SHAREHOLDER RIGHTS PLANS—DO THEY RENDER SHAREHOLDERS DEFENSELESS AGAINST THEIR OWN MANAGEMENT?

I. INTRODUCTION

A shareholder rights plan,[1] adopted by a target company[2] in response to or in anticipation of a raider's[3] hostile tender offer,[4] is an innovative and controversial defensive tactic.[5] As the number of

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1. Shareholder rights plans have been pejoratively described as "poison pills" by the courts and commentators. Although there are a variety of poison pills, this comment will focus exclusively on those which confer some right on the target shareholder to purchase additional shares or to sell shares at attractive prices, subject to certain triggering conditions.

2. A target company is one which is the subject of a takeover bid.

3. According to the court in Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252, 1254 (S.D.N.Y. 1985), a "raider is known for his 'hostile' takeover attempts." *Id.*

4. A tender offer is deemed "hostile" if the directors of a target company decide to resist the attempt of the bidder to gain control. *See* Comment, *"Leg-Ups" and "Lock-Ups": An Analysis of Manipulation Under Section 14(e) of the Williams Act*, 49 ALBANY L. REV. 478, 478-79 (1985). Tender offers, unlike mergers, do not require approval by the directors or the target shareholders before the offer is made. *See, e.g.*, N.Y. BUS. CORP. LAW §§ 902-903 (McKinney Supp. 1986).

5. *See, e.g.*, Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter Easterbrook & Fischel]. Scholarly debate has centered around the board's proper role in responding to tender offers which it deems hostile. Those opposing active board participation argue that defensive tactics, such as shareholder rights plans, permit target managers to entrench themselves and avoid accountability at the expense of shareholders. They contend that defensive tactics deny shareholders the opportunity to maximize their investment by selling their securities at a premium price. *See id.* These authors have taken the most extreme position regarding management's role in responding to tender offers, contending that management's role should be one of complete passivity. *Id.* at 1198. Defensive tactics would never be justified on the ground that they happen to benefit the target shareholders in a particular case. *Id.* Because the "passivity theory" is too far out of the mainstream, it is not likely to gain widespread acceptance. Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law be Mobilized to Overcome the Business Judgment Rule?*, 8 J. CORP. L. 337 (1983). Other commentators, although not adopting as extreme a position as Easterbrook and Fischel, also argue that aggressive defensive tactics deny shareholders the ability to accept tender offers. *See* Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1984) [hereinafter Gilson]. Professor Gilson has proposed a "structural" rule whereby an offeror, without managerial intervention, shall have a reasonable time in which to present the offer to shareholders. During such time, the only action a target company may take is to: (1) disclose to the public or its shareholders information on the

major American companies adopting shareholder rights plans continues to increase,[6] the debate concerning their legality and effectiveness intensifies.[7] Some commentators have called these plans "bulletproof" show-stoppers to hostile tender offers resulting in management entrenchment,[8] while others have argued that they allow the target company's management the flexibility to substitute alternative strategies for creating shareholder value.[9]

Perhaps the most controversial aspect of the plans is their effect on the corporate governance structure.[10] A recent SEC Study de-

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attractiveness of the offer, and (2) seek out alternative transactions which it believes may be more favorable to target shareholders. *Id.* at 878-89. Essentially, Gilson would limit management action to that which facilitates an auction for the target company.

On the other hand, proponents of aggressive defensive takeover tactics contend that they prevent shareholders from the abuse of tender offer coercion. For a discussion of coercion in the tender offer process, see *infra* notes 38-50 and accompanying text. Furthermore, proponents contend that it is the board's fiduciary duty to protect its shareholders' investments, and defensive tactics achieve this result. Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The Poison Pill Preferred*, 97 HARV. L. REV. 1964, 1968 (1979) [hereinafter Note, *Protecting Shareholders*]. Martin Lipton is the most noted proponent of the aggressive defensive tactic argument. Lipton contends that once a board has determined that a takeover should be rejected, it should take any reasonable action to accomplish this objective. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 130 (1979) [hereinafter Lipton, *Takeover Bids*]. For other commentators espousing Lipton's argument, see Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 J. CORP. L. 107 (1980); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249 (1983) [hereinafter Lowenstein]; Steinbrink, *Management's Response to a Takeover Attempt*, 28 CASE W. RES. L. REV. 882 (1978).

6. According to the Investor Responsibility Research Center, as of January 14, 1987, 338 major American corporations had adopted a shareholder rights plan of some type.

7. *Compare* Clafman & Schlefer, *Recipe for Management Autocracy*, N.Y. Times, Dec. 14, 1986 § 3, at 2, col. 1 (plans deprive shareholders right to control company, and deter offers for the company's stock) *with* Lipton, *A Sensible Deterrent to Takeover Mania*, N.Y. Times, Dec. 14, 1986, § 3, at 2, col. 1 (plans create opportunity to maximize shareholder value) [hereinafter Lipton, *Sensible Deterrent*].

8. *See Exotic Takeover Tactics Dominate Discussion at Annual PLI Institute*, 17 Sec. Reg. & L. Rep. (BNA) 1751 (Nov. 9, 1985); *Latest Development in Takeover, Financing Methods Analyzed by Experts*, 17 Sec. Reg. & L. Rep. (BNA) 1969 (Nov. 8, 1985).

9. *See* Lipton, *Sensible Deterrent*, *supra* note 7, at 2, col. 1.

10. In Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985), the court stated that "corporate governance is predicated upon a division of powers between the shareholders and the board of directors." *Id.* at 1260 n.6. The two basic attributes of common stock ownership are the right to vote and the right to make independent decisions concerning the purchase or sale of stock. *Id.* This corporate governance theme was echoed by the court in Norlin Corp. v.

scribed shareholder rights plans "as the most potent defensive tactic available against hostile takeovers that does not require approval by [target] shareholders."[11] Thus, an important question arises as to whether these plans violate a basic premise of corporate democracy: the right of shareholders, as the legal owners of the corporate entity, to decide whether to sell their stock to a willing purchaser,[12] and to control the corporation's ultimate destiny.[13] Because shareholder rights plans are unilaterally adopted by the target company's board of directors, a conflict may arise between the unrestricted right of shareholders to entertain tender offers for their stock and the ability of the board of directors to fulfill its fiduciary duties and increase the bargaining power of the target company.[14] Courts reviewing these plans have noted that they present a potential clash of fundamental interests within a company's corporate governance structure.[15]

This comment will first examine the coercive nature of the tender offer process emphasizing the heightened coerciveness of two-tier and partial offers. The adoption of shareholder rights plans as an attempt to minimize the pressure felt by target shareholders to tender their shares, thus "leveling the playing field" between raiders and target companies, will then be discussed. Part III will provide a general overview of the rights conferred upon target shareholders. Following this overview, the author will present a survey of leading cases ruling on the plans' legality and effect on corporate structure, with emphasis on the landmark case of *Moran v. Household International, Inc.*[16] Finally, in Part V, the author will argue that a board's unilateral adoption of a shareholder rights plan usurps the right of shareholders to decide who controls the company, thus replacing shareholder democracy with management autocracy. In order to remedy this situation, the author proposes that, through an amendment to state statutes, all

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Rooney Pace, Inc., 744 F.2d 255, 258 (2d Cir. 1984), when it stated: "While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for shareholders to make in accordance with democratic procedures." *Id.*

11. OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMM'N, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 2 (Oct. 23, 1986) [hereinafter SEC Study, THE EFFECTS OF POISON PILLS].

12. *See infra* note 274 and accompanying text.

13. *See* Lipton, *Sensible Deterrent*, *supra* note 7, at 2, col. 1.

14. *See infra* note 311 and accompanying text.

15. *See* Asarco, Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468, 474 (D.N.J. 1985); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1074 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

16. 500 A.2d 1346 (Del. 1985).

shareholders rights plans be required to be approved by a majority of the company's stockholders.

II. TENDER OFFERS AND THEIR COERCIVE EFFECT

A. *Tender Offers*

A tender offer[17] is an invitation or solicitation by a company, an individual or a group to shareholders of a target company to tender their shares for sale at a specified consideration in cash or securities.[18] The consideration usually represents a premium over the current market price of the securities.[19] Additionally, the opportunity to tender shares remains open only for a limited time.[20]

A tender offer is primarily made for the purpose of gaining

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17. Although there is no statutory definition of a "tender offer," the court in Wellman v. Dickinson, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd*, 682 F.2d 355 (2d Cir. 1982), *cert. denied*, 460 U.S. 1069 (1983), set forth eight characteristics as indicative of a tender offer. Those characteristics are: (1) the offeror engages in active and widespread solicitation of public shareholders for the shares of an issuer; (2) the offeror seeks a substantial percentage of the issuer's stock; (3) the offer is made at a premium over the prevailing market price; (4) the terms of the offer are firm; (5) the offer is contingent on the tender of a fixed number of shares, often a fixed maximum; (6) the offer is open for a limited time; (7) the shareholder is subjected to pressure to sell his stock; and (8) there is a public announcement of a purchasing program. *Id.*

18. Tender offer activity is regulated by the Williams Act, adopted by Congress in 1968 as an amendment to the Securities and Exchange Act of 1934. 82 Stat. 454 (codified at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (1981)). The goal of the Williams Act is to give shareholders the opportunity, through the free flow of information, to decide whether or not to accept a tender offer on its merits, without interference from either the bidder or the target company. *See* Edgar v. MITE Corp., 457 U.S. 624, 633 (1984) ("There is no question that in imposing [the Williams Act] Congress intended to protect investors.") (citations omitted)). At least one commentator has argued that shareholder rights plans, by restricting the shareholder's decision whether or not to accept a tender offer, are inconsistent with the objectives of the Williams Act. *See* Chittur, *Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense*, 8 J. CORP. L. 25, 53 (1985) [hereinafter Chittur]. However, defensive takeover activity is currently regulated by state law, while the tender offer is regulated by the Williams Act.

19. Comment, *Two-Tiered Tender Offers and the Poison Pill: The Propriety of a Potent Takeover Defense*, 17 PAC. L.J. 891, 893 (1986) [hereinafter Comment, *Two-Tiered Tender Offers*]. The premiums that shareholders realize are beyond doubt, and can be quite substantial. An SEC study of 148 tender offers between 1981 and 1983 revealed that the premium can range from 31.3% of the market price to 63.4%, depending on the type of tender offer. 49 Fed. Reg. 26,755, 26,760, table 4 (June 29, 1984) [hereinafter SEC Study].

20. *See* Comment, *Two-Tiered Tender Offers*, *supra* note 19, at 893.

control of a target company,[21] and is an effective offensive takeover weapon because, unlike mergers, it does not require the target board's approval.[22] Thus, when a target's board resists the tender offer, usually because it concludes that the offer is "inadequate,"[23] the offer is characterized as "hostile."[24] Recently, tender offers have become increasingly popular,[25] replacing the proxy contest as the favorite means of overcoming an unwilling target company.[26]

The general propriety of tender offers has been the subject of intense debate.[27] Critics of tender offers argue that their use as a takeover weapon places undue emphasis on short-term earnings and results in a general decline in competitiveness.[28] Additionally, critics contend that using the tender offer in battles for corporate control creates an expansion of debt in the economy, enlarges business cycles, causes bankruptcies,[29] and results in economic dislocation.[30]

Conversely, proponents argue that tender offers create efficiency

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21. Note, *The Developing Meaning of "Tender Offer" Under the Securities and Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1253 (1973) [hereinafter Note, *Developing Meaning*]. Prior to the early 1960's, tender offers were primarily used by corporations as a vehicle for the purchase of their own securities. *Id.*

22. *See Edgar*, 457 U.S. at 643 (distinguishing tender offers from mergers).

23. Matheson & Norberg, *Hostile Share Acquisitions and Corporate Governance: A Framework for Evaluating Antitakeover Activities*, 47 U. PITT. L. REV. 407, 438 (1986) [hereinafter Matheson & Norberg].

24. *See, e.g.*, *Moran*, 500 A.2d at 1351.

25. *See* Note, *Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholders: Toward a Shareholder Approval Rule*, 60 ST. JOHN'S L. REV. 94 (1985) [hereinafter Note, *Internal Transfers*]. The number of tender offers nearly doubled from 1983 to 1984. In 1983, there were 77 tender offers; while in 1984, there were 142. *Tender Offer Update: 1985*, 20 MERGERS & ACQUISITIONS 67 (Spring 1985). However, the number fell slightly in 1985 to 121. *Tender Offer Update: 1986*, 21 MERGERS & ACQUISITIONS 55 (Spring 1986). *See generally* Truesdell, *Does* Norlin Corp. v. Rooney Pace, Inc. *Preserve for Shareholders Control of a Corporation's "Ultimate Destiny"?*, 20 COLUM. J. L. & SOC. PROBS. 325, 326-27 (1986) (discussion of factors contributing to the increase).

26. *See generally* Note, *Developing Meaning*, *supra* note 21, at 1253 (suggesting tender offer is simpler and cheaper than proxy contest in takeover attempts).

27. For a comprehensive discussion of the benefits and drawbacks of tender offers for target shareholders, see Strauch, *Regulating Two-Tier Tender Offers: A Compromise Proposed with Negligible Disruption*, 22 WILLAMETTE L. REV. 41, 47-52 (1986) [hereinafter Strauch]; Comment, *Two-Tiered Tender Offers*, *supra* note 19, at 896-99.

28. *See* Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231, 1233 (1980).

29. *See* Summer, *Hostile Tender Offer is Critical Issue for Congress*, 7 Legal Times 19 (1985).

30. *See* Saul, *Hostile Takeovers: What Should be Done?* 5 HARV. BUS. REV. 22 (1985).

in the marketplace by serving as an important mechanism for monitoring management.[31] In addition to providing shareholders with an opportunity to tender their shares for a premium above the market price,[32] proponents contend that tender offers foster national economic growth.[33]

B. *Front-End Loaded Two-Tier and Partial Tender Offers*

The use of two-tier[34] and partial[35] tender offers has been a major development in the tender offer process.[36] While it is generally recognized that any tender offer involves an element of coercion,[37] many commentators,[38] courts,[39] and the advisory committee of the

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31. *See* Gilson, *supra* note 5, at 841. *See also Edgar*, 457 U.S. at 643 (tender offers can improve management efficiency and competition). *But see* Strauch, *supra* note 27, at 66-67 (presenting arguments against the premise that tender offers necessarily result in the removal of inefficient management).

32. *See supra* note 19 and accompanying text.

33. *See* Ginsburg & Robinson, *The Case Against Federal Intervention in the Market for Corporate Control*, 1986 THE BROOKINGS REV. 9, 10-12.

34. In a front-end loaded two-tiered tender offer, the premium is greater in the first of the two tiers. *See SEC Request for Comments on Two-Tier Tender Offers*, 16 Sec. Reg. & L. Rep. (BNA) § 1119 (June 29, 1984) [hereinafter *SEC Request for Comments*]; Comment, *The Front-End Loaded Two-Tiered Tender Offer*, 78 NW. U. L. REV. 811, 812 (1983) [hereinafter Comment, *Tender Offers*]. *See also* SEC Study, *supra* note 19 (the average premium offered in the first tier was 63.5% over market price, while in the second tier it was only 47.1% over market price).

