directors' refusal to redeem rights in response to BNS's tender offer for all of Koppers' outstanding stock.[146] The court stated that the directors "have a continuing duty to evaluate the fitness of their defensive strategy in light of developments in the ongoing battle"[147] and their actions should also conform to the standards set forth in *Unocal*.[148]

In applying these standards, the court found that the directors acted reasonably in rejecting BNS's first and second offers as inadequate,[149] be-

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139. *Id.* at 440.

140. *Id.* at 441. The directors are afforded a great deal of discretion, as long as their motive is to enhance bidding and to raise the price for the benefit of shareholders *Id.*

141. *Id.* at 440.

142. *Id.* at 424.

143. *Id.* at 442. In this case, the court determined that "the auction [was] still in progress, especially in the absence of a representation by CRTF both that it believe[d] its bid [was] the higher, and that, in the absence of a still higher, later, competing bid, it has made its highest and final bid." *Id.*

144. *Id.*

145. 683 F. Supp. 458 (D. Del. 1988).

146. *Id.* at 473. Koppers adopted its rights plan in February, 1986, and the plan contained both flip-in and flip-over provisions. *Id.* at 462.

147. *Id.* at 474. The court cited language from *Moran v. Household Int'l, Inc.* as support: "The Board has no more discretion in refusing to redeem the Rights than it does in enacting any defensive mechanism." *Id.*, (quoting Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985)).

148. *Id.*

149. *Id.* at 475. The directors did not reject the first offer until it had seriously analyzed the relevant factors, including its own valuation of the company, the advice of its invest-

cause the inadequacy of the price constituted a threat to the corporation and its shareholders.[150] BNS claimed that Koppers directors' refusal to negotiate represented bad faith, but the court found there was no duty to negotiate.[151] Even if there were a duty, Koppers had not taken irrevocable steps to defeat BNS's offer, nor had they taken steps to put the company on the auction block.[152] In the final analysis, the directors' refusal to negotiate and redeem the rights caused BNS to increase their bid twice.[153]

3. *Facet Enterprises, Inc. v. Prospect Group, Inc.*[154]

Facet Enterprises, Inc. ("Facet") implemented a flip-in rights plan after Prospect Group, Inc. ("Prospect") issued an all cash tender offer.[155] Facet's objectives in implementing the plan were to increase its ability to negotiate, to allow the board more time to consider alternatives, to protect shareholders from an unfair, back-end merger, and to deter a "street sweep" or "creeping acquisition."[156] Prospect claimed it would be a breach of fiduciary duty for Facet's directors to "hide behind a poison pill" and prevent shareholders from deciding for themselves whether or not to accept an offer. Facet responded that since an auction was about to begin, it was proper to keep the pill in place to fulfill its intended objectives.[157]

The Delaware Chancery Court recognized the directors' role as a negotiator and restated their view of the directors' fiduciary duty from *Moran*.[158] The court then addressed the issue of whether the directors should be allowed to keep the rights in place until the auction process has rea-

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ment bankers, the possibility of better offers, and the likelihood of failure of the BNS offer. *Id.* The second offer was similarly evaluated and rejected. *Id.*

150. *Id.* The court also stated that Koppers' directors were considering a recapitalization plan, but had not yet endorsed or announced a particular plan. Only when the company took definitive action could the court *possibly* intervene. *Id.*

151. *Id.* at 476. The court noted that the plaintiff cited no cases imposing such a duty. *Id.*

152. *Id.*

153. *Id.*

154. 1988 WL 36140 (Del. Ch. 1988).

155. *Id.* at *3.

156. *Id.*

157. *Id.* at *4-5.

158. The court reviewed the principles in *Moran* as follows:

> A board armed with a Rights Plan of the type now under review will possess a bargaining tool which can be used to extract concessions from an acquiror [sic] which it otherwise would not secure, or to deter the acquisition effort entirely. Through its power to redeem the rights before a triggering event occurs the Household Board has assumed a plenary negotiating role. It has also taken upon itself the responsibility for assuring that the rights are not triggered in such a fashion as to inflict harm upon the corporation by rendering it acquisition-proof.

