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Shareholder Rights Plans: Shields or Gavels?

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NOTES

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I. INTRODUCTION

Since 1980 corporate takeover transactions have increased dramatically in size and volume.[1] Along with the rise in acquisition activity has

1. *See* SENATE COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, TENDER OFFER DISCLOSURE AND FAIRNESS ACT OF 1987, S. REP. No. 265, 100th Cong., 1st Sess. 9 [hereinafter Tender Offer Act]. Between 1981 and 1986 the numher of merger transactions nearly doubled from 2,326 to 4,084. The reported value of the transactions nearly tripled during the same time. Transactions over $1 billion grew four times in number, representing over 34% of the total merger and acquisition value in 1986. In 1986 there were 29 transactions in excess of $1 billion. *Id.*; *see* Dobrzynski, *A New Strain of Merger Mania*, BUS. WK., Mar. 21, 1988, at 122, 122 (relating that even in light of the October 1987 crash, corporations and individuals proposed $50 billion worth of acquisitions in the first two months of 1988); Jensen, *Takeovers: Their Causes and Consequences*, 2 J. ECON. PERSP. 21, 21 (1988) (stating that the value of transactions in the takeover market ran at a record rate of about $180 billion per year in 1985 and 1986, 47% above the 1984 record of $122 billion); Weber &

come a marked increase in the number of contested or hostile takeovers.[2] The proliferation of hostile bids[3] for corporate control[4] has

Baum, *Takeovers Are Back, But Now the Frenzy is Gone*, BUS. WK., Feb. 8, 1988, at 24, 24 (commenting that takeover activity reached a "frenzy" in 1986 and 1987 when approximately $380 billion worth of companies changed hands); *see also* Jarrell, Brickley & Netter, *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP. 49, 49-50 (1988) (citing COUNSEL OF ECONOMIC ADVISORS, ECONOMIC REPORT OF THE PRESIDENT 187-216 (1985)). The Council of Economic Advisors indicated that in the period from 1981 to 1984, the average annual reported real value of mergers and acquisitions was 48% greater than in any four year period from the late 1960s to the early 1970s. In addition, 89 of the 100 largest takeover transactions recorded through 1983 took place after 1979, and 65 occurred after 1982. *Id.* at 50. *See generally* 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS § 1.01 (1987) (noting that "[s]ince the adoption of the Williams Act in 1968, the popularity and acceptability of takeover or 'tender offer' bids has grown"); Winter, Rosenbaum, Stumpf, Parker, *State Takeover Statutes and Poison Pills*, in 3 SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER (1988) [hereinafter STATE TAKEOVER STATUTES].

2. Tender Offer Act, *supra* note 1, at 9. Although hostile or contested tender offers represent a small fraction of all transactions (2.8%), they represent a large portion of the value of all mergers and acquisitions (44.4%). Because hostile takeover battles often involve large companies with thousands of shareholders and workers, the concern for use of abusive tactics in the takeover process is high. *Id.*; *see* 1 AMERICAN LAW INSTITUTE—AMERICAN BAR ASSOCIATION COMM. ON CONTINUING PROFESSIONAL EDUC., TAKEOVER DEFENSES AND DIRECTORS' LIABILITIES 3 (M. Lipton ed. 1986) [hereinafter 1 TAKEOVER DEFENSES] (noting the increase in the number, the scope, and the intensity of takeover battles in recent years); Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 44 & n.1 (1983) (noting tbe unprecedented increase in corporate takeovers); *Concept Release on Takeovers and Contests for Corporate Control*, 18 Sec. Reg. & L. Rep. (BNA) No. 32, at 1187 (Aug. 8, 1986) [hereinafter *Concept Release*]; *see also* Levine, Lykos & Chafetz, *Application of the Federal Securities Laws to Defensive Tactics in Control Contents*, in TENDER OFFERS 193 (M. Steinberg ed. 1985). In the Levine, Lykos, and Chafetz article the authors noted:

> Contests for corporate control have become ever more frequent phenomena on the American business scene. Waged with the intensity of military campaigns and the weaponry of seemingly bottomless bankrolls, these battles determine the destinies of large and small corporations alike. Elaborate strategies and ingenious tactics have been developed both to facilitate takeover attempts and to defend against them. Skirmishes are fought in company boardrooms, in shareholders' meetings, and with increasing regularity, in the courts.

Id. at 193 & n.1 (quoting Norlin Corp. v. Rooney Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984)).

3. Campeau Corporation and Federated Department Stores recently concluded a hostile takeover battle which included R. H. Macy & Company. For a discussion of the contest, see *Betting the Store: Campeau at Last Gets Federated—Now Can He Make a Go of It?*, Wall St. J., Apr. 4, 1988, at 1, col. 6.

4. The surge in takeover contests prompted the Securities and Exchange Commission (SEC) and both houses of Congress to consider tender offer reform as early as 1983. To date, however, no legislation has been enacted. For a full discussion of the ongoing debate and commentary on SEC recommendations and on the recently proposed House (H.R. 2172) and Senate (S. 1322) bills, see *The Battle over Tender Offer Reform: From the States and the Courts to Congress*, 20 Sec. Reg. & L. Rep. (BNA) No. 2, at 60 (Jan. 15, 1988). To ensure that no amendment would be added to the Senate Bill preempting state antitakeover laws, Senator William Proxmire, the author of S. 1322, agreed to delete a provision from the Bill that would have prohibited a target company from adopting a poison pill during a tender offer. *Id.* at 70. For the full text of the Senate Bill and the accompanying Report of the Committee on Banking, Housing, and Urban Affairs, see Tender Offer Disclosure and Fairness Act of 1987, [CCH Special 1] Fed. Sec. L. Rep. (CCH) No. 1268, at 1-189. *See* Leebron, *Games Corporations Play: A Theory of Tender Offers*, 61 N.Y.U. L. REV. 153, 154-59 & nn.6-18 (1986) (outlining the various views on tender offer regulation).

brought about the development of new offensive[5] and defensive takeover tactics.[6] One of the newest defensive devices is known as a "poison pill," or shareholder rights plan.[7] This device is designed to make the target corporation (target) prohibitively expensive to an acquiring corporation (acquiror) in the event of a hostile takeover or tender offer.[8] Since the 1985 decision in *Moran v. Household International, Inc.*,[9] in which the Delaware Supreme Court upheld the adoption of a poison pill defensive plan[10] by the Household board of directors,[11] several hundred

5. *See* M. LIPTON & E. STEINBERGER, *supra* note 1, §§ 1.06, 5.02(1) (explaining "bear hugs," "casual passes," and "Saturday night specials"); 1 TAKEOVER DEFENSES, *supra* note 2, at 4-20 (discussing such takeover techniques as "bust-up" or "boot-strap" takeovers, "proxy fights," "two-tier, front-end loaded bids," and "two-price bids"); Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 15-26 (1987) [hereinafter Lipton, *Corporate Governance*] (discussing techniques such as "creeping acquisitions," "sweeping the street," and "partial tender offers").

6. *See* Steinberg, *Some Thoughts on Regulation of Tender Offers*, in TENDER OFFERS, *supra* note 2, at 273, 273-75 (defining defenses such as "lock-ups," "golden parachutes," and "shark repellants"); Empirical Research Project, *Defensive Tactics to Hostile Tender Offers—An Examination of their Legitimacy and Effectiveness*, 11 J. CORP. L. 651, 688-702 (1986) (discussing the legality and validity of the various defensive tactics); *see also* Block & Miller, *supra* note 2, at 52-66. *See generally* M. LIPTON & E. STEINBERGER, *supra* note 1, § 6.01-09.

7. *See* P. RICHTER, CORPORATE ANTI-TAKEOVER DEFENSES: THE POISON PILL DEFENSE (1987); Dawson, Pence & Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423 (1987) (detailing the various types of poison pill plans available); Helman & Junewicz, *A Fresh Look at Poison Pills*, 42 BUS. LAW. 771 (1987) (furnishing brief history of poison pill plans and factors to consider in the evaluation of a poison pill plan); Herzel & Shepro, *The Changing Fortunes of Takeover Defenses*, 15 SEC. REG. L.J. 116 (1987) (reviewing recent developments in the areas of discriminatory self-tender offers and poison pill defensive tactics); Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964 (1984) [hereinafter Note, *"Poison Pill" Preferred*] (arguing that state courts using a "substantial business purpose" test should determine the validity of poison pill preferred stock); Note, *Recent Developments in the Use of the Poison Pill Antitakeover Defense: Limiting the Business Judgment Rule*, 31 ST. LOUIS U.L.J. 1083 (1987) [hereinafter Note, *Developments in the Use of the Poison Pill*] (concluding that the Seventh Circuit's analysis in Dynamics Corp. of America v. CTS Corp., 794 F.2d 250 (7th Cir. 1986), should be utilized by other courts in their analysis of poison pill plans); Comment, *Share and Share Unalike: Judicial Response to Poison Pill Discrimination Among Shareholders of the Same Class*, 33 WAYNE L. REV. 1067 (1987) [hereinafter Comment, *Poison Pill Discrimination*] (discussing the judicial treatment of poison pills that discriminate among shareholders of the same class or series); Note, Dynamics Corp. of America v. CTS Corp.: *Posner's Plan for Poison Pills*, 1987 WIS. L. REV. 711 (focusing on the business judgment rule's application to poison pills). *See generally* 1 A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 54-94 (Supp. 1987); M. LIPTON & E. STEINBERGER, *supra* note 1, § 6.03[4]; 1 TAKEOVER DEFENSES, *supra* note 2, at 95-122.

8. Dawson, Pence & Stone, *supra* note 7, at 423; Herzel & Shepro, *supra* note 7, at 121-22; *see also* OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMM'N, THE EFFECTS OF POISON PILLS ON THE WEALTH OF TARGET SHAREHOLDERS 6 (Oct. 23, 1986) [hereinafter POISON PILL EFFECTS] (stating that "[i]f the pill is 'swallowed' it is designed to economically 'poison' the acquiror"); OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMM'N, THE ECONOMICS OF POISON PILLS (March 5, 1986) [hereinafter POISON PILL ECONOMICS]; *New Guise for Poison Pills*, 21 MERGERS & ACQUISITIONS, July-Aug. 1986, at 21.

9. 500 A.2d 1346 (Del. 1985).

10. *Id.* at 1357 (upholding the adoption of the plan on the theory that it was a legitimate

large public corporations have implemented their own versions of the shareholder rights plan.[12] Although more than 500 companies have adopted poison pill plans, the device remains controversial.[13]

Poison pill plans typically are enacted by a potential or actual target corporation's board of directors without shareholder approval[14] and are implemented through the issuance of a pro rata dividend of "purchase rights"[15] to stockholders.[16] Each right usually entitles the holder to purchase a share of stock at a specified price.[17] The rights generally may not be transferred separately from the underlying common stock and may not be exercised until the occurrence of a specified "triggering event,"[18] such as a tender offer or third-party acquisition of a certain percentage of outstanding stock.[19] Upon occurrence of the

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exercise of business judgment). Only 37 companies had poison pills in place as of the date of the *Moran* decision. *Concept Release*, *supra* note 2, at 1189.

11. Household's board adopted the plan for the purpose of preventing future hostile advances. *Moran*, 500 A.2d at 1349.

12. Herzel & Shepro, *supra* note 7, at 121 (commenting that poison pills are now the primary takeover defense of several large companies); Letter from Martin Lipton to clients of Wachtell, Lipton, Rosen & Katz (July 14, 1987) [hereinafter Lipton Letter] (relating that over 400 of the nation's largest companies had adopted shareholder purchase rights plans by mid-1987); *see also* *The Instant Recap Pill*, 22 MERGERS & ACQUISITIONS, Sept.-Oct. 1987, at 22 (poison pills adopted in the second quarter of 1987); *New Looks for Old Pills*, 22 MERGERS & ACQUISITIONS, Mar.-Apr. 1988, at 21 (naming companies implementing poison pills during the fourth quarter of 1987); *Shelter of a State Law*, 22 MERGERS & ACQUISITIONS, Jan.-Feb. 1988, at 22 (listing 15 companies adopting pills in the third quarter of 1987 and relating that poison pills continued to be the most popular antitakeover measure). The data indicates that rights plans are very popular with Fortune 500 Companies.

13. Richards, Brussard & Williams, *Rights Plans Developments and Recent Litigation*, Nat'l L.J., May 23, 1988, at 28, col. 1.

14. *See, e.g.*, CRTF Corp. v. Federated Dep't Stores, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,680, at 98,114 (S.D.N.Y. Mar. 18, 1988); *see also* 1 TAKEOVER DEFENSES, *supra* note 2, at 97-98; *Concept Release*, *supra* note 2, at 1189. The board of directors of a company with sufficiently authorized but unissued common stock can implement a poison pill plan without shareholder approval. Likewise, a company without sufficient unissued common stock, but which possesses authorized and unissued blank check preferred stock, can achieve the same result by distributing rights exercisable for a preferred stock that are formulated to be equivalent economically to the common stock. 1 TAKEOVER DEFENSES, *supra* note 2, at 97-98.

15. The rights generally have a fixed-term of existence, or exercise period that is determined by the board of directors (*e.g.*, 10 years). 1 TAKEOVER DEFENSES, *supra* note 2, at 97; Dawson, Pence & Stone, *supra* note 7, at 426. The issuance of the rights is a nontaxable activity for both shareholder and issuer. 1 A. FLEISCHER, *supra* note 7, at 64. Because the rights are "out of money," they do not dilute earnings per share or otherwise alter the company's capital structure. *Id.*

16. *See* 1 A. FLEISCHER, *supra* note 7, at 64; 1 TAKEOVER DEFENSES, *supra* note 2, at 97; Dawson, Pence & Stone, *supra* note 7, at 423.