35. In a partial tender offer, the bidder makes a tender offer for less than all of the shares of the target company but usually does not state any intention to purchase the remaining shares. *See* Comment, *Front-End Loaded Tender Offers: The Application of Federal and State Law to an Innovative Corporate Acquisition Technique*, 131 U. PA. L. REV. 389, 396-97 (1982) [hereinafter Comment, *Front-End Loaded Tender Offers*]. The difference between the partial and the two-tier offer is the freezing out of the minority shareholders in the second tier. However, in many cases, a partial tender offer is followed up with an offer to purchase additional shares, and this becomes a two-tier offer. Booth, *Is There a Valid Reason Why Target Managers Oppose Tender Offers?*, 14 SEC. REG. L.J. 43, 46-47 (1986).

36. *See* Comment, *Two-Tiered Tender Offers*, *supra* note 19, at 894. *See also* 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 Finkelstein] (providing excellent discussion concerning factors contributing to rise of two-tier and partial tender offers).

37. *See* Strauch, *supra* note 27, at 46. Coercion, as used in this context, means that target shareholders are unduly pressured into tendering their shares. *Id.*

38. *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) [hereinafter Brudney & Chirelstein, *Fair Shares*]; Brudney, *Equal Treatment of Shareholders in Corporate Distributions and Reorganizations*, 71 CALIF. L. REV. 1072 (1983); Finkelstein, *supra* note 36. *But see* Strauch, *supra* note 27, at 57-60 (presenting arguments disputing coercive nature of two-tier offers).

39. *See, e.g.*, Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130, 1133

SEC[40] have taken the position that the coerciveness inherent in the tender offer process is maximized by the use of two-tier and partial offers.[41]

A two-tiered tender offer, or, as it is often called, the front-end loaded two-tier, involves a single offer to acquire 100% control of the target company in two steps with a two-tier pricing arrangement.[42] In the first step the acquiring entity offers to purchase, at a premium price,[43] only enough shares to acquire a controlling interest in the company.[44] Once the controlling position is established, the acquiror, in the second step, merges the target company into itself or a subsidiary and squeezes out minority shareholders in exchange for cash or securities valued at a lower price[45] than the price paid in the first step.[46]

(D. Nev. 1985) ("A front-end loaded, two-tier tender offer thus is coercive and unfair to the shareholders."); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (similar).

40. ADVISORY COMMITTEE ON TENDER OFFERS, SECURITIES & EXCHANGE COMMISSION, REPORT OF RECOMMENDATIONS 25-26 (1983).

41. *See* Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 679-81 (1984) [hereinafter Greene & Junewicz, *A Reappraisal*]. *But see SEC Request for Comments*, *supra* note 34, at 1120 (noting any tender offer involves an element of coercion or pressure); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 727 (1982) (dismissing argument that two-tier offers are unduly coercive by noting the premium in the front-end is nothing more than compensation offered to tendering shareholders "who facilitate the movement of control at some risk"); Strauch, *supra* note 27, at 57 (arguing two-tier offers are not inherently harmful nor unduly coercive).

42. *See* Comment, *Front-End Loaded Tender Offers*, *supra* note 35, at 389. *See also* Comment, *Tender Offers*, *supra* note 34, at 812 (first tier offer is usually made in cash, while the second offer, after the freeze-out merger, is made in long-term debt securities issued by the acquiring company).

43. *See, e.g.*, SEC Study, *supra* note 19, at 26,759 (premium offered in the first tier was approximately 63.5% above the market price).

44. *See* Strauch, *supra* note 27, at 45. *See also* Note, *Delaware's Attempt to Swallow a New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. L. 569, 571-73 (1985) [hereinafter Note, *Delaware's Attempt*] (offeror's bid is usually for 20%-50% of the company, a recognized range which assures practical control of the corporation). For a discussion of the premiums offered in a tender offer, see *supra* note 19 and accompanying text.

45. *See* SEC Study, *supra* note 19, at 26,759 (premium offered in the second tier was approximately 47.1% above the market price, as compared to 63.5% in the first tier).

46. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1708 (1985); Comment, *Tender Offers*, *supra* note 34, at 812. This type of merger is known as a "back-end" merger because it is accomplished by squeezing out the minority shareholders in the back end of the two-step merger. *See* Brudney, *Equal Treatment*, *supra* note 38, at 1118-19; Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 485 (1983); Note, *Delaware's Attempt*, *supra* note 44, at 572. The merger between the target and

Commentators argue that this two-step acquisition and two-tier pricing structure pressures shareholders and creates a "stampede atmosphere."[47] Since the acquiror has announced that the attempted acquisition for control will occur with a two-tier pricing structure, shareholders fear that their failure to tender in the first step, even if they believe the offering price is inadequate, will relegate them to a less attractive position of accepting a lower premium in the second step.[48]

Partial tender offers involve a different type of coercion. In a partial offer, the bidder offers to buy a controlling, but not complete, interest in the target company.[49] Therefore, target shareholders are pressured into tendering their shares out of fear that a single majority shareholder will discourage the future purchase of shares held by the minority nontendering shareholders.[50] Additionally, shareholders are

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acquiror requires the approval of the target shareholders. However, the acquiror can legally vote its controlling interest in favor of the merger, which usually will be sufficient to approve the merger. For a discussion of the rights of dissenting shareholders, see *infra* note 56.

47. Greene & Junewicz, *A Reappraisal*, *supra* note 41, at 692. *See* Note, *Protecting Shareholders*, *supra* note 5, at 1966, providing the following example to emphasize the coercion inherent in a two-step, two-tier acquisition and pricing tender offer:

> Instead of offering to buy all of the target's shares at price X, the bidder offers to buy fifty-one percent of the shares at price X + Y and announces its desire to acquire the remainder in a second-step merger at price X-Y. Thus, the target's shareholders are induced to tender both by the carrot (the premium offered in the first step) and by the stick (the lower price offered in the second).

Id.

48. *See* Greene & Junewicz, *A Reappraisal*, *supra* note 41, at 679. Two commentators, Professors Brudney and Chirelstein, have described the two-step acquisition strategy as having a "whipsaw" effect on target shareholders:

> Given the inability of [a target's] dispersed stockholders to communicate with one another during the tender offer, the act of offering a higher price on tender than would be paid on merger would have a "whipsaw" effect on [the target's] stockholders. Individual stockholders would find it difficult or impossible to refuse a tender price of $40 when they are also made aware that if the tender succeeds, the remaining shares will be merged out at $30. In effect, an announced disparity between the tender and the merger figure would deprive [the target's] stockholders of their ability to make an unforced, independent judgment on whether an average of $35 per share is an acceptable overall price for the assets of the firm.

Brudney & Chirelstein, *Fair Shares*, *supra* note 38, at 337.

49. *See* Greene & Junewicz, *A Reappraisal*, *supra* note 41, at 676; Strauch, *supra* note 27, at 47. *See also* Finkelstein, *supra* note 36, at 293 (offerors usually intend to effectuate a two-step freeze-out after control is established).

50. *See* Greene & Junewicz, *A Reappraisal*, *supra* note 41, at 676.

concerned that once the bidder acquires control, it may adopt policies for its own benefit at the expense of the minority shareholders.[51]

It is this pressure, commentators argue, which causes shareholders to tender their shares without making an "informed decision" as to the merits of the offer.[52] Although shareholders are aware that a forthcoming any-and-all[53] offer could yield a higher premium than a partial or two-tier offer,[54] the individual shareholder lacks the collective power, as well as the time, to bargain with the hostile bidder. As a result, he acts as any rational shareholder would when faced with a similar situation.[55] Rather than risk being forced to accept either a lower premium or the status of a minority position, the shareholder tenders to an acquiror even if he thinks the offering price is inadequate.[56] This situation, in the context of a two-tier

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51. *See id.* Other factors which coerce shareholders who are subject to a partial tender offer include lack of an obligation on the bidder's part to take out the minority, and the fact that a bidder may have a questionable reputation, or be unfamiliar with the target company's business. *Id.* While derivative litigation by minority shareholders could be pursued, it is expensive and so fraught with uncertainty that it provides little deterrence to controlling shareholders. *Id.*

52. *Id.* at 692 ("Front-end loading creates a stampede atmosphere that is inconsistent with informed decisionmaking.").

53. An any-and-all tender offer states that the bidder will buy any and all tendered shares of the target firm, as long as enough shares are tendered to insure control. *See SEC Request for Comments, supra* note 34, at 1124.

54. SEC Study, *supra* note 19, found that any-and-all offers yield an overall premium of 63.4% over market price, as compared to a 55.1% blended premium in a two-tier tender offer and 31.3% in a partial offer. Thus, it is argued that the coercion inherent in a two-tier or partial offer induces shareholders to tender when an alternative any-and-all offer may yield a higher overall premium.

55. *See* Lipton, *Takeover Bids, supra* note 5, at 113-14 ("[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion—they will tender . . . .").

56. Virtually all states provide shareholders who vote against a merger the right to receive a cash payment from the merged company equal to the "fair value" of their shares. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(h) (Cum. Supp. 1982); N.Y. BUS. CORP. LAW § 623(h)(4) (McKinney 1982). However, the statutory appraisal rights conferred upon shareholders are not designed to give target shareholders any share of the target's acquisition gains, and the consideration paid to minority shareholders is rarely as high as the price of the premium paid to tendering shareholders. Furthermore, appraisal statutes have been criticized by commentators as being difficult to apply and unresponsive to new forms of corporate transactions. *See* Comment, *Front-End Loaded Tender Offers, supra* note 35, at 416. *See also* Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decision-making*, 57 CALIF. L. REV. 1, 85 (1969) [hereinafter Eisenberg] (describing the appraisal remedy as "technical . . . expensive . . . uncertain in result, and . . . unlikely to produce a better result than could have been obtained on the market"). Professor Eisenberg has called the appraisal "a remedy of desperation." *Id.*

offer, has been described as analogous to the "prisoner's dilemma."[57]

III. A RESPONSE TO TWO-TIER AND PARTIAL TENDER OFFERS

A. *A General Overview of Shareholder Rights Plans*

Shareholder rights plans are adopted, at least ostensibly, by target companies to "protect" their shareholders from the coercive effects of both partial and two-tier offers.[58] Through the use of blank-check stock,[59] a target company's board of directors typically creates and issues, as a dividend on common stock, rights for the purchase of shares of a new class of preferred stock.[60] The preferred stock carries with it special rights or privileges, most notably the rights of conversion and redemption,[61] and supermajority voting privileges.[62] The rights, however, are only activated and exercisable upon the

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57. *See SEC Requests for Comments, supra* note 34, at 1125 n.7. The prisoner's dilemma was described as follows:

> The prisoner's dilemma is created by placing two suspected perpetrators [target shareholders] in separate rooms and presenting each with the following proposition. If you confess [tender] and your partner does not, he receives the harshest punishment [lower premium in the second tier] and you go free [higher premium in the first tier]. If he confesses and you do not, then you receive the harshest punishment and he goes free. If both confess, then both receive moderate punishment [higher blended premium equal to an existing any-and-all offer]. The rational prisoner [target shareholder] will confess to avoid the harshest punishment even though no confession results in both going free [higher premium expected from a forthcoming any-and-all offer].

Id.

58. *See* Note, *Protecting Shareholders, supra* note 5, at 1967; R. CLARK, CORPORATE LAW 514 (1986). It is generally agreed that Martin Lipton, a senior partner in the law firm of Watchell, Lipton, Rosen & Katz, was the "inventor" of the shareholders rights plan as a defensive tactic.

59. Blank-check stock is stock whose terms are fixed by board resolution at the time of issuance. Note, *Protecting Shareholders, supra* note 5, at 1975 n.54. The issuance of blank-check stock at the discretion of a company's board of directors is permitted under many state corporate statutes. *See* DEL. CODE ANN. tit. 8, §§ 102(a)(4), 151(a), 151(g) (1983). The language of these statutes places no restrictions on the board, thus granting it broad power, as long as it acts in accordance with the provisions of the certificate of incorporation. *See* Note, *Delaware's Attempt, supra* note 44, at 577. For a comprehensive discussion of blank-check stock, see Note, *Protecting Shareholders, supra* note 5, at 1973-75.

60. There are several variations of rights plans, and not all the plans involve the issuance of "rights." Some involve warrants or options. Additionally, not all entail the purchase of preferred stock. However, it is typical to effectuate the rights plan in the manner described in the text.

61. *See* Note, *Protecting Shareholders, supra* note 5, at 1964.

62. *See* Note, *Delaware's Attempt, supra* note 44, at 575.

occurrence of predetermined triggering events,[63] typically consisting of either a third party's announcement of a tender offer for a controlling percentage of the target company's stock,[64] or an actual acquisition of a specified percentage of target stock.[65]

B. *The Mechanics of Shareholder Rights Plans*

1. Conversion Rights

Once activated, the conversion, redemption, and supermajority rights entitle their holder to some favorable exchange at the expense of the hostile acquiror. Under the terms of the "original" shareholder rights plan,[66] if the target company was involved in a merger or other business combination, the conversion rights enabled their holder to convert or exchange his preferred stock into the substitute preferred stock of the acquiror. Thus, in the event of an acquisition of, for example, 30% or more of the target company's common stock, followed by a second step freeze-out merger, the target's preferred stock would be exchanged or converted into the common stock of the acquiror.[67] The target shareholders thus receive for each of their shares an amount of the acquiror's common stock which is equal in value to the highest price paid by the acquiror for the target's common or preferred shares during the battle for the acquisition of the company.[68]

A recent popular variation of this conversion right, called a flip-over,[69] allows its holder, in the event of a merger or other business

63. *See SEC Concept Release on Takeovers and Contests for Corporate Control*, 18 Sec. Reg. & L. Reg. (BNA) 1187, 1189 (Aug. 8, 1986) [hereinafter *SEC Concept Release*]. *See also infra* note 65 and accompanying text (specific triggering events activating the right).

64. *See supra* note 44 and accompanying text.

65. *See SEC Concept Release*, *supra* note 63, at 1189. Although the numerical percentages vary from Plan to Plan, the rights are typically activated by the acquisition of 15-20% or more of the target's stock, or by the announcement of a tender offer for 30% or more of the target's shares. *See, e.g.*, *Moran*, 500 A.2d at 1348-49 (Plan is triggered by tender offer for 30% or more of the shares or acquisition of 20% of shares).

66. The word "original" is used because this type of convertible right has not been utilized since 1983. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at Table 1.

67. If the target company survives the transaction, the conversion rights become the right to purchase the target's stock at a similar discount.

68. *See* Lipton & Brownstein, *Responses and Directors' Responsibilities—An Update*, 40 BUS. LAW. 1403, 1422 (1985) [hereinafter Lipton & Brownstein, *Responses and Responsibilities*].

69. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at Table 1

combination, to purchase the acquiror's common stock at substantially below the market price.[70] The right holder is typically able to purchase the acquiror's common stock at approximately half price.[71]

While originally conversion rights were intended to discourage the use of front-end loaded two-tier offers by equalizing the price of the tiers,[72] the convertible flip-over rights of the more recent plans are devised to deter this type of offer by subjecting the acquiror to a severe dilution of his capital in the target company following a merger.[73] The less the offeror is able to acquire in the first step, the more dilution he faces in his equity upon acquisition of the target company.[74]

2. Redemption Rights

Unlike conversion rights, which allow the stockholder to "call" common stock upon payment of a fixed exercise price,[75] redemption rights allow the target's common shareholders, as holders of the

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(of the 245 plans adopted from 1983 to 1986, 118 utilized a flip-over right as their central operative device).

