DELAWARE'S ATTEMPT TO SWALLOW A NEW TAKEOVER DEFENSE: THE POISON PILL PREFERRED STOCK

I. INTRODUCTION

Of the myriad tactical defenses[1] available to a board of directors in this age of epidemic mergers and hostile takeovers, one recent method has gained especially wide-spread attention, particularly in Delaware.[2] This tactic is known as the Convertible Preferred Stock

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1. For a full discussion of these defenses, see generally Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291 (1984) [hereinafter cited as Finkelstein]; Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defense Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) [hereinafter cited as Gilson]; Black & Smith, *Antitake over Charter Provisions: Defending Self-Help for Takeover Targets*, 36 WASH. & LEE L. REV. 699 (1979) [hereinafter cited as Black & Smith]; Note, *Target Defensive Tactics as Manipulative Under Section 14(e)*, 84 COLUM. L. REV. 228 (1984) [hereinafter cited as Note, *Defensive Tactics*]; Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621 (1983); Lipton, *Takeover Responses and Director's Responsibilities: An Update, printed in* ABA National Institute, *The Dynamics of Corporate Control: Evolving Legal Standards Applied to the Frontiers of Corporate Strategy* (1983) [hereinafter cited as Lipton, *Takeover Responses*].

2. The recent case of National Educ. Corp. v. Bell & Howell, No. 7278 (Del. Ch. Aug. 25, 1983), directed the attention of many as to how the Delaware courts would rule on the legitimacy of this new defense. Unfortunately, there was no definitive ruling on the defense from Chancellor Grover C. Brown on NEC's petition for a preliminary injunction. The chancellor had little time to decide all the issues and found the petition could not be granted due to the failure on either side to show the likelihood of success on the merits. All eyes are now on the present appeal of Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985), now before the Delaware Supreme Court.

Moran, was argued before Vice-Chancellor Walsh of the Delaware Court of Chancery, and the poison pill plan was upheld as a valid exercise of the director's informed decision under the business judgment rule. Moran has appealed to the Delaware Supreme Court, and the Securities and Exchange Commission has filed an *amicus curiae* brief on behalf of the appellants. Oral arguments before the court were heard on May, 21, 1985. For other cases in Delaware dealing with this area of dividend issuance, see generally Thompson v. ENSTAR Corp., No. 7641 (Del. Ch. June 20, 1984) (revised July 5, 1984); Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979).

Dividend Plan,[3] or more commonly as the poison pill.[4] This plan has gained much notoriety as a viable option for use by directors in defending their corporations and staving off hostile tender offers and takeovers in Delaware.

In light of the recent development of this defense, as well as the prolific press attention it has received,[5] this article will examine the poison pill plan and evaluate its effectiveness as a legitimate defense to hostile takeovers. The first section will discuss the poison pill preferred stock dividend and takeover situations that warrant issuance of such a dividend. The second section will deal with the duties and responsibilities of directors to the company, as well as to the stockholders, in response to a tender offer they feel is potentially hostile. The third section will survey recent cases challenging the poison pill in the Delaware Court of Chancery and highlight the court's decisions regarding various parts of the defense. The fourth section will examine the considerations a board must confront in using a poison pill defense tactic, and the concluding section will outline suggestions for corporate directors when choosing such a course of action in Delaware.

II. THE POISON PILL PLAN

The poison pill plan is used frequently by a board of directors when confronted with a potential or existing hostile takeover from

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3. *See* Exhibit 1, Memo to Clients of Wachtell, Lipton, Rosen & Katz, *reprinted in* ABA National Institute, *The Dynamics of Corporate Control: Evolving Legal Standards Applied to the Frontiers of Corporate Strategy* (1983) [hereinafter cited as Lipton]. Martin Lipton conducted a session of the Institute entitled "Takeover Responses and Director's Responsibilities: An Update." His first exhibit was a memo to his clients setting forth a proposed plan that claimed to be the most acceptable form of this poison pill defense in light of regulations, previous cases, and the lack of direct attention courts have given this plan.

4. The poison pill preferred stock plan was first used by Lenox, Inc. in response to a tender offer by Brown-Forman Distillers Corp. to purchase any and all outstanding Lenox common shares. The Lenox board rejected the offer as "inadequate" and declared a dividend on Lenox' common stock of shares displaying characteristics of the newly recognized poison pill defense. Brown-Forman Distillers Corp. v. Lenox, Inc., No. 83-2116 (D.N.J. June 20, 1983). *See also* Wall St. J., June 16, 1983, at 2, col. 2.

5. For examples of the discussion and publicity generated by the poison pill plan, see generally N.Y. Times, Sept. 24, 1984, at D1, col. 1; Wall St. J., Feb. 13, 1985, at 3, col. 2; Wall St. J., Mar. 20, 1985, at 6, col. 1; Wall St. J., Mar. 29, 1985, at 8, col. 2; Wall St. J., Apr. 19, 1985, at 17, col. 1; Wall St. J., Apr. 22, 1985, at 10, col. 2 and at 16, col. 4; Wall St. J., Apr. 29, 1985, at 5, col. 1; Wall St. J., May 15, 1985, at 6, col. 1 and at 16, col. 3.

a raiding bidder. The central mechanism of this defensive weapon is either the issuance of preferred stock as a pro rata dividend of the outstanding common stock in the target company[6] or the issuance of a right to purchase the same. These preferred shares are issued with special provisions[7] that may include redemption and conversion privileges[8] as well as supermajority voting.[9] The forced equity provisions of redemption and conversion give rise to the name "poison pill."[10] The shareholders in a hostile takeover are all assured equitable and fair compensation for their holdings in the raided company depending on which provision or combination of provisions are used. This raider is required to compensate all shareholders accordingly and, in so doing, swallows the target "pill." A discussion of the tender offer situation requiring the use of such a defense mechanism as the poison pill will lend greater clarity to the reader.

A. *The Threatening Tender Offers*

One type of tender offer which has become popular in recent years is known as the "front-end loaded two-tier," or simply the two-tiered tender offer.[11] A two-tiered tender offer is "a partial tender offer . . . coupled with an announced plan to follow up with a second

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6. The dividend must be issued pro rata or a board will run into discrimination problems as did the board of directors in Baker v. Providence & Worcester Co., 364 A.2d 838 (Del. Ch. 1976), *rev'd*, 378 A.2d 121 (Del. 1977). Although it was reversed, the case raises important questions concerning discrimination.

7. These provisions must carry distinctive rights to justify calling these shares preferred. In Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979), the Delaware Court of Chancery in found the supermajority voting right provision to be the only distinctive right the issuance and was, therefore, an improper attempt to alter common voting rights.

8. These privileges provide the shareholders with the ability to redeem their shares for a fair and substantial price if the raider acquires control of the company redemption privilege or to convert their preferred stock dividends into stock in the acquiring company's shares.

9. This provision (conversion privilege) permits its holders to block mergers with nonpublic corporations unless a certain number of the holders, up to as many as four-fifths, assent to such a merger. *See generally* Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984) [hereinafter cited as Note, *Protecting Shareholders*].

10. The effect of these provisions is to reduce the market price of the target company's common stock as well as the market price of the raider's stock once the tender offer is made. *See* Lipton, *supra* note 3, at G-11.