17. *See infra* notes 43-115 and accompanying text (describing what the various rights plans entitle their holders to do upon issuance).

18. *See, e.g.*, *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118; *see also* 1 A. FLEISCHER, *supra* note 7, at 64; Dawson, Pence & Stone, *supra* note 7, at 423.

19. *See, e.g.*, *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118. The Federated plan could be triggered by: 1) the acquisition by a third person or group of 20% or more of Federated's shares; 2) a tender offer that would result in the acquiring person's owning

triggering event, the rights detach[20] and become exercisable.[21]

A poison pill plan may contain a convertible preferred stock provision,[22] a "flip-over" provision,[23] a "flip-in" provision,[24] a "back-end" or note purchase provision,[25] or a voting provision.[26] Most of these provisions allow only nonacquiring shareholders to exercise their rights.[27] By threatening a severe dilution in the investment capital, equity, or voting power of the bidder, the poison pill encourages the acquiror to negotiate the terms of a takeover with the target's board of directors.[28] The target's board also may encourage negotiation by reserving the option to redeem the rights at a nominal cost[29] at some time prior to or within a specified time following the occurrence of a triggering event.[30]

30% or more of Federated's shares; or 3) a determination by the directors tbat any person holding more than 15% was "adverse." *Id. See generally* 1 A. FLEISCHER, *supra* note 7, at 64-65; *Concept Release, supra* note 2, at 1189-90.

20. 1 TAKEOVER DEFENSES, *supra* note 2, at 98; Helman & Junewicz, *supra* note 7, at 772. In tbe case of the Federated Plan, the occurrence of a triggering event resulted in the issuance of separate rights certificates on a "distribution date." *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118.

21. At this point, the rights may be traded separately. Helman & Junewicz, *supra* note 7, at 772. As of the date of distribution, tbe Federated poison pill plan entitled the holder to purchase a share of Federated preferred stock at a disadvantageous price, thus discouraging the holder from exercising the right in such manner. However, if tbe board decided not to redeem tbe rights, the rights entitled each bolder to purchase common stock of "Federated—that is the flip-in right—or of the acquiring person—the fiip-over right—with a value twice the exercise price of the right" (*e.g.*, $500 worth of stock for the price of $250). *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118. The exercise price is intended to reflect tbe long-term value of tbe company's stock. 1 A. FLEISCHER, *supra* note 7, at 64.

22. *See infra* notes 55-69 and accompanying text.

23. *See infra* notes 70-84 and accompanying text.

24. *See infra* notes 85-95 and accompanying text.

25. *See infra* notes 96-106 and accompanying text.

26. *See infra* notes 107-119 and accompanying text.

27. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118; Dawson, Pence & Stone, *supra* note 7, at 423.

28. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,120 (recognizing tbat a poison pill "provides the directors with a shield to fend off coercive offers and with a gavel to run an auction"); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (stating that the "directors' role cbanged from defenders of tbe corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company"); *see also* Herzel & Shepro, *supra* note 7, at 131; Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986) (arguing that target managers should be viewed primarily as negotiating agents for target shareholders); Note, *Developments in the Use of the Poison Pill, supra* note 7, at 1086.

29. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118. The Federated board could redeem the rights for five cents eacb. *Id.* Federated argued that its refusal to redeem the rights prevented CRTF from utilizing coercive techniques such as a "street sweep" or a "front-end loaded offer," wbich would have resulted in damage to sharebolder welfare. *Id.* at 98,120; *see also* Oesterle, *supra* note 28, at 121 & n.19; Comment, *Poison Pill Discrimination, supra* note 7, at 1069 & n.17.

30. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118; *see also* 1 A. FLEISCHER, *supra* note 7, at 65 (indicating tbat the extent to which the rights are redeemable

This Note analyzes the theories that have been used by various courts to evaluate the legal and economic validity of poison pills. Part II describes the different types of shareholder rights plans that have been utilized by corporations, detailing the objectives, tbe effects, and the risks of the plans. Part III examines the validity of poison pill plans under state corporate law, focusing on poison pill plans that disallow acquiring shareholders to exercise their rights. Part IV considers the capacity of a board of directors to issue poison pill plans under state fiduciary law and discusses the factors that should be considered by a board when issuing a shareholder rights plan. Finally, Part V concludes that courts should give primacy to the effect of the plans on shareholder wealth maximization, but should consider all relevant factors in determining the validity of the plans under a modified business judgment rule.

II. Shareholder Rights Plans

A. *The Objectives*

Most boards of directors have adopted poison pill plans[31] in response to the dramatic rise in highly leveraged[32] and speculative takeovers[33] during the 1980s.[34] Poison pills are designed to provide a target

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after a triggering event is dictated by strategic factors and legal judgment); 1 TAKEOVER DEFENSES, *supra* note 2, at 99 (stating that the redemption feature "is designed to permit a negotiated merger or a white knight transaction even after a hostile tender offer has been commenced").

31. Poison pill plans typically are adopted without the approval of the corporation's stockholders. *See Concept Release, supra* note 2, at 1189; 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).

32. The proliferation of "junk" bonds has increased takeovers because junk bonds can be issued with very little equity backing. Junk bonds are typically high yielding, below investment grade bonds or preferred stocks that frequently have variable rates of exchangeability options coupled with detachable warrants or other equity "kickers." To counter the increased vulnerability of corporations to takeovers, boards of directors bave adopted defensive tactics such as poison pills. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 4-8.

33. A number of states, including Indiana, have passed antitakeover statutes to deter the speculative takeover bidder. *See, e.g.,* HAW. REV. STAT. §§ 416-171 to 416-172 (1985); IND. CODE ANN. §§ 23-1-42-1 to 23-1-42-11 (Burns Supp. 1988); MO. ANN. STAT. § 351.407 (Vernon Supp. 1987); OHIO REV. CODE ANN. § 1701.83.1 (Anderson 1985 & Supp. 1986); WIS. STAT. ANN. § 180.25(9) (West Supp. 1987); *see also* Act of July 22, 1987, ch. 3, § 2, 1987 Ariz. Legis. Serv. 32, 38-41 (West) (to be codified at ARIZ. REV. STAT. ANN. §§ 10-1211 to 10-1217); Act of July 21, 1987, ch. 272, 1987 Mass. Adv. Legis. Serv. 200 (Law. Co-op.) (to be codified at MASS. GEN. L. ch. 110D, §§ 1-8, cb. 110E, §§ 1-7); Act of June 25, 1987, ch. 1, § 24, 1987 Miun. Sess. Law Serv. 911, 928-35 (West) (to be codified at MINN. STAT. ANN. § 302A.671). Delaware also recently adopted an antitakeover statute. For a copy of the text of the Delaware takeover bill, see *Delaware Takeover Bill (HB396), As Passed by the Legislature and Signed by the Governor,* 20 Sec. Reg. & L. Rep. (BNA) No. 5, at 209-211 (Feb. 5, 1988).

Indiana's "control share acquisition" statute was upheld recently by the United States Supreme Court in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69 (1987). For a tborough corporation's board of directors with the negotiating power necessary to respond to a variety of coercive or abusive acquisition techniques.[35] In particular, some poison pill provisions protect shareholders against partial[36] and front-end loaded, two-tiered bids[37] by establishing a mechanism[38] which ensures that the shareholders of the target receive a "fair"

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discussion and analysis of the *CTS* case, see Langevoort, *The Supreme Court and the Politics of Corporate Takeovers: A Comment on* CTS Corp. v. Dynamics Corp. of America, 101 HARV. L. REV. 96 (1987) (criticizing the Court for failing to consider the difficult problems posed by takeover regulation).

34. *See supra* notes 1-2 and accompanying text; *see also* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 727 (1982) (discussing the effects of partial and two-tier tender offers on the control of a corporation); Lipton, *Corporate Governance, supra* note 5, at 3-11 (discussing the stages of corporate development in the U.S. and the role that institutional investors and tax and accounting developments have played in causing the current takeover boom).

35. *See supra* note 5 and accompanying text; *see also* Finklestein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Priced Mandatory Bid and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291 (1984) (noting the rise in partial and two-tier tender offers and concluding that carefully drafted fair price, mandatory bid, and flip-over provisions can be valid defenses to these takeover devices). Certain poison pill features are more effective when adopted in advance of a takeover attempt (*e.g.*, flip-over and flip-in provisions), while others are more appropriate if enacted in response to a specific takeover attempt (*e.g.*, note purchase and voting provisions).

36. A partial tender is an offer by an acquiror to purchase a controlling but less than 100% interest in a target. Partial tender offers permit a bidder to commence takeover bids for larger entities because a bidder only needs to obtain financing for the acquisition of the controlling interest. *See* Cities Serv. Co. v. Mesa Petroleum Co., 541 F. Supp. 1220 (D. Del. 1982). Because a partial tender offer allows an acquiror to obtain control of a target and engage in a squeeze-out merger or in self-dealing, minority shareholders are under pressure to sell their shares to avoid being locked into a dangerous position. *See* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 631 (D. Md. 1982); Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982); *see also* Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695, 1710-13 (1985); Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974); Finklestein, *supra* note 35, at 293; Lipton, *Corporate Governance, supra* note 5, at 17-18; Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307-08 (1983); Note, *"Poison Pill" Preferred, supra* note 7, at 1966.

37. In a front-end loaded, two-tiered offer the acquiror makes a cash tender offer for a controlling interest in the target and, at the same time, announces the intention that upon gaining control of the company, the target will be merged into itself at a lower second-tier price. The difference in prices unfairly pressures target shareholders. The coercive nature of two-tiered tender offers is recoguized widely. *See, e.g., Martin Marietta Corp.*, 549 F. Supp. at 630 (stating that "[i]f the [tender] offer is in fact 'coercive,' it would only be because its two-tier structure is revealed"); *Radol*, 534 F. Supp. at 1312 (commenting that a two-tiered tender offer is inherently coercive); *see also* Finklestein, *supra* note 35, at 293 (stating that two-tier tender offers "put pressure on shareholders to tender their shares to avoid being frozen out for lesser consideration in the second-step transaction" (footnote omitted)); Lipton, *Corporate Governance, supra* note 5, at 18-19 (observing that "[t]he two-tiered tender offer . . . gives the raider a mechanism for forcing target shareholders to tender because the squeeze-out merger is an announced part of the deal"); Lowenstein, *supra* note 36, at 308 (noting that "[t]he two-tier pricing structure was concededly intended . . . to coerce shareholders into tendering at the first stage"); Note, *"Poison Pill" Preferred, supra* note 7, at 1966 (observing that the two-tier tender offer "maximizes the coercion inherent in the tender offer process").

38. Most plans are triggered either by the acquisition of a specified percentage (*e.g.*, 20%) of shares by one entity, or by a tender offer for a specified percentage (*e.g.*, 30%) of shares. *See*

price[39] for their stock.[40] Directors also might implement a poison pill to deter a "bootstrap" or "bust-up" acquisition[41] and to preclude a large shareholder from engaging in a self-dealing transaction.[42] Most importantly, a poison pill may encourage a prospective raider to negotiate with the target[43] and, thus, ensure an orderly auction of the target corporation for a fair price.[44]

CRTF Corp., [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118. Upon the occurrence of a triggering event, the economic aspects of the rights plans allow shareholders either to redeem their rights for cash or securities, to purchase shares of stock in the acquiror or target at a substantial discount, or to exchange their rights for stock with increased voting privileges. *See infra* notes 45-119 and accompanying text.

39. In the case of a partial tender offer, a fair price is a price that is equal to or higher than that paid in the partial offer. For a front-end loaded, two-tiered bid, it is a price for the second step of the transaction that is equal to or higher than the price paid in the first step of the transaction. *See* Dawson, Pence & Stone, *supra* note 7, at 425.

40. Poison pill plans with flip-over, note purchase, or convertible preferred stock provisions deter front-end loaded, two-tiered takeovers. *See infra* notes 55-106 and accompanying text. Flip-in provisions, as well as note purchase and convertible stock plans, deter partial tender offers. *See infra* notes 55-69, 96-106 and accompanying text.

41. A bootstrap or bust-up bid is used by an acquiror which is interested in acquiring only certain assets or businesses of a target. The acquiror, which may have limited financial resources, will join with other parties interested in other assets of the target and make a joint bid with a view towards dividing up the target after gaining control. *See* M. LIPTON & E. STEINBERGER, *supra* note 1, § 104[8].

42. Examples of self-dealing include: reducing dividends; selling assets to affiliates on terms less favorable than the target could have obtained in arm's length negotiations; increasing compensation levels for the acquiror; and recapitalizing or reclassifying the target's stock to increase the proportionate interest of the acquiror. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 99-100; Dawson, Pence & Stone, *supra* note 7, at 428.

43. *See* Edelman v. Fruehauf Corp., 798 F.2d 882 (6th Cir. 1986); *see also* 1 TAKEOVER DEFENSES, *supra* note 2, at 100; Herzel & Shepro, *supra* note 7, at 131.