A "flip-over" right calls for the preferred stock of the target to be converted into the preferred stock of the acquiror at the time of the merger, allowing shareholders to maintain a continuing equity interest in any combined entity. Flip-over stock may also allow the stockholder to demand redemption in the event of a partial or two-tier offer at the highest price paid by an acquiror for shares of the target's stock. *See* Finkelstein, *supra* note 36, at 300. The flip-over feature has been compared to fair price and mandatory bid amendments in certain limited respects. For a discussion of their similarities and differences, see *id.* A variation of the flip-over plan is the "flip-in" plan, which provides that if the acquiring firm consummates a merger or other business combination, the target shareholder can present the right to the acquiror in exchange for securities valued at substantially below market price. *SEC Concept Release, supra* note 63, at 1190 n.19.

70. *See, e.g., Moran,* 500 A.2d at 1349 (target shareholder can purchase $200 worth of the acquiror's stock for $100).

71. *See* Fleisher & Golden, *Poison Pills,* Nat'l L.J., Feb. 24, 1986, at 17, 26, col. 1 [hereinafter Fleisher & Golden]. The exercise price of the right is substantially in excess of the underlying stock, and is sometimes equivalent to the estimated long-term value of the stock. Furthermore, if the target company survives the transaction, the right allows the target shareholder to purchase the target's stock at a similar discount.

72. *See* Lipton & Brownstein, *Responses and Responsibilities, supra* note 68; Note, *Protecting Shareholders, supra* note 5, at 1967.

73. *See, e.g., Moran,* 490 A.2d at 1066, *aff'd,* 500 A.2d 1346 (Del. 1985) ("resultant dilution of the acquiror's capital is immediate and devastating").

74. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 10-11 (comprehensive discussion of the deterrent effects of the flip-over plans).

75. *See* Lipton & Brownstein, *Responses and Responsibilities, supra* note 68, at 1425-26.

rights, to redeem or "put" their common stock to the target company in exchange for debt securities at a specified "fair price" after a triggering event.[76] The specified price could be, for example, the highest price paid for the target's shares during a specified period.[77]

Recent redemption rights plans involve an added feature: discrimination against the acquiror at the time of redemption. One type of plan, called a "back-end" plan,[78] provides that if an acquiring entity accumulates enough shares to exceed a specified shareholding limit, the target shareholders, as the holders of the rights, may attach each right to their common stock and tender it to the company for a package of cash and securities having a value greater than the current market price of the stock.[79] However, the acquiror's rights become null and void and he is excluded from the redemption provision.[80]

Another form of discriminatory dilution occurs with a provision called a "flip-in"—under this provision, when an acquiror crosses a specified ownership threshold (usually 30-50% of the common stock), a new issue of stock allows the right holders, except the acquiror, to purchase a unit of the target's securities at substantially below the market price.[81] Thus, the shares accumulated by the excluded

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76. *See* Finkelstein, *supra* note 36, at 295-96. A fair price means the highest price offered to tendering shareholders during the first tier of the tender offer. Fair price provisions are typically adopted as an amendment to the certificate of incorporation. *Id.* However, in the context of stock redemption rights, fair price means a price selected by the target's board of directors.

77. *See* Note, *Protecting Shareholders, supra* note 5, at 1967. Variations of redemption rights plans have been adopted by several companies. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 635 F. Supp. 1174 (N.D. Ill.), *aff'd in part*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987) ("back-end" shareholder rights plan adopted giving shareholders rights upon acquisition of 28% or more of company's common stock); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) ("poison pill" plan adopted by which shareholders receive the right to be bought out by the corporation at a substantial premium on the occurrence of a stated triggering event). *See also* Fleisher & Golden, *supra* note 71, at 216 (as a variation of this plan if a second-step offer is consummated at less than a fair price, target shareholders are entitled to the difference between fair price and price actually paid).

78. *See supra* note 77.

79. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 14.

80. *Id.* at 13.

81. *See, e.g.*, Dynamics Corp. of Am. v. CTS Corp., 635 F. Supp. 1174 (N.D. Ill.), *aff'd in part*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987) (several variations of flip-in plans were reviewed in response to a tender offer including an "acquisition flip-in" plan, a flip-over plan, a self-dealing flip-in plan, and an equity flip-in plan).

acquiror lose significant value, subjecting him to a discriminatory dilution.[82]

The redemption rights granted to target shareholders are aimed at deterring the use of partial tender offers and creeping acquisitions by giving the target shareholders the power to deplete the target company's assets through the redemption of the rights in the event that the acquiror does not attempt a 100% acquisition.[83] However, recent redemption rights plans seem to deter all offers for the target's stock because of the discriminatory dilution facing a potential acquiror.[84]

3. Voting Rights

Finally, target companies have employed discriminatory supermajority voting plans consisting of an issuance of a pro rata dividend of preferred stock, with superior voting rights, to holders of common stock.[85] The plan might provide, for example, that if the rights were triggered by the acquisition of a specified voting percentage, all of the rights holders, other than the acquiror, would have one or more votes for each share held.[86] A variation provides for "phased" voting rights, which give greater voting rights to long-term holders of the stock.[87] By granting the right holders a greater than majority requirement in approving certain business combination transactions, the voting rights severely hinder the acquiror's voting power, which makes it difficult for the acquiror to unilaterally gain control of the target company.

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82. *See* Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229, 1233 (S.D.N.Y. 1986) (court found that flip-in provision would substantially dilute acquiror's equity).

83. *See* Note, *Protecting Shareholders, supra* note 5, at 1967.

84. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 12-14.

85. *See* Note, *Delaware's Attempt, supra* note 44, at 575 (noting that the majority requirement, effective in blocking mergers and hostile takeovers, ranges from 66% to 95%). *See, e.g.*, Unilever Acquisitions Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (distribution of preferred stock with supermajority voting privileges to all target shareholders); Asarco, Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985) (special voting rights stock issued in effort to resist takeover; court held the issuance of preferred stock creating different voting rights within the same class or series of stock was ultra vires).

86. *See, e.g.*, *Unilever*, 618 F. Supp. at 408 (one share of preferred entitles holder to 25 votes).

87. *See, e.g.*, *id.* (if preferred share is transferred, new holder may exercise only one-fifth of the voting power for first 36 months stock is held).

4. The Effect of the Rights

While these conversion, redemption, and voting rights have not completely thwarted raiders' attempts to gain control of target companies through the tender offer process,[88] the issuance of the rights does place impediments in the path of any entity attempting to acquire substantial shares directly from the target shareholder without first obtaining the target board's approval.[89] Essentially, shareholder rights plans are intended to deter, through the triggering of the "poisonous" rights, tender offers which have not been negotiated and approved by the target company's board of directors.[90] Because the plans typically include a provision which allows the board of directors to redeem or cancel the plan at a nominal cost,[91] hostile tender offerors are forced to negotiate with the board in order to avoid the plan's devastating effects.[92]

This power to either cancel the plan or to unleash its "poison" propels the board to the status of prime negotiator for the shareholders, interjecting it into what is supposed to be "a private transaction between a willing seller and a willing purchaser."[93] The result

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88. A major reason why the privileges do not render a company completely safe from a hostile raider is that the rights become effective only when a raider attempts a partial or two-tier offer. *See* Note, *Protecting Shareholders*, *supra* note 5, at 1967, 1968. *See also* Chittur, *supra* note 18, at 36-37 (limitations of conversion and redemption rights); Finkelstein, *supra* note 36, at 300-01 (same); Fleisher & Golden, *supra* note 71, at 28 (limitations of the flip-over provision). *See generally Moran*, 500 A.2d at 1354 (discussing ways that hostile raider could gain control of a target company even though it adopted a flip-over rights plan). For a discussion of two takeovers which have been successfully completed despite the presence of a shareholder rights plan, see generally *SEC Concept Release*, *supra* note 63, at 1191.

89. *SEC Concept Release*, *supra* note 63, at 1189-90.

90. *Id.* at 1190. *See, e.g.*, Horwitz v. Southwest Forest Indus., Inc., 604 F. Supp. 1130, 1132-33 (D. Nev. 1985) (cost would be so high as to make any merger infeasible). Proponents of the plans argue that their deterrence aspects allow a board of directors to negotiate more favorable alternatives to maximize shareholder value. *See* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 19; Lipton, *Sensible Deterrent*, *supra* note 7, at 2.

91. *See, e.g.*, *Dynamics Corp.*, 635 F. Supp. at 1179 (board could redeem the rights for $.05 per share); *Revlon*, 506 A.2d at 177 (board could redeem the rights for $.10 each); *Moran*, 490 A.2d at 1066, *aff'd*, 500 A.2d 1346 (Del. 1985) (board could redeem rights for $.50).

92. *See, e.g.*, *Moran*, 490 A.2d at 1066, *aff'd*, 500 A.2d 1346 (Del. 1985) (dilution suffered by the acquiring entity would be "immediate and devastating"). *See also* Matheson & Norberg, *supra* note 23, at 476 ("[A]ny attempt to merge or consolidate with the target while the poison pill is in place is tantamount to financial suicide.").

93. *Minstar*, 621 F. Supp. at 1260 n.6.

is a reallocation of authority which infringes on stockholders' rights and upsets the governance structure of the corporation.[94] As one court recently stated, "To buy [the company], you must buy out its management."[95]

IV. JUDICIAL REVIEW OF SHAREHOLDER RIGHTS PLANS

While the plans do realign the normative model of corporate decision making,[96] courts have been unwilling to render them invalid per se. Rather, because defensive takeover activity is governed by state law,[97] courts have reviewed the legality of a shareholder rights plans according to the state law under which they were adopted. In their review, the courts seem to be using a two-prong test.[98] The threshold inquiry involves a determination of whether the state's corporate statutes grant the target company's board of directors the authority to unilaterally adopt the specific provisions which comprise the plan.[99] If the court is satisfied that the state's corporate law permits its adoption, the court, under the second prong, determines whether the board's decision falls within the protections of the business judgment rule.[100]

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94. *See, e.g.*, *Moran*, 490 A.2d at 1076 (plan results in transfer of power from shareholders to directors).

95. *Dynamics Corp.*, 794 F.2d at 259, *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

96. *See generally* Eisenberg, *supra* note 56, at 1 (citing R. BAKER & W. CARY, CORPORATIONS CASES AND MATERIALS 89 (3d ed. 1959) (outlining the "legal model" of corporate decision making).

97. Defensive takeover tactics have been interpreted by the courts under an analysis which involves whether or not a board of directors has breached its fiduciary duty by either adopting the tactic or by its actual implementation. *See, e.g.*, *Revlon*, 506 A.2d at 180 (board has power, without a breach of fiduciary duty, to adopt rights plan). *See also infra* note 101 and accompanying text (commentators critical of state corporate laws).

98. Although courts have not expressly set forth their inquiry as a two-prong test, their analyses have been conducted under these guidelines. For an example of this type of analytical framework, see *Moran*, 500 A.2d at 1351-53, 1356-57.

99. Several recent rights plans have not been able to satisfy the statutory threshold; thus, the courts have not reached the decision of whether the board's decision to adopt a rights plan is protected by the business judgment rule. *See, e.g.*, Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (voting rights plan illegal under Delaware law); Asarco v. M.R.H. Holmes A Court, 611 F. Supp. 468, 477 (D.N.J. 1983) (same under New Jersey law).

100. Although a comprehensive discussion of the business judgment rule is beyond the scope of this comment, it is such an important factor in the legality of the plans that it merits a general discussion. Essentially, the business judgment rule is a "presumption that in making a business decision the directors of a corporation

A. *Statutory Authorization*

Two recent Delaware Supreme Court decisions clearly indicate that a target board does have the statutory authority in Delaware to unilaterally adopt certain types of rights plan.[101] In *Moran v. Household International, Inc.*[102] and in *Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc.*,[103] the supreme court held that a target board could lawfully adopt plans involving flip-over rights[104] and those involving a redemption right excluding the hostile offeror from participation.[105]

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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." *Moran*, 500 A.2d at 1356 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). However, in Delaware, while the business judgment rule is applicable to a board's decision to adopt a defensive takeover tactic, the initial burden lies with the directors to show that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed." Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (citing Cheff v. Mathes, 199 A.2d 548, 554 (1964)). The directors meet their burden by showing good faith and reasonable investigation. *Unocal*, 493 A.2d at 955. The board must also show that the defensive mechanism was reasonable in relation to the threat posed. *Id.* While the initial burden lies with the board, the ultimate burden is on the plaintiff to prove that the directors breached their fiduciary duties to the shareholders. *Id.* at 958. In essence, the business judgment rule is a judicial laissez faire approach, governed by the premise that a court will not substitute its judgment for that of a board, unless a breach of fiduciary duty is revealed. *Id.*

Commentators have been critical of the use of the business judgment rule in the corporate takeover setting. *See generally* Gelfond & Sebastian, *Reevaluating the Duties of Target Management in a Hostile Tender Offer*, 60 B.U.L. REV. 403, 434 (1980) [hereinafter Gelfond & Sebastian] (business judgment rule lacks clearly articulated standards to govern management in a conflict of interest setting); Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 623-24 (1983) (business judgment rule provides too much protection to directors whose loyalty to the corporation may be compromised by the prospect of a corporate takeover and a loss of control). *But see generally* Lipton, *Takeover Bids*, *supra* note 5, at 131 (business judgment rule should apply to defensive tactics in the same manner it applies to other board decisions); Matheson & Norberg, *supra* note 23, at 446 (business judgment rule is properly applied in hostile takeover setting).

101. Commentators have been very critical of the inadequacy of state law, primarily for the reason that it is perceived as an instrument of corporate control and management entrenchment. *See* Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991, 991-92 (1976); Eisenberg, *supra* note 56, at 181.

102. 500 A.2d 1346 (Del. 1985).

103. 506 A.2d 173 (Del. 1986).

104. *Moran*, 500 A.2d at 1353. In *Moran*, the target board of directors adopted a plan which allowed target shareholders, in the event of a merger, to flip-over their conversion rights and purchase the acquiror's common stock at a 50% discount. *Id.* at 1349.

105. *Revlon*, 506 A.2d at 180. In *Revlon*, the target shareholders were permitted to redeem a right of the target company in exchange for a valuable package of

These two decisions have had a major impact on the number of companies adopting a rights plan as part of their preventive takeover strategy,[106] and have influenced state and federal courts which have held that other states' corporation laws also authorize the adoption of rights plans.[107] On the other hand, several federal courts have recently enjoined, on statutory grounds, plans which either involved discrimination against the acquiror by restricting his voting rights or by excluding him from the right to participate in the purchase of shares from the target company.[108] These federal courts have expressly declined to follow the Delaware Supreme Court, and have displayed reluctance to validate plans which do not provide for equal treatment of shareholders in the same class.[109] More importantly, it is submitted that the underlying theme in these decisions is that the board's unilateral adoption of rights plans constitutes an unwarranted infringement of the rights of shareholders to jointly participate with management in making decisions regarding the fundamental structure of the corporate entity.

1. *Moran v. Household International, Inc.*

The 1985 Delaware Supreme Court decision in *Moran v. Household International, Inc.*[110] stands as the seminal case regarding the legality of shareholder rights plans. In accordance with the two-prong

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securities. The right to redeem would arise after anyone acquired 20% or more of the target's shares. However, the acquiror would be excluded from participation. *Id.* at 177.