11. "The two-tier, front-end loaded tender offer has replaced the any and all cash offer as the favored, strong bid." Lipton, *Takeover Responses*, *supra* note 1, at 8-8.

step merger at a lower price per share."[12] In applying this method, a raider makes his bid for the corporation by first offering his bid in cash for twenty to fifty percent of the outstanding shares of the target.[13] Once the raider has secured control of a majority holding, the remaining shareholders are then "squeezed out" in a back-end merger by being forced to accept either a lower price for their shares or a different form of consideration.[14] This tender offer method has been successful because each shareholder fears being one of those who will receive the lower back-end consideration in the squeeze-out merger.[15] The end result of this fear is generally a stampede to tender out and avoid being caught in the back-end.[16]

A typical example of this is the situation in which the raider offers to buy a majority of stock for a premium price (X + Y), instead of offering all the shareholders a fair price (X) for all the stock. Coupled with this offer is an announcement that the remainder of the stock will be acquired later at a lower price.[17] The coercion involved is apparent and easily explains the readiness of shareholders to tender immediately.[18]

A second method of tender offer that may elicit the use of the poison pill dividend is the partial tender offer. This is a simple offer to buy a controlling majority of the target's stock with no promise

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12. Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983).

13. Today it is well recognized that practical control of the corporation can exist within this percentage range. *See* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 114 (1979) [hereinafter cited as Lipton, *Takeover Bids*]; Note, *Protecting Shareholders, supra* note 9, at 1965 n.4.

14. *See* Brief of Defendant Bell and Howell Co. in Opposition to Plaintiff's Motion for a Preliminary Injunction at 7-8, National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Mar. 12, 1984) [hereinafter cited as Defendant's Brief]. *See also* Lipton, *Takeover Responses, supra* note 1, at 8-7 to 8-8.

15. *See Brudney, Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CAL. L. REV. 1072, 1118-19 (1983) [hereinafter cited as Brudney]. Brudney expresses the utmost concern about unequal treatment of the shareholders in this situation. Attention is focused on preventing the bidder from "taking advantage of the power of a single offeror to whipsaw dispersed offerees." *Id.* at 1119. The question is whether the bidder should be allowed "to pay less in the coerced second step even though doing so restricts, or indeed denies, the free choice investors are assumed to, and led to believe they do, have in the first step." *Id.*

16. *See supra* note 13.

17. Note, *Protecting Shareholders, supra* note 9, at 1966.

18. Lipton had the following to say regarding shareholder coercion:

> [T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion—they will tender, therefore, it is misleading to speak of a free shareholder choice at all. The existence of an offer to acquire a controlling interest in a company makes

of any second-step merger or other transaction in the future.[19] The partial offer has arisen and gained popularity due to ease of financing. The raider is only required to obtain a controlling interest in the takeover bid and not to buy all the shares up front. However, when Rule 14d-8[20] was amended requiring uniform proration rights during a partial tender offer,[21] use of the partial tender method was curtailed. Uniform proration rights eliminate the use of multiple proration pools[22] which "lock in" early tendered shares and so tarnish the attractiveness of such a procedure for raiders.[23]

B. *The Poison Pill Defense to the Takeover*

The poison pill plan is a direct step to overcoming the burdens and hostilities of both the partial and two-tiered takeovers. "The

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> it almost impossible for a shareholder in the target to prudently retain his shares unless he does so for the purpose of exchanging them in a promised subsequent tax-free exchange. Once a raider has acquired control—and target shareholders must assume that the raider will acquire control—it is highly unlikely that shareholders will receive a higher price than that initially offered; since there is no possibility of a competing offer at a higher price, the public trading market (if one still exists) will have been capped at the price offered in the tender offer and the raider is not likely to offer more for the target's shares once it has achieved control. Retaining the target's shares in the face of a tender offer will bring the shareholder no benefit. He is likely to be forced out through a merger at a later date for the same price he could have realized upon the initial offer. The outcome of a shareholder referendum conducted in the form of a tender offer cannot realistically be said to reflect a careful appraisal of the merits or demerits of the offer. Each individual shareholder must look to his own interest and must pragmatically assume that most other shareholders will tender with the result that the nontendering shareholder will be left in a minority, illiquid investment position. Thus, any uncoerced decision *against* acceptance of a tender offer can *only* be made at the board of directors level.

Lipton, *Takeover Bids, supra* note 13 at 113-14. *See also* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974); Brudney, *supra* note 15, at 1119.

19. Thus, the major difference between the partial and the two-tiered tender offer is the back-end buyout at a lower price in the latter. *See generally* Brudney, *supra* note 15, at 1118-19.

20. 17 C.F.R. § 240.14d-8.

21. *See* Lipton, *Takeover Responses, supra* note 1, at 8-23. Rule 14d-8 requires a bidder in "a partial tender offer to accept on a prorated basis all securities tendered during the entire period that the offer remains open. Proration had previously been required only during the first ten calendar days of an offer and for ten calendar days following an increase in the offer price."

22. *See* Release No. 34-19336 [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,306 (Dec. 15, 1982).

23. *See Finkelstein, supra* note 1, at 292.

redemption privilege attached to the stock discourages the making of partial tender offers by giving its holders the power to deplete the target company's assets substantially; the conversion privilege discourages two-tiered tender offers by equalizing the prices of the tiers."[24]

These provisions can be issued in two different ways: (1) as attachments to a preferred stock dividend issued to the common shareholders; or (2) as a new series of participating preferred stock which may be purchased, upon exercise, pursuant to a right issued as a dividend to the common shareholders. The rights do not become exercisable nor transferrable until the occurrence of certain events: (1) acquisition by any person of a certain percentage (usually twenty to thirty) of the common shares; (2) the acquisition of the right to vote that percentage of the common shares; or (3) the acquisition of that same percentage by a combination of persons acting in concert. The announcement of a person's intention to tender or exchange that same percentage of the outstanding common stock will also trigger the effectiveness of the rights.

The redemption or fair price privilege and the conversion privilege attached to the preferred stock dividend are similar in their application. If a raider acquires a twenty to fifty percent holding in the target's voting power and does not follow through with a second-step merger within a certain period of time, the holder of the redemption privilege may redeem his preferred stock at a price equal to the highest price paid by the tender offeror within a given period of time.[25] The conversion right provides the privilege holder with a "flip-over" option to exchange his preferred for substitute common or preferred shares of the raider if the twenty to fifty percent acquisition is followed by a freeze-out merger.[26]

These provisions do not completely thwart the raider's takeover effort.[27] They become effective only when the raider attempts either

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24. Note, *Protecting Shareholders, supra* note 9, at 1967. The redemption provision will survive the merger and allows the holder of the dividend stock to continue his equity interest in any combined entity. *See* Finkelstein, *supra* note 1, at 300-01.

25. *See* Lipton, *Takeover Responses, supra* note 1, at 8-19 to 8-20.

26. *Id.*

27. See Note, *Protecting Shareholders, supra* note 9, at 1968 (footnotes omitted), where it was stated:

> The conversion privilege presents only a small obstacle to the bidder willing to purchase all of the preferred stock. If the bidder desires a second-stage merger, there is no way to prevent nontendering share holders from diluting the ownership power of the acquiring company's shareholders in

the two-tier or partial takeover previously described. The result is a neutralization of the coercive effects of these tender offers "by allowing shareholders to decline to tender their shares yet still receive the tender offer price in cash or its equivalent if the tender offer succeeds."[28]

A supermajority voting right provision can also be contained in the poison pill plan. These rights can be used by the stockholders as a greater than majority requirement to approve certain business transactions.[29] The vote is effective in blocking mergers and hostile takeovers. The majority requirement ranges from two-thirds to ninety-five percent but is generally set at eighty percent.[30] Usually, the provision is of limited applicability, as the holders of eighty percent of the preferred stock must approve any merger with a nonpublic corporation. This high approval percentage is designed to preserve the value of the preferred stockholders' rights to receive a substitute preferred of the acquiring corporation in the event of a merger.[31]

C. *The Power to Issue the Poison Pill*

Implicit in the issuance of a preferred stock dividend is the board's authority to devise and proclaim such a share. It is the shareholders who both authorize this preferred stock and approve the certificate of incorporation. Provisions can be made in the certificate[32] to authorize the board of directors to issue "blank-check"

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the acquiring company itself. But if the bidder is willing to purchase all the preferred shares at a fair price, the holders of the few remaining untendered shares will not be able to effect a substantial dilution of control. Moreover, dilution of control is not an unusual incident to mergers: shareholders of the expiring corporation are commonly allowed to exchange their shares for stock in the surviving corporation.