44. *See CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,120; Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); *see also* Dawson, Pence & Stone, *supra* note 7, at 425; Herzel & Shepro, *supra* note 7, at 129-31. A number of states have enacted statutes functionally similar to the shareholder rights plan in that they inhibit second-step mergers designed to give the raider control of the target's assets. These statutes prevent a 10% shareholder from effecting a business combination with a target for five years following the 10% acquisition, unless the combination is approved hy the target's board prior to acquisition of the 10% stake. See IND. CODE ANN. § 23-1-43-18 (West. Supp. 1987); KY. REV. STAT. ANN. § 271A.397(3) (Michie/Bobbs-Merrill Supp. 1986); MO. ANN. STAT. § 351.459 (Vernon Supp. 1987); N.J. STAT. ANN. § 14A:10A-4 (West Supp. 1987); N.Y. BUS. CORP. LAW § 912(17)(b) (McKinney 1986); *see also* Act of July 22, 1987, ch. 3, § 2, 1987 Ariz. Legis. Serv. 32, 44-44 (West) (to he codified at ARIZ. REV. STAT. ANN. § 10-1221 to 10-1223); Act of June 25, 1987, ch. 1, § 25, 1987 Minn. Sess. Law Serv. 911, 936-45 (West) (to be codified at MINN. STAT. ANN. § 302A.673); Act of Aug. 10, 1987, ch. 4, § 4, 1987 Wash. Legis. Serv. 10, 19-20 (West); Act of Sept. 17, 1987, 1987 Wis. Laws 45 (to be codified at WIS. STAT. §§ 180.725 to 180.726 (setting time limit at three years rather than five)).

B. The Types

Five basic versions of poison pills[45] have been introduced since the early 1980s:[46] (1) convertible preferred stock dividend plans;[47] (2) flip-over plans;[48] (3) flip-in plans;[49] (4) back-end[50] or note purchase plans;[51] and (5) voting plans.[52] Corporations have used various combinations of

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45. Very similar to poison pills, "poison" securities are becoming an increasingly popular takeover defense. *See* Clemens, *Creating Financial Perils for Hostile Acquirors*, 22 MERGERS & ACQUISITIONS, Nov.-Dec. 1987, at 27 (discussing "poison preferred" and "poison debt"); *The Debt Repellent*, 22 MERGERS & ACQUISITIONS, Jul.-Aug. 1987, at 21-22 (noting companies implementing poison put options).

46. Dawson, Pence & Stone, *supra* note 7, at 424. *See generally* 1 A. FLEISCHER, *supra* note 7, at 54-92; 1 TAKEOVER DEFENSES, *supra* note 2, at 95-122; Veasey, Finklestein & Abrams, *Selected Tactics in Control Contests: Poison Pills, Lock-Ups, Stockholder Consents and Other Defenses; Application of the Business Judgment Rule and Allocating the Burden of Proof*, in 3 DYNAMICS OF CORPORATE CONTROL III 77-96 (1986) [hereinafter *Selected Tactics in Control Contests*].

47. *See* 1 A. FLEISCHER, *supra* note 7, at 55-64; Note, *"Poison Pill" Preferred*, *supra* note 7, at 1964-65 & nn.2-3. In Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979), the Delaware Chancery Court enjoined an early attempt to issue poison pill preferred stock as a defensive device, holding that the directors lacked authority to issue a preferred stock that would deprive common stockholders of their pre-existing right to approve mergers by a majority vote. Four years later, in National Education Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Aug. 25, 1983), the Delaware Chancery Court considered a more sophisticated pill and refused to enjoin its issuance. *See also* 1 TAKEOVER DEFENSES, *supra* note 2, at 95-96; *Selected Tactics in Control Contests*, *supra* note 46, at 87.

48. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 96-101; Dawson, Pence & Stone, *supra* note 7, at 426-28; *Selected Tactics in Control Contests*, *supra* note 46, at 83-85. In *Moran* the Delaware Supreme Court upheld the validity of a flip-over pill. *Id.* at 1357; *see also* 1 A. Fleischer, *supra* note 7, at 64-69; POISON PILL ECONOMICS, *supra* note 8, at 4-5.

49. *See* 1 A. FLEISCHER, *supra* note 7, at 71-92; Dawson, Pence & Stone, *supra* note 7, at 428; Herzel & Shepro, *supra* note 7, at 121-29. Flip-in plans have met some opposition in the courts. *See* Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1229 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir. 1987); R.D. Smith & Co. v. Preway, Inc., 644 F. Supp. 868 (W.D. Wis. 1986); Dynamics Corp. of America v. CTS Corp., 637 F. Supp. 406 (N.D. Ill. 1986), *aff'd*, 794 F.2d 250 (7th Cir. 1986). *But see CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,122-23; Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

50. "Back-end" or "fair market rights plans" more commonly are referred to as note purchase rights plans.

51. *See* 1 A. FLEISCHER, *supra* note 7, at 70-71; POISON PILL ECONOMICS, *supra* note 8, at 6; 1 TAKEOVER DEFENSES, *supra* note 2, at 101-02; Dawson, Pence & Stone, *supra* note 7, at 428-29; *Selected Tactics in Control Contests*, *supra* note 46, at 87-89. Courts have enjoined the use of note purchase plans in at least three cases. *See Edelman*, 798 F.2d at 882; Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985); *Revlon*, 506 A.2d at 173.

52. *See* 1 A. FLEISCHER, *supra* note 7, at 61-64; POISON PILL ECONOMICS, *supra* note 8, at 7; 1 TAKEOVER DEFENSES, *supra* note 2, at 124-26; Dawson, Pence & Stone, *supra* note 7, at 430-31; *Selected Tactics in Control Contests*, *supra* note 46, at 90-96. The courts and the SEC have given super-voting provisions a cold reception. *See Minstar*, 621 F. Supp. at 1257-59 (declaring the plan unlawful under New Jersey law); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 409-10 (S.D.N.Y. 1985) (preferred stock unlawful under Delaware corporate law); ASARCO Inc. v. M.R.H. Holmes A. Court, 611 F. Supp. 468 (D.N.J. 1985) (special voting rights not permitted by the New Jersey Business Corporation Act); Packer v. Yampol, No. 18432 (Del. Ch. April 8, 1986) (granting a preliminary injunction against a super-voting preferred stock on

these different poison pill provisions in defending against hostile acquisitions.[53] The newest poison pill plans include both a flip-over and a flip-in provision.[54]

The convertible preferred stock dividend plan, or "poison pill preferred,"[55] is the precursor of all poison pill plans.[56] Issued as a pro rata dividend to all holders of a target company's common stock,[57] the preferred stock possesses special redemption and conversion privileges that are designed to ensure that shareholders receive a fair price for their shares[58] and to allow the holders to retain their interest in the target following a takeover.[59] At a specified time[60] following a bidder's acquisition of control of the target company,[61] the preferred holders are entitled to redeem their shares for a "fair price" as determined by the plan.[62] Alternatively, in the event of a substantial stock acquisition[63] followed by a second-step merger,[64] the preferred stock of the target can be exchanged for an equivalent amount of voting stock of the acquiror.[65] Consequently, these two provisions deter acquisition by either

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fiduciary rather than statutory grounds).

53. *See supra* note 12 and accompanying text.

54. *See, e.g., CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118-19; Dawson, Pence & Stone, *supra* note 7, at 428; *New Looks for Old Pills, supra* note 12, at 21; *Shelter of State Law, supra* note 12, at 22; Lipton Letter, *supra* note 12, at 2-3.

55. *See* Note, *"Poison Pill" Preferred, supra* note 7, at 1964-65.

56. 1 TAKEOVER DEFENSES, *supra* note 2, at 95. This plan was used in 1982 and 1983 by several target companies facing a tender offer or a stock accumulation to protect shareholders from partial and front-end loaded, two-tier offers.

57. *Selected Tactics in Control Contests, supra* note 46, at 78.

58. 1 TAKEOVER DEFENSES, *supra* note 2, at 95.

59. Dawson, Pence & Stone, *supra* note 7, at 430; Note, *"Poison Pill" Preferred, supra* note 7, at 1968.

60. The specified period is typically 30 days. *See* Dawson, Pence & Stone, *supra* note 7, at 429.

61. A number of other triggering events may be specified in the plan, such as acquisition of 30% or more of the target's voting power.

62. The redemption privilege attached to the stock is designed to discourage the making of a particular tender offer by giving the shareholders of the target the power to deplete substantially the target company's assets. *See* Note, *"Poison Pill" Preferred, supra* note 7, at 1967. The redemption price is determined through a formula provided in the shareholder rights plan, which may reflect the average price for the issuer's common stock over a specified period of time (*e.g.*, the previous 12 months) or the highest price paid by the bidder for a share of the target's stock. Dawson, Pence & Stone, *supra* note 7, at 430. However, exercise of this redemption right may be suspended for 120 days. *Id.*; 1 TAKEOVER DEFENSES, *supra* note 2, at 96.

63. Typically the acquisition of 30% or more of a company's outstanding stock is deemed substantial. 1 TAKEOVER DEFENSES, *supra* note 2, at 96.

64. *See supra* notes 36-37 and accompanying text.

65. The conversion privilege discourages two-tiered tender offers by equalizing the prices of the tiers. *See* Note, *"Poison Pill" Preferred, supra* note 7, at 1967; *see also* Dawson, Pence & Stone, *supra* note 7, at 430. The conversion rights "flip-over," with the substitute preferred stock being convertible into the common stock of the acquiror. The market value at time of conversion is equal to not less than the highest price paid by the acquiror for shares of the target during the last

depleting the target's assets,[66] or diluting the value of acquiror's stock.[67] Although few preferred stock dividend plans have been adopted since 1983,[68] these plans form the theoretical basis for the newer pills.[69]

Flip-over plans became popular[70] following the decision of the Delaware Supreme Court in *Moran*. The flip-over provision is designed to encourage an acquiror to negotiate with the board of directors of the target company[71] rather than proceeding with a hostile acquisition.[72] Under a flip-over plan corporations typically distribute to their common stockholders a pro rata dividend consisting of a right to purchase stock.[73] Prior to the occurrence of a triggering event, the right is subject to redemption by the board of directors[74] and can neither be exercised nor transferred separately.[75] Once a triggering event such as the acqui-

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twelve months. 1 TAKEOVER DEFENSES, *supra* note 2, at 96.

66. If a bidder acquires a significant ownership of the target's stock but no business combination is consummated, the target's assets are depleted by the payment to stockholders of the issuer's "fair value" through redemption of the preferred stock.

67. If a business combination is consummated, the acquiror's stock is diluted through the conversion of the preferred stock of the target into the voting stock of the acquiror. The redemption and conversion options neutralize the coercive effects of partial and two-tier tender offers by allowing the shareholders to decline to tender their shares yet still receive the tender offer price in cash or its equivalent if the tender offer succeeds. Note, *"Poison Pill" Preferred*, *supra* note 7, at 1967.

68. *See* POISON PILL ECONOMICS, *supra* note 8, at 4. The three or four companies known to have adopted these plans eventually were taken over, and no companies are reported to have adopted any form of these plans since 1983. *Id.*

69. The redemption and conversion features show up in the subsequent plans and are analogous to a "flip-in" and a "flip-over" plan respectively. *See supra* note 56 and accompanying text.

70. *See supra* notes 9-12 and accompanying text.

71. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 96; *infra* note 280 and accompanying text.

72. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 96; *supra* note 5 and accompanying text.

73. *See* 1 A. FLEISCHER, *supra* note 7, at 64; 1 TAKEOVER DEFENSES, *supra* note 2, at 97; Dawson, Pence & Stone, *supra* note 7, at 426; *Selected Tactics in Control Contests*, *supra* note 44, at 80. The duration, or exercise period, of the rights is a period of time (usually between three and ten years) that is determined by the board. The board fixes the exercise price of the rights at a figure that approximates the value of the stock at the end of the exercise period (a figure that is typically two or more times the current market value of the stock). Because the exercise price is "out of money," the rights do not dilute the company's earnings per share when they are issued and may not have any negative impact on the market price of the company's common stock. *See* sources cited *supra*.

74. Typically, the rights are redeemable by the board of directors for a nominal price prior to, or within a short time following, the occurrence of a triggering event. Dawson, Pence & Stone, *supra* note 7, at 426. This feature is designed to permit a negotiated merger or a white knight transaction even after a hostile tender offer has been commenced. 1 TAKEOVER DEFENSES, *supra* note 2, at 99.

75. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118. Initially, the rights are transferrable only with the common stock and are not exercisable. *Id.* Under the Federated plan, as of the distribution date a holder of a right could buy a share of Federated preferred stock at a "very disadvantageous price." *Id.* This feature discouraged the shareholder from using the right to purchase preferred stock. This Federated stock could be redeemed by the board at a price of 5 cents each. *Id.*

sition of a specified amount of the company's stock by one entity[76] or the commencement of a tender offer[77] occurs,[78] however, the issuer distributes certificates evidencing the rights to the shareholders.[79] At that time, the rights become exercisable, tradable,[80] and sometimes nonredeemable.[81] If the acquiror triggers the plan and then proceeds with a merger or similar business combination transaction,[82] the flip-over provision entitles each rights holder to purchase the acquiror's common stock at a substantial discount.[83] Because the flip-over provision does not operate unless the bidder attempts to acquire all the target company's common stock by a merger or by some other type of business combination, flip-over pills do not prevent all-cash tender offers for all of the target's shares, or open-market purchases of a controlling interest in the target.[84]

To fill this gap, corporations have added flip-in provisions to their flip-over plans.[85] Flip-in provisions enable common stockholders other than the acquiror[86] to purchase shares of stock of the target company at a bargain price[87] following certain self-dealing transactions[88] or trigger-

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76. The threshold under the Federated rights plan was 20% of the company's stock. *Id. see also* Dawson, Pence & Stone, *supra* note 7, at 426.