106. As of the date of the *Moran* decision, only 33 companies had adopted a rights plan. *Corporate Control Alert*, at 1 (Dec. 1986). As of December 1, 1986, over 300 companies had adopted a rights plan. Investor Responsibility Research Center, 3 CORP. GOVERNANCE BULL. 85, 86 (Nov./Dec. 1986). It is well accepted that the Delaware Supreme Court decisions are a major factor contributing to the steep increase. *See generally Corporate Control Alert, supra*, at 1.

107. *See, e.g., Dynamics Corp.*, 635 F. Supp. at 1176, *aff'd*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987) (legal under Indiana law following Delaware); Horwitz v. Southwest Forest Indus., 604 F. Supp. 1130, 1135 (D. Nev. 1985) (legal under Nevada law following Delaware); City Fed. Savings & Loan v. Mann, No. 84-4010 (D.N.J. Aug. 2, 1985), *aff'd*, 782 F.2d 1027 (3d Cir. 1986) (legal under Delaware law); APL Corp. v. Johnson Controls, Inc., No. 85-C-990 (E.D.N.Y. Mar. 25, 1985) (legal under New York law).

108. *See, e.g.*, Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 409 (S.D.N.Y. 1985) (voting rights discrimination invalid under Delaware law); Asarco, Inc. v. M.R.H. Holmes A Court, 611 F. Supp. 468, 477 (D.N.J. 1985) (same under New Jersey law). *But see* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180 (Del. 1986) (discriminatory rights plan excluding offeror from participation valid under Delaware law).

109. *See supra* note 108.

110. 500 A.2d 1346 (Del. 1985).

test discussed above, the court initially focused its attention on whether the Delaware General Corporation Law granted the Household board of directors the statutory authority to adopt a flip-over rights plan[111] as a preventive mechanism to protect the company against hostile two-tier tender offers.[112] Although the board of directors had considered proposing charter amendments which would have rendered a takeover more difficult, the board decided instead to unilaterally adopt the rights plan.[113]

The flip-over right was the plan's central operative device, and its most controversial provision. Through the use of Delaware's blank-check statute, which allows a board to issue stock at its discretion and to endow it with any designations, preferences, and rights,[114]

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111. The plan adopted by the Household board worked as follows: The Household common shareholders received one right for each share of outstanding common stock. *Moran*, 490 A.2d at 1066, *aff'd*, 500 A.2d 1346 (Del. 1985). Each right, having a term of ten years, entitled the holder thereof to purchase 1/100 of a share of a new series of preferred stock for $100. *Id.* The preferred stock was nonredeemable and subordinate to the company's other series of preferred. *Id.* The rights did not trade independently, and were not exercisable unless triggered by two events, called the 20% trigger events. The rights detached from the common stock and were exercisable if a person or group: (a) acquired 20% of Household's common shares, or (b) achieved the right to purchase 20%, or (c) achieved the right to vote 20%, or (d) announced the formation of a group of persons holding 20% to act together. *Id.* The 30% trigger was activated upon the announcement of a tender offer or exchange offer for 30% of Household's stock. *Id.* Once a triggering event occurred, the rights could be exchanged for the new preferred upon payment of the exercise price. Furthermore, if a right was not exercised for the preferred and a merger or consolidation occurred, Household's shares would be exchanged for those of the acquiror, and the flip-over provision would be effectuated. *Id.* The flip-over provision would enable the right holders to buy $200 worth of the common stock for the $100 exercise price of each right held. The lower court found that the flip-over provisions would produce an "immediate and devastating" dilution of the acquiror's capital. *Id.* However, the rights were redeemable by the board for a nominal price of $.50 per right at any time before the occurrence of the 20% trigger, and at any time before or after the 30% trigger. The rights would be nonredeemable only after the 20% trigger. *Id.*

112. *Moran*, 500 A.2d at 1350. The rights plan was not adopted in response to a specific threat, but rather in anticipation of a possible "boot-strap" or "bust-up" takeover. *Id.* at 1357. As a result of the preventive nature of the Household board's response, the court found that it was "even more appropriate" to apply the business judgment rule. *Id.* at 1350.

113. *See* Note, *Internal Transfers*, *supra* note 25, at 108 n.63. It has been suggested that had the board submitted the Plan for a vote to the shareholders, it would not have gained their approval. The author suggests this because the evidence in the lower court indicated that a "charter amendment" would have barely been approved by the Household shareholders. *Id.*

114. DEL. CODE ANN. tit. 8, § 151(g) (1983), provides in relevant 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,

the Household board issued rights to its shareholders to purchase fractional shares at a new issue of preferred stock.[115] The rights traded with the common stock unless they were triggered by an outside party's acquisition of twenty percent of the outstanding common stock or by the announcement of a tender offer for at least thirty percent of the common stock.[116] If the right was triggered by the acquisition of the threshold percentage stock, the right detached from the common stock and became exercisable for the purchase of fractional shares of the preferred.[117] However, if the right was not exercised for the preferred stock and a merger or consolidation occurred, Household's shares would be exchanged for those of the acquiror, and the flip-over right would be effectuated.[118] The plan provided that the right holder would be allowed to purchase common stock of the acquiror at a price reflecting a market value of twice the exercise price of the right.[119] The complexity of the plan was designed in part to create uncertainty on the part of the acquiror, as well as to subject him to an "immediate" and "devastating" dilution of his capital in the event of a successful takeover.[120]

While the court deemed the applicability of the business judgment rule to be the primary issue, and ultimately validated the plan on that ground,[121] it began by analyzing section 157 of the Delaware

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> 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.

115. *See Moran*, 490 A.2d at 1066. The right entitled the holder thereof to purchase 1/100 of a share of the new series of preferred for $100. The rights were issued pursuant to DEL. CODE ANN. tit. 8, § 157 (1983). *See also Moran*, 500 A.2d at 1351.

116. *Moran*, 490 A.2d at 1066.

117. *Id.*

118. *Id.* The trial court found that the result would be a dilution of the acquiror's capital of "immediate" and "devastating" consequences. *Id.*

119. *Id.* The $.50 discount would, in effect, allow the Right's holder to purchase $200 worth of the acquiror's common stock for only $100. *Id.*

120. *Id.*

121. The court found that the Household board had satisfied the requirements

General Corporation Law.[122] This statute grants the directors, absent limiting provisions in the corporation's certificate of incorporation, wide latitude in issuing rights entitling the holders thereof to purchase from the corporation "shares of its capital stock of any class or classes" at prices and terms provided by the board's resolution.[123] The Household board correctly noted that section 157 enabled it, without shareholder approval, to issue the flip-over rights to its shareholders, entitling them to purchase a series of Household stock.[124] In response, Moran argued that this statute has traditionally been recognized solely as one utilized for corporate financing purposes, and not a device related to contests for corporate control or takeover defenses.[125] Thus, Moran argued that the plan was statutorily invalid because the Household board had exceeded its corporate authority by attempting to reallocate corporate control in the form of an issue of securities.[126]

Following its tradition of liberally interpreting the state's corporate enabling statutes,[127] the court refused to limit the use of section 157 solely to corporate financing without evidence that the legislature

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which would protect its decision under the business judgment rule. *Moran*, 500 A.2d at 1356-57. The court concluded that the Household board had a "good faith" belief that the plan was necessary for the welfare of the corporation, and that the plan was reasonable in relation to the threat posed by abusive acquisition techniques. *Id.*

122. DEL. CODE ANN. tit. 8, § 157 (1983), provides in relevant part:

> 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 right or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

123. *Id. See* E. FOLK, DELAWARE GENERAL COPORATION LAW: A COMMENTARY AND ANALYSIS 128 (1972). As long as there is consideration, the statute provides that in the absence of actual fraud the judgment of the board of directors as to price and terms is conclusive. 1 R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 5.12, at 244 (1986).

124. Opening Brief of Appellee Household International at 64, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) [hereinafter Household's Brief].

125. Opening Brief of Appellant Moran at 38, Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) [hereinafter Moran's Brief] ("Nothing in the legislative history of Section 157 remotely suggests that its purpose had anything to do with corporate control in general or takeover defenses in particular.").

126. *Moran*, 500 A.2d at 1351. *See also* Eisenberg, *supra* note 56, at 142 (stock issuances cannot be utilized for purpose of reallocating control).

127. *See infra* note 256.

intended such a narrow use.[128] Furthermore, the court reaffirmed an earlier ruling that the silence of the General Corporation Law on a specific matter should not be construed to mean that a corporation's action is therefore prohibited.[129]

Second, Moran contended that if section 157 did authorize the issuance of stock rights for defensive takeover purposes, it did not authorize the issuance of "sham" rights.[130] Moran argued that the rights were by design never intended to be exercised by the Household shareholders[131] analogizing the Household plan to one invalidated by the Delaware Court of Chancery in *Telvest v. Olson*.[132] In *Telvest*, the court found that a board's issuance of "preferred stock" in an attempt to unilaterally impose a super-majority voting requirement on mergers and other business combinations was invalid because the stock issued was not truly preferred; the only real preference was in its voting rights.[133]

The *Moran* court distinguished the plan in *Telvest* from the Household plan on the ground that the Household plan's issuance of preferred stock contained rights which had significant economic value.[134] The court found that the preferred stock had superior dividend and liquidation rights, in contrast to the illusory rights invalidated in *Telvest* .[135] Furthermore, the court compared the Household plan with the one adopted by the Crown Zellerbach board in its attempt to thwart the takeover bid by Sir James Goldsmith.[136] In that takeover battle, Goldsmith triggered the rights and they were exercised by the Crown Zellerbach stockholders, demonstrating that

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128. *Moran*, 500 A.2d at 1351.

129. *Id.* (citing *Unocal*, 493 A.2d at 957).

130. *Id. See* Moran's Brief, *supra* note 125, at 37 ("The 'Right' was not a right, the 'dividend' was not a dividend, and the preferred stock was never intended to issue. The entire device was a sham . . . .").

131. *Moran*, 500 A.2d at 1351.

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

133. *Id.*, slip op. at 8. The *Telvest* court held that the preferred stock dividend issued by the target board had, in fact, no significant dividend, liquidation, or conversion rights. The only meaningful preference was in its supermajority voting rights. Thus, the court enjoined the issuance on the grounds that the voting rights could not be altered without the consent of shareholders. *Id.*

134. *Moran*, 500 A.2d at 1352.

135. *Id.*

136. *Id. See* Crown Zellerbach v. Goldsmith, 609 F. Supp. 187 (S.D.N.Y. 1986). *See also* Johnson, *Taking Over*, N.Y. Times, Aug. 17, 1986, § 7 (Magazine), at 14 (excellent discussion of Goldsmith's successful takeover of Crown Zellerbach).

the rights, issuable upon the triggering events, had substantive economic value.[137]

The court turned next to Moran's contention that the plain language of section 157 did not grant the Household board the authority to issue a right entitling its own shareholders to purchase another company's capital stock upon a merger or consolidation.[138] In response, the Household board contended that it did not issue rights to purchase shares of another company's stock, but rather the rights ensured their holders that in the event of a merger they would be able to exercise the rights to protect the economic value of the newly issued preferred stock.[139] The court agreed with the Household board, analogizing the "flip-over" right to an anti-destruction clause, a statutory provision which generally ensures holders of securities the protection of their right of conversion in the event of a merger.[140] Moran was unable to persuade the court to distinguish between anti-destruction clauses which are "incidental" to a corporation's power to finance itself by issuing convertible securities, and the flip-over right in the Household plan, which he contended was the primary device in the takeover defense.[141]

In concluding that the Household board was statutorily authorized to issue the preferred stock and its underlying rights in the context of a battle for corporate control,[142] the court noted that a

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137. *Moran*, 500 A.2d at 1352. At least two commentators have concluded that the court's reliance on the Crown Zellerbach takeover battle was misplaced. *See* Matheson & Norberg, *supra* note 23, at 457. The authors note that Goldsmith gained control of Crown Zellerbach by open market purchases, not by tender offer. *Id.* The *Moran* court's analogy, according to the authors, was inappropriate. *Id.*

138. *Moran*, 500 A.2d at 1352. In essence, Moran contended that the statute did not allow the issuance of "flip-over" rights.

139. *See* Household's Brief, *supra* note 124, at 68.

140. *Moran*, 500 A.2d at 1352. *See* DEL. CODE ANN. tit. 8, § 121(a) (1983). The protection offered by an "anti-destruction" clause is accomplished by giving its holders the right to convert their securities into whatever securities are to replace the stock of the acquired company. The novelty in the Household plan was the "two-for-one" conversion rate.

141. *Moran*, 500 A.2d at 1352.

142. The court similarly dismissed Moran's final two statutory arguments. First, the court rejected the argument that the board's reliance on § 157 was contradictory to Delaware's tender offer notice statute. *Moran*, 500 A.2d at 1352. Moran attempted to characterize that statute as evidence that the legislature intended to reject any impediments in the tender offer process. *Id.* at 1353. Second, the court rejected Moran's argument that if 157 authorized the rights plan, it would be unconstitutional under the commerce and supremacy clauses. *Id.* The court held that there was insufficient state action for the commerce or supremacy clauses to be implicated. *Id.*

board of directors has broad discretion in managing the corporation's "business and affairs."[143] According to the court, this gave the Household board "additional authority" upon which to enact the rights plan.[144]

While the court was correct in its literal interpretation of the statutory provisions relied on by the Household board, it is submitted that the court failed to adequately consider the spirit or policy of the statutory scheme of the General Corporation Law.[145] Its strict construction condoned the board's use of corporate financing statutes in such a way as to alter the corporate governance structure.[146] This was accomplished by allowing the board to position itself as the sole negotiating agent of its shareholders, thus wrestling ownership powers away from their shareholders without their consent.[147] The resulting reallocation of authority effectively gave the board absolute veto power over all acquisition offers for the company's stock.[148]

Although a board of directors does have a broad mandate, the General Corporation Law ensures that it is not absolute. Several provisions of the General Corporation Law grant shareholders voting power on questions concerning the ultimate destiny of the corpo-

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143. *Id. See* DEL. CODE ANN. tit. 8, § 141 (1983).

144. *Moran*, 500 A.2d at 1353.

145. The Delaware General Corporation Law respects the rights of shareholders, as owners of the entity, to make decisions which would affect the corporation's ultimate destiny. *See, e.g.*, Wylain v. TRE Corp., 412 A.2d 338, 344 (Del. Ch. 1980) ("The stockholders of a Delaware corporation have certain specific and enforceable rights . . . for example: to be able to vote on fundamental corporate changes.").

146. Through the use of § 157 and § 151, the Household board was able to appoint itself as the sole negotiating agent for its shareholders. It is submitted that this constituted a change in the corporate governance structure because, prior to the adoption of the plan, Household's stockholders had the exclusive power to decide who should own the company, and whether to dispose of the shares.

147. The fact that the plan was adopted without shareholder consent is the major reason why the court should not have condoned the plan. It is suggested that this unilateral action is counter to traditional ownership powers of shareholders. *See generally* 15 W. FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATIONS § 7063 (1983) (stockholder has right to continuation of existing corporate structure unless changed with proper action by stockholders).