28. *Id.* at 1967.

29. *See* Black & Smith, *supra* note 1, at 713.

30. *See id.*

31. *See* Defendant's Brief, *supra* note 14, at 63.

32. The Bell & Howell Certificate of Incorporation provided:

> The Board of Directors is expressly authorized to adopt, from time to time, a resolution or resolutions providing for the issuance of No Par Cumulative Preferred Stock, as a class or in one or more series, with such voting powers, full or limited or cumulative, or no voting powers, and with such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions adopted by the Board of Directors.

Id. at 24-25.

stock.[33] "Delaware law permits the authorization of 'blank check' preferred stock, which may be issued by the directors at their discretion and may be endowed with any features, designations, preferences, or rights selected by the board at the time of issuance."[34] Under section 102(a)(4)[35] and 151(a)[36] of the Delaware General Cor-

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33. "Blank-check" stock is stock whose terms are fixed by board resolution at the time of issuance. Note, *Protecting Shareholders, supra* note 9, at 1972 n.54.

34. Finkelstein, *supra* note 1, at 299.

35. DEL. CODE ANN. tit. 8, § 102(a)(4) (1983) provides:

(4) If the corporation is to be authorized to issue only 1 class of stock, the total number of shares of stock which the corporation shall have authority to issue and the par value of each of such shares, or a statement that all such shares are to be without par value. If the corporation is to be authorized to issue more than 1 class of stock, the certificate of incorporation shall set forth the total number of shares of all classes of stock which the corporation shall have authority to issue and the number of shares of each class that are to have a par value and the par value of each share of each such class, the number of shares of each class that are to be without par value, and a statement of the designations and the powers, preferences and rights, and the qualifications, limitations or restrictions thereof, which are permitted by § 151 of this title in respect of any class or classes of stock or any series of any class of stock of the corporation and the fixing of which by the certificate of incorporation is desired, and an express grant of such authority as it may then be desired to grant to the board of directors to fix by resolution or resolutions any thereof that may be desired but which shall not be fixed by the certificate of incorporation. The foregoing provisions of this paragraph shall not apply to corporations which are not organized for profit and which are not to have authority to issue capital stock. In the case of such corporations, the fact that they are not to have authority to issue capital stock shall be stated in the certificate of incorporation. The conditions of membership of such corporations shall likewise be stated in the certificate of incorporation or the certificate may provide that the conditions of membership shall be stated in the bylaws . . . .

36. DEL. CODE ANN. tit. 8, § 151(a) (1983) provides:

(a) Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation. Any of the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of any such class or series of stock may be made dependent upon facts ascertainable outside the certificate of incorporation or of any amendment thereto, or outside the resolution or resolutions providing for the issue of such stock adopted by the board

poration Law, a board of directors is properly authorized to issue preferred stock by resolution of the directors. Section 151(g) [37] completes the triple crown by providing that a certificate of designation filed under section 151 has the effect of amending the certificate of incorporation.

Thus, Delaware allows a board of directors to issue a dividend of preferred stock to the stockholders on any terms it fixes by resolution, provided it is pursuant to the provisions of the certificate of incorporation. The language of the statute places no restrictions on the board. The board may determine the precise characteristics needed in defending a tender offer and may delay the decision until the board becomes aware of the threat of a hostile takeover.[38] A broad power to issue blank-check stock thus exists. Additionally, the statute contemplates "that substantive limitations on the board's power should be set by the shareholders themselves rather than by courts construing the terms of the statute."[39] Shareholders have the ability to restrict or deny the board any power when voting on charter provisions.

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of directors pursuant to authority expressly vested in it by its certificate of incorporation, provided that the manner in which such facts shall operate upon the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of such class or series of stock is clearly and expressly set forth in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors. The power to increase or decrease or otherwise adjust the capital stock as provided in this chapter shall apply to all or any such classes of stock.

37. DEL. CODE ANN. tit. 8, § 151(g) (1983) provides in pertinent part:

When any corporation desires to issue any shares of stock of any class or of any series of any class of which the voting powers, designations, preferences and relative, participating, optional or other rights, if any, or the qualifications, limitations or restrictions thereof, if any, shall not have been set forth in the certificate of incorporation or in any amendment thereto but shall be provided for in a resolution or resolutions adopted by the board of directors pursuant to authority expressly vested in it by the provisions of the certificate of incorporation or any amendment thereto, a certificate setting forth a copy of such resolution or resolutions and the number of shares of stock of such class or series shall be executed, acknowledged, filed, recorded, and shall become effective, in accordance with § 103 of this title. . . .

When any certificate filed under this subsection becomes effective, it shall have the effect of amending the certificate of incorporation.

38. *See* Finkelstein, *supra* note 1, at 299-300; Note, *Protecting Shareholders*, *supra* note 9, at 1973.

39. Note, *Protecting Shareholders*, *supra* note 9, at 1974.

The source of authority enabling a corporation to issue poison pill preferred stock is found in section 157 of the Delaware General Corporation Law.[40] Under this section, a corporation is given the power to "issue 'rights' entitling the holders of such rights to purchase 'shares of its capital stock of any class or classes' upon such terms and at such prices as provided 'in a [board] resolution providing for the creation and issue of such rights.'"[41] The corporation, when issuing rights, must also file a certificate of designation for the rights in addition to the certificate filed pursuant to section 151(g).

III. THE DUTIES AND RESPONSIBILITIES OF DIRECTORS IN RESPONSE TO TAKEOVERS

The shareholders' protection against receiving unequal consideration for their shares or against the threat of being compelled to tender is of major importance to a board of directors in responding to a takeover attempt. The directors of a corporation stand in a fiduciary relationship to the corporation and its shareholders.[42] "Their

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40. DEL. CODE ANN. tit. 8, § 157 (1983) provides:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

The terms upon which, including the time or times, which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.

In case the shares of stock of the corporation to be issued upon the exercise of such rights or options shall be shares having a par value, the price or prices so to be received therefor shall not be less than the par value thereof. In case the shares of stock so to be issued shall be shares of stock without par value, the consideration therefor shall be determined in the manner provided in § 153 of this title.

41. *See* Answering Brief of Defendants Below-Appellees 62, Moran v. Household Int'l, Inc., Nos. 37 & 47 (consolidated) (Del. Apr. 22, 1985).

42. *See, e.g.,* Aronson v. Lewis, 473 A.2d 805 (Del. 1984); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939).

obligation as fiduciaries is to exercise their business judgment and act in what they reasonably determine in good faith, after appropriate consideration, to be in the best interests of the company and its shareholders. Decisions made on such basis are protected by the 'business judgment rule.'"[43] The Supreme Court of Delaware succinctly enunciated the business judgment rule in *Aronson v. Lewis.*[44] The court announced:

> The business judgment rule is an acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a). It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.[45]

There are certain governing principles limiting this protection. The Supreme Court of Delaware in *Aronson* stated that the business

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43. Lipton, *Takeover Responses, supra* note 1, at 8-1.

44. 473 A.2d 805 (Del. 1984).