Id. at *6, (quoting Moran v. Household Int'l, Inc. 490 A.2d 1059, 1083 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985)).

sonably run its course."[159] The court concluded that it should not enjoin the plan and/or require redemption of the rights until Facet had a "reasonable opportunity to conduct and complete the auction."[160] Citing *Federated,* the court stated that a properly used poison pill provided a "shield" against coercive offers and a "gavel" to conduct an auction.[161]

4. Recent Cases

In *Nomad Acquisition Corp. v. Damon Corp.,*[162] the Delaware Chancery Court stated that under Delaware law, the directors have a duty to oppose inadequate offers. A court should not order redemption of rights where the shareholders' ability to realize the full value of their shares would be adversely affected.[163]

The Delaware Chancery Court refused to order the redemption of rights in the case of *In re Holly Farms Corp. Shareholders Litigation,*[164] because there was no evidence that the board was improperly using the pill.[165] The court did enjoin several features of the auction,[166] so that the directors could carry out their duty to maximize shareholder value, but the court found the pill was sufficiently functioning to meet the objective of shareholder value maximization.[167]

C. *Redemption of Rights Ordered by the Court*

1. *Southdown, Inc. v. Moore McCormack Resources, Inc.*[168]

In 1986, Moore McCormack Resources, Inc. ("Moore McCormack") suffered large operating losses, and shortly thereafter, adopted a shareholder rights plan.[169] The court determined that "[s]etting up barriers to owner control after a disastrous performance support[ed] an inference that the

159. *Id.* at *6.
160. *Id.* at *7.
161. *Id.* at *6.
162. 1988-89 Transfer Binder Fed. Sec. L. Rep. (CCH) ¶ 94,040, at 90,868 (Del. Ch. Sept. 16, 1988) (case involved a flip-in rights plan where the court refused to order redemption of rights).
163. *Id.* at 90,872.
164. 1988 WL 143010 (Del. Ch. Dec. 30, 1988).
165. *Id.* at *6.
166. *Id.* These features included a lock-up provision, termination fee, and reimbursement provisions. The court enjoined them because they appeared to preclude a genuine auction. *Id.*
167. *Id.*
168. 686 F. Supp. 595 (S.D. Tex. 1988).
169. *Id.* at 601. The board did not get shareholder approval for the rights plan (approval was not required). The board also passed several by-law amendments that served to strengthen management's position. *Id.*

action was not taken to serve the shareholders."[170]

Southdown, Inc. ("Southdown") made an unsolicited, all cash, non-coercive tender offer,[171] and after three amendments, the price offered was well within valuations made by Moore McCormack and its investment bankers.[172] The court found Moore McCormack's statements that the offer was inadequate to be conclusory and "at best, a market-manipulative falsehood to perpetuate the management's incumbency."[173] Southdown's offer for the stock exceeded the price levels that management had been able to achieve through their own performance. Although federal securities laws allowed management time to persuade shareholders "to choose management over merger" and shop for other bidders, Moore McCormack had stalled too long and it was time to let the shareholders decide.[174] Continued use of the pill, by not redeeming the rights, constituted a threat to the company's financial health and the rights of its shareholders.[175]

2. *City Capital Associates Ltd. Partnership v. Interco Inc.*[176]

City Capital Associates Ltd. Partnership ("CCA") made a non-coercive, all cash tender offer[177] which Interco, Inc. ("Interco") rejected as inadequate.[178] Interco had acted prudently in determining the value of their own stock and had designed a restructuring that they believed had slightly greater stock value than CCA's tender offer.[179] Interco refused to redeem the rights of its "flip-in" poison pill because the directors feared that shareholders would choose to accept the tender offer of cash, rather

170. *Id.* The court found other evidence, such as revaluation of stock options, that led them to conclude that the directors "placed their personal relationships above the shareholders' rights." *Id.* The exercise price of stock options for the CEO were adjusted downward after the 1987 stock market crash. *Id.* This diluted shares of surviving shareholders and increased the cost to a potential acquirer. *Id.*

171. *Id.* at 602. The court distinguished this from a two-tiered, front-end loaded offer. *Id.* Southdown's offer allowed shareholders to make a decision under "neutral economic criteria without pressure of potential exclusion" because a shareholder would get the same amount regardless of whether the shareholder waited to sell after Southdown acquired a controlling share. *Id.*

172. *Id.* at 603. In fact, Southdown's last offer reflected a 68% premium over the pre-offer market price. *Id.*

173. *Id.*

174. *Id.* at 604. Under federal securities law, a tender offer must remain open for 10 days. Since Southdown amended its offer three times, Moore McCormack had over 40 days to shop the company. *Id.* at 602.

175. *Id.* at 602.

176. 551 A.2d 787 (Del. Ch. 1988).

177. *Id.* at 790.

178. *Id.* at 795.