148. The board's power was manifested in its ability either to redeem the rights, or to unleash the "poison" in the rights. Although the board contended that the plan would prevent coercive two-tier offers, the SEC, in its *amicus curiae* brief, contended the plan blocked all acquisition offers, substantial stock accumulations, and concerted action by substantial stockholders. *See* SEC Amicus Curiae Brief at 25-30, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1986) [hereinafter SEC Brief].

ration, a reflection of legislative intent to permit a shareholder to participate in decisions which affect his ownership rights.[149] While a shareholder's primary concern is his economic interest, the ownership rights are no less important because they allow the shareholder to protect and advance that interest.

By approving the board's unilateral adoption of the rights plan, the *Moran* court also defied previous Delaware decisions which have attempted to ensure that the provisions of the General Corporation Law are not used as mechanisms for accomplishing inequitable results.[150] As the court itself previously stated, "[I]nequitable action does not become permissible simply because it is legally possible."[151] In *Moran* the Household board of directors manipulated corporate financing statutes in a manner which was inequitable to the owners of the corporate entity. In essence, the board was allowed to separate the stockholders, as owners of the corporation, from the statutory rights and benefits of their ownership, all under the guise of shareholder protection.[152] Just as the court would not have allowed the Household board to amend, without shareholder consent, the company's charter to provide for a strict policy against accepting tender offers, it should not have allowed the board to deprive its shareholders indirectly of their right to decide whether to sell their stock to a willing purchaser.[153]

2. Other Cases

The influence of the Delaware Supreme Court regarding the propriety of a board's unilateral adoption of a rights plan was recently illustrated in *Dynamics Corp. of America v. CTS Corp.*[154] In response to a partial tender offer and proxy contest mounted by Dynamics Corporation of America (DCA), the CTS board of directors adopted

149. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 242, 252 (1983) (charter amendments and mergers).

150. *See* Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971); Lerman v. Diagnostic Data, Inc., 421 A.2d 906 (Del. Ch. 1980).

151. *Schnell*, 285 A.2d at 439.

152. The Household board defended the adoption of the rights plan on the ground that it needed to protect its shareholders from coercive acquisition techniques, namely bust-up takeovers. *Moran*, 500 A.2d at 1357.

153. As the court in Conoco, Inc. v. Seagram Co., 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981), emphasized, while the directors have a fiduciary duty to the shareholders, it is the shareholders who have a right to make their own decisions concerning their economic interest.

154. 637 F. Supp. 406 (N.D. Ill.), *aff'd in part*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

and implemented a rights plan which contained a flip-over conversion right similar to the one adopted by the Household board, and a discriminatory flip-in redemption right.[155] The flip-in right, which was the heart of the controversy, provided that if a person or group acquired fifteen percent or more of CTS's common stock, all holders of the common stock, except the acquiror, whose rights became null and void, would be able to purchase a unit of CTS securities at a substantial discount of the market value.[156] The dilution effect of the flip-in provision would have imposed an economic loss of $24 million on DCA should it have attempted to complete its tender offer acquisition.[157]

The District Court for the Northern District of Illinois applied Indiana law, but opined that Delaware decisions would be controlling because of the Indiana courts' reliance on Delaware decisions in matters of corporate law.[158] The district court rejected Dynamics' contention that the CTS board exceeded its corporate authority by creating, without shareholder approval, two classes of stock which caused discrimination among shareholders.[159] The court stated that Indiana law, like Delaware's, permits a board to create and issue rights.[160] Moreover, the court concluded that the CTS board was merely exercising its managerial authority in creating and issuing conversion and redemption rights.[161]

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155. *Id.* at 407. The plan consisted of a flip-in and flip-over provision. *Id.* Under the terms of the plan, the CTS shareholders received one right per share, which was worthless until triggered. The first triggering event is the acquisition of 15% or more of the CTS stock by any one person or group. *Id.* Once the triggering event occurs, the flip-in provision becomes effective. This provision allows all holders of CTS stock, other than the acquiror (whose rights become null and void), to purchase a unit of CTS securities. *Id.* The unit consistsof a fractional share of CTS common stock and debentures, at a price equal to 25% of the then-market value of such securities. *Id.* The flip-over provision, or the second triggering event, occurs upon the acquisition of CTS in a merger, business combination, or the sale of all or a majority of assets. *Id.* Upon this "flip-over" event, the right entitles the holder, for an exercise price of $75, to purchase common stock of the acquiring company having a market value of $150. *Id.*

156. *See supra* note 155.

157. *Dynamics Corp.*, 637 F. Supp. at 408.

158. *Id.*

159. *Id.* The plaintiffs contended that since the rights plan amounted to a charter amendment to the company's certificate of incorporation, it was subject to shareholder approval under Indiana Law. *Id.*

160. *See* IND. CODE § 23-1-26-5 (1986) (equivalent to DEL. CODE ANN. tit. 8, § 157 (1983)).

161. *Dynamics Corp.*, 637 F. Supp. at 408.

Although the CTS rights plan was enjoined on business judgment rule grounds,[162] which was affirmed by the Seventh Circuit,[163] the district court followed the lead of the Delaware Supreme Court, specifically its decisions in *Unocal* and *Revlon*, in concluding that a board can lawfully discriminate against a potential acquiror.[164] However, unlike the *Moran* court, which was not presented with a flip-in redemption rights plan, the district court did address the argument that a rights plan which contains a discriminatory feature specifically aimed at blocking tender offers was statutorily invalid.[165]

In holding that a discriminatory provision of a rights plan does not render it statutorily invalid, the district court relied on an earlier Delaware decision in *Providence & Worcester Co. v. Baker*.[166] In that case a corporate charter provided that voting rights of large shareholders would be limited, resulting in a discrimination in voting power among shareholders of the same class or stock.[167] The court of chancery, striking down the charter, held that the Delaware General Corporation Law did not permit this type of scaled voting discrimination.[168] However, the Delaware Supreme Court reversed the lower court's decision.[169] Its holding, relied on by the district court in *Dynamics Corp.*, was that discrimination was permissible as long as it applied to the stockholder and not to the stock per se.[170]

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162. *Id.* at 413-19. The district court opined that the rights plan was adopted without a reasonable investigation, and that because the plan would deter all hostile acquisitions, it was not reasonable in relation to the threat posed. *Id.* at 418. The notion that a defense tactic must be reasonable in relation to the threat posed was promulgated by the Delaware Supreme Court. *See Unocal*, 493 A.2d at 958.

163. 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987). Judge Posner wrote the affirming circuit court opinion.

164. *Dynamics Corp.*, 637 F. Supp. at 409-11. In *Unocal*, the Delaware court permitted the target company to effectuate a discriminatory self tender in response to a two-tier tender offer. *Unocal*, 493 A.2d at 751. In *Revlon*, the court allowed the board to adopt a rights plan which excluded the acquiror from the redemption right. *Revlon*, 506 A.2d at 178.

165. *Dynamics Corp.*, 637 F. Supp. at 408.

166. 378 A.2d 121 (Del. 1977).

167. *Id.* at 124.

168. Baker v. Providence & Worcester Co., 364 A.2d 838 (Del. Ch. 1976), *rev'd*, 378 A.2d 121 (Del. 1977).

169. *Providence & Worcester*, 378 A.2d at 124.

170. *Id.* at 123. The supreme court relied on DEL. CODE ANN. tit. 8, § 212(a), finding that the legislature did not expressly prohibit scaled-voting rights. Del. Code Ann. tit. 8, § 212(a) provides in relevant part:

> (a) Unless otherwise provided in the certificate of incorporation . . . each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder. If the certificate of incorporation provides for

The *Providence & Worcester* decision illustrates that the Delaware Supreme Court will allow a corporation to discriminate in voting rights among shareholders of the same class.[171] It could have enormous impact if and when the supreme court is faced with a rights plan involving only discriminatory voting rights, notwithstanding the court of chancery's decision in *Telvest*.[172]

In contrast to these decisions, several federal courts have taken exception to the notion that a board of directors has statutory authority to impose restrictions upon or discriminate against shareholders of the same class, even if the board can prove that the decision was made in the best interests of the company.[173] When a board has attempted to issue a preferred stock with the objective of unilaterally imposing a supermajority voting requirement with respect to a merger with, or acquisition by, a hostile raider, the federal courts, interpreting both Delaware and New Jersey law, have invalidated the plans pursuant to the state's corporation laws.[174] It is submitted that the courts have refused to allow a board to utilize the state's corporation law in an effort to usurp the rights of its shareholders.

A federal case applying Delaware law illustrates this judicial reluctance to give discriminatory voting plans a statutory seal of approval. In *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*,[175] the Richardson-

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more or less than 1 vote for every share, on any matter, every reference in this chapter to a majority or other proportion of stock shall refer to such majority or other proportion of the votes of such stock.

171. It is important that the scaled-voting provisions were contained in the articles of incorporation, and were not imposed by the unilateral action of the board of directors. Furthermore, the case did not arise in the context of a battle for corporate control.

172. *See supra* notes 132-33 and accompanying text. Thus far, the Supreme Court has only ruled on the validity of rights plans involving economic consequences and which only indirectly impacted on shareholder voting rights in the same series or class. However, the *Providence & Worcester* decision could provide the court with precedent allowing discrimination in voting rights. It will be interesting to see how the court interprets the impact of *Providence & Worcester* in the context of a battle for corporate control.

173. *See, e.g.*, Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985) (district court, applying New Jersey law, rejects discrimination between holders of a class of securities); Asarco v. M.R.H. Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985) (District Court of New Jersey does not believe New Jersey would allow this kind of discrimination).

174. *See, e.g.*, Unilever Acquisitions Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985) (applying Delaware law); Asarco v. M.R.H. Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985) (applying New Jersey law).

175. 618 F. Supp. 407 (S.D.N.Y. 1985).

Vicks board, in response to a tender offer by Unilever, attempted to issue a preferred stock to its common shareholders which, if transferred, would give the transferee a reduced number of votes for a limited time after its transfer.[176] The plan's effect, according to the court, would have increased the Richardson family's voting power from one-third to an absolute majority.[177]

The District Court for the Southern District of New York concluded the plan was illegal under Delaware corporation law for two primary reasons.[178] First, it found that the plan clearly affected the transferability of shares because after the issuance of the preferred, the target shareholder would be unable to transfer two-thirds of his voting power.[179] The court concluded that Delaware law explicitly prohibits restrictions which have not been approved by the shareholders.[180] Second, the court found that discrimination among shareholders of the same series would result because the transferee would have one-fifth of the voting power of a non-transferring shareholder.[181]

The Richardson-Vicks board pointed out to the court that the Delaware Supreme Court had permitted discrimination among stockholders in *Providence & Worcester* and in *Unocal*.[182] However, the court distinguished those situations from the one in the present case.[183] The court opined that the discrimination under the Richardson-Vicks rights plan would result in destroying the shareholder's "ability to transfer voting rights without prior warning, compensation or shareholder authorization, creating two classes within one series of shares."[184] The plan, according to the court, resulted in a change

176. *Id.* at 408. Under the rights plan, the Richardson-Vicks board issued one preferred share of stock, as a dividend, to common stockholders for each five shares of outstanding common. The preferred share was to entitle its holder to cast 25 votes on all issues which the common could vote. However, if it was transferred, the transferee-holder could only exercise 5 of the 25 votes for the first 30 months after its transfer. *Id.*

177. *Id.*

178. *Id.* at 409-10.

179. *Id.*

180. *Id.* The court relied on DEL. CODE ANN. tit. 8, § 202(b) (1983), which provides in relevant part: "No restriction [on transfer of shares] 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."

181. 618 F. Supp. at 410. The court also noted that the Richardson-Vicks' articles of incorporation provided that all shares of the same series of preferred stock shall have identical rights. *Id.*

182. *Id.*

183. *Id.*

184. *Id.*

in corporate structure of such magnitude as to require the approval of the shareholders under Delaware law.[185]

The District Court for the Southern District of New York was also confronted with a rights plan which discriminated among shareholders by issuing rights which were nontransferable. In *Minstar Acquiring Corp. v. AMF, Inc.*,[186] the board of directors of AMF, Inc. issued nontransferable rights, exercisable upon change of control triggering events, to persons holding AMF stock prior to a specified date.[187] The rights were redeemable by the board at a nominal cost until triggered, at which time they became automatically nonredeemable.[188] The rights were to become exercisable if a person acquired 30% or more of AMF common stock without a plan to acquire all remaining shares at a price deemed fair by the AMF board.[189] Under the plan, the right entitled its holder to exchange one share of AMF common stock for a "unit" consisting of one-tenth of a share of a new series of AMF stock, which was designated as Series B Preference Stock.[190] Only the persons owning shares before the specified date had the right to vote on mergers, which was a requirement for AMF to merge with any other company.[191]

The court found that the non-transferability of the rights was the plan's "fatal flaw."[192] It held that this type of discrimination between holders of the same class of securities was illegal under New Jersey law unless the corporation had obtained shareholder approval.[193] Although the court acknowledged that the board had the authority to issue rights, it concluded that their non-transferability constituted a division of the common stock into two classes, consisting of those shares purchased before and those purchased after the board's specified date.[194] Because the value of the shares purchased after the

185. *Id. See* DEL. CODE ANN. tit. 8, § 202(b)(1983) (text at *supra* note 180).

186. 621 F. Supp. 1252 (S.D.N.Y. 1985).

187. *Id.* at 1256.

188. *Id.* at 1257. The rights were redeemable by the board for $.10 at any time prior to a change in control. *Id.*

189. *Id.* at 1256.

190. *Id.*

191. *Id.* at 1259.

192. *Id.* at 1258. The court found that the non-transferability constituted a division of the common stock into two classes, consisting of those rights which were issued before the specified date and those obtained upon transfer. *Id.* at 1258 n.4.

193. *Id.* The court viewed the nontransferability of the rights as discriminatory because the rights issued before the board-specified date had "significantly greater" value than those obtained after the date. *Id.*

194. *Id.*

date was significantly lower, the court considered the plan to be a "discriminatory reclassification of common stock."[195]

The *Minstar* court expressly rejected the Delaware Supreme Court's conclusion in *Unocal* that discrimination among shareholders of the same class of securities was permissible if the board perceived that the shareholder who was the subject of the discrimination was also posing the threat to the corporation.[196] Furthermore, the court implicitly rejected the *Providence & Worcester* holding that discrimination was permissble as long as it applied only to the shareholder and not to the stock per se.[197] Additionally, the *Minstar* court found that the non-transferability of the rights constituted an "unreasonable restraint" on the alienability of the underlying common stock.[198] Since the rights could not be transferred along with the underlying common stock, the value of the stock to an acquiring person after the specified date was dramatically reduced.[199] While the court acknowledged that New Jersey statutory law did permit some restraints on alienation,[200] it found this type to be unreasonable.[201]

Finally, the court concluded that the plan unlawfully attempted to give shareholders of the non-transferable rights the ability, upon exercise pursuant to the triggering events, to vote on a merger as a class.[202] Since the shareholders before the specified date were the only ones able to convert their rights, those shareholders had effective control over any merger.[203] The court found that "such major changes in structure and voting rights may only be approved by the shareholders," and not by the board's unilateral action.[204]

The District Court of New Jersey followed the lead of the Southern District of New York in invalidating a plan which attempted, through the unilateral action of the board of directors, to impose supermajority voting requirements with respect to the target company's merger with a hostile offeror. In *Asarco v. M.R.H. Holmes*

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195. *Id.*

196. *Id.* at 1258 ("We believe that the courts of New Jersey would not follow the [Supreme Court] of Delaware.").

