

THE EVER-EVOLVING POISON PILL: THE PILL IN ASSET PROTECTION AND CLOSELY-HELD CORPORATION CASES

ABSTRACT

The poison pill has been a staple of Delaware corporate law for several decades. It was originally developed to ward off hostile takeovers and has been quite successful. Given the potency of the pill, Delaware courts have always applied an enhanced level of scrutiny, the Unocal test, when a board of directors' decision to implement the poison pill is challenged. There has been a recent spate of litigation involving the poison pill in situations not previously litigated including Air Products & Chemicals, Inc. v. Airgas, Inc.; Versata Enterprises, Inc. v. Selectica, Inc.; and eBay Domestic Holdings, Inc. v. Newmark.

This Note reviews the history of the poison pill including attempts to expand the potency of the pill in takeover situations, from alterations in the 1990s to the recent court decisions which discuss the use of the poison pill in combination with other corporate mechanisms, specifically the staggered board. The Note then focuses on the recent evolution of the poison pill outside of the corporate takeover context. The poison pill has been used successfully to protect corporate assets and unsuccessfully to protect corporate culture.

This Note argues that context is key when courts review poison pills, particularly when they are implemented outside of a corporate takeover. Corporate law is constantly evolving; this will create growing pains as the Delaware courts grapple with these new mutations. As the poison pill is increasingly used in innovative ways the courts must remain cognizant of the context in which directors are acting, to ensure the appropriate standard of review is applied. The Unocal test is highly dependent on the takeover context and exists to ensure that directors are not entrenching themselves when they decline a takeover offer. Applying this test to asset protection or closely-held corporation cases where there is no takeover offer, nor even an entrenchment motivation, may produce results that can unexpectedly stunt the growth of this developing area of corporate law.

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I. INTRODUCTION

"[C]orporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."¹ The Delaware Supreme Court made this declaration more than twenty-five years ago, but

¹*Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 957 (Del. 1985). The court even went so far as to endorse creativity within the corporate law arena: "[m]erely because the General Corporation Law is silent as to a specific matter does not mean that it is prohibited." *Id.*

could not have fully grasped the impact of those words. The court validated the poison pill, a defensive measure historically used to ward off a hostile takeover, based on that statement, and the pill has grown and developed since its inception.² This article will trace the evolution of the poison pill and the Delaware courts' reaction to this evolution.

The Delaware courts authorized the use of the poison pill in the 1980s and have continually applied a heightened standard of review, the *Unocal* standard, when the pill is implemented by corporate boards.³ The pill became more potent in the 1990s with the invention of "dead hand" and "no hand" pills, developed to make hostile takeovers even more difficult by handcuffing a board's ability to remove a poison pill.⁴ The poison pill is also very potent when combined with a staggered board provision.⁵ This article will review recent litigation, including *Air Products & Chemicals, Inc. v. Airgas, Inc.*,⁶ and focus on the threshold question of whether these combinations should be reviewed by courts as a unified response or as independent actions, ultimately concluding that the context in which the measures were adopted will be determinative in each case.

The poison pill has recently been adapted for use in non-takeover situations. In *Versata Enterprises, Inc. v. Selectica, Inc.*, a board of directors successfully used the poison pill to protect corporate assets.⁷ Conversely, in *eBay Domestic Holdings, Inc. v. Newmark*, a board of directors used the pill unsuccessfully to protect corporate culture.⁸ This article dissects both decisions and additionally explores a potential alternative holding for *eBay*, assessing whether the Delaware Court of Chancery applied the appropriate standard of review in that case. This article ultimately concludes that the facts present in *eBay* could pass the two-prong *Unocal* test under an alternative theory; however, it also concludes that the court incorrectly applied the *Unocal* standard to the closely-held

²See *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 27 (Del. Ch. 1998) ("[T]he story of the poison pill has been a work-in-progress, with each variation and innovation generating new litigation . . .").

³See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1355-56 (Del. 1985).

⁴See Brian J. McTear, *Has the Evolution of the Poison Pill Come to an End?*—Carmody v. Toll Brothers, Inc.; *Mentor Graphics, Inc. v. Quickturn Design Systems, Inc.*, 24 DEL. J. CORP. L. 881, 894 (1999) ("[T]hese provisions severely limit a hostile acquiror's chances of succeeding . . . [e]ven if a hostile bidder were successful in a proxy contest, the newly elected board members would be powerless to redeem the [pill] and consummate the merger.").

⁵See *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 113 (Del. Ch. 2011).

⁶*Id.*

⁷5 A.3d 586 (Del. 2010).

⁸16 A.3d 1 (Del. Ch. 2010).

corporation, possibly creating inadvertent future consequences for closely-held corporations.

II. HISTORY OF THE POISON PILL

A. *Establishment of Validity*

The poison pill became a popular and effective defense against hostile corporate takeovers in the 1980s.⁹ The pill, or "Shareholder Rights Plan," works by attaching dormant rights to each share of a corporation's common stock.¹⁰ These rights become exercisable upon a triggering event, typically the acquisition of 15% to 20% of a company's outstanding shares.¹¹ The rights allow the holder to purchase new shares in the corporation at a steep discount.¹² The person triggering the pill, however, is exempt from exercising these rights, resulting in the dilution of their ownership position.¹³ Before a shareholder's rights become exercisable, the board of directors typically has the opportunity to redeem these rights.¹⁴ This redemption option provides the board of directors with flexibility when the corporation is presented with a tender offer. The board of directors may decide an offer is in the best interest of shareholders and redeem the rights, allowing the offer to pass through the defensive measure.¹⁵

Prior to 1985, the Delaware Supreme Court authorized the use of defensive measures, but not specifically the poison pill.¹⁶ In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court held that usage of defensive measures was inherent in a director's fiduciary duty to protect the corporation.¹⁷ This duty includes protecting the corporation from hostile bidders, particularly from two-tier coercive offers that are designed "to

⁹See McTear, *supra* note 4, at 882. In the 1980s, the availability of junk bond financing caused a wave of hostile takeovers to be initiated, which conversely led to corporate boards searching for some means of defensive protection. *Id.*; see also Ronald J. Gilson, *UNOCAL Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491, 494 (2001) ("[T]he application of junk bond financing to acquisitions—generated an extreme reaction.").

¹⁰See Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 382 (2002).

¹¹See, e.g., Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 321 (Del. Ch. 2010).

¹²See Velasco, *supra* note 10, at 382; McTear, *supra* note 4, at 884-85.

¹³See Velasco, *supra* note 10, at 382; McTear, *supra* note 4, at 884-85.

¹⁴See Velasco, *supra* note 10, at 382.

¹⁵See *id.* at 383.

¹⁶See, e.g., *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964).

¹⁷See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 958 (Del. 1985) ("[I]n the face of the destructive threat [the] tender offer was perceived to pose, the board had a supervening duty to protect the corporate enterprise, which includes the other shareholders, from threatened harm.").

stampede shareholders into tendering [shares] . . . out of fear."¹⁸ The court recognized directors' potential abuse of these defenses to perpetually entrench themselves in office.¹⁹ Therefore, before a board of directors can invoke the broad protection of the business judgment rule, it must satisfy the heightened *Unocal* standard, showing that the directors implemented the defensive measure to protect the corporate form and not due to director self-interest.²⁰

Shortly after legitimizing defensive measures in general, Delaware courts acknowledged the poison pill as a valid defensive tactic.²¹ Despite its initial ominous reputation,²² the Delaware Supreme Court noted that the poison pill "does less harm to the value structure of the corporation than do other mechanisms."²³ The rights plan has no effect on proxy contests, leaving an avenue for a hostile acquirer to achieve control.²⁴ The existence of a rights plan requires a hostile acquirer to achieve control through the ballot box instead of through the almighty dollar.²⁵ The court emphasized that the use of poison pills would be scrutinized under the *Unocal* standard, not only when the pill is initially adopted by the board of directors, but also when the directors do not redeem the rights after the pill is triggered.²⁶ This

¹⁸*Id.* at 956.

¹⁹*See id.* at 954.

²⁰*See id.* Board actions are typically adjudged by the business judgment rule; however, in using defensive measures, the court explained that a higher standard was needed: "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests . . . there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Unocal*, 493 A.2d at 954. This heightened standard for defensive measures is now known as the *Unocal* standard. *See* McTear, *supra* note 4, at 888.