45. *Aronson*, 473 A.2d at 812 (citations omitted). *See* Brief for Defendant, Pretrial, at 58, Moran v. Household Int'l, Inc., 490 A.2d 1059 (Del. Ch. 1985). As S. Samuel Arsht has noted:

> [T]he Business Judgment Rule is that a transaction which involves no self-dealing by the directors or no personal interest of the directors will not be enjoined for misconduct of directors, and the directors who authorize such transactions will not be held personally liable for resultant damages unless the record discloses at least one of three circumstances or conditions: (1) that the directors did not exercise due care to ascertain the relevance of the available facts before voting to authorize the transaction; or (2) that the directors voted to authorize the transaction even though they could not have reasonably believed the transaction to be for the best interest of the corporation; or (3) that in some other way the directors' authorization of the transaction was not in good faith.
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> The Business Judgment Rule is circumscribed by two important limitations which I have included in my formulation of the rule. Those limitations are: (1) it is available only to a director who has no personal interest in the transaction; *and* (2) only if he has paid informed attention to his duties. A director cannot close his eyes to what is going on about him in the conduct of a corporate business and have it said that he is exercising business judgment. For the Business Judgment Rule to be applicable, a director's judgment must be brought to bear with specificity on the challenged transaction.

Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 660-61 (1979) (footnotes omitted).

judgment rule's "protection can only be claimed by disinterested directors whose conduct otherwise meets the test of business judgment [i.e.,] that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[46] The court further noted that "to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties."[47] A director has to exercise undivided and unselfish loyalty to the corporation, and there shall be no conflict between duty and self-interest.[48] In the absence of a showing of bad faith, fraud, or self-dealing, the courts will respect the business judgment of directors.[49]

Corporate directors must exercise their best business judgment in scrutinizing all business transactions, including tender offers. Defense tactics should not, therefore, be condemned in general. Of course, the board's fiduciary duty "requires the directors to attempt to block takeovers that would be harmful to the target company,"[50] yet the directors must not act upon any selfish motive nor seek to perpetuate their own control in breach of that duty.[51] As mentioned previously, the directors' decision will be presumed to be based on sound business judgment and can only be rebutted by a showing of

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46. *Aronson*, 473 A.2d at 812 (citations omitted).

47. *Id.*

48. *See, e.g.*, Singer v. Magnavox Co., 380 A.2d 969, 977 (Del. 1977); Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).

49. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); *see also* Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 650 (1983) [hereinafter cited as Note, *Tender Offer Defensive Tactics]*.

> The business judgment rule has been justified on several grounds. First, it allows directors the discretion necessary to formulate effective company policy. Second, it encourages competent people to become directors without fear of personal liability for honest errors in judgment. Third, it relieves the courts of the burden of second-guessing complex corporate decisions, a task for which they are not well-equipped. The business judgment rule essentially shields directors from liability for the honest mistakes of judgment which are an incident of corporate management, so long as these mistakes do not result from the failure to act with loyalty and care.

Id. at 650-51 (footnotes omitted).

50. Note, *Protecting Shareholders, supra* note 9, at 1968.

51. *See, e.g.*, Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del. 1971).

fraud, bad faith, or gross overreaching.[52] The stance of the Delaware court has been to allow the directors to prevail upon a showing of a rational, unselfish business purpose underlying their actions.[53] The courts are willing to defer to the decisions of the board since it is the board's duty to run the company and make decisions based on its best judgment, while courts, on the other hand, are ill-equipped to evaluate such judgment.[54]

Problems may occur when a board plans to implement a takeover defense, in that a conflict of interest can arise concerning their duty of loyalty.[55] One example of such a problem is the "interested director transaction,"[56] in which the business judgment rule is inapplicable. "If a successful defense will perpetuate the directors' control, the directors' decision to fight a tender offer may be motivated by a desire to retain control."[57] Such self-interest can lead readily to the utilization of defensive tactics detrimental to the corporation and shareholders.[58] At this point the board must demonstrate the "intrinsic fairness" of its decision in order to receive court approval.[59] However, in the context of complex takeover questions, courts have been reluctant to apply this test and have, instead, applied the

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52. *See, e.g.*, Warshaw v. Calhoun, 43 Del. Ch. 148, 157, 221 A.2d 487, 492-93 (Del. 1977). *See also* Note, *Tender Offer Defensive Tactics, supra* note 49, at 652 (footnote omitted), where it is stated:

> A decision by the board or directors to defend against a tender offer may be based upon a number of valid considerations, including inadequate price, inappropriate timing, legal obstacles that might prevent consummation of the takeover, and failure of the offer to provide equally for all target shareholders. In these situations, the business judgment rule operates to protect directors who act fairly and reasonably in the interests of the corporation.

53. *See, e.g.*, *Sinclair Oil Corp.*, 280 A.2d at 720. Under such a lax standard of review, it is not surprising to find that directors' decisions are seldom overturned. *See* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75-81 (1972).

54. *See* Gilson, *supra* note 1, at 822-23 (1981).

55. The duty of loyalty requires only that the director's dealings with the corporation be consistent with the "fiduciary" position held. *Id.* at 822 (footnote omitted).

56. The interested director transaction occurs when a director "is either serving on two boards and the two corporations have some interrelated activities, or where you have a director who is involved in a transaction with his own company where that transaction is designed to benefit that director personally." Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674 (1979).

57. Note, *Tender Offer Defensive Tactics, supra* note 49, at 652.

58. *See id.*

59. *See* Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 314, 93 A.2d 107, 110 (1952). The rule is now codified in Delaware. DEL. CODE ANN. tit. 8, § 144(a)(3) (1983).

business judgment rule—providing directors have established a valid business motive, and good faith conduct in enacting the defense.[60]

IV. EXAMINATION OF THE POISON PILL PLAN

The Delaware Supreme Court has yet to rule on the poison pill preferred stock plan.[61] The Delaware Chancery Court has encountered the plan in such cases as *Telvest, Inc. v. Olson,*[62] *National Education Corp. v. Bell & Howell Co.*, [63] and more recently, in *Moran v. Household International, Inc.*[64] The latter has provided some substantive results.

Many issues must be resolved with respect to the plan. For example, do the directors, via the plan, unlawfully alter the pre-existing voting rights of the holders of common stock? Do the provisions of the preferred stock unlawfully restrict the authority of future boards of directors? Do the provisions unlawfully discriminate among different holders? Does the board have authority to enact a poison pill plan and issue the blank-check stock or issue rights to purchase the same? Do the conversion/redemption provisions violate Delaware General Corporation Law? Does the plan impose an illegal restraint on alienation of the shares of common stock? Does the business judgment rule insulate the board of directors in a blanket of protection and security, or should the court use stricter scrutiny

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60. *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357 (2d Cir. 1981); Crouse-Hinds v. InterNorth, 634 F.2d 690 (2d Cir. 1980) (both cases holding that the mere fact that use of defensive tactics will enable directors to retain corporate control does not, by itself, constitute a showing of a conflict of interest sufficient to make the business judgment rule inapplicable). *See also* Lipton, *Takeover Responses, supra* note 1, at 8-2 to 8-3.