77. Under the Federated Plan, the commencement of a tender offer for 30% of the company's stock was viewed as a triggering event. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118.

78. The Federated plan also regarded the acquisition of 15% of the company's stock by an adverse person as a triggering event. *Id.*

79. Ten business days after the occurrence of one of the triggering events, separate rights certificates were to be issued under the Federated plan. *Id.*; *see also* Dawson, Pence & Stone, *supra* note 7, at 427.

80. Dawson, Pence & Stone, *supra* note 7, at 427, *Selected Tactics in Control Contests*, *supra* note 46, at 80.

81. Dawson, Pence & Stone, *supra* note 7, at 427; *Selected Tactics in Control Contests*, *supra* note 46, at 81. *But see CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118 (Federated rights could be redeemed even after the triggering event).

82. 1 A. FLEISCHER, *supra* note 7, at 65; 1 TAKEOVER DEFENSES, *supra* note 2, at 98.

83. The Federated flip-over provision entitled the rights holder to purchase common stock of the acquiror with a value two times the exercise price of the right (*i.e.* $500 worth of stock for an exercise price of $250, a 50% discount). *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118; *see also* 1 TAKEOVER DEFENSES, *supra* note 2, at 99; Dawson, Pence & Stone, *supra* note 7, at 427. Because the extent of the dilution of stock depends on the number of rights outstanding prior to the merger or other business combination, the potential dilution resulting from the right to purchase the acquiror's stock at half price is obvious.

84. *See* 1 A. FLEISCHER, *supra* note 7, at 69; 1 TAKEOVER DEFENSES, *supra* note 2, at 97; Herzel & Shepro, *supra* note 7, at 122. Sir James Goldsmith used a creeping acquisition strategy to avoid the flip-over rights and to take control of Crown Zellerbach. Goldsmith acquired over 50% of Crown Zellerbach's shares on the open market and took control of the board of directors. POISON PILL ECONOMICS, *supra* note 8, at 5 & n.2.

85. *See* Herzel & Shepro, *supra* note 7, at 122.

86. This disparate treatment among shareholders is what has prompted several courts considering the flip-in provisions to find unlawful discrimination. *See supra* note 49.

87. Under the Federated plan, common stockholders could purchase shares at a 50% dis-

ing events.[89] The purpose of flip-in provisions is to ensure that target shareholders are not pressured into selling their shares for fear of the acquiror utilizing coercive tactics or proceeding with a squeeze-out merger.[90] Flip-in provisions also encourage acquirors to negotiate[91] with the target company's board of directors during a takeover contest to avoid dilution in the value of the target's shares.[92] Recently, corporations have begun to strengthen their flip-in pills by increasing the exercise price of the rights,[93] lowering the acquisition threshold,[94] and eliminating the "window period" before the rights become nonredeemable.[95]

Back-end or note purchase plans[96] involve the issuance of rights[97] to common shareholders that allow the shareholders other than the ac-

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count. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,118.

88. Herzel & Shepro, *supra* note 7, at 122 n.21. Herzel and Shepro have identified self-dealing transactions by an acquiror that create flip-in rights as including:

> (1) mergers of the [acquiror] or an affiliate into the target, where the other stockholders are not squeezed out; (2) transfers of assets to the target for target stock; (3) sales, purchases, or pledges to, from, or with the target of any assets; (4) receipt of employment compensation from the target; (5) receipt of loans from the target; and (6) reclassifications, such as reverse stock splits, that increase the [acquiror]'s percentage holdings.

Id.; *see also* Dawson, Pence & Stone, *supra* note 7, at 428.

89. The same triggering events that applied to Federated's flip-over provision applied to its flip-in provision. *See supra* notes 76-78 and accompanying text.

90. 1 TAKEOVER DEFENSES, *supra* note 2, at 122.

91. *See supra* note 28 and accompanying text.

92. In a letter to the firm's corporate clients, dated July 14, 1987, Martin Lipton suggested a revised flip-in provision that would be triggered at a 20% acquisition threshold. Lipton Letter, *supra* note 12, at 2. The 20% threshold is designed to prevent a raider from sweeping the street or otherwise acquiring control through market purchases or a partial tender offer. *Id.* The new plan also provides for a shareholder vote if a nonabusive takeover is proposed. *Id.* at 3. If a bidder who does not hold more than 1% of the shares of the target proposes to acquire all of the shares of the target for cash at a fair price and has financing commitments for its bid, the company must, at the bidder's request, hold a special shareholders' meeting to vote on a resolution requesting the target's board to accept the bidder's proposal. *Id.* The shareholders' meeting, one half of the cost of which must be paid by the acquiror, would be held within 90-120 days after the bidder's request. *Id.* at 5. If a majority of the owners of the outstanding shares of the company approves the bidder's resolutions the pill would be redeemed and the bidder and the target could either enter into a merger agreement or the bidder could make a bid for 100% of the company. *Id.*

93. Increasing the exercise price of the rights has the effect of making the rights plan more dilutive to prospective acquirors and reduces the risk that an acquiror would be willing to "swallow the pill."

94. Lowering the acquisition threshold to 10% is designed to deter open market purchases and street sweeps. The effect is to require prospective acquirors to compete by means of a tender offer, which requires equal treatment of shareholders and full disclosure.

95. Richards, Brussard & Williams, *supra* note 13, at 29, col. 1. Eliminating the 10-day window period prevents an acquiror from quickly gaining a large position in the stock of the target and forcing the board of directors to redeem the rights.

96. *See supra* notes 50-51. While flip-over plans focus on the second step in an acquisition and typically provide protection only in the event of a second-step transaction, note purchase plans provide protection even if there is no second step.

97. The rights typically are issued as a pro-rata dividend.

quiror to "put"[98] their stock to the issuer for a specified package of securities[99] following the occurrence of certain triggering events.[100] The effect of the back-end plan, if the takeover is successful, is to require the acquiring company to buy out the remaining shareholders at a price established by the target's management.[101] Because back-end pills, when triggered, involve an exchange offer that is not open to all shareholders, they are similar in financial effect to discriminatory self-tender offers[102] and, thus, may be illegal[103] under the Securities Exchange Act of 1934.[104] Although note purchase right plans may provide valuable protection to shareholders when adopted in response to a partial or two-tiered tender offer,[105] they are not favored currently by corporations because of their suspect legal status.[106]

In contrast to the economic rights plans, voting rights plans involve the issuance of securities[107] with special voting powers to all of the target company's common shareholders.[108] In one version of the voting rights plan, the target issues preferred stock[109] that grants supervoting

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98. Note purchase plans are sometimes called "put" pills. Put pills usually are issued in the context of a specific, unsolicited bid. *See* 1 A. FLEISCHER, *supra* note 7, at 70; 1 TAKEOVER DEFENSES, *supra* note 2, at 101.

99. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 102. A package of "securities may contain provisions designed to make a bidder's financing more difficult or unobtainable, such as restrictions upon incurrence of debts sales of assets and maintenance of certain financial ratios." *Id.* The value of the securities package in the note purchase plan may be intended to reflect the high end of the long-term, realizable value of the issuer over the duration of the plan, or to reflect the present minimum "fair value" of the issuer. Dawson, Pence & Stone, *supra* note 7, at 429.

100. Typically, the acquisition of 30% to 50% of the issuer's capital stock will be treated as a triggering event. POISON PILL ECONOMICS, *supra* note 8, at 6.

101. The effect of these plans is to deter, or effectively to reject, partial tender offers, front-end loaded, two-tiered acquisitions, and certain open market purchases and to establish a minimum price for nonnegotiated takeovers. Dawson, Pence & Stone, *supra* note 7, at 429.

102. *See* 1 A. FLEISCHER, *supra* note 7, at 70-71; Herzel & Shepro, *supra* note 7, at 118-21.

103. *See* 1 A. FLEISCHER, *supra* note 7, at 71. Reacting "to Unocal's exclusionary self-tender offer in response to Mesa Petroleum's takeover threat, the SEC proposed a rule requiring self-tenders to be open to all of an issuer's stockholders." *Id.* The "all-holders" rule is now effective. *See* 17 C.F.R. § 240.14(d)(10)(a)(1) (1986).

104. *See* 1 A. FLEISCHER, *supra* note 7, at 71. Fleischer has noted:

> The SEC staff has indicated in "no action" letters that, under certain circumstances, it may view the operation of a put right as a transaction subject to the self tender rules; in the case of the Allied Stores put pill, the SEC advised the district court that the terms of that put pill were subject to the all-holders rule.

Id.

105. *See supra* note 101 and accompanying text.

106. The courts also have not reacted favorably to note purchase plans. *See* cases cited *supra* note 51.

107. The securities may be supervoting common stock or multiple or scaled voting preferred stock. *See Selected Tactics in Control Contents*, *supra* note 46, at 90-91.

108. *See* POISON PILL ECONOMICS, *supra* note 8, at 7; Dawson, Pence & Stone, *supra* note 7, at 430.

109. *See* Dawson, Pence & Stoue, *supra* note 7, at 430.

privileges[110] to all shareholders, except for the acquiror,[111] upon the occurrence of a triggering event.[112] Under another version, the target in response to a tender offer[113] issues preferred stock[114] that confers voting rights which increase with the holding period of the stock,[115] preventing those shareholders who sell their stock to the bidder from transferring full voting power.[116] Both of these versions result in a severe dilution of the voting power of the acquiror seeking control.[117] Several courts interpreting state law,[118] however, have invalidated these voting plans on the basis of discrimination.[119]

C. *The Validity Debate*

Proponents of poison pill plans[120] argue that shareholder rights plans give a target corporation's board of directors the power to protect shareholders from the potentially coercive tactics of a hostile bidder.[121] In addition to discouraging front-end loaded and partial tender of-

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110. *See* ASARCO Inc. v. M.R.H. Holmes A. Court, 611 F. Supp. 468, 471 (D.N.J. 1985). Each share of the new preferred stock was to be entitled to 50 votes on all matters submitted to shareholders. However, once any person owned more than 20% of ASARCO's common stock or the new preferred stock, any preferred shares owned by the 20% holder were stripped of all voting rights. *Id.*

111. This is the discriminatory feature of the voting provisions.

112. In *ASARCO* the acquisition threshold was 20%. *ASARCO*, 611 F. Supp. at 471.

113. *See* Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 408 (S.D.N.Y. 1985).

114. *Id.* The new series of preferred stock was proposed to be issued in a ratio of one share for every five shares of common stock. *Id.*

115. *Id.* Tbe preferred shares were to have been convertible at any time into five shares of common stock and were to have five votes per share. However, if the preferred shares were owned by the same person since the time of their original issuance, or for a continuous period of more than 36 months, that holder would have had 25 votes per share. *Id.*

116. *Id.* Those persons who decided to sell their shares pursuant to the Unilever offer only could sell diminished voting rights, and those who decided to retain their shares retained greater voting rights. *Id.*

117. Dawson, Pence & Stone, *supra* note 7, at 430-31.

118. *See* cases cited *supra* note 51.

119. POISON PILL ECONOMICS, *supra* note 8, at 7.

120. Poison pill plans are supported widely by a large number of the Fortune 500 companies. *See supra* note 12; *see also* Brownstein, *Rights Plans: Still the Most Effective Defense*, 1 INSIGHTS, July 1987, at 9, 9 & n.3. The Brownstein article cites data compiled by Wachtell, Lipton, Rosen & Katz, through April 2, 1987, that indicates adoption of poison pills by 38% of the Fortune 100 companies, 40% of the Fortune 200 companies, and over 32% of the Fortune 500 companies. *Id.* The most notable and prolific of the plans' supporters is Martin Lipton, a partner with the New York law firm of Wachtell, Lipton, Rosen & Katz. Lipton is credited with inventing the shareholder rights plan.

121. *See Moran*, 500 A.2d at 1349 (Lipton discussing the frequency of "bust-up" takeovers as a justification for the adoption of a pill); *see also* Dynamics Corp. of America v. CTS Corp., 635 F. Supp. 1174, 1178 (N.D. Ill. 1986) (discussing the "threat" or "evil" posed by squeeze out mergers); *supra* notes 35-44 and accompanying text.

fers,[122] the pills deter large shareholders from engaging in self-dealing transactions.[123] Supporters of the shareholder rights plans also contend that the plans force an acquiror to negotiate the terms of a business combination with the target's board.[124] Moreover, some commentators argue that the pills furnish target directors and management with the bargaining power necessary to force raiders to pay substantially higher premiums for the target's stock.[125] Empirical studies confirm the proponents' belief that poison pills enacted by directors help maximize shareholder wealth in hostile bidding contests.[126] Without the pills, the

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122. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 99-100; *supra* notes 36-37 and accompanying text.

123. *See supra* note 42 and accompanying text.

124. The commentators note the effect of a poison pill on the negotiating power of a target's board of directors. They observe that poison pills create substantial uncertainty in the pricing of a tender offer and a nonnegotiated business combination; provide bargaining power to the issuer's directors by making a nonnegotiated acquisition extremely difficult and expensive; and delay a nonnegotiated potential bid, thus permitting the target's board to negotiate a better deal, to seek out a white knight, or to put together a higher bid sponsored by management. *See supra* notes 28, 43-44 and accompanying text; *see also* Dawson, Pence & Stone, *supra* note 7, at 431-32.