²¹*Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985) (finding sufficient authority to support the usage of the poison pill under multiple sections of the Delaware corporate statutes).

²²*See* McTear, *supra* note 4, at 883-84 ("A poison pill was initially regarded as a 'show-stopper' that would prevent all hostile acquisitions.").

²³*Moran*, 500 A.2d at 1354.

²⁴However, a rights plan coupled with a staggered board can affect the use of proxy contests to achieve control. *See* Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 113 (Del. Ch. 2011).

²⁵*See Moran*, 500 A.2d at 1355; *see also* Gilson, *supra* note 9, at 501 ("[T]he Delaware Supreme Court's . . . preference [is] that control contests be resolved through an election, rather than a market: a target can block a tender offer so long as a stymied bidder can press its case through a proxy fight."). Notably, however, the enormous expense generated from a proxy contest may deter a potential acquirer from proceeding down this path instead of through the originally intended tender offer.

²⁶*See Moran*, 500 A.2d at 1354 (discussing a board's duty when faced with a request to redeem the pill: "[T]hey will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards . . . as they were held to in originally approving the Rights Plan.").

requires the board to pass the heightened standard laid out in *Unocal* whenever it makes a decision related to a poison pill.²⁷

B. *The Unocal Standard*

The *Unocal* standard is a two-pronged test. First, directors must demonstrate "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."²⁸ Directors can satisfy this burden by showing they performed a reasonable investigation executed in good faith.²⁹ Courts give the directors' actions additional credence if "a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards" approved the pill.³⁰ There is, however, no requirement that the board respond to a specific threat. Courts even consider preventive pills, adopted when directors fear their company is vulnerable to a takeover, as reasonable.³¹ Also, directors can reasonably react to a threat regardless of where it originates—whether the threat stems from third parties or existing shareholders.³²

After determining the directors perceived a valid threat, the court applies the second prong of *Unocal*, looking at the board's response to the threat. The court aims to ensure that the pill is proportional and, hence, "reasonable in relation to the threat posed."³³ The Delaware Supreme Court emphasized the inquiry is not designed to substitute the court's retrospective business judgment in place of directors'.³⁴ Therefore, as long as the directors' decision is not "draconian," and falls "within a range of reasonableness," the court will uphold the responsive action.³⁵ Draconian responses are those which are coercive or preclusive.³⁶ A coercive response would pressure

²⁷*See id.*

²⁸*Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del. 1985).

²⁹*See id.*

³⁰*Id.*

³¹*See Moran*, 500 A.2d at 1350. *Moran* was the seminal case validating the use of poison pills. The pill in that case was adopted without a current threat of a hostile takeover. *See id.*

³²*See Unocal*, 493 A.2d at 955 ("[The board's] duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders.").

³³*Id.*

³⁴*See Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1385-86 (Del. 1995) ("If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.") (citing *Paramount Comm'n, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-46 (Del. 1994)).

³⁵*Unitrin*, 651 A.2d at 1387-88 (citing *Paramount*, 637 A.2d at 45-46).

³⁶*Unitrin*, 651 A.2d at 1387-88.

shareholders to accept a different alternative,³⁷ while a preclusive response would make a hostile bidder's attempt to gain control through a proxy contest "realistically unattainable."³⁸

In summary, as long as a board reasonably perceived a threat to the corporation and enacting the poison pill was a reasonable response, the court will afford the directors' actions the presumption of the business judgment rule.³⁹ Because the pill was potent and subject only to the reasonableness of director actions, it became a fixture of Delaware corporate law.⁴⁰ The pill has, in fact, changed the dynamic of hostile offers, resulting in "a remarkable transformation in the market for corporate control."⁴¹ Hostile bidders were almost forced to use proxy contests in addition to tender offers to circumvent the effects of a poison pill.⁴²

III. TESTING THE BOUNDARIES: THE FIRST EVOLUTION OF THE POISON PILL

A. "Dead Hand" Poison Pills

The first progression away from the traditional poison pill was an attempt to deaden the effect of a hostile bidder winning a proxy contest, coincidentally coined a "dead hand" provision.⁴³ This provision, invalidated by the Delaware Court of Chancery in *Carmody v. Toll Bros.*, operated to prevent any slate of directors, other than those who were on the board when the poison pill was adopted, from redeeming the pill.⁴⁴

³⁷See *id.* at 1387.

³⁸*Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 601 (Del. 2010) (quoting *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998)). The *Unitrin* court defined preclusive as either "mathematically impossible or realistically unattainable." *Unitrin*, 651 A.2d at 1389. However, the Delaware Supreme Court recently narrowed the test in *Selectica* to "realistically unattainable," reasoning that "mathematically impossible" is already assumed if a matter is "realistically unattainable." See *Selectica*, 5 A.3d at 601.

³⁹See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 958 (Del. 1985).

⁴⁰See, e.g., *Account v. Hilton Hotels Corp.*, 780 A.2d 245, 249 (Del. 2001). In upholding a corporation's right to adopt a poison pill, the Delaware Supreme Court, under the doctrine of *stare decisis*, made the premise crystal clear: "[i]t is settled Delaware law that a corporation chartered under the laws of this State may adopt shareholder rights plans." *Id.* at 248.

⁴¹*Unitrin*, 651 A.2d at 1379.

⁴²See *id.*; see also *McTear*, *supra* note 4, at 893-94 ("[H]ostile bidders have developed ways to circumvent the poison pill . . . a potential acquiror may 'combine a tender offer with a consent solicitation or proxy contest' to transcend the board's reluctance to accept the bidder's offer." (quoting Shawn C. Lese, *Preventing Control From the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175, 2183 (1996))).

⁴³*McTear*, *supra* note 4, at 894.

⁴⁴723 A.2d 1180, 1184 (Del. Ch. 1998). Even if a bidder won a proxy contest and

This provision limits a hostile bidder's use of a proxy contest to gain control of a company,⁴⁵ which is inconsistent with the Delaware courts' preferred method for resolving control situations.⁴⁶ Therefore, it was unsurprising when the Court of Chancery struck down the "dead hand" pill on multiple grounds. The court concluded that the "dead hand" pill violated several Delaware statutory provisions.⁴⁷ Most notably, it created separate classes of directors with distinct voting powers, which can only be done through the certificate of incorporation.⁴⁸ The Court of Chancery also found the "dead hand" provision coercive and preclusive under the *Unocal* test, rendering it an unreasonable response.⁴⁹

B. "No Hand" Poison Pills

Another development of the poison pill, the "no hand" pill, was swiftly challenged in the Delaware courts after the "dead hand" pill died in *Carmody*.⁵⁰ The court invalidated the "dead hand" pill because it created two distinct classes of directors. The "no hand" pill used in *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, on the other hand, did not create classes.⁵¹ Instead, this new pill "evenhandedly prevent[ed] all members of a newly elected target board, whose majority [was] nominated or supported by the hostile bidder, from redeeming the rights to facilitate an acquisition by the bidder . . . for six months after the new directors [took] office."⁵² The

controlled seats on the board, these new directors would lack the authority to pull the pill. *Id.*

⁴⁵McTear, *supra* note 4, at 894; *see also Carmody*, 723 A.2d at 1187 ("[I]f only the incumbent directors . . . could redeem the pill, it would make little sense for shareholders or the hostile bidder to wage a proxy contest . . .").

⁴⁶*See* Gilson, *supra* note 9, at 501 ("[T]he Delaware Supreme Court's . . . preference [is] that control contests be resolved through an election, rather than a market: a target can block a tender offer so long as a stymied bidder can press its case through a proxy fight."); *see also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985) (discussing that poison pills do not have an effect on proxy contests and therefore are valid).

⁴⁷*Carmody*, 723 A.2d at 1190-91.

⁴⁸*Id.* The court also found the "dead hand" pill violated Delaware law because it created a situation where some directors were "created less equal than other directors," and this type of pill "impermissibly interfere[s] with the directors' statutory power to manage the business and affairs of the corporation." *Id.* at 1191. Furthermore, the court found the "dead hand" pill violated the director's duty of loyalty. *Id.* at 1193.

⁴⁹*See id.* at 1195.