61. The Delaware Supreme Court has now ruled on the issue (*see* addendum).

62. No. 5798 (Del. Ch. Mar. 8, 1979).

63. No. 7278 (Del. Ch. Aug. 25, 1983).

64. 490 A.2d 1059 (Del. Ch. 1985). This case has settled much of the heightened curiosity concerning the legitimacy of the poison pill plan in the eyes of the chancery court. From the time of this decision until the present, many corporations have initiated the plan in defense of the epidemic hostile takeovers that threaten their independence. *See generally supra* note 5. Among the list of corporations that have considered or initiated the plan are Tenneco, see Wall St. J., Apr. 22, at 16, col. 3 and Mar. 29, 1985, at col. 2; AMF, see Wall St. J., May 15, 1985, at 16, col. 3; Raytheon, see Wall St. J., Apr. 26, 1985, at 12, col. 3; Upjohn, see Wall St. J., Apr. 22, 1985, at 10, col. 4; Hilton, see Wall St. J., May 7, 1985, at 22, col. 2; Rorer, see Wall St. J., Apr. 19, 1985, at 17, col. 1 and May 9, 1985, at 20, col. 3; Phillips, see Wall St. J., Feb. 13, 1985, at 3, col. 2 and Feb. 25, 1985, at 3, col. 2; and Crown Zellerbach, see Wall St. J., Apr. 12, 1985, at 5, col. 1, Apr. 26, 1985, at 3, col. 2, May 9, 1985, at 4, col. 3, May 10, 1985, at 7, col. 2, May 14, 1985, at 4, col. 2, May 15, 1985, at 6, col. 1, and May 16, 1985, at 8, col. 1.

in evaluating the takeover defense? Some of these questions may be conclusively answered in the Delaware Supreme Court's pending opinion in *Moran*. Others may be answered by looking to a few cases that have dealt with some of the provisions of the poison pill plan.

In *Telvest*, the directors used the blank stock provision in response to an active takeover by a raider. A stock dividend was issued, creating a new series of preferred stock which had an eighty percent vote requirement for an interested merger.[65] The court, in *Telvest*, based its decision on the preliminary injunction issue. While not all issues were addressed, the court did confront the supermajority voting rights provision. The court found the challenged stock was not truly "preferred" since the only preference was a change in the voting rights towards supermajority.[66] Because it had been issued only as a pro rata dividend to the common holders, the court perceived the sole effect of the stock to be the increase in the requisite percentage for approval of certain mergers from fifty-one percent to eighty percent. The court determined this to be an impermissible alteration of voting rights.[67]

It is noteworthy that the board acted during an ongoing hostile tender offer, rather than prior to such a raid. Notwithstanding the lack of preference, this may have had an adverse effect on the court's holding.[68] It is significant that this decision occurred prior to the Delaware legislature's amendment of section 151(g)[69] of the Delaware General Corporation Law.[70] As previously discussed, section 151(g) allows boards of directors to act by board resolution pursuant to blank-check authority in issuing preferred stock containing voting

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65. *See Symposium, Delaware Corporation Law Today*, 6 DEL. J. CORP. L. 429, 509 (1981).

66. *See Telvest*, No. 5798, slip op. at 8.

67. *See* Note, *Protecting Shareholders*, *supra* note 9, at 1975; Lipton, *Takeover Responses*, *supra* note 1, at 8-20. As noted in *Moran*, the "piggyback" preferred stock dividend in *Telvest* had no significant dividend, liquidation, or conversion rights. Its preference rested solely on its supermajority voting rights. *See Moran*, 490 A.2d at 1076.

68. In Seibert v. Gulton, No. 5631 (Del. Ch. May 25, 1979), *aff'd without opinion*, 414 A.2d 822 (Del. 1980), the court found that amendments to a corporate charter providing for supermajority vote for approval of a merger were permissible when the shareholder vote occurred prior to any active contest for control of the company.

69. It has been suggested that this amendment came about in response to the harmful affects of broadly interpreting the *Telvest* holding. *See Note, Protecting Shareholders*, *supra* note 9, at 1977; Defendant's Brief, *supra* note 14, at 68.

70. Section 151(g) was amended in 1983. *See* 64 Del. Laws 112, § 12 (1983) (amending DEL. CODE ANN. tit. 8, § 155(g) (1983)).

provisions. The plain language of amended section 151(g) should be taken on its face to afford directors this privilege. As was the case in *Telvest*, the court will be sensitive to the issuance of deceptive, false preferred stock, equally subject to injunction. This will be differentiated from true preferred stock with noticeable preferences, including specified dividend and liquidation priorities.[71]

Telvest was distinguished in the case of *National Education Corp. v. Bell & Howell.*[72] In *Bell & Howell*, a stockholder petitioned the Chancery Court of Delaware to enjoin Bell & Howell from issuing the present convertible preferred stock dividend plan with redemption, conversion, and supermajority provisions. Again, as in *Telvest*, time was limited and the number of issues to be resolved prohibited Vice-Chancellor Brown from deciding conclusively the soundness of the poison pill preferred stock.[73] The court did note that in this case, unlike the *Telvest* situation, section 151 of the Delaware Code allows a board of directors to amend the certificate without shareholder approval by adopting a certificate of designation creating the attributes of the preferred stock.[74] In response to the plaintiff's arguments that issuance of "convertible preferred stock dividend would violate Delaware General Corporation Law and Delaware's policy against altering shareholders' voting rights without a shareholder vote,"[75] the court ruled that the plaintiff had failed to sustain his burden of showing a reasonable probability of success on the merits as to any of his allegations or claims.[76]

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71. In *Bell & Howell,* Vice-Chancellor Brown, who authored the Opinion in *Telvest*, wrote:

> I have reviewed the briefs and affidavits of the parties at length since the time of argument. I must confess as [sic] this point that I am not totally convinced that the rationale in *Telvest* controls here. I remain of the opinion that that decision was a proper one on its facts. The piggyback preferred stock that was to be issued there as a stock dividend to the common shareholders was clearly a sham insofar as it purported to be preferred stock. It carried no real preferences whatever other than a grant of increased voting power. So viewed, it was nothing more than an attempt by a board of directors, by resolution, to change the existing voting rights of the common shareholders without their consent so as to make a hostile acquisition of the corporation more difficult to achieve. Moreover, it was action taken in direct response to an ongoing hostile take-over attempt.

Bell & Howell, No. 7278, slip op. at 9-10.

72. *See generally id.*

73. *Id.* at 4-5.

74. *Id.* at 5-7.

75. Lipton, *Takeover Responses, supra* note 1, at 8-20.

76. *See Bell & Howell,* No. 7278, slip op. at 11.

It is important to note some factual findings which the court found significant. First, the board had acted without the pressure of an ongoing tender offer. The fact that the board consisted of eleven members, nine of whom were independent, indicated that the board members were not acting to entrench themselves in management.[77] These considerations may play an important role when directors are deciding to take defensive action. Further discussion of these considerations will follow.

The most significant decision to date validating the poison pill plan is the chancery court's holding in *Moran*. This was the first case to go to full trial and in which most of the issues arising from the defense were litigated. Vice-Chancellor Walsh discussed thoroughly most of the relevant questions regarding the legitimacy of the poison pill and raised some additional questions. He gave full approval to the plan as "an appropriate exercise of managerial judgment under the business judgment rule"[78] and provided a broad overview of the back ground, details, and contingencies involved in this somewhat broad acceptance.

Vice-Chancellor Walsh regarded the essence of the case[79] to be a "clash of fundamental interests within the corporate structure: the unrestricted right of shareholders to participate in nonmanagement sanctioned tender offers versus the right of a board of directors to increase its bargaining powers in tender offers by limiting the ability

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77. *See* Finkelstein, *supra* note 1, at 308-09.

78. *Moran*, 490 A.2d at 1079.

79. *Moran* involved the action of a director-investor of Household International seeking to block the rest of the board of directors' decision to implement the poison pill plan. The plan involved issuing rights with "flip-over" conversion privileges to the common shareholders to purchase a preferred share. The rights remain attached to the common and are not exercisable nor transferrable until certain "triggering" events occur.