197. *Id.*

198. *Id.*

199. *Id.*

200. *See* N.J. STAT. ANN. § 14A:7-2 (West 1983). The statute provides that the restraints must be "reasonable." *Id.*

201. *Minstar*, 621 F. Supp. at 1258.

202. *Id.* at 1256, 1258.

203. *Id.* at 1259.

204. *Id.*

A Court,[205] the Asarco board of directors issued a new series of preferred stock as a dividend to common shareholders in an effort to withstand a forthcoming hostile offer from Holmes A Court.[206] The district court found that the "extraordinary" aspect of the Asarco plan was its provision which stated that if a person or group became the beneficial owner of twenty percent or more of Asarco common or newly issued preferred stock, the preferred stock would grant greatly increased voting rights to all stockholders except the person triggering the increase in voting power.[207] It concluded that the scaled voting rights provisions effectively blocked an acquisition not approved by management.[208]

The district court enjoined the issuance of the preferred stock, holding that it was illegal under New Jersey law.[209] The court held that equality of voting power among stockholders of the same class is a "basic concept in corporate law."[210] Although acknowledging that New Jersey law permitted a board of directors to determine the rights and preferences of blank-check stock,[211] the court was adamant in its holding that a board cannot abuse this power to manipulate

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205. 611 F. Supp. 468 (D.N.J. 1985).

206. *Id.* at 471. One-tenth of a share of new preferred was to issue for each share of outstanding common. The preferred would be entitled to a quarterly dividend and was entitled to priority over the common stock dividends. *Id.*

207. *Id.* Each one-tenth of Series C stock owned by anyone other than the 20% stockholder would have five votes in all matters submitted to holders of common stock. *Id.*

208. *Id.* The court, through the use of a hypothetical, noted that the effect of the plan was that a 20% stockholder of both the common and preferred stock would have only 4.1% of the total votes, even though he held one-fifth of the stock. *Id.*

209. N.J. STAT. ANN. § 14A:7-2 (West. 1985) provides in pertinent part:

> (1) The division of shares into classes and into series within any class or series, the determination of the designation and the number of shares of any class or series, the determination of the relative rights, preferences and limitation, may be accomplished by the original certificate of incorporation or may be accomplished by an amendment or amendment thereto.
>
> (2) Such an amendment may be made by action of the board if the certificate of incorporation authorizes the board to make such divisions and determinations.

Judge Debevoise emphasized however, "that while the Business Corporation Act permits changes of voting rights as *between* classes or series of voting stock, it does not permit an amendment under Section 7-2 which would redistribute voting power within a class." *Asarco*, 611 F. Supp. at 477.

210. *Asarco*, 611 F. Supp. at 477.

211. *Id.* at 475. N.J. STAT. ANN. § 14A:7-2 (West 1985) is similar to Delaware's blank-check stock statute. DEL. CODE ANN. tit. 8, § 151 (1983).

corporate control and deprive shareholders of their basic right to equal voting power within the same class or series of stock.[212]

The *Asarco* court also addressed the discrimination approved by the Delaware Supreme Court in *Providence & Worcester*.[213] The *Asarco* court followed the *Minstar* court's condemnation of the holding in *Providence & Worcester*.[214] The *Asarco* court stated that it was not "persuaded by the logic of the opinion of the Delaware Supreme Court . . . and [did] not believe it would be followed in New Jersey."[215] Furthermore, the court cited the *Telvest* decision for the proposition that a board cannot unilaterally manipulate the voting rights in an effort to withstand changes in corporate control.[216]

The most recent invalidation of a shareholder rights plan under New Jersey law was provided by the District Court for the Southern District of New York. Again, the reason for the invalidation was the discriminatory treatment of shareholders in the same class or series. In *Amalgamated Sugar Co. v. NL Industries, Inc.*,[217] the NL Industries (NLI) board of directors adopted a rights plan which contained a flip-over provision similar to the Household rights plan,[218] and a flip-in provision similar to the CTS rights plan.[219] Under the terms of the flip-in provision, if the rights were triggered[220] and NLI

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212. *Asarco*, 611 F. Supp. at 480. The district court found the *Asarco* plan "difficult to rationalize," not only since it inequitably redistributed voting power, but also because Asarco's directors "imposed the provision long after the stock was issued and in the hands of the shareholders." *Id.* at 478.

213. *See supra* notes 168-72 and accompanying text.

214. *See supra* note 197 and accompanying text.

215. *Asarco*, 671 F. Supp. at 478. The great potential for abuse inherent in a shareholder rights plan persuaded the court that such a plan is not authorized under the New Jersey Business Corporation Act. *Id.*

216. *Id.* at 479. According to the court, the *Telvest* decision stands for the proposition that a board cannot alter the voting rights of common shareholders through the issuance of preferred stock as a pro rata dividend. *See* Telvest, Inc. v. Olsen, No. 5798 (Del. Ch. Mar. 8, 1979).

217. 644 F. Supp. 1229 (S.D.N.Y. 1986).

218. *See supra* note 111 and accompanying text. The critical difference found by Judge Broderick between the Household plan and the instant one was that the former was found not to be "much of an impediment to the tender offer process." *Amalgamated Sugar*, 644 F. Supp. at 1232-34.

219. *See supra* note 155 and accompanying text.

220. The NLI board declared a dividend of one right per share to all outstanding stockholders. The rights were triggered either by an announcement that a shareholder held 20% or more of NLI common stock, or the announcement of a tender offer for 30% or more of NLI's common stock. However, the rights would not be

was the surviving entity in a merger with the twenty percent or more acquiring shareholder, all rights holders, except the acquiror, would be entitled to purchase $100 worth of NLI stock for $50.[221]

The district court held that because the flip-in provision subjected an acquiring person's voting rights and equity to a discriminatory dilution, it was illegal under New Jersey law.[222] Although the court acknowledged that New Jersey does permit differences in voting rights between classes or series of stock, it concluded that this should not be construed to mean that the privileges could be extended to include redistribution of voting power within the same class or series.[223] The court found this was "clearly" illegal in New Jersey.[224] In response to the target board's argument that the flip-in provision was statutorily approved by the *Dynamics Corp.* court, the *Amalgamated Sugar* court stated it would not rely on that decision because it was governed by Delaware law.[225] Furthermore, the *Amalgamated Sugar* court found the *Asarco* decision persuasive with respect to the discrimination in

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triggered if NL Industries, one of its subsidiaries, or its employee benefits plan purchased 20% of NLI stock. More importantly, the plan effectively precluded NLI from negotiating with third-party suitors including a white knight. *Amalgamated Sugar*, 644 F. Supp. at 1232.

221. The court noted that the flip-in provision effects a substantial dilution of the acquiror's equity in NLI and of his voting power. *Id.*

222. *Id. See* N.J. STAT. ANN. § 14A:7-1 (West 1985). The court used a hypothetical to illustrate how the flip-in would cause a discrimination in both the equity and voting power of the acquiror.

223. *Amalgamated Sugar*, 644 F. Supp. at 1234-35. The target board contended that N.J. STAT. ANN. § 14A:7-7 (West 1985) gave it unbridled discretion to issue rights under terms and conditions fixed by the board. However, the court rejected the applicability of this statute, contending that board discretion would circumvent the provisions of § 14A:7-1 (West 1985), which provides that a board cannot redistribute voting power within a class or series. *Id.* The court stated, "It is axiomatic that one cannot read one section of a statute to accomplish an end that is impermissible under another section of the statute." *Id.* However, in Delaware the courts have formulated a doctrine of "independent legal significance," which seems to be antithetical to the *Amalgamated Sugar* court's reasoning. Under the doctrine, "[t]he mere fact that the result of actions taken under one section [of the General Corporation Law] may not be the same as the result of action taken under another section does not require that the legality of the result must be tested by the requirements of the second section." Orzeck v. Englehart, 195 A.2d 375, 377 (Del. 1963).

224. *Amalgamated Sugar*, 644 F. Supp. at 1234. In reaching its result, the court observed that the effect of the rights plan was to alter the fundamental equity and voting structure of NLI and to make the corporation "completely safe from tender offers for ten years." *Id.* at 1235.

225. *Id.* at 1234.

voting rights,[226] while the *Dynamics Corp.* court refused to rely on *Asarco* or *Unilever* on the theory that those rights plans "constituted a pure vote altering scheme with no economic consequences."[227] The *Amalgamated Sugar* and *Dynamics Corp.* courts viewed flip-in rights, which have both economic and voting rights implications, in a completely different manner. The *Dynamics Corp.* court failed to even discuss the effect of the flip-in right on the acquiror's voting power.

From the preceding discussion concerning the statutory authorization provided by the state corporation laws, several conclusions may be drawn. First, the Delaware Supreme Court has given the green light to target boards to unilaterally adopt either a flip-over conversion[228] or a discriminatory redemption right[229] without fear that the board will exceed its corporate authority. Second, several federal courts have declined to follow Delaware's policy of allowing discrimination against the acquiror, whether it be in his voting power or in his equity.[230] Third, the federal courts have reviewed the implications of a flip-in right differently, depending on whether the court has looked to Delaware for precedent in deciding the legality of a rights plan.[231]

However, the Delaware Supreme Court has not been confronted with a rights plan involving only vote altering provisions with no economic consequence. Although this type of plan was struck down by the chancery court in the *Telvest* decision,[232] *Telvest* was decided before the supreme court's decisions in *Unocal* and *Revlon*, which

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226. *Id.* at 1233-34. Although the *Asarco* rights plan did not have the equity consequences found in the plan adopted by NL Industries, the *Amalgamated Sugar* court stated that "[t]he basic arithmetic in *Asarco* and in the NLI Plan is the same. Given a trigger, there suddenly exist votes that did not exist before which have the effect of upsetting normal corporate structure." *Id.*

227. *Dynamics Corp.*, 637 F. Supp. at 409.

228. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1983) (flip-over rights plan held lawful by Delaware Supreme Court which determined that "the rights plan does not prevent stockholders from receiving tender offers").

229. *See, e.g.*, MacAndrews & Forbes Holdings, Inc. v. Revlon, 506 A.2d 173, 181 (Del. 1986) (discriminatory back-end plan implemented by Revlon's board held to be permissible so long as it was untainted by director self-interest).

230. *See supra* notes 173-226 and accompanying text.

231. *Compare* Amalgamated Sugar Co. v. NL Indus., Inc., 644 F. Supp. 1229 (S.D.N.Y. 1986) *with* Dynamics Corp. of Am. v. CTS Corp., 637 F. Supp. 406 (N.D. Ill.), *aff'd in part*, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

232. *See supra* notes 132-33 and accompanying text.

undermine the premise that discrimination against the acquiror is invalid per se. Additionally, the *Providence & Worcester* decision, though not decided in the context of a battle for corporate control, indicates that the court might tolerate discrimination in voting rights imposed unilaterally by a board if its decision to adopt a rights plan is protected by the business judgment rule.[233]

B. *Effect on Corporate Structure*

The underlying implications of the recent decisions discussed above indicate an emerging conflict between the Delaware Supreme Court and some federal courts on the issue of whether rights plans effect a change in corporate structure of such magnitude as to require shareholder approval.[234] Thus far, the Delaware Supreme Court has exhibited indifference toward the argument that these plans infringe on the rights of shareholders to control the governance of the corporation.[235] On the other hand, the federal courts have considered the infringement a primary barrier to gaining the courts' approval.[236] What these decisions indicate is that the federal courts are not willing to allow the board to strip shareholders of their right to decide structural changes, without first gaining the consent of those shareholders.[237]

1. *Moran v. Household International, Inc.*

The Delaware Supreme Court's position on the question of whether a rights plan should be subject to shareholder approval is

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233. The target board may be able to rely on DEL. CODE ANN. tit. 8, §§ 151, 157 (1983), for the statutory authorization necessary to overcome the threshold inquiry. Furthermore, its decision could be protected under the business judgment rule if the board is able to show, inter alia, that the plan was adopted because the directors had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . ." *Unocal*, 493 A.2d at 955 (citing Cheff v. Mathes, 192 A.2d 548, 554-55 (Del. 1964)).

234. *Compare* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1986) *with* Asarco v. M.R.H. Holmes A Court, 611 F. Supp. 468 (D.N.J. 1985). *See supra* note 221 and accompanying text.

235. *See, e.g.*, *Moran*, 500 A.2d at 1354 (little change in governance structure nor compelling evidence indicating that the rights plan was primarily implemented to entrench incumbent management).

236. *See, e.g.*, *Minstar*, 621 F. Supp. at 1259-60 (plan causing major structural changes held unlawful by Southern District Court of New York since business judgment rule not applicable where the plan is used to solidify management's corporate control).

237. *See, e.g.*, *Unilever*, 618 F. Supp. at 410 (structural changes require shareholder approval); *Minstar*, 621 F. Supp. at 1259 (same).

illustrated by its response to the arguments set forth by the appellants (Moran and others) in *Moran*. The appellants, and the SEC, in its amicus curiae brief,[238] argued that the rights plan severely deterred (and thus blocked) virtually all hostile tender offers,[239] thus changing the corporate governance structure by usurping the shareholders' right[240] to consider the merits of a tender offer.[241] Furthermore, Moran argued that because it is the stockholders' right to control the ultimate fate of the corporation,[242] the reallocation of corporate power from stockholders to the directors requires,[243] at a minimum, the stockholders' consent.

In an interesting and persuasive argument, Moran sought to distinguish the Household rights plan from other types of defensive takeover tactics.[244] Moran asserted that unlike other defensive tactics, the rights plan altered the company's fundamental structure and was outside the scope of the board's "management" powers.[245] In essence, Moran attempted to distinguish tactics which are managerial in nature from those which are structural in nature, thereby mandating the vote of the shareholders.[246] Moran contended that the rights plan,

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238. The SEC intervention, by a 3 to 2 vote of the commissioners, represented the first time the Commission involved itself in a takeover contest that did not directly raise questions of federal law. *See SEC Urges Delaware Court to Void Poison Pill Preferred Takeover Defense*, 17 Sec. & Reg. L. Rep. (BNA) 481 (Mar. 22, 1985).

239. The SEC argued that "the Rights Plan will deter not only two-tier offers, but virtually *all* hostile tender offers." SEC Brief, *supra* note 148, at 12. *See* Moran's Brief, *supra* note 125, at 20-25.

240. The chancery court expressly, and the supreme court impliedly, rejected the argument that shareholders have a "right" to receive tender offers. *Moran*, 490 A.2d at 1070. The lower court stated, "Shareholders do not possess a contractual right to receive takeover bids. The shareholders' ability to gain premiums through takeover activity is subject to the good faith business judgment of the board of directors." *Id.*

241. *Moran*, 500 A.2d at 1353-54. *See* Moran's Brief, *supra* note 125, at 52-55.

242. *See* Moran's Brief, *supra* note 125, at 54-55 ("defendants cited no case holding that directors have express authority to alter the fundamental structure of [the corporation] without a vote of stockholders").

243. The chancery court acknowledged that the rights plan did alter the structure of the corporation, resulting in a "fundamental transfer of a power from one constituency (shareholders) to another (the directors)." *Moran*, 490 A.2d at 1076.

244. *See* Moran's Brief, *supra* note 125, at 55.

245. *Id.* Moran contended that other defensive tactics employed by management were managerial in nature, and did not involve reallocation of corporate decision-making power. *Id.*

246. *But see* Household's Brief, *supra* note 124, at 51 ("The proposed distinction between 'structural' or 'fundamental' changes and other corporate steps cannot withstand analysis. It has no judicial support.").

by rendering the company completely safe from tender offers not approved by management, fell into the latter category.