⁵⁰McTear, *supra* note 4, at 903 (explaining that the "dead hand" and "no hand" poison pills were both challenged in Delaware courts within six months of each other); *see* *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 27 (Del. Ch. 1998) ("This case involves the pill's most recent incarnation—a 'no hand' poison pill . . .").

⁵¹*See Mentor Graphics*, 728 A.2d at 28 (explaining the difference between the "dead hand" pill and the "no hand" pill is that the latter does not create separate classes of directors).

⁵²*Id.*

board's rationale for implementing the "no hand" pill in *Quickturn* was to allow the new board time to familiarize itself with the company's business and overall value "before the board decided to sell the company to *any* acquiror [sic]."⁵³

The Delaware Court of Chancery held that the "no hand" pill, as used in *Quickturn*, was a disproportionate response under the second prong of the *Unocal* standard.⁵⁴ The current board intended to prevent a new board from selling to *any* acquiror for six months.⁵⁵ Given the pill's proscription against acquisition *only* by the hostile bidder who supported the new slate of directors, the court determined the justification did not match the response.⁵⁶ By invalidating the "no hand" pill based on the facts in *Quickturn*, the court left the door open in regard to the validity of the "no hand" pill in other circumstances.⁵⁷ On appeal, however, the Delaware Supreme Court promptly closed that door.⁵⁸ The court held that the "no hand" pill violated Delaware statutory law and directors' fiduciary duties in a similar manner as the "dead hand" pill.⁵⁹ Both versions of the pill inappropriately restricted the board's power in contravention of the certificate of incorporation.⁶⁰

The *Carmody* and *Quickturn* decisions precluded the expansion of the poison pill.⁶¹ When it disenfranchises shareholder votes in a proxy contest⁶²

⁵³*Id.* at 36.

⁵⁴*See id.* at 50.

⁵⁵*Mentor Graphics*, 728 A.2d at 50.

⁵⁶*See id.* ("The [pill] does not create a six month pill redemption delay in all cases . . . [i]t creates such a delay only if a newly elected board seeks to sell [to the hostile bidder] . . . a new board could sell the company to anyone other than [the hostile bidder] on its very first day in office.").

⁵⁷*See id.* at 52 n.105 ("[S]hould a delayed redemption provision be found invalid under 8 *Del. C.* § 141(a) because it temporarily deprives a newly elected insurgent board of a portion of its core authority . . . ? This Opinion does not meet that challenge.").

⁵⁸*McTear*, *supra* note 4, at 917; *see Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1290 (Del. 1998) (concluding the "no hand" pill does violate Delaware statutory law).

⁵⁹The court found both the "dead hand" and the "no hand" poison pills violated the same provisions of Delaware law. *See, e.g., Quickturn*, 721 A.2d at 1292 ("[W]e hold that the ['no hand' pill] is invalid under Section 141(a), which confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation."); *see also Carmody v. Toll Bros.*, 723 A.2d 1180, 1191 (Del. Ch. 1998) ("[T]he 'dead hand' provision would impermissibly interfere with the directors' statutory power to manage the business and affairs of the corporation . . . conferred by 8 *Del. C.* § 141(a).").

⁶⁰*See Quickturn*, 721 A.2d at 1291 ("[The] certificate of incorporation contains no provision purporting to limit the authority of the board in any way."); *Carmody*, 723 A.2d at 1190-91 (discussing that voting power distinctions must be expressed in the articles of incorporation).

⁶¹*See McTear*, *supra* note 4, at 909 ("[These] decisions severely restrict the expansion of the poison pill.").

⁶²*See Carmody*, 723 A.2d at 1195.

or restricts the duties of the board of directors,⁶³ the pill becomes too potent and, therefore, fails the second prong of the *Unocal* standard. Although these decisions limited the evolution of the poison pill from an operational perspective, they did not seek to limit the circumstances under which the poison pill could be utilized.

C. *The Poison Pill and the Staggered Board*

The Delaware courts have allowed directors to utilize the poison pill in combination with other corporate measures, like staggered boards, which inherently raises the pill's potency.⁶⁴ The poison pill limits a bidder's ability to acquire shares, forcing the bidder to pursue a proxy contest.⁶⁵ However, if a staggered board is in place the bidder must wage two proxy contests to gain control of the board as only one third of a typical classified board is elected each year.⁶⁶ One of the threshold questions in a dispute involving a corporation with both a staggered board and a poison pill is whether these measures should be viewed by the court as a combined response to a threat or as independent actions; if viewed collectively they are more likely to be considered preclusive under the second prong of the *Unocal* test.⁶⁷

This "combination" issue has been the subject of recent litigation in the Delaware courts. The *eBay* and *Selectica* decisions addressed the issue, but Chancellor Chandler's begrudging allowance of these combined measures in *Airgas*⁶⁸ has brought this discussion to the forefront of Delaware corporate law.⁶⁹ This section of the article will briefly discuss the interpretation of the combination issue by the courts. This article concludes that the fact-specific circumstances, including not only the effect but more importantly the purpose of implementation, are key when deciding whether a

⁶³See *Quickturn*, 721 A.2d at 1292; *Carmody*, 723 A.2d at 1191.

⁶⁴See *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010); *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 129 (Del. Ch. 2011).

⁶⁵See *supra* notes 24-25 and accompanying text.

⁶⁶See *Airgas*, 16 A.3d at 113. The court clearly saw a potential for the combination of a poison pill and a staggered board as preclusive under the *Unocal* test. *Id.* at 122 n.480.

⁶⁷See *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 27-28 (Del. Ch. 2010).

⁶⁸See *Airgas*, 16 A.3d at 115 (discussing how the court is "bound by this clear precedent"); see also Hon. William B. Chandler III, C. Del. Ch., Keynote Address at the Delaware Journal of Corporate Law Symposium: Irreconcilable Differences? Director, Manager, and Shareholder Conflicts in Takeover Transactions (Apr. 11, 2011) (discussing the erosion of *Unocal* and how a staggered board combined with a poison pill can be preclusive).

⁶⁹See Ashby Jones, *Delaware Speaks: Airgas and Its Poison Pill Prevail Over Air Products*, Wall St. J. L. Blog (Feb. 15, 2011 8:20PM), <http://blogs.wsj.com/law/2011/02/15/delaware-speaks-airgas-and-its-poison-pill-prevail-over-air-products> (discussing how the *Airgas* decision was a landmark decision and watched by many in the legal community).

poison pill and a staggered board are a unified response, thus subject to the *Unocal* test as a whole, or if they should be reviewed independently.⁷⁰ Had the Chancery Court recognized the independent contexts surrounding Airgas's adoption of the staggered board and poison pill, it could have more easily reached its decision to uphold the measures in that case.

In *eBay* the directors adopted a poison pill, a staggered board, and a new share issuance all on the same day.⁷¹ Chancellor Chandler clearly stated the rule for determining whether these actions are a combined defense: "Where all of the target board's defensive actions are inextricably related, the principles of *Unocal* require that such actions be scrutinized collectively as a unitary response to the perceived threat."⁷² Despite the adoption of these measures all on a single day, giving them the taint of a unified defensive response, the court believed the facts in *eBay* required the court to view them as not inextricably related.⁷³ The directors implementing the staggered board controlled a majority of the board prior to it being staggered and therefore did not gain further control when it became staggered.⁷⁴ This led the court to conclude the staggering of the board was not a defensive response and should be reviewed separate from the poison pill which the court clearly viewed as defensive.⁷⁵

The Delaware Supreme Court recognized in *Selectica* that although a staggered board will always act as an anti-takeover defense, "[c]lassified boards are authorized by statute and are adopted for a variety of business purposes."⁷⁶ For these reasons the court held "the combination of a classified board and a Rights Plan do not constitute a preclusive defense."⁷⁷ The court reasoned that the mere fact that a combination of measures makes obtaining control more difficult does not automatically render the measures preclusive.⁷⁸

⁷⁰When these actions are viewed as independent measures the court may review them under different levels of scrutiny. See *eBay*, 16 A.3d at 28.

⁷¹See *id.* at 27.

⁷²*Id.* at 28 (citing *Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1386-87 (Del. 1995)).

⁷³See *id.* at 27 ("This case does not present a situation in which I must view each Action as a unified response to a specific threat.").