The rights are triggered when a person or group acquires 20% or more of the outstanding common stock or acquires the rights to vote such percentage; or when anyone makes a tender offer for 30% or more of Household's outstanding stock. Once a triggering event occurs, the rights may be exercised by the holder and also become detachable from the common and separately tradeable. The rights are redeemable by the board until the 20% triggering event and then become nonredeemable. The rights have a ten year life span unless extended by the board. *See id.* at 1065-66.

The "flip-over" provisions of the rights constitute the poison pill aspect of the plan. They provide:

> [I]f a merger or consolidation occurs under the terms of which Household's common shares are exchanged for securities of the acquiror, the right "flips-over" and enables the holder, at the then exercise price of the right,

of a hostile acquiror to secure control . . . ."[80] The right of directors to establish the poison pill plan was validated by the court with respect to the case law concerning the business judgment rule applied to takeover situations.[81] The court noted that the presumption of good faith that continues to afford protection to the directors must be prefaced by a showing of a well informed board making the decision.[82] This protection will be heightened where the majority of directors are independent or outsiders.[83] The court also indicated that evidence of a "pre-planned or prospective" decision, as opposed to a reactive decision,[84] further demonstrated that the board had acted in the shareholders' interest.

The chancellor summarized his business judgment rule analysis by concluding that it was insignificant whether the action was a pre-planned strategy or a "reactive device adopted on an *ad hoc* basis" or whether there was a showing of a motive to retain control on behalf of the directors. The real issue was whether the takeover defensive device alters the structure of the corporation and "results in a fundamental transfer of a power from one constituency (shareholders) to another (the directors)" and, if so, then "the business judgment rule will not foreclose inquiry into the directors' action."[85]

Household was found to have used the power of redemption in the poison pill plan as a tool to retain control as prime negotiator in partial tender offers. The court viewed this as an "allocation of authority affect[ing] the structural relationship between the board

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> to purchase common stock of the acquiror at a price reflecting a market value of twice the exercise price of the right.

Id. at 1066. "The resultant dilution of the acquiror's capital is immediate and devastating." *Id.*

Moran was also a chairman of Dyson-Kisser-Moran Corp., a closely held investment company in New York. Household initiated the poison pill plan after Moran had open discussions with other members of the board about a possible leveraged buyout by D-K-M Corp. Moran sought to have the court declare the plan illegal and beyond the business judgment protection.

80. *Id.* at 1074.

81. *See id.* at 1076.

82. Among the 16 directors comprising Household's board, 9 were outsiders. *Id.* at 1064.

83. *Id.* at 1074.

84. "Prospective contingency plans reduce the risk of ill planned reactive devices which harm shareholder interests and lose the protection of the business judgment rule." *Id.* at 1075 (referring to Warner Communications v. Murdoch, 581 F. Supp. 1482 (D. Del. 1984)).

85. *Moran*, 490 A.2d at 1076.

and the shareholders."[86] This result invokes the *Cheff v. Mathes*[87] standard "which requires the Board to present evidence, the business judgment rule notwithstanding, that its approval of the Plan was . . . motivated by a *reasonable belief* that the Plan was necessary to protect the corporation from a perceived threat to corporate policy and effectiveness."[88]

Vice-Chancellor Walsh made clear this was not an imposition of the intrinsic fairness standard.[89] The burden on the defendant corporation should be "viewed as the burden of going forward on a showing of reasonableness rather than a burden of persuasion. Because of the protection afforded directors by the business judgment rule the latter burden does not shift and remains with the plaintiffs."[90]

Several other contentions were also answered. The chancellor dismissed the notion that the preferred stock issuable under the rights plan were such sham securities as were found in the *Telvest* case. Drawing from the *Bell & Howell* case, the chancellor declared the preferred were valid securities:

> The rights are separately tradeable, and the preferred issuable, only in the event of a triggering event and at such time their combined economic significance will be obvious—they serve to protect shareholders from the coercion of a partial tender offer. Even when issued, however, the preferred will not affect existing voting rights or impose a supermajority approval on prospective mergers. Their dividend and liquidation preferences are independently established in relation to Household's common stock. They also survive a merger at a stated exchange rate and thus they may be viewed as having an antidestructive effect, contractually secured in the Rights Plan.[91]

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86. *Id.*

87. 199 A.2d 548 (Del. 1964). This decision involved the burden of proof under the business judgment rule with respect to the repurchase of a raider's shares used as a defensive device in response to a takeover threat.

88. *Moran*, 490 A.2d at 1076 (emphasis added).

89. Under the intrinsic fairness test, unlike under the business judgment rule, the burden of proof shifts to the directors to prove lack of self-dealing. *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717 (Del. 1971); Sterling v. Mayflower Hotel Corp., 93 A.2d 107 (Del. 1952).

90. *Moran*, 490 A.2d at 1076.

91. *Id.* 1077 (referring to Wood v. Coastal States Gas Corp., 401 A.2d 932, 937 (Del. 1979).

Whether or not the Poison Pill Rights plan restricted the alienability of shares by preventing shareholders from participating in tender offers was also decided. Section 202(b) of the Delaware General Corporation Law[92] prohibits restrictions on the transfer or registration of securities without consent of the holders. The chancellor noted, however, that "[t]he Rights Plan does not affect the trading of Household shares or the registration of shares once traded. The negotiability of shares is not conditioned and shares remain freely transferable as provided by § 159 of the DGCL."[93]

One concern of the chancellor was the potential restriction of the Rights Plan on proxy contests. "The proxy inhibition arises because one of the events which trigger issuance of the preferred is the formation of a group representing 20% of Household stock for the purpose of conducting a proxy contest."[94] The chancellor dismissed this concern as somewhat speculative and not significant when seen in relation to the overall plan and its background to formation.[95] The chancellor cited a study concluding that there was "no correlation between the size of an insurgent's holdings and the likelihood of success."[96]

The chancellor concluded that Household had met the burden of reasonableness in its decision to use the poison pill plan by showing the plan was properly adopted under Delaware law and instituted in the best interests of the corporation to protect it from the coercive nature of certain tender offers.[97] Additionally, the vice-chancellor added a caveat that "the Rights Plan also creates the potential for the misuse of directorial authority, [using as an example the] possible arbitrary power by the Household Board in using the Rights Plan

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92. DEL. CODE ANN. tit. 8, § 202(b) (1983) provides:

> A restriction on the transfer or registration of transfer of securities of a corporation may be imposed either by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

93. *Moran*, 490 A.2d at 1079. Section 159 provides in relevant part: "The shares of stock in every corporation shall be deemed personal property and transferable as provided in Article 8 of Subtitle I of Title 6." DEL. CODE ANN. tit. 8, § 159 (1983).

94. *Moran*, 490 A.2d at 1079.

95. *Id.*

96. *Id.*

97. *See id.* at 1082-83.

to deter acquisition approaches which might well be in the interests of all share holders."[98] By its control of the redemption factor prior to a triggering event, the board has acquired the responsibility for assuring the rights are not triggered unnecessarily.[99]

V. DIRECTOR'S CONSIDERATIONS IN THE USE OF THE POISON PILL DEFENSE

Once the board has examined carefully its duties and responsibilities as fiduciaries to the company and stockholders, it must consider the implications of using the poison pill plan. Directors issuing the right or dividend should be prepared to satisfy the substantial business purpose test, but other elements must be also considered. If a preferred stock or right is issued after the tender offer has been made, a court may look suspiciously to the underlying purpose and deny responses to takeovers beyond those necessary to facilitate an auction.[100] It would be wise for a board to facilitate use of the poison pill defense upon reasonable suspicion of a hostile tender offer, rather than after the fact. The board should bear in mind the *Moran* case, where it was found not to matter conclusively that the plan was "a reactive device adopted on an *ad hoc* basis."[101]

A board must be careful to inspect the preferences of the dividend stock in order to insure that the challenged stock is really preferred. The "preferences" which the new stock will grant must not in fact be preferences over the common stock held by the very persons to whom the new preferred stock is being distributed. This was the case in *Telvest v. Olson*[102] where the court found no true preferences and scrutinized the decision of the board to determine the actual motivating factor behind the decision. Where there are no true preferences, the dividend will be found an invalid transaction. Without the preferences, there will be no valid reason for the issuance. As was found in *Moran,* the dividend must have an independent investment significance for the company or the shareholders to show the directors are acting in accordance with their fiduciary duty.