The *Moran* court disagreed with Moran's premise that the rights plan erected insurmountable barriers to any hostile takeover effort.[247] In response to the argument that the rights plan would render any contemplated merger financially impossible,[248] the court found that there were "many methods around the plan."[249] The court suggested several methods, including making an offer with the condition that the board redeem the rights, or an offer with a high minimum condition of shares and rights; making an offer and soliciting consents to remove the board and redeem the rights; acquiring fifty percent of the shares and causing Household to self tender for the rights; or forming a group of up to 19.9% of the shares and soliciting proxies for consents to remove the board and redeem the rights.[250]

In analyzing the effect of the rights plan, the court engaged in a spirited defense of its position that the plan did not drastically affect either the value structure or the governance structure of the corporation.[251] The court compared the noneconomic impact of the rights plan with other defensive tactics and concluded that "it does less harm to the value structure of the corporation than do other mechanisms."[252] In rejecting the argument that the plan resulted in an impermissible reallocation of authority, the court tied the board's decision whether to redeem the rights, thus cancelling the plan, to the fiduciary standards of the business judgment rule.[253] The court

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247. *Moran*, 500 A.2d at 1354. However, the court implied that it approved of the board's effort to withstand coercive "two-tier tender offers." *Id.* at 1357 n.14.

248. *Id.* at 1354. The SEC and Moran both contended that Household's market price was approximately $2 billion. If the rights were exercised by the Household shareholders, it would cost an acquiror $6 billion in dilution as well as the purchase price of Household stock. *See* Moran's Brief, *supra* note 125, at 3 n.2; SEC Brief, *supra* note 148, at 7-8.

249. *Moran*, 500 A.2d at 1354. *But see* SEC Brief, *supra* note 148, at 20-25 (disputing premise that methods around the plan were economically or practically feasible).

250. *Moran*, 500 A.2d at 1354. *See supra* note 249.

251. *Moran*, 500 A.2d at 1354. The court also rejected the argument that the plan restricted stockholders' rights to conduct a proxy context. *Id.* at 1355.

252. *Id.* at 1354. The court listed three other defensive tactics, concluding that these resulted in increased debt to the corporation. The mechanisms were the sale of a crown jewel, paying greenmail to eliminate a hostile threat, and a discriminatory self-tender. *Id.*

253. *Id.* According to the SEC, the "wait-and-see" approach endorsed by the court in determining the permissibility of the board's action under the business judgment rule will deter even friendly offers. The plan will increase the cost of any

stated that the board would not have absolute discretion in carrying out the plan in that it could not "arbitrarily" reject any tender offer.[254] Thus, according to the court, "the Rights Plan is not absolute . . . . The Board has no more discretion in refusing to redeem [cancel] the Rights than it does in enacting any defensive mechanism."[255] Furthermore, the court again emphasized that there were numerous methods to get around the plan, and that the plan did not effectively permit Household's management to be the ultimate decisionmaker in questions of changes in corporate control.[256]

The fallacy of the court's decision is in its denial that the plan altered the decision-making process of the corporation. Even in its decision to validate the rights plan, the trial court acknowledged that the plan resulted in a "fundamental transfer of power from one constituency (shareholders) to another (the directors)."[257] Although the board may not have absolute discretion to refuse to redeem the rights, the potentially devastating dilution facing any acquiror serves to deter any tender offers.[258] The board's power to redeem the rights expands the scope of its role from that of "manager" to that of "owner."[259] The contingency aspect of the rights plan gives the Household board supreme negotiating authority for the shareholders without their consent.[260] It constitutes a direct alteration of the corporate governance structure and should not be permitted without the approval of the governed.

Furthermore, the *Moran* court should have concluded that the plan unjustly blocked all offers, even friendly ones, because of its severe dilutive potential. Any defensive takeover device which would result in forcing the acquiror, in the event the board refused to

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successful tender offer to the point where potential acquirors will seek other, more available target companies. *See* SEC Brief, *supra* note 148, at 27.

254. *Moran*, 500 A.2d at 1354.

255. *Id.*

256. *Id.* The court's reluctance to restrict management's authority, as manifested in its decision to allow the Household board to utilize a rights plan as a bargaining chip, has been the subject of intense debate among commentators. *Compare* Cary, *Federalism and Corporation Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1973) (Delaware courts have interpreted the General Corporation Law so as to allow management to exploit shareholders) *with* Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982) (Delaware courts have never permitted management to exploit shareholders in contravention of the general corporation law).

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

258. *See supra* note 253.

259. *See* Matheson & Norberg, *supra* note 23, at 476.

260. *Id.*

redeem the rights, to pay an extra $6 billion for a company with a market value of $1.8 billion certainly deters any acquiror from contemplating a merger with the company.[261] Although the court pointed out that there were, in theory, methods around the plan, the SEC amicus brief correctly noted that these suggestions were impractical.[262] The Household shareholders, as owners, should be the constituency deciding whether it wants to make the company an undesirable takeover candidate.

2. Other Cases

Although the *Moran* court was unwilling to concede that a rights plan does in fact alter the corporate governance structure of the corporation, the federal courts which have invalidated plans pursuant to either the business judgment rule,[263] or state corporate statutes, have reviewed the plans more critically with regard to their effect on corporate democracy.[264]

In affirming the trial court's decision to invalidate the target board's flip-over and flip-in plan on business judgment rule grounds, Judge Posner, writing for the Seventh Circuit in *Dynamics Corp. of America v. CTS Corp.*,[265] was sensitive to the effect of the plan on the corporate governance structure. He acknowledged that in some circumstances a rights plan can benefit shareholders,[266] but he stated that the court had "grave doubts" about its general benefit to target shareholders.[267] The court pointed out at the outset that it is not management's company, or "at least it's not supposed to be."[268]

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261. *See supra* note 248 and accompanying text.

262. *See* SEC Brief, *supra* note 148, at 20-25.

263. *See, e.g.*, Dynamics Corp. of Am. v. CTS, 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987) (plan held invalid under business judgment rule).

264. *See, e.g.*, Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985) (invalid under New Jersey law).

265. 794 F.2d 250 (7th Cir. 1986), *rev'd on other grounds*, 107 S. Ct. 1637 (1987).

266. For example, the rights plan adopted by the Revlon board in its effort to thwart the takeover efforts of Pantry Pride initiated an auction for the target company, thereby enhancing shareholder value. *See* Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

267. *Dynamics Corp.*, 794 F.2d at 255. Although Judge Posner's comments on rights plan were dicta, they could carry significant weight because of his reputation in the "law and economics" movement. 3 CORP. GOVERNANCE BULL. 68 (Sept./Oct. 1986).

268. *Dynamics Corp.*, 794 F.2d at 255. The court went on to state, "It is supposed to be the shareholders' company for it is they who are entitled to all the income that company generates after paying off all . . . expenses." *Id.*

Thus, the erection of "insuperable" barriers by management to hostile takeovers is inconsistent with the fiduciary duties owed by management to its shareholders.[269]

One of the court's primary concerns about rights plans was that they are not adopted with the approval of the shareholders. According to the court, the plans seem to be more a reactive device used by management for entrenchment purposes than a measure designed to maximize shareholder wealth.[270] Unlike other tactics, such as charter amendments[271] approved by shareholders in an effort to assure that all shareholders receive the same price in a tender offer,[272] the court opined that because plans involving equity rights severely dilute the offerer's shares, they defeat the value enhancing purpose of the tender offer.[273] It seems that underlying the court's criticisms is the presumption that the shareholders are capable of making their own decisions on matters concerning their investments.

Similarly, in cases where plans deplete the offeror's voting power rather than his equity, the courts' invalidations of the plans on statutory grounds are due in part to concern for the effect of the plans on corporate democracy. In *Minstar*, the court was disturbed by the fact that the rights plan would interfere with a shareholder's ability to sell his stock in a tender offer. According to the court, "The right of a shareholder to sell his stock is a private transaction between a willing seller and a willing purchaser . . . a board of director's assertion of a unilateral right . . . to act as a surrogate for the shareholder's independent right of alienation is troublesome."[274] Although the court found that the target board had acted lawfully in its decision to resist the offer, it found that the means utilized violated fundamental principles of corporate governance.[275]

The *Unilever* court also displayed concern about the board's unilateral adoption of a voting rights plan. While striking it down under

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269. *Id.*

270. *Id.* at 252. The court described the benefits and drawbacks of rights plans in general from a purely economic perspective. *Id.*

271. A charter amendment is typically adopted by target companies, with the approval of the shareholders, to make takeover attempts more difficult. *See* R. WINTER, M. STUMPF & G. HAWKINS, SHARK-REPELLANTS AND GOLDEN PARACHUTES (1983) (comprehensive discussion of charter amendments).

272. This type of charter amendment has been called a "fair price amendment" because it requires the acquiror, upon a second step merger, to pay the shareholders the highest price paid during the tender offer. *Id.* at 44-45.

273. *Dynamics Corp.*, 794 F.2d at 256.

274. *Minstar*, 621 F. Supp. at 1260 n.6.

275. The means employed was a rights plan involving a nontransferable right issued to target shareholders. *See supra* notes 193-204 and accompanying text.

Delaware statutory law, the court found that a plan which is calculated to alter the corporate structure and which "strips the shareholders of the ability to transfer voting rights without . . . shareholder authorization" is invalid.[276]

Finally, the courts in *Asarco* and *Amalgamated Sugar* contributed to the condemnation of rights plans generally, and to voting plans specifically. In *Asarco*, the court stated it would take "little imagination to think of situations where corporate control could be manipulated by issuing blank check preferred stock carrying voting rights which would impose, through the board's unilateral action, a supermajority voting requirement for changes of corporate control."[277] The court cited an early New Jersey case which noted that "[t]he right to vote is a basic contractual right. It was an incident to membership or of property in the stock, of which the stockholder or member cannot be deprived without his consent."[278] Thus, the court could have invalidated the plan on corporate governance grounds.

The *Amalgamated Sugar* court was equally blunt in its criticism of rights plans. The court found that the rights plan constituted a "disservice" to target shareholders who were deprived of the right to exercise their own investment judgment regarding the worth of a forthcoming tender offer.[279] The court implied that the board's usurpation of the shareholders' right to tender shares could not be tolerated under the guise of shareholder protection.

V. EVALUATION AND PROPOSAL

It has been stated that "corporation law is constitutional law."[280] The Delaware General Corporation Law, and presumably all state

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276. *Unilever*, 618 F. Supp. at 410.

277. *Asarco*, 611 F. Supp. at 478.

278. *Id.* at 477 (citing Faunce v. Boost Co., 15 N.J. Super. 534, 539, 83 A.2d 649, 654 (1954)).

279. *Amalgamated Sugar*, 644 F. Supp. at 1236-37. The *Amalgamated Sugar* case is factually distinguishable from *Moran* because in *Amalgamated Sugar* the acquiror had already activated the 20% trigger, and the target board had refused to redeem the rights. The *Amalgamated Sugar* court went into great detail in comparing the situation in this case and the one in *Moran*. *Id.* The court discussed the methods the *Moran* court suggested as ways around the plan, concluding that none was possible in this case. Because the court found that the target company rendered itself safe from a hostile takeover for at least the next 10 years, the plan constituted a "disservice" to its shareholders who were not able to consider the merits of a forthcoming tender offer. *Id.*

280. Eisenberg, *supra* note 56, at 4.

corporation law, is guided by the principle that the shareholders, as the owners of the corporation, should make their own investment decisions, as well as any decision to reallocate corporate power.[281] Thus, when a board of directors adopts a measure "calculated to alter the structure of the corporation, removing decisions in takeover matters from individual stockholders and reposing them in the Board,"[282] it has violated at the very least the spirit of the corporate constitution. Indeed, one commentator has suggested that it is "noblesse oblige at best, corporate fascism at worst."[283]

The role of a board of directors in managing the corporation's normal business and affairs is not being contested.[284] It would be impractical as well as inefficient for a shareholder to assume these responsibilities. However, the directors' statutory powers are limited in the sense that they may be used only to decide matters related to the management of the corporation's business.[285] Thus, management's power should not extend to structural decisions, which are left to the shareholders as the proprietors of the corporate entity.[286] Moreover, "owner participation in corporate governance is necessary and proper."[287]

The limitation of a board's power to effectuate structural changes is provided by state corporate statutes. Even though they are thought of as enabling rather than limiting statutes,[288] the power to control the ultimate fate of the corporation is properly entrusted to the

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281. *See infra* notes 289-95 and accompanying text.

282. *Asarco*, 611 F. Supp. at 474.

283. Fiflis, *Of Lollipops and Law—A Proposal for National Policy Concerning Tender Offer Defenses*, 19 U. CAL. DAVIS L. REV. 303, 337 (1986).

284. *See* DEL. CODE ANN. tit. 8, § 141 (1983). *See also* Buxbaum, *The Internal Division of Powers in Corporate Governance*, 73 CAL. L. REV. 1671, 1672 (1985) [hereinafter Buxbaum] ("[E]xisting corporation law is based on shareholder participation.").

285. *See* Eisenberg, *supra* note 56, at 142 where Professor Eisenberg states that a board's powers may be used to achieve business purposes, and not to effectuate structural decisions.

286. *Id.* at 143.

287. Buxbaum, *supra* note 284, at 1672. *But see* Easterbrook & Fischel, *supra* note 5, at 1173 (disputing premise that shareholders have interest in participating in corporate decisionmaking); Fishel, *The Corporate Governance Movement*, 35 VANDERBILT L. REV. 1259, 1277 (1982) (shareholders are "passive" owners who are unwilling to participate in corporate governance; a dissatisfied shareholder merely exercises his rights by disposing of his investment in the corporation).

288. For an example, Delaware prides itself on the "flexibility" of its corporate statutes, for which it has been the subject of intense criticism.

shareholders.[289] For example, shareholders elect[290] and remove directors,[291] amend articles of incorporation,[292] and approve matters like mergers and consolidations,[293] sale of substantially all assets,[294] and dissolutions.[295] What these statutes illustrate is that a shareholder acquires fundamental ownership rights that flow from the corporate structure itself, and are a part of the corporate democracy which allows shareholders to limit the directors' broad mandate in managing corporate affairs.[296]

In carrying out its role as manager, the board is not authorized to do what stockholders can do for themselves.[297] A basic incident of stock ownership is the right to make decisions about who is to control the corporation,[298] and whether to sell shares to a person seeking to acquire control of the company.[299] No matter how well

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289. *See* H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS 195 (3d ed. 1983).