⁷⁴See *eBay*, 16 A.3d at 36 ("[T]he Staggered Board Amendments . . . did not affect [the directors'] ability to control the board.").

⁷⁵See *id.* ("It would be inappropriate to apply *Unocal* to the Staggered Board Amendments because they do not implicate the concerns that drive *Unocal*; there is no 'omnipresent specter' that the Staggered Board Amendments are being used for entrenchment purposes.").

⁷⁶*Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010) (citations omitted).

⁷⁷*Id.*

⁷⁸See *id.*

The combination of a poison pill and a staggered board were also an issue in the *Airgas* controversy.⁷⁹ The court reviewed the defensive measures collectively after determining they were inextricably related, but without much discussion of why they were related.⁸⁰ Given the clear direction from the Delaware Supreme Court in *Selectica*, Chancellor Chandler felt compelled to hold that Airgas's combination of a staggered board and a poison pill was not preclusive.⁸¹

The court reluctantly held that the combined measures in *Airgas* were not preclusive.⁸² However, viewing them as separate measures could have eased the court's reluctance. Contrasting the *eBay* and *Airgas* decisions provides credence to viewing Airgas's actions as independent measures and therefore not inextricably related. eBay's directors implemented the poison pill and staggered board on the same day showing a clear defensive purpose, however, these were not held to be inextricably related actions simply because the *outcome* of the staggered board didn't have the effect that was likely intended.⁸³ On the other hand, Airgas had a staggered board for more than a decade before an acquirer expressed interest,⁸⁴ and did not adopt the poison pill until the potential acquirer stepped forward in 2007.⁸⁵ Although a board's decision more than a decade ago may affect a takeover attempt today, without a thorough review of why the board was staggered it appears difficult to "inextricably" relate these decisions that span more than a decade. This conclusion is further supported when that decade old decision relates to implementing a staggered board which is statutorily sanctioned and can be adopted for purposes not tied to corporate defense.

Had the court considered Airgas's actions independent measures, it could have applied the *Unocal* test to the poison pill adoption and not cloud the analysis with the staggered board issue. Although the staggered board ultimately made the attempted takeover more difficult, this does not warrant

⁷⁹See *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 62 (Del. Ch. 2011).

⁸⁰See *id.* at 113 n.432 ("Airgas's defensive measures are inextricably related in their purpose and effect.").

⁸¹See *id.* at 115 (discussing how the court is "bound by this clear precedent"); see also Chandler *supra* note 68 (discussing the erosion of *Unocal* and how a staggered board combined with a poison pill can be preclusive).

⁸²See *Airgas*, 16 A.3d at 115.

⁸³See *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 27-28, 36 (Del. Ch. 2010).

⁸⁴Airgas's regulatory filings indicate it had a staggered board since at least 1995. See Airgas's Proxy Statement Pursuant to Schedule 14A of the Securities and Exchange Act of 1934, dated July 5, 1995, <http://www.sec.gov/Archives/edgar/data/804212/0000804212-95-000009.txt>. Air Products began to express interest in acquiring Airgas in 2007. See *Airgas*, 16 A.3d at 63.

⁸⁵See *Airgas*, 16 A.3d at 62 n.39.

pulling it into the poison pill's *Unocal* analysis.⁸⁶ Directors make many decisions over the life of a corporation that may make a takeover more difficult;⁸⁷ however, decisions from years past should not be lumped together as a single defensive action in the present. To combine and view these decisions as a unitary response would effectively require boards to consider every prior board action and its potential cumulative effect on the decision the board faces today, even if those prior actions were not related to the situation at hand. Although a board that adopts a staggering provision and a poison pill in the same day certainly raises the specter of a unitary response,⁸⁸ a board that makes decisions separated by multiple years with potentially different purposes should be reviewed as independent actions.

IV. THE SECOND EVOLUTION: THE POISON PILL IN NON-TAKEOVER SITUATIONS

The Delaware Supreme Court authorized the use of defensive measures in *Unocal*, citing the need for corporate law to change and not remain static.⁸⁹ As much as times changed, resulting in the need for the poison pill, the evolution continues today.⁹⁰ The threat of coercive two-tier offers financed by high-yield debt has subsided,⁹¹ and the courts are "mindful of changing conditions in the corporate world that may warrant the [c]ourt's recognition of a new, valid corporate purpose for adopting a rights plan."⁹²

Delaware courts have ruled on the use of the poison pill in two non-takeover situations.⁹³ The Delaware Supreme Court upheld the use of a poison pill to protect corporate assets via a low-threshold trigger in *Selectica*.⁹⁴ However, in *eBay*, the Delaware Court of Chancery struck down

⁸⁶See *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 604 (Del. 2010).

⁸⁷These measures can include, inter alia, stock repurchase programs, issuance of new shares, or additional debt.

⁸⁸However, the Delaware Supreme Court has broadly stated that even that scenario should not be interpreted as preclusive. See *Selectica*, 5 A.3d at 604.

⁸⁹See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985).

⁹⁰See *Gilson*, *supra* note 9, at 511-12 (discussing that the threat of junk bond financed tender offers of the 1980's has subsided and a different structure exists today given that large institutional investors exist).

⁹¹See *id.* at 512.

⁹²*eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 32 (Del. Ch. 2010).

⁹³See *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 599 (Del. 2010); *eBay*, 16 A.3d at 30-31.

⁹⁴See *Selectica*, 5 A.3d at 606.

the use of the poison pill in a closely-held corporation to protect corporate culture.⁹⁵

This section of the article details the pertinent factual and legal conclusions offered by the Delaware courts and argues that, had the Court of Chancery viewed *eBay* as an action to protect corporate assets, the directors' implementation of the poison pill would have been upheld. Alternatively, even though *eBay* could have passed the *Unocal* standard, *Unocal* is not appropriate in closely-held corporations.⁹⁶ Applying the *Unocal* standard defies precedent and logic, while potentially precluding small companies from utilizing the benefits of the evolving non-takeover poison pill.

A. *Versata v. Selectica*

1. Facts

Selectica, Inc., a Delaware corporation specializing in software, became a public entity in March 2000, but consistently failed to generate an annual profit.⁹⁷ While its market capitalization was close to \$23 million, the corporation's history of annual losses generated accumulated net operating loss carry forwards ("NOLs") estimated to be worth \$160 million.⁹⁸ NOLs are a contingent asset, requiring a future profit to unlock the value of the NOLs; otherwise they expire worthless.⁹⁹ A NOL's value can also be impaired under the Internal Revenue Code ("IRC") if more than 50% of the corporation's stock changes hands in a three-year period.¹⁰⁰ For purposes of determining if an "ownership change" occurred, IRC §382 looks at transactions involving "those who hold, or have obtained . . . a 5% or greater block of the corporation's shares outstanding."¹⁰¹

In late 2008, Trilogy Inc., a competitor, stockholder, and creditor of Selectica,¹⁰² began making offers for Selectica's assets, buying more than 5%

⁹⁵See *eBay*, 16 A.3d at 35.

⁹⁶See *Stroud v. Grace*, 606 A.2d 75, 83 (Del. 1992) (discussing the need for the directors to lack control of the company in order for the *Unocal* standard to apply).

⁹⁷*Selectica, Inc. v. Versata Enters., Inc.*, 2010 WL 703062, at *2 (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. 2010).

⁹⁸*Id.* (identifying these figures as of the end of March 2009). "NOLs can be a valuable asset, as a means of lowering tax payments and producing positive cash flow." *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 589 (Del. 2010).

⁹⁹See *Selectica*, 5 A.3d at 589.

¹⁰⁰See *id.* (explaining that this interpretation of the complex calculation under §382 is at its simplest form).

¹⁰¹*Versata*, 2010 WL 703062, at *1.