Telvest demonstrated additional considerations which boards must

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98. *Id.* at 1083.
99. *Id.* at 1086.
100. *See* Data Probe Acquisition Corp. v. Datatab, Inc., [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,451 (S.D.N.Y. Aug. 16, 1983).
101. *Moran,* 490 A.2d at 1076.
102. No. 5798 (Del. Ch. Mar. 8, 1979).

address in enacting the poison pill plan. The court found that in issuing the dividend, the only preference was a supermajority voting right with respect to certain business combinations and concluded that Telvest's board was impermissibly trying to alter the voting rights of the common stock.[103] The Delaware General Corporation Law, section 242(b)(4), as amended provides:

> Whenever the certificate of incorporation shall require for action by the board of directors, by the holders of any class or series of shares or by the holders of any other securities having voting power the vote of a greater number or proportion than is required by any section of this title, the provision of the certificate of incorporation requiring such greater vote shall not be altered, amended or repealed except by such greater vote.[104]

Thus, the board must insure it will not incur the wrath of the courts by running afoul of this statute through alteration of the voting rights of stockholders.

A board of directors must be provident in the drafting of the redemption rights of the preferred stock they issue. A common occurrence in structuring this provision is not to allow a certain percentage (twenty-five to fifty) shareholder, who is the entity acquiring control, to possess the same redemption and conversion privileges which other shareholders possess.[105] This appears to discriminate among holders of the same class and series of stock and so might violate the "spirit and intent of . . . section 151(a)."[106] Section 151(a) of the Delaware General Corporation Law refers to classes and series, implying items relating to each share must be in conformity with each other, and does not contemplate discrimination among holders.[107] The case of *Providence & Worcester Co. v. Baker*[108] seems to illustrate this problem. The Delaware Supreme Court "upheld a voting scheme in which every common shareholder received

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103. *See* Lipton, *Takeover Responses, supra* note 1, at 8-20.

104. DEL. CODE ANN. tit. 8, § 242(b)(4) (1983).

105. *See Bell & Howell*, slip op. at 6. The terms of the preferred stock issue granted the holders redemption and conversion rights in the event any party acquired 40% or more of Bell & Howell's stock, but denied these rights to the party owning 40% or more interest.

106. *Id.*

107. *See supra* note 36.

109. 364 A.2d 838 (Del. Ch. 1976), *rev'd*, 378 A.2d 121 (Del. 1977).

108. Note, *Protecting Shareholders, supra* note 9, at 1978.

one vote for each of his first fifty shares and one vote for every block of twenty shares thereafter" limiting twenty-eight percent of the shareholders to three percent of the voting power.[109] The court allowed the differ ing shareholder rights among the same class or series because the restrictions were "limitations upon the voting rights of the shareholder, not variations in the voting power of the stock per se."[110] A board of directors will want to exercise due care not to discriminate among shareholders in violation of the Delaware General Corporation Law.[111]

It has been noted previously[112] that a board of directors of a corporation has the authority to issue "blank check stock" pursuant to a "blank check stock" provision in the certificate of incorporation. The argument against such power was raised in *Telvest and Bell & Howell but not raised in Moran*. This may be indicative that the Delaware Bar, as well as the bench, regards this argument as moot, and the accepted view is that the corporate board does have the authority to issue this preferred stock with various provisions. A board would do well to consider the language of the corporation's certificate and determine if it allows them to issue the stock.

A board must be cautious in structuring the plan so as not to totally prevent a takeover merger. This could be found impermissible by the courts. The poison pill in Bell and Howell's plan did not prevent tender offers. If a bidder is "willing and able to acquire 65 percent of the company, half the common plus 80 percent of the preferred stock, [it] can take absolutely any action it wants."[113] What the poison pill preferred plan did was to ensure fair treatment of all stock holders and to protect the rights of those who chose to retain their equity position after the merger.[114] The plan does not restrict future boards "in any way since any merger proposal recommended by a future board can always be approved by an 80% vote of the

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110. *Providence & Worcester*, 378 A.2d at 123.

111. The court in *Providence & Worcester* noted that § 212(a) of the Delaware Code specifically empowers a board to deviate from the one share-one vote standard. *See* DEL. CODE ANN. tit. 8, § 212(a) (1983). *See also* Note, *Protecting Shareholders*, *supra* note 9, at 1978 ("The provisions dealing with redemption and conversion allow the board similar discretion.").

112. *See supra* text accompanying notes 33-40.

113. Note, *Protecting Shareholders*, *supra* note 9, at 1967. "Acquiring half the common stock gives the bidder control of the target, and obtaining eighty percent of the preferred stock allows the new preferred holder to eliminate the defensive terms of the preferred by charter amendment." *Id.*

114. *See* Lipton, *supra* note 3, at E-1 to E-2.

preferred in addition to the two-thirds vote of the common."[115] In *Moran*, the vice-chancellor was explicit in advising Household that by initiating the plan it had to "take upon itself the responsibility of assuring that the rights are not triggered in such a fashion as to inflict harm upon the corporation by rendering it acquisition proof."[116] A board must be sure to allow the merger and not totally bar *any* takeover, or the court is likely to strike down the action and refuse to invoke the protection of the business judgment rule.

A minor concern with the poison-pill plan is the significance of the defense tactic in light of section 14(e) of the Williams Act.[117] Section 14(e) prohibits "manipulative acts or practices in connection with any tender offer . . . ."[118] "The language and history of section 14(e) demonstrate that 'manipulative acts and practices' include deliberate attempts to artificially affect the price of or market for a security."[119] Because the poison pill may be seen as manipulative in forcing the raider to bid for more stock than originally planned, it should be viewed with caution in some jurisdictions.[120]

Two final concerns that must be dealt with were discussed previously in connection with the *Moran* case. First, section 202(b) of the Delaware General Corporation Law[121] requires there be no restrictions on the transfer or registration of securities without the holder's consent. Although a minor concern, this section will have to be complied with in delineating the terms of the poison pill plan. The second concern is of more significance. Vice-Chancellor Walsh, although dismissing this source of "trouble," looked carefully at the effect of the plan on the ability of shareholders to wage a proxy contest for control. This contention may become more troublesome in the eyes of the court in the future.

XI. Conclusion

In attempting to defend a corporation against a raid, the board of directors must exercise extreme caution in setting up the ramparts.