179. *Id.* CCA's final offer was for $74 cash per share and Interco valued its restructuring for at least $76 per share. *Id.*

than accept the assumptions on which the restructuring valuation was based.[180] Interco claimed that shareholders' interests would be damaged by CCA's inadequate bid, and that the pill had to be kept in place to protect the restructuring that would give the shareholders greater value.[181]

It was clear to the court that the continued use of the pill was not to give the board time to explore alternatives or to negotiate for a higher bid, but to deprive the shareholders of the opportunity to accept a non-coercive offer.[182] CCA's offer could not be considered a threat to the shareholders' interest, due to the similarity of the offer and the value under the restructuring as well as the uncertainty of key assumptions used in formulating the restructuring value.[183] In applying the *Unocal* test, the court concluded that keeping the pill in place was not reasonable in relation to the threat.[184] The directors' fiduciary duty required them to redeem the rights and let the shareholders choose.[185]

3. *Grand Metropolitan PLC v. Pillsbury Co.*[186]

Grand Metropolitan PLC ("Grand Met") claimed that Pillsbury Company's ("Pillsbury") refusal to redeem the rights of its "flip-in" plan violated the fundamental rule of corporate governance.[187] Pillsbury claimed its decision was made in good faith, by independent directors, who after reasonable investigation, concluded that the decision was in the best interests of the shareholders and the corporation.[188] Pillsbury believed its actions were protected by the business judgment rule because the plan was reasonable in relation to the threat of an inadequate bid.[189] The Del-

180. *Id.* at 799.
181. *Id.* at 795.
182. *Id.* at 799-800.
183. *Id.* at 799.
184. *Id.* at 800. The court elaborated earlier in the opinion on the nature of threats to shareholders and essentially laid out two types: 1) threats to "voluntariness" that come up in the two-tiered, front-end loaded offers where a shareholder must decide in the first stage or risk a lesser value for his shares in the second stage and; (2) threats from "inadequate" but non-coercive offers whereby continued use of the pill could result in a higher bid or an alternate proposal. *Id.* at 797.
185. *Id.* at 799.
186. 558 A.2d 1049 (Del. Ch. 1988).
187. *Id.* at 1053. The fundamental rule of corporate governance is that shareholders ar the owners of a corporation, and a poison pill acts as a barrier to the shareholders' consideration of an offer to sell its share. Shareholders were the owners of a corporation, and that the poison pill acted as a barrier to the shareholders' consideration of an offer to sell their shares. *Id.*
188. *Id.* at 1054.
189. *Id.* In an earlier slip opinion, Justice Duffy said that although a pill effectively acts as a barrier to shareholders' consideration of a tender offer, Pillsbury's exploration of alternatives could go on indefinitely as long as the offers on the table were coercive or inade-

aware Chancery Court concluded that the bid was adequate and the directors' refusal to redeem the rights served only to preclude shareholders from accepting the tender offer.[190] Therefore, the decision to keep the pill in place was not reasonable in relation to the threat and not protected by the business judgment rule.[191]

IV. Conclusion

The number of companies implementing sophisticated defense devices, such as the "poison pill," is increasing dramatically. As long as shareholder approval is not required, issues of fiduciary duty and business judgment will continue to be litigated in the courts. The Delaware courts have created a framework for analysis, and controversial litigation has moved from implementation of shareholder rights plans to continued use of the plans by the refusal to redeem rights.

The courts appear willing to continue to extend the protection of the business judgment rule to boards decisions as long as the directors are motivated by concerns for the corporation and the best interests of the shareholders. Evidence of good faith and informed judgment are critical factors that will be scrutinized by the court. It is recommended that a corporation considering a takeover policy document a strategy, seek a thorough valuation from its investment banker, maintain a majority of disinterested directors on the board, and keep the directors informed as to all aspects of the decision. A board of directors can refuse to negotiate as long as tender offers are inadequate or coercive, but there comes a point when the board must let the shareholders decide for themselves whether to accept a tender offer. The courts, although reluctant to substitute their judgment in complex business decisions, are subjecting corporate boards of directors to a heightened level of scrutiny and will enjoin abuses of discretion that can often accompany such positions of power.

Wendy B. Gayle

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quate. The court said noncoercive, all cash, all shares offer can be a threat to shareholders if it is inadequate. *See* 1988 WL 119402 (Del. Ch. Nov. 7, 1988)(revised Nov. 9, 1988).

190. *Pillsbury*, 558 A.2d at 1060. The bid was not considered inadequate because Grand Met's tender offer was the only factor supporting Pillsbury's present stock price and Pillsbury's valuation based on building from within was based on numerous "if" assumptions. *Id.* at 1057-58. It should be the stockholder's choice to decide whether to take the tender offer or wait to see if Pillsbury's assumptions become reality. *Id.* at 1057.

191. *Id.* at 1060.