125. Lee, *"Poison Pills" Benefit Shareholders by Forcing Raiders to Pay More for Targets, Study Says*, Wall St. J., Mar. 31, 1988, at 55, col. 2, 3 (quoting Martin Lipton in stating that "[t]he study confirms that the pill 'is the most effective way to equalize the negotiating strength of management with the overwhelming advantage that the corporate raider has' "); *see also* Baysinger & Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257, 1300 (1985) (stating that antitakeover measures may allow incumbent management not only to maximize the price of a company's stock but also to reduce agency costs associated with the market for corporate control); Lipton, *Corporate Governance*, *supra* note 5, at 31 (arguing that a shareholder rights plan forces a raider to negotiate with the target's board and ensures that the raider will not abuse the tender offer process); Oesterle, *supra* note 28, at 155 (concluding that plans that are intended to delay tender offers in order to coax a better price from a bidder or to stimulate an auction should receive preferential treatment by courts); Oesterle, *Target Managers as Negotiating Agents for Target Shareholders in Tender Offers: A Reply to the Passivity Thesis*, 71 CORNELL L. REV. 53, 53 & n.4 (1985) [hereinafter Oesterle, *Target Managers*] (contending that shareholder wealth may be optimized by target management acting responsibly as bargaining agents). *See generally* R. POSNER & K. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 195-231 (1980); Herzel, Schmidt & Davis, *Why Corporate Directors have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107, 109-10 (1980) (arguing that a board through negotiation can force the offeror to raise the premium, persuade the bidder to accept more favorable terms, or seek other bidders). Indeed, directors may have a fiduciary duty to maximize the control premium for shareholders. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 893 (Del. 1985) (finding that managers violated their fiduciary duty by not soliciting alternative offers and not providing information to their stockholders).

126. Lee, *supra* note 125, at 55, col. 2. The study was conducted by New York proxy solicitor Georgeson & Co., which has helped companies defend their poison pills against shareholder challenges. Although the objectivity of Georgeson is questionable, the study showed that 27 companies with pills received final offers at an average of 78.5% above where their stock was trading six months before the takeover contests began; whereas, the 21 companies without pills averaged only a 56.7% gain. *Id.*

Adjusting for movement in the Standard & Poor's 500-stock Index, companies with pills outperformed the index by an average of 52.7%, while those without pills beat the index by an average of 31.3%. *Id.* Critics argue that the study fails to cite conclusions as to the causes of the higher premiums would not be attainable because shareholders typically are dispersed widely and unable to negotiate collectively.[127] Finally, supporters contend that shareholder rights plans are more favorable than other types of defensive tactics, such as a "scorched earth defense," because they do not result in a major structural change in the business or in the financial or earnings capacity of the target.[128]

Critics argue that defensive tactics in general, and poison pill plans in particular: (1) transfer power from stockholders to directors; (2) entrench management; (3) preclude all takeovers; and (4) decrease shareholder wealth.[129] Institutional investors and corporate raiders are the most vehement opponents of shareholder rights plans.[130] These groups complain that poison pill plans almost always are adopted by a board of directors without shareholder approval[131] and, thus, deprive shareholders the opportunity to decide if a takeover is in the best interests of a corporation.[132] Many commentators argue that in effect this transfer of

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premiums and the effects of the pills on takeovers that were never completed or initiated. *See* Lipton, *Corporate Governance*, *supra* note 5, at 31 n.132. Lipton cites a Kidder, Peabody & Co. study which found that stock prices of 75% of the companies surveyed increased following the announcement of a poison pill plan and that the companies, as a whole, outperformed the Standard & Poor's 400 Index. *Id. But see* POISON PILL EFFECTS, *supra* note 8, at 43 (concluding that "poison pills are harmful to target shareholders"); POISON PILL ECONOMICS, *supra* note 8, at 13-14 (stating that "the market considers the typical poison pill to be significantly harmful to shareholder welfare").

127. *See* Lowenstein, *supra* note 36, at 267.

128. 1 TAKEOVER DEFENSES, *supra* note 2, at 100.

129. *See* POISON PILL ECONOMICS, *supra* note 8, at 13-15; 1 TAKEOVER DEFENSES, *supra* note 2, at 100-01; *see also* Brownstein, *supra* note 120, at 9; Jarrell, Brickley & Netter, *supra* note 1, at 58-59, 63-64; Jensen, *supra* note 1, at 41-44; Note, *Developments in the Use of the Poison Pill*, *supra* note 7, at 1086-87. In 1981 Professors Frank H. Easterbrook and Daniel R. Fischel advanced the passivity thesis for takeovers which proposes that the management of a target corporation subject to a tender offer should be prohibited from resisting the offer in any manner. *See* 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, *Target Management's Role*]; *see also* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982) [hereinafter Easterbrook & Fischel, *Corporate Control*]; Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1 (1982) [hereinafter Easterbrook & Fischel, *Auctions and Sunk Costs*]; Easterbrook & Fischel, *Antitrust Suits by Targets of Tender Offers*, 80 MICH. L. REV. 1155 (1982).

130. *Institutional Investors Oppose Poison Pill Plans, IRRC Survey Shows*, 19 Sec. Reg. & L. Rep. (BNA) No. 46, at 1751-52 (Nov. 20, 1987). A study released by the Investor Responsibility Research Center indicated that 81% of the institutional investors responding to the group's annual survey supported shareholder resolutions asking companies to rescind their poison pills or put them to a shareholder vote. *Id.* at 1751.

131. *Id.*

132. Easterbrook & Fischel, *Auctions and Sunk Costs*, *supra* note 129, at 1. Professors Easterbrook and Fischel question the competence and the motives of corporate officers who defend against hostile tender offers, asserting that target managers who engage in defensive tactics rarely do so in the best interests of the shareholders. *Id. But see* Brownstein, *supra* note 120, at 9 (arguing that a policy of passivity is not consistent with the legal standards of directorial responsibility and ignores the reality that shareholders are a widely dispersed body).

power from the stockholders to the directors results in the entrenchment of the current management and board of directors.[133] Critics also contend that the severe consequences of the shareholder rights plans[134] deter all unsolicited tender offers.[135]

Opponents of the poison pill plans further argue that the plans reduce both shareholder and social welfare.[136] Professors Frank H. Easterbrook and Daniel R. Fischel contend that even if target boards defend against takeovers exclusively in the best interests of their shareholders, there is a net reduction in shareholder and social wealth because of high agency costs.[137] This view receives empirical support from

133. *See* 1 TAKEOVER DEFENSES, *supra* note 2, at 100; Easterbrook & Fischel, *Auctions and Sunk Costs, supra* note 129, at 1. In most cases, resistance reflects either mismanagement (to the extent it pointlessly denies shareholders the opportunity to obtain a premium) or manager's self-protection (to the extent its point is to preserve managers' jobs or "sell" their acquiescence in exchange for bonuses or promises of future employment). *See* Note, *Developments in the Use of the Poison Pill, supra* note 7, at 1086. *But see Moran*, 500 A.2d at 1354 (stating that "[t]here is little change in the governance structure as a result of the adoption of the Rights Plan"); Oesterle, *Target Managers, supra* note 125, at 56-73 (contending that target managers can act virtuously as bargaining agents for target shareholders).

134. *See supra* note 28 and accompanying text.

135. 1 TAKEOVER DEFENSES, *supra* note 2, at 104-05. The SEC raised the following argument in its amicus curiae brief in the *Moran* cases: "The Chancery Court's decision seriously understates the impact of this plan. In fact, as we discuss below, the Rights Plan will deter not only two-tier offers, but virtually all hostile tender offers." *Moran*, 500 A.2d at 1354. *But see* Brownstein, *supra* note 120, at 10. A study completed in April 1987 by Wachtell, Lipton, Rosen & Katz indicated that, as of that time, 42 of the companies which had adopted poison pills (amounting to over 10% of all the companies that adopted the plans) subsequently were acquired, with 17 of the 42 being acquired by the initial hostile bidder. *Id.*

136. Commentators argue that society and investors benefit from takeovers that move corporate resources from less efficient managers to those who can use the resources more efficiently. Efficiency gains are realized from business consolidations that result in greater integration of production and more effective use of information, or "synergy." Managers of tender offer targets, therefore, should not resist tender offers because takeovers allow shareholders to recognize these gains by replacing inferior management. *See* Easterbrook & Fischel, *Target Management's Role, supra* note 129, at 1164 (arguing for managerial passivity in the face of a takeover bid); Easterbrook & Fischel, *Takeover Bids, Defensive Tactics and Shareholders' Welfare*, 36 BUS. LAW. 1733 (1981); Jarrell, Brickley & Netter, *supra* note 1, at 58-59, 63-64; Jensen, *supra* note 1, at 41-44. *But see* Baysinger & Butler, *supra* note 125, at 1302; Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 104-05 (1979) [hereinafter Lipton, *Takeover Bids*] (concluding that takeover bids lower social welfare by constraining long-range planning); Lipton, *Takeover Bids in the Target's Boardroom—An Update after One Year*, 36 BUS. LAW. 1017 (1981) [hereinafter Lipton, *Takeover Bids II*] (citing judicial decisions affirming directors' actions that were reasonable in the face of takeover bids); Oesterle, *Target Managers, supra* note 125, at 94-95 (arguing that shareholder wealth can be optimized through judicial supervision of defensive tactics); *supra* note 126 and accompanying text.

137. Easterbrook & Fischel, *Auctions and Sunk Costs, supra* note 129, at 2. Professors Easterbrook and Fischel believe that premium bids encouraged by defensive devises reduce private and social gains. They state that "[t]he fact that the bid occurs at a premium over the market price indicates that revamping the target's structure of management would generate private and, in all likelihood, social gains. Resistance to the bid, if successful, frustrates the achievements of these gains." *Id.* at 1. Professors Easterbrook and Fischel also believe that auctions reduce both

a Securities and Exchange Commission study in which the Office of the Chief Economist concluded that poison pills generally are harmful to target shareholders' net.[138] Some opponents question the propriety of evaluating poison pills and other such defensive tactics under the business judgment rule.[139]

D. Current Regulation

Current federal legislation does not provide an answer to the debate.[140] Federal regulation of coercive tender offers is limited essentially to the enforcement of disclosure requirements.[141] Recently, the United States Supreme Court in *CTS Corp. v. General Dynamics Corp. of America*[142] upheld the validity of Indiana's "Control Share Acquisition" Statute[143] and acknowledged the supremacy of the states in the area of corporate governance.[144] The law of the state of incorporation, therefore, governs judicial appraisal of directors who enact defensive measures when confronted with a tender offer.

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shareholder and social welfare:

> Drawing on a theoretical argument that investors would be willing to allow acquisitions for bargain prices if that were necessary to promote outside monitoring, and on empirical work establishing that the number of tender offers falls to the extent that state laws facilitate auctioning, we conclude that auctions do not benefit investors as a group even though they may raise the price realized in particular cases. By raising the price, auctions reduce the number of acquisitions and thus the amount of monitoring. The decrease in monitoring results in higher agency costs of management and thus in lower returns on investment. On this hasis we conclude that all defensive tactics, whether or not for the purpose of triggering an auction, reduce shareholders' wealth.

Id. at 2 (footnotes omitted). *But see* Bebchuk, *The Case for Facilitating Competing Tender Offers: A Reply and Extension*, 35 STAN. L. REV. 23 (1982) (concluding that auctions increase both shareholder and social wealth); Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 868-75 (1981) [hereinafter Gilson, *The Case Against Defensive Tactics*].

138. POISON PILL EFFECTS, *supra* note 8, at 43; *see also* POISON PILL ECONOMICS, *supra* note 8, at 13-15; Jarrell & Bradley, *The Economic Effects of Federal and State Regulations of Cash Tender Offers*, 23 J. L. & ECON. 371, 398-403. *But see* Brownstein, *supra* note 120, at 10-11. Brownstein points out that the SEC's conclusion was reached only after several refinements eliminated nearly 85% of the companies in the survey sample. The SEC's analysis of the entire 245 companies in the sample found no statistically significant reduction of stock prices. *Id.* at 10.

139. *See* Easterbrook & Fischel articles cited *supra* note 129; *see also* Gilson, *The Case Against Defensive Tactics*, *supra* note 137, at 822-23; Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1910 (1983).

140. For a summary of recently proposed legislation, see *supra* note 4.

141. *See, e.g.*, Sante Fe Indus. Inc. v. Green, 430 U.S. 462 (1977) (holding that without material omissions or misstatements, merger transactions involving manipulation are beyond the purview of general federal law).

142. 107 S. Ct. 1637 (1987).

143. IND. CODE ANN. §§ 23-1-42-1 to 23-1-42-11 (Burns Supp. 1988).

144. *See* Langevoort, *supra* note 33, at 1.