¹⁰²*Selectica*, 5 A.3d at 605.

of Selectica's shares.¹⁰³ Selectica's board, knowing the company's "ownership change" percentage stood at 40% and could surpass the 50% threshold, revised their existing poison pill to protect the NOLs.¹⁰⁴ Selectica's board lowered the trigger from the typical "15% to 4.99%, while grandfathering in existing 5% shareholders and permitting them to acquire up to an additional 0.5%."¹⁰⁵ Trilogy challenged the validity of the poison pill in court,¹⁰⁶ but also triggered the pill, swallowing the poison and diluting their position in Selectica.¹⁰⁷

2. Analysis

The Delaware Supreme Court, *en banc*, applied the *Unocal* standard to the board's adoption of the poison pill. The threat, viewed by Selectica's directors, was "that the NOLs were an asset worth preserving and that their protection was an important corporate objective."¹⁰⁸ The court, applying the first prong of *Unocal*, determined the threat presented "reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership."¹⁰⁹ Analyzing the second prong of *Unocal*, the court held that the 5% poison pill was not preclusive, because it did not make a proxy contest "realistically unattainable."¹¹⁰ Finally, the court found the pill fell within the range of reasonableness, stating "a longtime competitor sought . . . to intentionally impair corporate assets."¹¹¹ Because the poison pill satisfied both prongs of the *Unocal* standard, the court upheld the use of the poison pill to protect the NOLs.¹¹²

¹⁰³*Id.* at 593.

¹⁰⁴*Id.* at 594-95 (discussing that the decision was made after consulting with their investment banker, specialized NOL accountant, and Delaware counsel).

¹⁰⁵*Id.* at 595. *See also* Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 321 (Del. Ch. 2010) (discussing that the typical range for poison pill triggers are between 15% and 20%).

¹⁰⁶*See* Selectica, Inc. v. Versata Enters., Inc., 2010 WL 703062, at *1 (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. 2010).

¹⁰⁷*See* Selectica, 5 A.3d at 599 (discussing that the dilution occurred because the Reloaded NOL Pill called for the doubling of the company's common shares, reducing their holdings to 3.3% from 6.7%).

¹⁰⁸*Id.* at 599-600.

¹⁰⁹*Id.* at 601 (quoting *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del. 1985)).

¹¹⁰*Id.* at 604.

¹¹¹*Selectica*, 5 A.3d at 606.

¹¹²*Id.* at 606-07.

3. Evaluation

The court's decision in *Selectica* validated two important mutations of the poison pill. A poison pill can be used to protect corporate assets and, in some circumstances, may be triggered by gaining a very low percentage of ownership in a corporation.

Vice Chancellor Noble concluded that *Selectica* presented "a distinct departure from the poison pill's originally intended use."¹¹³ In sanctioning the use of the poison pill to shelter corporate assets, the court hinted that this type of corporate action may deserve *more deference* than preventing a takeover.¹¹⁴ The fact that the court upheld the use of the defensive measure to protect assets with questionable value and lacking "an obvious mechanism for their use,"¹¹⁵ speaks to how strongly Delaware courts view the protection of corporate assets.¹¹⁶

Although the Delaware courts tolerated a low trigger percentage in *Selectica*, it appears to have done so with mixed emotions. Specifically, restricting a shareholder's ability to increase ownership in a company to less than 5% may indirectly impact his or her ability to win a proxy contest, and could ultimately result in a court determining the poison pill was preclusive.¹¹⁷

While accepting the 5% trigger, the Delaware Supreme Court took time to re-emphasize its historical view that proxy contests are not dependent on ownership.¹¹⁸ First, there was testimony that fifty publicly traded corporations have 5% triggers, some of them well-known Fortune 1000

¹¹³*Selectica, Inc. v. Versata Enters., Inc.*, 2010 WL 703062, at *15 (Del. Ch. Feb. 26, 2010), *aff'd*, 5 A.3d 586 (Del. 2010). The poison pill had been used once previously to protect corporate assets but that was in the context of a corporate takeover. *See Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 290 (Del. Ch. 1989). In that case, a poison pill was used to protect a potential \$5 billion monetary recovery, which would potentially be impaired if the takeover was completed. *See id.*

¹¹⁴*Selectica*, 2010 WL 703062, at *15 ("[P]rotection of corporate assets against an outside threat is arguably a more important concern of the Board than restricting who the owners of the Company might be.")

¹¹⁵*Id.* NOLs can be difficult to value because they are a contingent asset; the value of *Selectica's* NOLs was contingent on them reporting a future profit. *Id.* at *1. Given the company's failure to turn an annual profit, the company may be protecting an asset with little to no value to the company. *See id.* at *2.

¹¹⁶*Selectica*, 5 A.3d at 606-07 (holding that implementation of a poison pill was reasonable when "a longtime competitor sought to . . . intentionally impair corporate assets").

¹¹⁷*See id.* at 601-02. The hostile bidder argued that limiting a bidder's ownership percentage to less than five percent could prevent a bidder from "signaling its financial commitment to the company," thereby indirectly affecting the proxy contest. *See id.* at 601.

¹¹⁸*Id.* at 603.

companies.¹¹⁹ These low trigger plans, however, are normally adopted by companies with assets affected by ownership control, such as those companies holding NOLs.¹²⁰

Additional testimony analyzed the success of proxy contests in the past three years where the challenger had a low percentage of ownership: "of the fifteen proxy contests that occurred in micro-cap companies where the challenger controlled less than 5.49% of the outstanding shares, the challenger successfully obtained board seats in ten contests."¹²¹ The court also stated "[t]he key variable in a proxy contest would be the merit of the bidder's proposal and not the magnitude of its stockholdings."¹²² Before corporate boards across America start lowering the trigger threshold on their poison pills, the Delaware Supreme Court offered a word of caution:

[W]e have upheld the adoption of Rights Plans in specific defensive circumstances while simultaneously holding that it may be inappropriate for a Rights Plan to remain in place when those specific circumstances change dramatically. The fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs.¹²³

Given the court's stern warning, it seems unlikely the court will find a 5% trigger reasonable, except when there is an explicit reason for setting such a low trigger.

B. eBay v. Newmark

1. Facts

Craigslist, Inc. is the most used online classified website in the United States;¹²⁴ however, it is a small privately held company with no more than

¹¹⁹*Selectica*, 5 A.3d at 602.

¹²⁰*Id.* (noting that "5% Rights Plans are customarily adopted where issuers have 'ownership controlled' assets, such as the NOLs at issue in this case").

¹²¹*Id.* at 603.

¹²²*Id.* The court cites this holding as similar to the holding in *Unitrin*. *Selectica*, 5 A.3d at 603. This further proves that the Delaware courts still prefer control contests be decided via proxy contests. *See supra* note 25.

¹²³*Selectica*, 5 A.3d at 607.

¹²⁴*eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 8 (Del. Ch. 2010).

three parties owning the company at any time, and each owner having a seat on the board.¹²⁵ The company has a "community-service approach" to its business, and does not attempt to optimize revenue or profits.¹²⁶ This became a point of contention between the owners, eventually leading one of them, Phillip Knowlton, to put his shares up for sale.¹²⁷ eBay, a juggernaut in the internet auction space,¹²⁸ was immediately interested in acquiring the entire craigslist operation, but eventually settled for Knowlton's 28.4% stake.¹²⁹ eBay paid Knowlton for his shares, but also compensated the two remaining owners, Craig Newmark and James Buckmaster, in order to facilitate a new shareholder's agreement.¹³⁰ This agreement contained several provisions: (1) eBay was required to treat craigslist information as confidential; (2) eBay had the right to consent to certain corporate actions, including amendments to the corporate charter and changes in authorized shares; and (3) eBay was not prevented from competing with craigslist but such competition would result in eBay losing its consent and other rights.¹³¹

Within a few years, eBay used craigslist's "secret sauce," its confidential site metric data, to start a competing classified website known as Kijiji.¹³² This triggered eBay's loss of its consent rights and prompted Newmark and Buckmaster to request eBay end its relationship with craigslist. That request was gracefully declined.¹³³ Newmark and Buckmaster, suspecting eBay used craigslist data to launch its competing site, began to research protective measures.¹³⁴ One of the several defensive measures undertaken by craigslist was a poison pill with two triggers.¹³⁵ The first trigger applied to the three existing owners and would trigger if any shareholder's ownership percentage increased by 0.01%.¹³⁶ The second

¹²⁵*See id.* at 9.

¹²⁶*Id.* at 8.

¹²⁷*Id.* at 9.