290. DEL. CODE ANN. tit. 8, § 211 (1983); N.Y. BUS. CORP. LAW § 703 (McKinney Supp. 1984-85).

291. DEL. CODE ANN. tit. 8, § 141 (1983); N.Y. BUS. CORP. LAW § 706 (McKinney Supp. 1984-85).

292. DEL. CODE ANN. tit. 8, § 242 (1983); N.Y. BUS. CORP. LAW § 803 (McKinney Supp. 1984-85).

293. DEL. CODE ANN. tit. 8, § 251 (1983); N.Y. BUS. CORP. LAW § 903 (McKinney Supp. 1984-85).

294. DEL. CODE ANN. tit. 8, § 271 (1983); N.Y. BUS. CORP. LAW § 909 (McKinney Supp. 1984-85).

295. DEL. CODE ANN. tit. 8, § 275 (1983); N.Y. BUS. CORP. LAW §§ 1001, 1103 (McKinney Supp. 1984-85).

296. See H. BALLANTINE, PRIVATE CORPORATIONS § 97, at 320 (1927), which provides in relevant part:

> A general provision in the charter of a corporation or the general law, that *all the corporate powers* shall be vested in and exercised by a board of directors, and such officers and agents as said board shall appoint," refers merely to ordinary business transactions of the corporation, and does not extend to other acts which are not ordinarily within the power of the directors, but are done or authorized by the stockholders only—as the reconstruction of and fundamental changes in the corporate body . . . .

Accord 15 W. FLETCHER, CYCLOPEDIA OF THE LAW OF CORPORATION § 7063 (rev. ed. 1983).

297. *See, e.g.*, Wylain v. TRE Corp., 412 A.2d 338, 344 (Del. Ch. 1979) ("The stockholders of a Delaware Corporation have certain specific and enforceable rights under their contract with the corporation and the state, for example: to be able to vote on fundamental corporate changes." *Id.*); Watson v. Washington Preferred Life Ins. Co., 81 Wash. 2d 403, 406, 502 P.2d 1016, 1019 (1972) (*en banc*) ("Each shareholder of a corporation has a right to the continuation of the corporate structure unless and until it is altered or changed by proper action of the shareholders. . . . This right is just as valuable and real as other attributes of ownership of corporate share . . . .").

298. *See Minstar*, 621 F. Supp. at 1260 n.6; *Norlin*, 744 F.2d at 258.

299. *See* Matheson & Norberg, *supra* note 23, at 477.

intentioned a board might be in fulfilling its fiduciary duties,[300] it cannot take statutory rights away from the shareholders without their consent. As one court succinctly stated, "Were we to countenance that, we would be in effect approving a wholesale wrestling of corporate power from the hands of shareholders, to whom it is entrusted by statute, and into the hands of the officers and directors."[301]

However, this improper transfer of internal control is precisely what the Delaware Supreme Court condoned in *Moran*. Instead of using the occasion for requiring recourse to the shareholders to approve the lethal rights plan, the court allowed the board to adopt the plan, using the business judgment rule as the standard upon which the board would be judged at the time an acquiror requested redemption of the rights.[302] It is submitted that the court failed to consider the implications of its "wait and see" conclusion,[303] and severely limited the shareholders' ultimate authority over structural decisions through an expanded definition of "business judgment."

In essence, the *Moran* court concluded that a board could deprive shareholders of the rights and benefits of ownership if it met the liberal requirements of the business judgment rule.[304] This approach undermines corporate democracy and replaces it with a governance model which allows the board of directors to position themselves as the owners of the corporation. Since the Household plan, because of its potential for inflicting a devastating dilution to any hostile suitor, deterred all tender offers unapproved by management, the Household shareholders have become the hostages of their own board of directors.[305]

This reallocation of corporate power from the stockholders to the board of directors without the consent of the governed is the hallmark of any rights plan. Although plans such as Household's

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300. *See Norlin*, 744 F.2d at 267.

301. *Id.*

302. *See Moran*, 500 A.2d at 1357. The court stated:

> 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.

Id. (citations omitted).

303. *See* SEC Brief, *supra* note 148, at 27.

304. *See supra* note 100 (discussion of business judgment rule and requirements management must meet to gain its protections).

305. *See Dynamics Corp.*, 794 F.2d at 259 (Judge Posner's discussion of how a plan effectuates this "hostage" situation).

change the governance structure through the threat of equity dilution, others achieve the same end through a discriminatory dilution of voting rights or equity, or a combination of both. The common purpose in all of the plans is to allow management, through a stock issuance, to reallocate control, thus expanding the scope of transactions for which management approval is required.[306] In sum, it allows the target board to reach the "plateau of plenary negotiating authority"[307] without shareholder approval.

To avoid this undesirable result, the validity of any rights plan should be premised upon the approval by a majority of the target's shareholders.[308] Notwithstanding the fact that recent studies have

306. *See* Matheson & Norberg, *supra* note 23, at 476.

307. MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247 (Del. Ch. 1985), *aff'd*, 506 A.2d 173 (Del. 1986).

308. A shareholder approval requirement for defensive tactics in general, and rights plans specifically, has been suggested by commentators, the *Wall Street Journal*, the SEC, and institutional investors. *See* Lowenstein, *supra* note 5, at 317; Siegal, *Tender Offer Defensive Tactics: A Proposal for Reform*, CORPORATE PRACTICE COMMENTARY 46, 79 (1985); Note, *Internal Transfers*, *supra* note 25, at 108 & nn. 59-63; *Cooper Bracelets*, Wall St. J., Aug. 28, 1986, at 14, col. 2. Professor Lowenstein proposes that all "structural" defensive tactics adopted either after the announcement of a takeover bid or when one appears imminent should be subjected to shareholder approval. He suggests this proposal should be effectuated through an amendment to the Williams Act. Lowenstein, *supra* note 5, at 317-18. Professor Siegel has proposed the same requirement for all defensive tactics, accomplishing this objective through an amendment to the Model Business Corporation Act. Siegel, *supra*, at 78. The SEC's Advisory Committee on Tender Offers recommended that some defensive tactics should be submitted to the company's shareholders for a nonbinding advisory vote. *See* Advisory Committee on Tender Offers, Report of Recommendations (Recommendation 37) (July 8, 1983).

Recently, shareholder approval for rights plans has gained popularity among major institutional investors. In April of 1986, the Council of Institutional Investors, an organization of 36 pension funds controlling more than $160 billion of assets, drafted a "Shareholder Bill of Rights" which proposed, inter alia, that rights plans must have the endorsement of a majority of the target company's shareholders. *See* 2 CORP. GOVERNANCE BULL. 26-28 (June 1986). Furthermore, several major institutional investors, including the College Retirement Equities Fund and the California Public Employees Retirement System, have either proposed or plan to propose shareholder resolutions calling for companies to cancel their rights plans unless a majority of the company's shareholders vote in favor of their adoption. *See* Miller, *Common Defense Against Takeovers Faces New Hurdle*, Wall St. J., Nov. 4, 1986, at 26, col. 2.

In addition, T. Boone Pickens, chairman of Mesa Petroleum and a well known and controversial corporate raider, recently formed the United Shareholders Association of America, a Washington lobby group whose stated objective is to serve as an advocate of shareholder rights. Although the Association's agenda is "vague," it is pushing for increased shareholder participation in all phases of corporate governance. *See* 3 CORP. GOVERNANCE BULL. 59 (Sept./Oct. 1986).

indicated that a company's adoption of a rights plan can have a negative effect on the price of a target company's stock,[309] it is not suggested that rights plans are invalid per se. To the contrary, a rights plan can give the target board more time to initiate an auction for the target company, thereby maximizing shareholder value.[310]

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309. Two earlier studies, one conducted by the investment banking firm of Kidder Peabody, the other conducted by the chief economist of the SEC, produced conflicting results. The Kidder Peabody study found that rights plans do have an adverse effect on stock prices, while the SEC study found that the adoption of rights plans in the midst of takeover speculation resulted in an average 0.93 decline in stock price, which the study called "statistically insignificant." 3 CORP. GOVERNANCE BULL. 65 (Sept./Oct. 1986). Both studies were criticized: the SEC study for covering too small a sample (37 firms), and for measuring the impact over too short a time frame (two days); the Kidder Peabody study for measuring the impact over too long a time period (60 days, 30 before and 30 after the announcement of the rights plan). *Id.*

However, the SEC recently conducted a more exhaustive study covering 245 rights plans adopted between 1983 and 1986. SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 4. The study concluded, after taking into account "confounding events," that the adoption of a rights plan reduces the stock price of a company subject to takeover speculation by an average of 1.7% on a net basis over a two-day announcement period. *Id.* at 5. Of the 245 companies studied, 30 were involved in actual battles for corporate control. Fourteen of these, or 46%, "defeated" the hostile takeover attempt and remained independent. *Id.* at 25. The study attributed the high defeat rate to the rights plans, stating that such a rate is "very high compared with other defenses against hostile takeover attempts." *Id.* at 26. It also concluded that when a rights plan was used to defeat a hostile takeover attempt, stock prices fell an average of 17% calculated over a six-month period. However, when a company which has adopted a rights plan is in a takeover battle and eventually is "auctioned off," the average net-of-market stock for the company was 14%. *Id.* at 41. However, the study stated that "[t]hese benefits . . . do not balance out the losses from defeats." *Id.*

In other interesting findings, the study concluded that institutional holdings average 45.1% for rights plan adopting companies, as compared with 40.2% for all industries. *Id.* at 37. In light of the institutional investors' displeasure with rights plans adopted without shareholder approval, the study correctly concludes that obtaining shareholder approval for the rights plans could pose difficult problems for target management. *Id.* at 38. The study also casts doubt on the conventional wisdom that target companies adopt rights plans to defend against two-tier or partial tender offers. According to the study, of the 22 cases where a rights plan was introduced in direct response to a hostile offer, 15, or 70%, were any-and-all offers. *Id.* at 35. Thus, "[i]n actual takeover contests, [rights plans] are used against any-or-all offers more than twice as frequently as against two-tier or partial offers." *Id.* at 36.

In conclusion, the study stated that rights plans "are harmful to target shareholders, on net," finding "no statistical evidence that [rights plans] have systematically benefited target shareholders." *Id.* at 43.

310. In *Revlon*, the court concluded that the target company's adoption of a rights plan was a factor in causing the hostile acquiror to raise the bid for the company, and was "far from being a 'showstopper,' " as was contended in *Moran*.

Moreover, courts have consistently held that a board has not only the obligation but the duty to protect the company and its shareholders from what it perceives to be harmful, abusive acquisition techniques.[311]

Management would still maintain the prerogative to initiate rights plans. However, because a tender offer presents a board of directors with an inherent conflict of interest,[312] and because shareholders are the real target of the takeover bid, it is logical that the owners of the enterprise should determine the nature and degree of its management's response.[313] A shareholder approval requirement would allow target management to maintain an active role in battles for corporate control, while still affirming the principles of corporate democracy.

The shareholder approval requirement could be effectuated by amending state statutes that provide for the creation and issuance of rights entitling target shareholders to convert or redeem them upon the triggering events.[314] Currently, these rights may be conferred upon target shareholders subject only to the board's determination.[315] The amendment might provide, for example, that any rights issued to a target shareholder in response to or in anticipation of a hostile tender offer must first have the shareholders' approval.[316] Therefore, the issuance of the rights could not be attacked on the ground that a board attempted to unilaterally reallocate corporate control.

Revlon, 506 A.2d at 181. *See also* SEC Study, THE EFFECTS OF POISON PILLS, *supra* note 11, at 41 (target shareholders can benefit from adoption of rights plan if the company is eventually acquired).

311. In Panter v. Marshall Fields & Co., 486 F. Supp. 1168, 1195 (N.D. Ill.), *aff'd*, 646 F.2d 271 (7th Cir. 1980), *cert. denied*, 454 U.S. 1092 (1981), the court stated that directors have "not only the right but the duty to resist by all lawful means persons whose attempt to win control of the corporation, if successful, would harm the corporate enterprise."

312. *See generally* McCord, *Limiting Defensive Tactics in Tender Offers: A Model for the Protection of Shareholder Decisionmaking*, 21 HARV. J. ON LEGIS. 489, 491 (1984) ("The tender offer frequently threatens management, implicitly or explicitly, with forcible removal from control."); Gelfond & Sebastian, *supra* note 100, at 436 (board's interest in self preservation may shape decisions that are not always in the best interests of shareholders).

313. *See* Greene & Junewicz, *A Reappraisal*, *supra* note 41, at 725.

314. *See* DEL. CODE ANN. tit. 8, § 157 (1974); N.J. STAT. ANN. § 14A:7-7 (West 1983).

315. *See supra* note 123 and accompanying text.

316. Although not all rights plans would implicate this statute, the amendment could be inclusive enough to provide for shareholder approval for any variation of the rights plans.

The shareholder approval requirement might also alleviate other problems which courts have encountered and will continue to encounter in reviewing rights plans. First, the central issue of whether a rights plan violates the norm of corporate decisionmaking would become moot. Shareholders such as institutional investors, who are currently leading the fight against rights plans,[317] could not assert that the board is merely entrenching itself by their adoption. Second, the approval requirement would end the judicial inquiry into what constitutes a structural change, thereby implicating shareholder approval. Third, scaled voting rights plans might gain statutory authorization because they would be subject to the approval of the existing target shareholders.

It should be noted that the shareholder approval proposal does not require discarding the business judgment rule as the ultimate standard of review in evaluating the adoption of right plans. Rather, the rule would be utilized by the courts under two levels of analysis. First, it would come into play in evaluating the board's recommendation to the shareholders to approve the rights plan. If a court concluded that a board breached its fiduciary duties by recommending the plan,[318] it would be invalidated even if the board had obtained shareholder approval. Second, because the redemption features of the plan would still be vested in the board, a court could invalidate the plan if it concluded that a board's refusal to redeem the rights amounted to a breach of fiduciary duties.[319] Thus, a board, after obtaining stockholder approval, would still not have the absolute power to render the company free from hostile takeovers.

This approval requirement is premised upon the notion that a board should properly take the initiative in protecting its shareholders against abusive acquisition techniques, and in adopting strategies aimed at maximizing shareholder value. However, the ultimate decision to block a takeover should rest with the shareholders, since they are the ones who bear the ultimate risk of a company's success or failure.

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317. *See supra* note 308 and accompanying text.

318. A court could find, for example, that management recommended the rights plan for entrenchment purposes only, and not to maximize shareholder value. If that were found to be management's motive, the court could invalidate the rights plan.

319. This is precisely the type of analysis condoned by the *Moran* court. It is a reasonable and logical approach as long as the shareholders initially approved the adoption of the rights plan, which, of course, was not the case in *Moran*.

VI. CONCLUSION

Shareholder rights plans are legitimate and effective defensive tactics used by target companies to protect their shareholders from coercive acquisition techniques. A board of directors of a target company should continue to play an active role in protecting the corporation and its shareholders from what it perceives to be threats to the corporate existence.

Although the courts agree that a target board has a proper place in battles for corporate control, shareholder rights plans have not received a judicial rubber stamp of approval. While the Delaware Supreme Court has been enthusiastic in its defense of management's right to adopt rights plans, other courts have invalidated them based on state corporate statutes. This note has suggested that the underlying theme in these decisions is that the courts have been unwilling to tolerate the realignment of corporate democracy under the guise of shareholder protection.

Since the rights plans reallocate corporate decisionmaking, it has been suggested that they should be subject to shareholder approval. This requirement would preserve the norm of corporate democracy, while at the same time reaffirming the board's fiduciary duty in taking the initiative to protect its shareholders. Other defensive tactics which attempt to assure fair treatment for shareholders require shareholder approval, and there is no justification for the argument that shareholder rights plans do not deserve the same shareholder scrutiny.[320] If shareholders are to be rendered defenseless against their own management, it should be by their own choice, not by a unilateral decision of their board of directors.

Jonathan Shub

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320. Charter, or shark repellant, amendments require shareholder approval. *See, e.g.*, DEL. CODE ANN. tit. 8, § 242 (1983).