Courts, interpreting state law, have devised their own standards for reviewing defensive measures like poison pill plans.[145] For example, in *Moran* the Delaware Supreme Court upheld the validity of a flip-over plan against a challenge to the plan's legality under Delaware law.[146] However, more recent poison pill cases, which prohibit discrimination among shareholders or impose strict standards of reasonableness for triggering and payout provisions, have invalidated flip-in provisions and vote purchase provisions in certain situations.[147] Today, poison pill litigation involves two major issues: (i) whether the poison pill plan unlawfully discriminates against the acquiror; and (ii) whether the adoption of the plan will be protected by the business judgment rule in view of new procedural and substantive standards established by recent decisions.[148]

III. The Validity of Poison Pills Under State Corporation Law—Discrimination

A typical shareholder rights plan provides that the common shareholders may exercise and transfer certain rights upon the occurrence of a triggering event.[149] Because acquiring shareholders commonly are excluded from the group entitled to fully exercise these rights, discriminatory treatment among shareholders results which courts may find unlawful[150] or unauthorized.[151] Interestingly, courts that have consid-

145. State courts traditionally have refused to second guess directors' actions in the tender offer context and, instead, typically apply the business judgment rule to those board decisions. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981) (business judgment rule protects board's decision to resist a takeover); *see also* Gearhart Indus. Inc. v. Smith Int'l, Inc., 741 F.2d 707, 723-24 (5th Cir. 1984) (holding that under Texas law, no liability is imposed upon a disinterested corporate director unless the act was ultra vires or fraudulent); Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979) (stating that the business judgment rule bars judicial inquiry into the actions of corporate directors taken in good faith and in furtherance of legitimate business purposes). For a definition of the business judgment rule, see *infra* note 151.

146. *Moran*, 500 A.2d at 1357.

147. *See* cases cited *supra* notes 49, 51.

148. *See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The traditional business judgment rule involved:

> a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts.

Id. (citations omitted).

149. *See supra* notes 18-21 and accompanying text.

150. *See, e.g.*, DEL. CODE ANN. tit. 8, § 212 (1983); N.H. REV. STAT. ANN. § 19A:5-10 (1969); WIS. STAT. ANN. § 180.25(i) (West Supp. 1987). *But see* Oesterle, *supra* note 28, at 131 n.58 (arguing that the real issue is whether poison pill plans benefit target shareholders, and court findings of illegal discrimination among shareholders of the same class merely cloud the basic issue).

151. This assumes the shareholders did not approve the poison pill plan. *See, e.g.*, Unilever

ered plans that discriminate among shareholders of the same class have reached different conclusions.

Recent cases interpreting New York,[152] New Jersey,[153] and Colorado[154] law have invalidated poison pills that discriminate against an acquiror. These decisions rest on the principle that at least when shareholder approval has not been obtained, the state law in question does not permit discrimination among similarly situated shareholders.[155]

Under New Jersey corporate law a board of directors may amend the articles of a corporation to issue new stock and to specify the stock's relative rights, preferences, and limitations when authorized to do so in the certificate of incorporation.[156] In *ASARCO Inc. v. M.R.H. Holmes A. Court*[157] the New Jersey court determined that New Jersey law did not grant the board of directors the authority to reapportion the voting powers of shareholders within the same class. The court reasoned that in light of the general rule entitling each shareholder to one vote, the board only possessed the authority to alter rights and preferences between different classes of stock.[158] In *ASARCO* the board sought to issue preferred stock as a dividend to common shareholders to increase their voting power. However, the preferred stock was exercisable only in the event that any person or group acquired twenty percent or more of ASARCO's stock,[159] and a shareholder of twenty percent or more was not entitled to exercise the increased voting power.[160] Emphasizing the basic corporate law concept of equality in voting power among shareholders of the same class, the *ASARCO* court held that the preferred stock in question was discriminatory and, thus,

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Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407, 410 (D.C.N.Y. 1985) (change in corporate structure of great magnitude requires stockholder approval under DEL CODE ANN. tit. 8, § 202(b) (1983)). Section 202(b) provides that "no restriction so imposed [on the transfer of shares] shall be binding with respect to securities issued prior to the adoption of this restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction." DEL. CODE ANN. tit. 8, § 202(b) (1983).

152. *See* Bank of New York Co., Inc. v. Irving Bank Corp., Transcript of Oral Opinion (N.Y. Sup. Ct. July 6, 1988), *aff'd*, No. 34386 (N.Y. App. Div. Oct. 4, 1988) (source on file with Author).

153. *See* Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1229 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir. 1987); Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985); ASARCO Inc. v. M.R.H. Holmes A. Court, 611 F. Supp. 468 (D.N.J. 1985).

154. *See* Spinner Corp. v. Princeville Dev. Corp., No. 86-0701 (D. Haw. Oct. 31, 1986) (interpreting Colorado law).

155. *Amalgamated Sugar*, 644 F. Supp. at 1234.

156. N.J. STAT. ANN. § 14A:7-1(1) (West 1969).

157. 611 F. Supp. 468 (D.N.J. 1985).

158. *Id.* at 477.

159. *Id.* at 471.

160. *Id.* The preferred stock voting provisions effectively blocked any acquisition not approved by management. *Id.*

illegal under New Jersey corporate law.[161]

Likewise, in *Minstar Acquiring Corp. v. AMF, Inc.*,[162] the District Court for the Southern District of New York found that a poison pill's restriction on the alienability of shares was unlawful under New Jersey corporate law.[163] AMF's board of directors wished to ensure that nontendering shareholders would receive fair value for their stock in the event of a hostile takeover. Therefore, the board adopted a plan to distribute a dividend[164] to all common shareholders that entitled the shareholders, upon the occurrence of a triggering event, to exchange their stock for subordinated debentures carrying a favorable rate of interest.[165] These rights, however, were not transferrable.[166] The common shareholders could neither trade these rights with their common stock, nor transfer the rights separately after the occurrence of the triggering event. Consequently, only those shareholders who held their shares as of the date of the distribution of the rights were entitled to convert their stock.[167] Finding that this nontransferability constituted an illegal restraint on the alienability of the stock,[168] the court enjoined the AMF board from implementing the discriminatory poison pill plan.[169]

In *Amalgamated Sugar Co. v. NL Industries*[170] the District Court for the Southern District of New York enjoined the use of a shareholder rights plan adopted by the directors of NL Industries (NLI).[171] Under the plan, each common shareholder received a dividend of one right per share.[172] These rights were triggered when a shareholder or group accumulated twenty percent or more of NLI common stock, or a tender offer was made for thirty percent or more of NLI stock.[173] The triggering

161. *Id.* at 477. According to the *ASARCO* court, "[e]quality of voting power among stockholders of the same class, or at least among the same series of a class that has more than one series, is a basic concept of corporate law." *Id.*; *accord* Baker v. Providence & Woosler Co., 364 A.2d 838, 847 (Del. Ch. 1976), *rev'd*, 378 A.2d 121 (Del. 1977). The *ASARCO* court rejected the distinction drawn in *Providence* between discrimination among shareholders, which was not found to violate the law, and discrimination among the shares of stock, which was deemed a statutory violation. *ASARCO*, 611 F. Supp. at 478.

162. 621 F. Supp. 1252 (S.D.N.Y. 1985).

163. *Id.* at 1258.

164. *Id.* at 1256. The dividend was in the form of a right.

165. *Id.* The interest rate was to have been 14.5%. *Id.*

166. *Id.* at 1257.

167. *Id.* at 1258.

168. *Id.* at 1259-61.

169. *Id.* at 1259. The court stated that "such major changes in structure and voting rights may only be approved by the shareholders." *Id.* The *Minstar* court did not cite authority for this proposition.

170. 644 F. Supp. 1229 (S.D.N.Y. 1986), *aff'd*, 825 F.2d 634 (2d Cir. 1987).

171. *Id.* at 1240.

172. *Id.* at 1232.

173. *Id.* at 1232. Upon the occurrence of the triggering event, the rights certificates were to be distributed to all shareholders.

event activated either the flip-in or the flip-over provision, depending upon the circumstances of the acquisition.[174] The New York court scrutinized the plan's flip-in provision,[175] which prohibited the acquiror from exercising the rights made available to the other shareholders.[176] Declining to follow Delaware corporate law[177] the *Amalgamated Sugar* court interpreting New Jersey law concluded that because the flip-in provision subjected the acquiror's interests, voting rights, and equity to discriminatory dilution,[178] the plan unlawfully discriminated against shareholders of the same class.[179]

The Delaware Supreme Court has not expressly addressed the discrimination issue because the court concluded that by definition the flip-over pill upheld in *Moran* did not discriminate against the acquiror.[180] Under certain other circumstances, however, discrimination against an acquiror has been upheld under Delaware law. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[181] the Delaware Supreme Court stated in dicta that Revlon's note purchase rights plan, which provided note purchase rights to all shareholders except the acquiror, was not unlawful.[182] Although the *Revlon* court did not address the discrimination issue explicitly, it concluded that the board clearly had the power to adopt the note purchase plan, as long as there was a reasonable purpose for this corporate measure.[183]

In *Unocal Corp. v. Mesa Petroleum Co.*[184] the Delaware Supreme Court approved a defensive issuer self-tender offer that excluded Mesa Petroleum, which was then making a bid for Unocal.[185] The court stated that there was "no support in Delaware law for the proposition that, when responding to a perceived harm, a corporation must guarantee a benefit to a stockholder who is deliberately provoking the danger being addressed."[186] Because it did not address the legality of a discrimina-

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174. *Id.* at 1232.

175. *Id.* at 1234-39.

176. *Id.* at 1233.

177. The *Amalgamated Sugar* court cited Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977), *rev'g*, 364 A.2d 838 (Del. Ch. 1976).

178. *Amalgamated Sugar*, 644 F. Supp. at 1234-35.

179. *Id.* at 1235.

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

181. 506 A.2d 173 (Del. 1986).

182. *Id.* at 180.

183. *Id.* In reaching its decision, the *Revlon* court cited *Moran* and §§ 141 and 122(13) of the *Delaware General Corporation Law.* The statutory provisions cited by the court essentially state that corporations can incur debt obligations and do not address the subject of discrimination among shareholders.

184. 493 A.2d 946 (Del. 1985).

185. *Id.* at 951.

186. *Id.* at 958.

tory poison pill plan, *Unocal* is not controlling law. However, *Unocal* and *Revlon* taken together suggest that the Delaware Supreme Court probably would not invalidate a poison pill solely because it is discriminatory. Decisions interpreting the corporate law of Indiana, Minnesota, and Michigan also reach this result, concluding that flip-in poison pill plans discriminate among shareholders, rather than among shares of a particular class of stock, and, therefore, do not violate the antidiscrimination provisions of the state statute involved.[187]

In *Dynamics Corp. of America v. CTS Corp.*[188] an Illinois district court applying Indiana law ultimately enjoined the use of a flip-in plan on the basis of the board's failure to comply with the business judgment rule.[189] However, the court discussed the plan's flip-in provision in dictum, looking to Delaware corporate law for guidance. The *Dynamics* court cited with approval the position taken by the Delaware courts on the discrimination issue,[190] and specifically stated that it was not concluding that all flip-in provisions were illegal.[191] Although not binding, the *Dynamics* opinion indicates the possibility that flip-in provisions may be upheld under Indiana or Delaware law.

On the other hand, in *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*,[192] a New York court applying Delaware law invalidated a new class of preferred stock issued in the middle of a takeover fight that provided for different voting rights[193] within the same class of stock depending upon when the stock was acquired and how long it was held.[194] The *Unilever* court distinguished *Unocal* on the ground that

187. *See* Harvard Indus. v. Tyson, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,064, at 95,294 (E.D. Mich. Nov. 25, 1986) (bench opinion denying motion for preliminary injunction) (the court adopted "the position of the better-reasoned cases that such a rights plan does not discriminate among shares, but rather, among shareholders, which is not forbidden" under Michigan law); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part, vacated in part*, 811 F.2d 414 (8th Cir. 1987) (holding that Minnesota law, which is patterned on Delaware law, does not prohibit discriminatory poison pill plans); Dynamics Corp. of America v. CTS Corp., 637 F. Supp. 406 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986) (rejecting the argument that the flip-in provision of the CTS poison pill plan was unlawful under Indiana law, which the court treated as essentially the same as Delaware law, because the provision discriminated against the acquiror).

188. 637 F. Supp. 406 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986).

189. *Id.* at 418.

190. *Id.* at 408-09.

191. *Id.*

192. 618 F. Supp. 407 (S.D.N.Y. 1985).

193. Each share of preferred stock entitled the holder to cast 25 votes on all issues upon which the holders of the common stock could vote. However, if the preferred stock was transferred (*e.g.*, to a hostile bidder), the new holder could exercise only 5 of these 25 votes for the first 36 months that the preferred stock was held. *Id.* at 408.

194. *Id.* at 410 (stating that "[u]nder Delaware law, a change in corporate structure of this magnitude, reducing the transferability of a shareholder's ability to vote and the value of his or her asset to this degree, requires stockholder approval which has not been obtained").

Unocal involved what was permissible when a board was reacting to the advances of a well known "greenmailer,"[195] and focused on the fact that Richardson-Vicks' certificate of incorporation explicitly provided that all shares of any one series of preferred stock would be identical with each other.[196] Read in conjunction with the cases mentioned above which follow the New Jersey line of reasoning, *Unilever* could form the basis for an argument that Delaware law should be extended to invalidate discriminatory poison pill plans.