¹²⁸*eBay*, 16 A.3d at 9. The court took note of the immense differences between the two companies: "eBay is vastly different from craigslist; eBay focuses on generating income from each of the products and services it offers rather than from only a small subset of services. It might be said that 'eBay' is a moniker for monetization, and that 'craigslist' is anything but." *Id.*

¹²⁹*Id.* at 10-11.

¹³⁰*Id.*

¹³¹*eBay*, 16 A.3d at 11-12.

¹³²*Id.* at 17. "eBay executives calculated that the eBay-craigslist relationship would at least provide them with an opportunity to learn the 'secret sauce' of craigslist's success, presumably so that eBay could spread that sauce all over its own competing classifieds site." *Id.* at 14.

¹³³*Id.* at 19-20 (eBay's counsel responded to the request with a question: "[h]ow would Jim and Craig react if Whitman [eBay's CEO] told them to go 'pound sand?']").

¹³⁴*Id.* at 20.

¹³⁵*eBay*, 16 A.3d at 23.

¹³⁶*Id.*

trigger became operative if someone became an owner of fifteen percent or more of the stock.¹³⁷ The rights plan and the other defensive measures taken by craigslist were challenged by eBay in the Delaware Court of Chancery.¹³⁸

2. Analysis

The Delaware Court of Chancery applied the *Unocal* standard to determine if the execution of the poison pill by Newmark and Buckmaster was appropriate.¹³⁹ Although the pill was not adopted in the traditional anti-takeover sense, the court determined the *Unocal* standard was still appropriate and sought to satisfy the first prong of the test by identifying the threat perceived by the directors.¹⁴⁰

Newmark and Buckmaster argued that, in the event of their deaths, eBay would likely gain control of additional shares from their heirs and attempt to monetize the website, breaking from craigslist's corporate culture and its "public-service mission."¹⁴¹ The defendants based their argument on the Delaware Supreme Court's decision in *Paramount Communications, Inc. v. Time Inc.*, in which a defensive action was upheld "to protect a specific corporate culture."¹⁴² The Court of Chancery held that the *Time* decision was not meant to validate defensive measures whose sole purpose was to protect corporate culture.¹⁴³ Therefore, the court refused to sanction craigslist's use of a poison pill "to shape the future of the space-time continuum" as a valid threat under the first prong of *Unocal*.¹⁴⁴

¹³⁷*Id.*

¹³⁸*Id.* at 7. In addition to the rights plan, craigslist also adopted a staggered board and did a share issuance, granting "one new share of craigslist stock in exchange for every five shares over which any craigslist stockholder granted a right of first refusal in craigslist's favor." *Id.* at 6. The staggered board provision was discussed earlier in the Note. See *supra* notes 71-75 and accompanying text. The share issuance is not within the scope of this article and therefore is not discussed at great length.

¹³⁹See *eBay*, 16 A.3d at 28.

¹⁴⁰See *id.* at 31 ("These unique factors do not, however, eliminate *Unocal's* usefulness. . . . It is entirely possible that the board of a closely-held company such as craigslist could deploy a rights plan improperly. The *Unocal* standard of review is best equipped to address this concern.").

¹⁴¹*Id.* at 32.

¹⁴²571 A.2d 1140, 1148 (Del. 1990) ("The board's prevailing belief was that Paramount's bid posed a threat to Time's control of its own destiny and retention of the 'Time Culture.'"); see *eBay*, 16 A.3d at 32 (discussing that the Delaware courts in *Time* upheld defensive action "to protect a specific corporate culture").

¹⁴³*eBay*, 16 A.3d at 32-33 ("*Time* did not hold that corporate culture, standing alone, is worthy of protection as an end in itself. . . . [P]ursuing non-stockholder considerations must lead at some point to value for stockholders.").

¹⁴⁴*Id.* at 32, 34.

The craigslist poison pill was also found to be outside the range of reasonableness under the second prong of *Unocal*.¹⁴⁵ Its stated purpose, protecting corporate culture, would not be impacted by eBay selling its shares; Newmark and Buckmaster being majority owners "can maintain the craigslist 'culture' regardless of whether eBay sells some or all of its shares."¹⁴⁶ Having failed both prongs of the *Unocal* test, the court rescinded the poison pill adopted by Newmark and Buckmaster.¹⁴⁷

3. Evaluation

The court's decision in *eBay* could give directors of closely-held corporations pause before implementing a poison pill. It appears from the record, however, that the craigslist directors actually recognized a different threat which the court may have viewed more favorably. Had craigslist argued the directors acted to protect corporate assets, similar to the logic in *Selectica*, the court may have validated the use of the poison pill under the *Unocal* test. Alternatively, *Unocal* should not apply to closely-held corporations because there is no need for a heightened standard. Although these arguments are mutually exclusive, this article argues both positions to show craigslist's poison pill could be upheld under any standard, but it strongly argues that applying *Unocal* is not appropriate due to craigslist's closely-held status.

C. Applying *Unocal* to a Craigslist Claim of Protecting Corporate Assets

1. Threat Perceived to Corporate Assets

In *Selectica*, the board reasonably perceived a threat to their NOLs, which the court determined was "an asset worth preserving and that their protection was an important corporate objective."¹⁴⁸ In *eBay*, one could argue Newmark and Buckmaster perceived a threat to, arguably, craigslist's most important asset: its site metric data.¹⁴⁹ eBay admitted one of its reasons for investing in the company was "to learn the 'secret sauce' of craigslist's

¹⁴⁵*Id.* at 35.

¹⁴⁶*Id.*

¹⁴⁷*eBay*, 16 A.3d at 35.

¹⁴⁸*Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 600 (Del. 2010).

¹⁴⁹*See eBay*, 16 A.3d at 8 n.5 (noting that craigslist's granular site metric data, which "would be useful for business planning purposes," is not publicly available).

success, presumably so that eBay could spread that sauce all over its own competing classifieds site."¹⁵⁰ Given both eBay's and the court's view of the site metric data, the court likely would find that the site metric data is worth protecting.

The Delaware Supreme Court has emphasized that the first prong of *Unocal* is satisfied where a threat "existed because of another person's stock ownership."¹⁵¹ In *Selectica*, the NOL's value would be impaired if Trilogy were to continue acquiring additional stock in the company.¹⁵² eBay posed two potential threats related to its stock ownership in craigslist. After eBay launched their competing site, Newmark and Buckmaster suspected eBay had used craigslist's nonpublic information to launch the competing site.¹⁵³ This created an ongoing threat that eBay, as a minority holder of craigslist, could continue to use nonpublic craigslist information to improve their newly launched competing website.¹⁵⁴ In addition, if eBay felt it had already learned all of the ingredients in craigslist's "secret sauce," it could sell its ownership interest to someone else interested in learning the recipe, thereby further impairing craigslist's most valuable asset.¹⁵⁵ Although both of these threats present issues as to what would be considered a reasonable response, it is clear there were threats to craigslist's prized asset and they originated from eBay's stock ownership in craigslist.

2. Defensive Tactics within the Range of Reasonableness?

Because it seems likely the court could find a valid threat was perceived by Newmark and Buckmaster, the court would next turn to the second prong of *Unocal* to determine if the response was draconian

¹⁵⁰*Id.* at 14.

¹⁵¹*Selectica*, 5 A.3d at 601 (quoting *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 955 (Del. 1985)).

¹⁵²*Selectica*, 5 A.3d at 601.

¹⁵³*eBay*, 16 A.3d at 20 ("[Jim and Craig] began to suspect . . . that nonpublic craigslist data had been used to develop and expand Kijiji [eBay's competing site].").

¹⁵⁴*See id.*; *see also* *Stroud v. Grace*, 606 A.2d 75, 88 (Del. 1992) (discussing that corporations have a duty to disclose information to shareholders). Because eBay had a right to receive information as a minority stockholder, this threat is clearly related to eBay's stock ownership, satisfying the first prong of *Unocal*.

¹⁵⁵*See Stroud*, 606 A.2d at 89 (noting that under Delaware statutory law, "the courts have placed special emphasis on the need to protect privately-held corporations from the dissemination of confidential business information to 'curiosity seekers'" (quoting *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 794 (Del. 1982))).