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115. *Bell & Howell*, No. 7278, slip op. at 8.
116. *Moran*, 490 A.2d at 1086.
117. 15 U.S.C. § 78n (1982).
118. *Id.* § 78n(d)-(f).
119. Note, *Defensive Tactics, supra* note 1, at 252.
120. *Id.* at 258-62.
121. The opinion in Data Probe Acquisition Corp. v. Datatab, Inc., [1983-84 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,451 (S.D.N.Y. Aug. 16, 1983) (citing Mobil Corp. v. Marathon Oil Co., 669 F.2d 366 (6th Cir. 1981)), held that

To ensure that the courts will afford them the protection of the business judgment rule as defined in *Aronson* and heavily relied upon in *Moran*, the directors must demonstrate the lack of self-interest. This can be assured by adequately providing for the following concerns in a preferred dividend stock defensive tactic: (1) ensuring that all shareholders are afforded protection against coercive and unfair two-tier tender offers causing a freeze-out for those who do not tender and (2) allowing those who reject the offer to retain their equity interest without loss of liquidity. This will demonstrate to the scrutinizing court that the board is attending to the interests of the shareholder. While it is not necessary, as demonstrated in *Moran*, it is advisable to enact the plan prior to any formal tender offer as courts are more comfortable with action which precedes the heat of the battle.

The presence of a board of disinterested or independent directors also helps to indicate to a court that the board is not utilizing the poison pill tactic to manipulate the mechanisms of corporate control for their own selfish purpose or for manipulative purposes prohibited under the Williams Act.[122]

Another course of action available to a board of directors in assuring protection under the business judgment rule is to sufficiently inform themselves prior to the making of a business decision to defend the corporate structure from the raider. As the *Aronson* court stated, a board must make themselves aware of "all material information reasonably available to them."[123] Management will need the services of investment bankers and outside legal counsel to present all relevant factors in consideration of the defense chosen. This information consists of a panoply of statistics and analysis of historical financial results, projections of future financial information, an evaluation of the market, prices and quotes, pertinent timetables, impact

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the Williams Act prohibits manipulation that "unduly obstructs the exercise of informed shareholder choice," implying that defensive tactics designed to do more than facilitate an auction are prohibited. *Id.* at 96,580. *Marathon* has been seen as "an unwarranted extension of the Williams Act," Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.), *cert. denied*, 104 S. Ct. 550 (1983), and has been rejected by many courts and commentators. *See* Note, *Protecting Shareholders*, *supra* note 9, at 1979 nn.106-07.

122. For a good discussion of the implications of defensive tactics which are "manipulative" under the Williams Act, and therefore impermissible, see generally Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); Note, *Defensive Tactics*, *supra* note 1.

123. *Aronson*, 473 A.2d at 812.

on the company and its staff and employees, antitrust implications, and an analysis of the raider and its management.[124]

This comment hopefully offers a general overview and explanation of the poison pill defensive tactic to tender offers in Delaware. The plan is complex and requires considerable research in order to understand its intricacies and use it to one's benefit. Vice-Chancellor Walsh's opinion in *Moran v. Household International* clarified the plan considerably and answered numerous questions surrounding it. Hopefully in the future, the Supreme Court of Delaware will further illuminate the poison pill tactic and its many ramifications.

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124. *See* Lipton, *supra* note 3, at E-5 to E-7.

Addendum

During the interim between the completion of this note and the time it took to bring this volume to print, the Delaware Supreme Court released its opinion in the case of *Moran v. Household International, Inc.*,[1] on November 19, 1985, affirming the court of chancery's decision upholding "[t]he Rights Plan as a legitimate exercise of business judgment by Household."[2] The text of the opinion appears to answer many of the questions one may have concerning the validity of the poison pill plan, yet it leaves the reader with a caveat that this may not be the final chapter. Much of the information presented in this note was covered in the court's decision. The following hopefully brings the reader up-to-date on this as well as other areas raised and answered by the court.

The Delaware Supreme Court undertook the task of reviewing the poison pill plan (the rights plan) by dividing the perspective into two broad areas. First, the court scrutinized the authority of the Household Board to adopt such a plan. The court found sufficient authority did exist as set forth in title 8, section 157 of the Delaware Code[3] as well as in title 8, section 141(a)[4] (concerning the management of the corporation's "business and *affairs*") for the board to adopt the rights plan.

In this first half of the analysis, the court also resolved a number of unfounded ancillary contentions about the rights plan. The rights plan was not a fabrication of sham rights never to be exercised, as was found to be true in the case of *Telvest, Inc. v. Olson.*[5] The rights plan was analogous to anti-destruction or anti-dilution provisions which are valid under Delaware corporate law. The fact that the rights are set up to prevent coercive two-tier tender offers by allowing the purchase of the raider's stock does not invalidate their existence. The rights plan was also seen to fall in line with the underlying policies of the Williams Act and, therefore, not a violation of the commerce clause and not void under the supremacy clause.

The Supreme Court of Delaware, contrary to the arguments of the appellants, stated that the plan neither usurped the stockholders'

1. 500 A.2d 1346 (Del. 1985).
2. *Id.* at 1346.
3. DEL. CODE ANN. tit, 8, § 157 (1974).
4. *Id.* § 141(a).
5. No. 5798 (Del. Ch. Mar. 8, 1979).

right to receive tender offers nor restricted the stockholders' right to conduct proxy contests. The court referred to the recent Crown Zellerbach takeover, and enumerated various other methods of enacting successful takeovers in light of the rights plan. With regard to the proxy issue, the court expressed the sentiments of the court of chancery in the decision below in that the effect on the voting power of individual shares would be minimal in launching proxy contests.

Finally, the rights plan was declared to be no different from other defensive mechanisms enacted by a board of directors. It did not result in any structural change of the hierarchy of governing power between the stockholders and the board. The directors had no "unfettered discretion in refusing to redeem the rights."[6]

In the second half of its analysis, the Delaware Supreme Court tackled what it considered to be the primary issue in the review of the rights plan: the applicability of the businsss judgment rule. The court relied heavily on its recent decision of *Unocal Corp. v. Mesa Petroleum Co.*[7] in applying the business judgment rule to the adoption of a defensive mechanism:

> The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Notwithstanding, in *Unocal* we held that when the business judgment rule applies to adoption of a defensive mechanism, the initial burden will lie with the directors. The "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . [T]hey satisfy that burden 'by showing good faith and reasonable investigation . . . .' " In addition, the directors must show that the defensive mechanism was "reasonable in relation to the threat posed." Moreover, that proof is materially enhanced, as we noted in *Unocal,* where, as here, a majority of the board favoring the proposal consisted of outside independent directors who have acted in accordance with the foregoing standards. Then, the burden shifts back to the plaintiffs who have the ultimate burden of persuasion to show a breach of the directors' fiduciary duties.[8]

6. *Moran*, 500 A.2d at 1354.
7. 493 A.2d 946 (Del. 1985).
8. *Moran*, 500 A.2d at 1356 (citations omitted).

The court observed that there were no allegations of bad faith on behalf of the directors. The board enacted the plan prior to and not in the heat of a tender offer battle; and as mentioned above in the text, the majority of the board favoring the adoption consisted of outside independent directors. The Supreme Court of Delaware agreed with the court of chancery that the Household Board acted under a well-informed basis and were not grossly negligent, unlike the court's ultimate ruling concerning the Trans Union Corporation Board in *Smith v. Van Gorkom*.[9] The directors also presented enough evidence on the record to assure the court that the concerns of the board were sufficient to warrant the adoption of the plan. Their actions were "reasonable in relation to the threat posed."[10]

The final paragraph of the opinion leaves the reader with a somewhat bittersweet end to the "poison pill drama." The words of the court will suffice as an end to this note.

> 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 stockholders. Their use of the Plan will be evaluated when and if the issue arises.[11]

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9. 488 A.2d 858, 873 (Del. 1985).

10. *Moran*, 500 A.2d at 1356. The court stated: "The Directors adopted the plan in the good faith belief that it was necessary to protect Household from coercive acquisition techniques." *Id.* at 1357.

11. *Id.* (citations omitted).