After *Bank of New York Co. v. Irving Bank Corp.*,[197] flip-in provisions that discriminate among shareholders of the same class appear to be invalid under New York corporate law.[198] The New York Supreme Court in *Bank of New York* considered the legality of Irving Bank Corporation's (IBC) flip-in rights amendment that entitled each right holder, with the exception of a person or entity holding twenty percent or more of the shares of IBC, to purchase 400 dollars of IBC common shares for 200 dollars if any person or entity acquired twenty or more percent of the shares of IBC.[199] Although Justice Cahn noted that the flip-in amendment would make an acquisition of twenty percent or more of the IBC shares prohibitively expensive,[200] he implied that the amendment might increase the incentive for negotiation between the acquiror and IBC's board of directors.[201] The court, however, avoided evaluating the board's adoption of the flip-in provision under the busi-

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195. *Id.*

196. *Id.*

197. Transcript of Oral Opinion (N.Y. Sup. Ct. July 6, 1988), *aff'd*, No. 34386 (N.Y. App. Div. Oct. 4, 1988) (source on file with Author); *see also New York Court Enjoins Enforcement of Discriminatory Flip-In Provision*, 20 Sec. Reg. & L. Rep. (BNA) No. 32, at 1275 (Aug. 12, 1988) [hereinafter *New York Court*].

198. The Bank of New York sought a preliminary injunction preventing Irving Bank from executing the flip-in provision of its poison pill. The Bank of New York argued that the flip-in amendment adopted by Irving Bank's board of directors on May 19, 1988, was ultra vires as a matter of New York corporate law. *Bank of New York*, Transcript of Oral Opinion at 4.

199. *Id.* at 6. The court noted that the shareholder rights agreement "greatly dilutes the twenty percent shareholder's equity and voting rights and thus makes acquisition of all or a majority of the shares extremely expensive for the twenty percent acquirers." *Id.* at 7.

200. *Id.* at 6-7. The court explained that if triggered when a common share of IBC was trading at $72 per share, the flip-in provision would entitle "each IBC right holder, with the exception of the twenty percent or more holder . . . to purchase from IBC approximately five and four-sevenths shares of IBC for $200, while the twenty percent holder could buy none from IBC." *Id.* at 7. The court noted that even if the acquiring shareholder were able to purchase shares freely on the open market, he could only "obtain less than three shares per $200 expenditure and thus obtain less than four shares and votes per shares previously owned, plus $200;" whereas, the other rights holders would "have more than six shares and votes for each common share previously owned, plus $200." *Id.* at 7-8.

201. *Id.* at 6. Justice Cahn stated: "[T]he agreement has the effect of making acquisition of twenty percent or more of IBC shares prohibitively expensive and unprofitable unless the IBC Board approves such acquisition, at which time the IBC Board can have IBC redeem the rights." *Id.* at 6.

ness judgment rule[202] and, instead, found the discriminatory effects of the pill impermissible under New York statutory corporate law.[203]

The Bank of New York sought to have the flip-in provision enjoined on the grounds that it violated section 501 of New York's Business Corporation Law,[204] which directs that each share in the same class must be equal.[205] Bank of New York argued that the flip-in portion of the IBC pill discriminated among shares of the same class by allowing only those shareholders who own less than twenty percent to purchase IBC shares at a fifty-percent discount.[206] IBC contended that no issue of discrimination existed among shares because section 505,[207] which does not contain a prohibition against discrimination among shares of the same class, governed the rights issued by their board.[208] In addition, IBC argued that section 622[209] of New York Business Corporation Law authorizes discriminatory treatment between shareholders by providing a corporation with a method for disallowing shareholders to exercise their preemptive rights to preserve their voting and dividend power.[210] Following the reasoning in *Amalgamated Sugar*[211] and *FeBland v. Two Trees Management Co.*,[212] the Supreme Court of New York concluded that the express prohibition against discrimination in section 501(c) may not be avoided by a provision in a corporation's certificate of incorporation under section 622.[213] The court, therefore, granted Bank Of New York's motion for a preliminary injunction, preventing IBC's board of directors from enforcing the flip-in provision of its poison

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202. *Id.* at 5. The court noted that it did not attempt to arrive at any decision as to which offer—that of the Bank of New York or the contender, Banco Commerciale Italiana—was superior because that decision, if it involves "business judgment," is for the board of directors. *Id.* at 5. The court also found it unnecessary to evaluate whether the flip-in provision would he protected by the business judgment rule. For an analysis of the factors that would he considered in determining whether the actions of the IBC board would be protected, see *infra* notes 220-80 and accompanying text. Perhaps, the New York court would have found the flip-in provision adopted by IBC a reasonable response to the threat posed by Bank of New York's offer.

203. *Bank of New York*, Transcript of Oral Opinion at 10.

204. N.Y. Bus. Corp. Law § 501(c) (McKinney 1986). Section 501(c) states that "subject to the designations, relative rights, preferences and limitations applicable to separate series, each share shall be equal to every other share in the same class." *Id.*

205. *Bank of New York*, Transcript of Oral Opinion at 8 (quoting the New York statute).

206. *Id.* at 8.

207. N.Y. Bus. Corp. Law § 505 (McKinney 1986).

208. *Bank of New York*, Transcript of Oral Opinion at 9.

209. N.Y. Bus. Corp. Law § 622 (McKinney 1986).

210. *Bank of New York*, Transcript of Oral Opinion at 9. Under § 622, a corporation may include in its certificate of incorporation a provision that denies its shareholder preemptive rights. N.Y. Bus. Corp. Law § 622 (McKinney 1986); *see also Bank of New York*, Transcript of Oral Opinion at 9.

211. 644 F. Supp. 1229.

212. 66 N.Y.2d 556, 489 N.E.2d 223, 498 N.Y.S.2d 336 (1985).

213. *Bank of New York*, Transcript of Oral Opinion at 13.

pill.[214]

Recent decisions suggest that poison pills that discriminate against an acquiror are illegal under the corporate laws of New York, New Jersey, and Colorado.[215] Under Delaware, Indiana, Michigan, and Minnesota law,[216] however, discrimination against an acquiror is a factor that may influence a court's decision as to whether a target's board breached its fiduciary duty in adopting a shareholder rights plan. Two states, Ohio[217] and Wisconsin,[218] have amended their corporation laws to permit boards of directors to issue rights that prevent a holder of a specified percentage from exercising those rights.[219] Whether other states will follow Ohio and Wisconsin in specifically validating discriminatory flip-in pills remains unanswered.

IV. The Validity of Poison Pills Under State Fiduciary Law—The Business Judgment Rule

A. *The Modified Business Judgment Rule*

State courts traditionally have refused to second guess directors' reactions to tender offers and instead have applied a relatively deferential "business judgment rule" to those board decisions.[220] The business judgment rule creates a rebuttable presumption[221] that a board's actions are taken in good faith and "in the best interest of the stockholders."[222] Even board decisions to enact defensive tactics generally are given the benefit of the presumption.[223] Despite the traditional deference granted boards of directors under the business judgment rule, courts now carefully scrutinize the adoption of certain antitakeover measures for impermissible board activity.[224]

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214. *Id.* at 14.

215. *See supra* notes 152-54 and accompanying text.

216. *See supra* notes 180-91 and accompanying text.

217. Wis. Stat. Ann. § 180.155 (West Supp. 1988). *But see* P.D. Smith & Co. v. Preway, Inc., 644 F. Supp. 868 (W.D. Wis. 1986) (concluding that discriminatory poison pill unlawful under Wisconsin law).

218. Ohio Rev. Code Ann. § 1701.16 (Anderson Supp. 1987).

219. *See generally* State Takeover Statutes, *supra* note 1, at 934-36.

220. *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 293-95 (7th Cir. 1981); Auerbach v. Bennett, 47 N.Y.2d 619, 629, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); *see also* Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva* Zapata, 37 Bus. Law. 27 (1981).

221. By establishing a rebuttable presumption of validity, the business judgment rule protects corporate directors from liability based on judgments made in the ordinary management of the corporation. Aronson v. Lewis, 473 A.2d 805, 813 (Del. 1984).

222. The presumption only applies if the actions are made in good faith by a disinterested board of directors after reasonable inquiry into the best interests of the corporation and its shareholders. *Id.* at 812-13.

223. *See infra* notes 225-61 and accompanying text.

224. If a plaintiff can show that the board of directors' "sole or primary motive" in using an

In *Unocal Corp. v. Mesa Petroleum Co.*[225] the Delaware Supreme Court followed the general principle that the business judgment rule protects a board of directors that institutes an antitakeover defense without shareholder approval.[226] Although a poison pill plan was not at issue in *Unocal*, the case is important because it imposed on the Unocal board[227] the initial burden of proving the reasonableness of its decision to oppose a takeover bid.[228] Under *Unocal*, a board of directors must establish that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[229] The board can satisfy this burden by demonstrating "good faith and reasonable investigation."[230] In addition the board must show that the defensive measure adopted was "reasonable in relation to the threat posed."[231] In determining the reasonableness of its decision, the board may consider interests other than the maximization of shareholder wealth.[232] Once the board satisfies this initial burden, the burden then shifts back to the plaintiff to prove a breach by the board of its fiduciary duties.[233] Thus, the *Unocal*

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antitakeover tactic was to retain control of the company, the board loses its presumption of validity under the business judgment rule. *See, e.g.*, *Minstar*, 621 F. Supp. at 1261.

225. 493 A.2d 946 (Del. 1985).

226. *Id.* at 954. The court concluded:

> when a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. In that respect a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment.

Id.

227. Mesa Petroleum, a 13% shareholder of Unocal stock, launched a takeover fight against Unocal. Unocal responded by proposing a discriminatory exchange offer to all Unocal shareholders except Mesa. *Id.* at 951.

228. *Id.* at 955. The court noted:

> There are, however, certain caveats to a proper exercise of this function. Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination of the threshold before the protections of the business judgment rule may be conferred.

Id. at 954.

229. *Id.* at 955. This has been interpreted broadly to include threats to legitimate corporate and stockholder interests. *See* AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986).

230. *Id.* (quoting Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964)); *see also* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

231. *Unocal*, 493 A.2d at 955.

232. *Id.*

233. *Id.* at 958. The court stated:

> Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.

Id.

court modified the traditional business judgment rule and extended its protection in the hostile takeover context to a board of directors which can satisfy the initial burden of proof.[234] By allowing a court to examine the reasonableness of a board's adoption of a defensive tactic, *Unocal* cleared the way for judicial intervention in takeover cases.

The Delaware Supreme Court applied the *Unocal* business judgment rule approach to the adoption of a poison pill plan in *Moran.* In *Moran* the Household board of directors, which consisted of a majority of outside, independent directors,[235] adopted a poison pill plan to ward off potential hostile bidders.[236] Household's plan consisted of a distribution of rights that became exercisable when an individual or an entity acquired twenty percent of the company's stock, or when a tender offer was made for thirty percent of the stock.[237] The plan contained only a flip-over provision, and Household could redeem the rights at any time prior to the occurrence of one of the triggering events.[238] Concluding that the adoption of the poison pill plan was within the authority of the board of directors, the court then focused its attention on the application of the business judgment rule in the hostile takeover context.[239]

The *Moran* court applied the same standards for the business judgment rule established in *Unocal* and required the Household board of directors to satisfy the initial burden of proof.[240] The court noted that the board's ability to satisfy this burden was enhanced materially because a majority of the board of directors consisted of outside, independent directors.[241] The Household directors had to show that they had reasonable grounds for believing a danger to the corporation existed and that the defensive mechanism adopted was reasonable in relation to the threat posed.[242] Generally, a court only will apply the protection of the business judgment rule after the directors have satisfied burden of proof. Once a court applies the business judgment rule, however, the burden of proof shifts back to the plaintiffs to demonstrate that the board of directors has acted either in bad faith, or for purposes of entrenchment.[243]

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234. *Id.* at 957.

235. *Moran*, 500 A.2d at 1356.

236. *Id.* at 1349. This plan was enacted solely as a preventative measure.

237. *Id.* at 1348.

238. *Id.* at 1349.

239. *Id.* at 1355. Moran, the largest single shareholder of Household stock, attacked the plan on the ground that the Household board of directors was not authorized to adopt the plan. *Id.* at 1351.

240. *Id.* at 1346.

241. *Id.* at 1356.

242. *Id.* (stating that "when the business judgment rule applies to the adoption of a defensive mechanism, the initial burden will lie with the directors").

243. *Id.* (noting that the plaintiffs have the "ultimate burden of persuasion to show a breach

The *Moran* court held that the Household board of directors was entitled to the protection of the business judgment rule in its adoption of the shareholder rights plan because it had satisfied its burden of proof.[244] The board demonstrated that the directors had a good faith belief in the necessity of the plan to protect the company from coercive takeover tactics and that the plan was reasonable in relation to the threat posed.[245] Because the plaintiffs were unable to prove that the Household board acted in bad faith, or for the purpose of entrenchment, the court upheld the adoption of the shareholder rights plan.[246]

Emphasizing the prospective nature of the board's decisions, the *Moran* court implied that the directors' initial burden of proof might be less rigorous if the board adopts a poison pill plan in advance of a contested takeover.[247] On the other hand, a reactive decision, adopted to oppose a specific threat may increase the initial burden of proof.[248] By lessening the directors' burden of proof for a plan adopted in advance of a takeover bid, the *Moran* court weakened the *Unocal* test.[249]

In *Dynamics Corp. of America v. CTS Corp.*[250] the Seventh Circuit Court of Appeals more clearly specified the "good faith and reasonable investigation" test adopted in *Unocal*.[251] The court of appeals' approach was twofold: first, the court analyzed the role of the independent advisor;[252] and second, the court directed increased scrutiny of the actual terms of the poison pill plan.[253] The court of appeals remanded the case for further in-depth analysis because the court recognized the potential conflict between the interests of shareholders and the interests of the board of directors.[254] Both the district court and the court of

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of the directors' fiduciary duties").

244. *Id.* at 1357.

245. *Id.* at 1356-57 (citing Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985), and concluding the Household board had made an informed decision after reasonable investigation).