(coercive or preclusive) and, if not, whether it was within the range of reasonableness.¹⁵⁶

Implementing a poison pill to protect corporate assets in this situation is not coercive because the directors are attempting to protect the corporation and not coerce shareholders to accept a management-sponsored plan.¹⁵⁷ The poison pill adopted by craigslist is also not likely preclusive under the circumstances. The Court of Chancery opined that the craigslist poison pill was not considered fully preclusive because eBay was not precluded from selling its shares, only from selling them in lots larger than 14.99% for fear of triggering the pill.¹⁵⁸

Next, the court would have to consider if the directors' defensive response fell within the appropriate range of reasonableness. Even though eBay posed multiple threats to craigslist, the poison pill is likely only reasonable if employed in response to one of the threats mentioned above: eBay could sell its interest and allow the buyer access to the "secret sauce."¹⁵⁹

In *Selectica*, the court emphasized reasonableness is determined by context, finding a poison pill reasonable when "a longtime competitor sought . . . to intentionally impair corporate assets."¹⁶⁰ This is similar to craigslist's situation in that eBay, a longtime indirect competitor, began competing directly with craigslist and not only sought to impair assets in the future, but had also been suspected of already using corporate assets in a way that impaired their value.¹⁶¹

Newmark and Buckmaster's prior ownership issue lends more credence to their decision to implement a poison pill in response to the threat posed by eBay. When Knowlton, the original minority owner, wanted to sell his interest, the directors feared the shares would be sold to someone who "would 'bleed [craigslist] and suck it dry.'"¹⁶² After eBay became a minority owner, Newmark and Buckmaster suspected eBay was taking valuable information out of the company.¹⁶³ Furthermore, eBay was able to sell its minority interest freely, creating the same fears that ultimately came to

¹⁵⁶*See* *Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995).

¹⁵⁷*See id.* at 1387 (discussing that a poison pill is coercive when it is "aimed at 'cramping down' on its shareholders a management-sponsored alternative").

¹⁵⁸*eBay*, 16 A.3d at 35 ("[T]he Rights Plan is not fully preclusive.").

¹⁵⁹The ongoing threat that eBay would continue to use craigslist's "secret sauce" to improve its site would continue regardless of the poison pill; therefore, it could not be used to justify the deployment of the poison pill because the pill would have no effect on this threat.

¹⁶⁰*Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 606 (Del. 2010).

¹⁶¹*See eBay*, 16 A.3d at 20.

¹⁶²*Id.* at 9 n.8 (quoting testimony of craigslist's outside counsel).

¹⁶³*Id.* at 20. The fears were well founded as it was discovered at trial that eBay had in fact used craigslist's confidential data to launch their competing site. *See id.* at 17.

fruition when Knowlton sought to sell his shares.¹⁶⁴ Therefore, it would seem reasonable the directors would want to take action against this now recurring threat,¹⁶⁵ and protect the company from eBay selling to another minority owner who would continue bleeding information from the company.

Use of poison pills to protect against this type of threat is admittedly vulnerable to criticism. One could argue a pill is not reasonable here because it doesn't prevent eBay from selling its stake to a third party; rather, it merely prevents eBay from selling its whole 28% stake to one buyer.¹⁶⁶ Newmark and Buckmaster cannot prevent eBay from selling its shares, but could force eBay to break up its stake among several smaller minority owners if eBay sold its equity in craigslist. This reasoning should be sufficient to pass reasonableness, given the Delaware Supreme Court's deference to board actions:

[A] court applying enhanced judicial scrutiny should be deciding whether the directors made *a reasonable* decision, not *a perfect* decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination. Thus, courts will not substitute their business judgment for that of the directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.¹⁶⁷

Although this type of poison pill has never been used, it is likely to pass the range of reasonableness test. The craigslist's directors found themselves in a familiar situation: facing the threat of a minority holder seeking to impair corporate assets, potentially by selling its stake to a third party with adverse interests. Implementing the poison pill would be reasonable to protect these assets, because the only adverse effect on the minority owner is a small encumbrance on how he can sell his shares. Given this context, it is likely the court would have found craigslist acted within the

¹⁶⁴See *eBay*, 16 A.3d at 19 (noting that if eBay did not stop competing with craigslist, "the craigslist shares eBay owned would become freely transferable").

¹⁶⁵Newmark and Buckmaster feared this situation would occur when Knowlton sold his shares; their fears came to fruition and had the potential to re-occur.

¹⁶⁶See *eBay*, 16 A.3d at 35.

¹⁶⁷*Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994) (internal citations omitted).

range of reasonableness, thereby surviving the *Unocal* standard and granting the directors' actions the presumption of the business judgment rule.¹⁶⁸

D. *The Unocal Standard: Not Applicable in Most Closely-Held Corporations*

Even though craigslist could have made an argument passing scrutiny under the *Unocal* test, the Delaware Court of Chancery incorrectly applied *Unocal* to this poison pill. Although that notion may shock many readers, the Delaware courts have previously stated that *Unocal* does not apply in small, closely-held corporations with similar size and control circumstances as craigslist. Furthermore, in reviewing why Delaware courts employ enhanced scrutiny and by breaking down the elements of the enhanced scrutiny test, it becomes clear why the *Unocal* standard cannot apply to closely-held corporations. If the Delaware courts automatically apply the *Unocal* standard in reaction to a shareholder rights plan, such application could have an adverse effect on burgeoning areas of corporate law.

1. Precedent for Not Applying *Unocal*

The Delaware courts refused to apply the *Unocal* standard to board action in a closely-held corporation where directors were in complete control of the corporation.¹⁶⁹ In *Stroud v. Grace*, a minority shareholder challenged the board's decision to recommend amendments to the corporation's bylaws and charter which were subsequently approved by a shareholder vote.¹⁷⁰ The court affirmed that the *Unocal* standard typically applies when the board recognizes a threat and takes defensive measures.¹⁷¹ The court noted that lack of control, however, is a prerequisite for applying the heightened *Unocal* standard; if the board controls the company, there can be no cognizable threat.¹⁷²

¹⁶⁸eBay itself had the right to veto these types of corporate actions. *See eBay*, 16 A.3d at 12 ("The important consent rights provided [to] eBay . . . include the right to consent to (1) any amendment to the craigslist charter 'that adversely affects [eBay],'. . . the adoption of any agreement between craigslist and its officers or directors providing for the issuance of stock."). However, eBay decided to give up these rights when it chose to compete with craigslist. *See id.* at 19 (craigslist gave eBay ninety days to cure its competing website after which eBay would lose its consent rights to board action).

¹⁶⁹*See Stroud v. Grace*, 606 A.2d 75, 83 (Del. 1992).

¹⁷⁰*Id.* at 78, 81.

¹⁷¹*Id.* at 82.

¹⁷²*Id.* at 82.

In *Stroud*, the CEO controlled over 50% of the voting shares in the company.¹⁷³ The Delaware Court of Chancery refused to apply the *Unocal* standard, stating "[t]he amendments here could not have been adopted in response to some threat to corporate policy and effectiveness because management controls, and will control for the foreseeable [sic] future, well over 50% of the stock."¹⁷⁴ The Delaware Supreme Court affirmed, stating:

[T]he record shows beyond peradventure that there was no threat to the board's control. [The company] was neither a takeover target, nor vulnerable to one. No Delaware court has applied *Unocal* in the absence of a danger to corporate policy and effectiveness, or as here, in the face of a valid shareholder vote ratifying the challenged board action.¹⁷⁵

The court went on to say "[t]hese directors controlled the corporation in fact and law . . . [t]his obviates any threat contemplated by *Unocal*," and therefore the business judgment rule is the proper standard to analyze the board's decision.¹⁷⁶

In *eBay*, Newmark and Buckmaster, via a voting agreement, controlled greater than 50% of the stock, similar to the situation in *Stroud*.¹⁷⁷ In analyzing whether the poison pill was appropriate the court should have utilized the business judgment rule and not the heightened *Unocal* standard because of this control position. Furthermore, over 50% of craigslist's stockholders supported implementing the poison pill, similar to the *Stroud* case.¹⁷⁸

¹⁷³See *Stroud*, 606 A.2d at 83.

¹⁷⁴*Stroud v. Grace*, 1990 WL 176803, at *8 (Del. Ch. Nov. 1, 1990), *aff'd in part and rev'd in part on other grounds*, 606 A.2d 75 (Del. 1992).

¹⁷⁵*Stroud*, 606 A.2d at 83.

¹⁷⁶*Id.*

¹⁷⁷See *eBay Domestic Holdings, Inc. v. Newmark*, 16 A.3d 1, 25-26 (Del. Ch. 2010) ("Even though neither Jim nor Craig individually owns a majority of craigslist's shares, the law treats them as craigslist's controlling stockholders because they form a control group, bound together by the Jim-Craig Voting Agreement.")

¹⁷⁸See *Stroud*, 606 A.2d at 83 (referencing that the court's decision that *Unocal* is not the appropriate standard is "buttressed by the further fact that at least 70%" of the company's shareholders approved of the board action).

2. The Rationale and Elements of *Unocal*: An Awkward Fit for Closely-Held Corporations

The *Unocal* standard was originally developed as an enhancement to the traditional business judgment rule, which gives great deference to a board's decisions.¹⁷⁹ The enhanced scrutiny was needed in the context of defensive measures "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."¹⁸⁰ However, in the case of a typical closely-held corporation, like craigslist, the shareholders *are* the board of directors.¹⁸¹ This removes the potential that directors are acting in their own interests and not those of the shareholders because those interests are one and the same. If this potential conflict of interest is removed, there is no logical need for heightened scrutiny and the board's actions should be examined under the default standard, the business judgment rule. Interestingly, the court did apply this logic to craigslist's staggered board provision which was adopted the same day as the poison pill.¹⁸² However, because the court reasoned that poison pills are typically defensive devices, *Unocal* was applied.¹⁸³

Beyond the logic pronounced in *Stroud*, several of the elements of the *Unocal* standard make its application to closely-held corporations an awkward fit. Determining if directors acted in a draconian fashion, by taking action that was preclusive or coercive,¹⁸⁴ is unlikely to apply to a closely-held corporation. A measure is preclusive if it makes a proxy contest "realistically unattainable."¹⁸⁵ When a corporation is controlled by only a handful of owners, however, the ability to acquire shares or proxies from other owners may be "realistically unattainable" regardless of the board's action. This will not be the case in all closely-held corporations. In a corporation like craigslist, which is comprised of only three owners with voting agreements in place, winning a proxy contest is impossible before any board action. Therefore, applying the preclusive test to the board's action is a moot point.

¹⁷⁹See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946, 954 (Del. 1985) ("[T]here is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.").

¹⁸⁰*Id.* (emphasis added).

¹⁸¹See *eBay*, 16 A.3d at 9.

¹⁸²See *id.* at 35-36, 40.

¹⁸³See *id.* at 28 (noting that "rights plans . . . fundamentally are defensive devices").

¹⁸⁴See *Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387 (Del. 1995).

¹⁸⁵*Versata Enters., Inc. v. Selectica, Inc.*, 6 A.3d 586, 601 (Del. 2010).

It is also unnecessary in most closely-held corporations to determine whether board action is coercive. A coercive measure would pressure shareholders into accepting a management-sponsored option.¹⁸⁶ In many closely-held corporations, including craigslist, the owners are the managers.¹⁸⁷ When management and the shareholders are one and the same, it is a peculiar question to ask whether management was attempting to coerce itself.

Interestingly, the Delaware Court of Chancery conceded that the facts of the craigslist case are not similar to other rights plans that have been litigated.¹⁸⁸ Previous cases have dealt with companies that are public and have a widely dispersed and disempowered stockholder base.¹⁸⁹ Additionally, public companies are subject to management entrenching themselves over maximizing shareholder value.¹⁹⁰ Ignoring that the reasoning for the heightened standard was not present in this case, the court automatically applied the *Unocal* standard to the craigslist poison pill.¹⁹¹

This type of automatic reaction to a rights plan could have a negative effect on the alternatives a corporation has in dealing with external parties and shareholders. In *Selectica*, the Delaware Supreme Court embraced a new and innovative use of a rights plan to protect corporate assets.¹⁹² Protecting shareholders from hostile offers and protecting corporate assets are not the only illnesses the pill could cure.

For example, a rights plan may be useful when there are disputes between majority and minority shareholders.¹⁹³ Since the passage of the Sarbanes-Oxley Act, freeze-out mergers have increased as closely-held corporations try to avoid the enhanced regulations.¹⁹⁴ When minority shareholders contest these mergers, judicial review is required, which

¹⁸⁶See *Unitrin*, 651 A.2d at 1387.

¹⁸⁷See *eBay*, 16 A.3d at 8 (referencing that Jim and Craig were craigslist's principal management team).

¹⁸⁸See *id.* at 30 ("This case involves a unique set of facts heretofore not seen in the context of a challenge to a rights plan.").

¹⁸⁹See, e.g., *Paramount Commc'ns, Inc. v. Time Inc.*, 1989 WL 79880, at *3 (Del. Ch. July 14, 1989), reprinted in 15 Del. J. Corp. L. 700, 709 (1990), *aff'd*, 571 A.2d 1140 (Del. 1990).

¹⁹⁰See *eBay*, 16 A.3d at 30-31.

¹⁹¹See *id.* at 31. This reflex action was apparent when the court referenced a quote stating the *Unocal* test is "the most innovative and promising' case in our corporation law." *Id.* (quoting *City Capital Assocs. v. Interco Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988). The court failed, however, to realize what may have been innovative over two decades ago may not be relevant in the context of modern corporate law.

¹⁹²*Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 606-07 (Del. 2010).

¹⁹³See George S. Geis, *Internal Poison Pills*, 84 N.Y.U. L. REV. 1169, 1169 (2009).

¹⁹⁴See *id.*

ultimately takes up the court's time and resources.¹⁹⁵ Furthermore, these mergers typically require a court to appraise the value of the minority's stake; the term "judicial appraisal" typically makes both minority holders and the judiciary cringe.¹⁹⁶

Professor George S. Geis has proposed a variation of the typical shareholder rights plan called "internal poison pills," which deals with the contention between majority and minority holders in merger situations.¹⁹⁷ This type of pill would act as an economic incentive to ensure the majority does not dominate minority holders, while simultaneously preventing the minority from vetoing rational majority action.¹⁹⁸ This balancing act would prevent the need for freeze-out mergers and relieve the courts of unnecessary judicial review and appraisal.¹⁹⁹

The proper handling of "internal poison pills" is beyond the scope of this article. The Delaware Court of Chancery, however, signaled in *eBay* that its "Pavlovian" response to the word "poison pill" is to begin salivating for the *Unocal* standard. Given the awkward fit of this standard to closely-held corporations, the outcome of the dispute will rest on how the judge cuts corners off of the square peg to fit it in the round hole. Such uncertainty in a legal standard will likely incentivize closely-held corporations to stay on the sidelines. Most closely-held corporations would stay away from an innovative idea like the "internal poison pill" and may avoid using a poison pill to protect corporate assets, which is now a judicially sanctioned use of a rights plan.

V. CONCLUSION

The *Unocal* standard is labeled "flexible," but applying it to closely-held corporations stretches it beyond reasonable elasticity, as referenced by the Delaware Supreme Court's holding in *Stroud*. The courts developed *Unocal* to assess the usage of anti-takeover measures like the poison pill. The pill has clearly moved away from the anti-takeover context as corporations have found usefulness for the pill in other areas of corporate law. Therefore, courts must be cognizant of the context in which the poison pill was adopted and apply the appropriate test. Applying the *Unocal*

¹⁹⁵See *id.* at 1181-82.

¹⁹⁶See *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 125-26 (Del. Ch. 2011) (discussing the multiple problems associated with trying to appraise the value of shares in this particular case).

¹⁹⁷Geis, *supra* note 193, at 1174.

¹⁹⁸*Id.* at 1193-96.

¹⁹⁹See *id.* at 1221.

standard to closely-held corporations defies precedent and, more importantly, is likely to alienate such corporations from adopting poison pills and unlocking their potential value. The court's decision in *eBay* locks out closely-held corporations from achieving the value of existing poison pills and prevents them from using a rights plan in innovative ways. Instead of using these efficient corporate mechanisms, closely-held corporations will have to inappropriately rely on judicial resources. To prevent this, Delaware corporate law must not remain static; it must evolve to meet the changing needs of today's corporations.²⁰⁰

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²⁰⁰*See supra* note 1 and accompanying text.