246. *Id.* at 1357.

247. *Id.* at 1350 (stating that "pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment").

248. *Id.* (noting that "in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule").

249. *See Unocal*, 493 A.2d at 949. *Unocal* requires that tbe defensive measure be reasonable in relation to the threat posed. *Id.* The adoption of an extreme defensive tactic like the poison pill by a board responding to potential or remote threats probably would fail under *Unocal* but is encouraged by *Moran*.

250. 805 F.2d 705 (7th Cir. 1986).

251. *Id.* at 717.

252. *Id.* at 710. The independent advisor was Smith Barney.

253. *Id.* at 712. The court also questioned the valuation of CTS stock under the poison pill plan. *Id.* at 713.

254. Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503 (1986). Veasey states that "[s]ince a successful defense to a takeover will inevitably result in a continuation of the board in control, the motives of the board became an

appeals favored protecting the shareholders' interests over those of the board of directors. The two opinions held that the decision by the board of directors to adopt a poison pill plan had to be reviewed carefully in order to ensure that the plan was protecting the shareholders' interest in wealth maximization, instead of the board's interest in maintaining control of the company.[255]

Thus, with respect to contests for corporate control, courts judging the adequacy of particular poison pill plans have signaled that they first will protect the shareholders' goal of wealth maximization. A board of directors, therefore, must realize that the adoption of a particular poison pill plan will be subject to enhanced judicial review under a modified business judgment rule. In order to survive this heightened scrutiny, a board of directors' decision to adopt a poison pill plan must be supported by evidence of careful consideration of alternative defensive tactics and by proof that the plan will protect and maximize shareholder wealth.

When reviewing a board's decision to adopt a poison pill plan a court utilizing the modified business judgment rule will consider several factors. First, the timing of the implementation of the takeover device. A prospective adoption of a poison pill plan, such as the one in *Moran*,[256] will be viewed more favorably than a reactive implementation of the exact same plan. Second, the independence of outside counsel and directors. An outside advisor or director must be truly independent and have a minimal financial interest in the outcome of a plan.[257] Third, the fairness of the terms of the poison pill plan.[258] The board must introduce evidence to demonstrate the reasonableness of the trigger percentage and the trigger price.[259] A court will review the calculation of the

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issue." *Id.* at 508. In essence, the underlying conflict is a clash of fundamental interests within the corporate structure: the right of shareholders to receive and consider tender offers in order to maximize their wealth, on the one hand; and the desire of a board of directors to limit takeovers in order to maintain controls, on the other. The conflict is more apparent when a board of directors rejects a tender offer for a fair price because the tender offeror is hostile to the board and might be expected to replace the target's board members.

255. *Dynamics*, 805 F.2d at 708, *aff'g*, 635 F. Supp. 1174, 1178-80 (N.D. Ill. 1986).

256. *See supra* notes 235-49 and accompanying text.

257. *Dynamics*, 805 F.2d at 711.

258. The result of the plan must not be to prevent all tender offers. Evidence must be presented to show that the trigger percentage set by the board has a reasonable base, one which would give a minority shareholder blocking power. *Id.* at 712. "Blocking power" is the ability of a shareholder to obstruct a decision made by the board of directors. This power may exist where a large block of shares, even though a minority, is owned by one group and the remaining shares are widely scattered. *See* Gottesman v. General Motors Corp., 279 F. Supp. 361, 368 (S.D.N.Y. 1967), *aff'd*, 436 F.2d 1205 (2d Cir.), *cert. denied*, 403 U.S. 911 (1971).

259. The methods of valuating the price of the stock must be clarified. Poison pill plans usually deter tender offers at prices below the trigger price because the acquiror offers at one price, but then is forced to buy out nontendering shareholders at the higher "poison pill" price. *Dynam-*

trigger price and the selection of the trigger percentage, and if the price is set unrealistically high or the percentage is too low,[260] the poison pill plan will be invalidated.[261] Finally, a court may look at the board's willingness to negotiate and to act as an auctioneer when the company is faced with a tender offer.

B. *The Duty to Negotiate and the Role of The Board of Directors as Auctioneers*

Courts have begun to consider the idea that a board of directors must act as an impartial auctioneer during a control contest. Once a tender offer has begun and it becomes apparent that the acquisition or the break-up of the company is inevitable, a board that has adopted a poison pill plan may have a duty to negotiate with a hostile acquiror and to act as an impartial auctioneer in order to receive the protection of the business judgment rule.[262] Although the effect of this requirement places a premium on the maximization of shareholder wealth, it ultimately may weaken the ability of a board of directors to defend a corporation from a hostile suitor.[263]

The idea first appeared in Justice Walsh's Delaware Chancery Court opinion in the *Revlon* case.[264] Enjoining the "lockup option," Justice Walsh wrote that, "[o]nce the breakup of Revlon became inevitable . . . the board [had] to view its primary role as the promoter of bids, with price the dominant consideration."[265] On appeal, the Delaware Supreme Court endorsed the theory that the directors' fiduciary obligations change when it becomes apparent that the sale of the company or its parts is inevitable.[266] Under these circumstances, the board's role

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ics, 805 F.2d at 716. If the poison pill price exceeds the maximum reasonable sale value of the company, the poison pill plan may eliminate completely the market for corporate control. *Id.*

260. The court in *Dynamics* found that the trigger price could be considered unrealistic because of Dynamics' overly optimistic estimation of its expected earnings. The court stated that "consistent failure to achieve or even approach forecasted performance is relevant evidence on the realism of a company's methods of forecasting." *Id.* at 716.

261. *Id.* at 714. The trigger price is very important when deciding issues of reasonableness and good faith because if set too high it will "prevent all tender offers, not just those that are below the corporation's sale value." *Id.*

262. Oesterle, *Target Managers*, *supra* note 125, at 53.

263. *See* Bogen & Duke, *The Auctioneer's Duty: Unraveling Revlon*, 2 INSIGHTS, July 1988, at 3 (pointing out that *Revlon* suggests a narrowly constrained role for directors, contrary to the broad discretion typically afforded boards by the business judgment rule).

264. MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985) (Walsh, J.), *aff'd*, 506 A.2d 173 (Del. 1986). Revlon had given a lockup option on its health divisions to Forstmann Litte & Co. in the face of a hostile takeover attempt by Pantry Pride.

265. *Id.* at 1250-51.

266. *Revlon*, 506 A.2d at 182. The court stated that once the sale was inevitable, "[t]he duty of the board had . . . changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit." *Id.*

changes "from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[267] The Delaware Supreme Court concluded that the Revlon board breached this duty when it granted to a friendly party an option to purchase a division of the company at a price substantially below the estimated market value.[268]

The Second Circuit Court of Appeals, interpreting New York law in *Hanson Trust PLC v. ML SCM Acquisition, Inc.*,[269] reached a conclusion similar to *Revlon*, but with more emphasis on scrutinizing the procedures the board followed in deciding to grant a lockup option to block a takeover by Hanson Trust.[270] The Second Circuit concluded that the lockup was approved without sufficient careful consideration.[271] The *Hanson Trust* court implicitly suggested that the directors should have turned the matter over to a completely independent committee of directors.[272] Overall, the Second Circuit seemed more critical of specific board conduct than the decisions the board had reached.

Courts are now moving beyond implicit pressures on target boards to negotiate.[273] In *Edelman v. Fruehauf Corp.*[274] this new duty for takeover defense was discussed explicitly. The Sixth Circuit Court of Appeals, applying Michigan corporate law, enjoined a management leveraged buyout that had been put together hastily to block a bid by New York investor Asher Edelman. In keeping with *Revlon* and *Hanson Trust*, the Sixth Circuit found that the board had breached its duty to seek maximum value for its shareholders. However, the court also took the highly unusual step of ordering the target's board to conduct good faith negotiations with all potential offerors, including Edelman.[275]

In *CRTF Corp. v. Federated Dep't Stores*[276] the United States District Court for the Southern District of New York recognized the duty

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267. *Id.* Defining the duty that a board owes to stockholders when a sale of the company becomes inevitable, the court instructed:

> [A] board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders. . . . However, such concern for nonstockholder interests is inappropriate when an auction among active bidders is in progress, and the object no longer is to protect or maintain the corporate enterprise but to sell it to the highest bidder.

Id.

268. *Id.* at 185.
269. 781 F.2d 264 (2d Cir. 1986).
270. *Id.* at 275-77.
271. *Id.* at 277.
272. *Id.* at 283 (citing *Revlon*, 501 A.2d at 1249).
273. *See, e.g., In re* Anderson, Clayton Shareholders' Litig., 519 A.2d 669 (Del. Ch. 1986).
274. 798 F.2d 882 (6th Cir. 1986).
275. *Id.* at 885.
276. [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,680, at 98,114 (S.D.N.Y. Mar. 18, 1988).

of a board of directors, which has enacted a poison pill plan and which is faced with a tender offer, to negotiate and to serve as an auctioneer of the company.[277] Following the reasoning in *Revlon*, the *Federated* court stated that in an auction situation the directors are charged with a duty of selling the company at the price that will maximize the stockholders' profits.[278] The court also recognized the duty of a target board to negotiate and to "seek improvements in price and financing arrangements and . . . competing bids."[279] Refusing to enjoin the Federated poison pill plan, the court concluded that a poison pill plan that does not contain a price barrier[280] may assist the directors in complying with their fiduciary duties to negotiate and to maximize shareholder wealth.[281] In addition, the *CRTF* court observed that even during an auction, a poison pill plan may benefit shareholders be deterring a street sweep or front-end loaded offer by a bidder or third party that could otherwise end the auction.[282] Thus, a poison pill plan carefully structured with the relevant cases in mind can withstand the scrutiny of the courts both in the prospective and the reactive stage.

The Delaware Chancery Court in *City Capital Associates v. Interco Inc.*[283] clarified the duty to auction first announced in *Revlon*.[284] *Interco* involved two questions: (1) whether Interco's board of directors in refusing to redeem a poison pill plan was breaching their fiduciary duties to stockholders under *Unocal* and *Moran*;[285] and (2) whether the implementation of a restructuring plan constituted a violation of the board's fiduciary duty under *Unocal* and *Revlon*.[286] The *Interco* court concluded that the poison pill plan was not a reasonable response to the threat to Interco from City Capital Associates' (CCA) noncoercive offer.[287] The court upheld the restructuring, however, on the theory that

277. *Id.* at 98,118-19.

278. *Id.* at 98,118 (quoting *Revlon*, 506 A.2d at 184 n.16).

279. *Id.* at 98,119.

280. A price barrier may discourage offers below a perhaps artificially high trigger price. *See Dynamics*, 805 F.2d at 705.

281. *CRTF Corp.*, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH), at 98,120. Commenting on the duty of a board to negotiate and auction, the court stated that a poison pill plan "provides the directors with a shield to fend off coercive offers and with a gavel to run an auction." *Id.*

282. *Id.* The court remarked that a board of directors under Delaware law need not be a "passive observer;" on the contrary, a board should use its powers to defeat a coercive offer where it "believes the offer would not be in the best interest of the shareholders." *Id.*

283. C.A. No. 10105 (Del. Ch. Nov. 1, 1988).

284. *See supra* notes 264-68 and accompanying text.

285. *Interco*, C.A. No. 10105, slip op. at 1-2.

286. *Id.*

287. *Id.* at 4. The fact that CCA's offer was a cash offer for all shares, and thus noncoercive, seemed to weigh heavily in the court's decision to enjoin Interco's pill. The *Interco* court ruled that *Unocal* and *Moran* supply the appropriate legal framework for evaluating the adoption of a

it constituted a reasonable response to an offering price perceived by Interco's board to be "inadequate."[288] Concluding that by implementing the restructuring Interco's board had not breached any duties under *Unocal* and *Moran*, Chancellor Allen proceeded to clarify the fiduciary duties required by *Revlon*.[289]

CCA argued that the restructuring was in effect a sale and breakup of the company, and, therefore, Interco's board had a duty under *Revlon* to sell the company, by means of an auction, to the highest bidder.[290] The court, however, rejected CCA's argument, concluding that even when a company is clearly for sale a board of directors, if disinterested, is obligated to exercise business judgment in pursuing the stockholders' interest.[291] Chancellor Allen commented that *Revlon* should not be read as requiring a board to "shop" or conduct an auction process every time a merger agreement is signed. Instead, the duty of the board is to act in an "informed manner," which would include probing the market for the values of alternative transactions.[292] Although the court recognized that an auction or open contest may be the most reliable source for maximizing shareholder wealth,[293] it concluded that a board can satisfy its fiduciary obligations in ways other than a traditional auction.[294] In not specifying a uniform response that must be followed in the hostile takeover context and in requiring that a board of directors has a duty to react to a control contest in an informed manner that is designed to maximize shareholder wealth, *Interco* seems to allow a board to respond to a battle for corporate control with more latitude than *Revlon*.

V. Conclusion

When evaluating poison pill plans, courts should utilize the modified business judgment rule developed in *Unocal*, *Moran*, and *Dynamics*. Because a conflict of interest exists any time a board of directors adopts a defensive measure in response to a takeover threat, courts

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defensive tactic in the hostile takeover context. In addition, the court distinguished Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987), which placed on the board of directors the burden of proving the entire fairness of keeping a pill in place while implementing a recapitalization, as only applying to situations where a board has engaged in self-dealing. *Interco*, C.A. No. 10105, slip op. at 3.

288. *Id.* at 4.

289. *Id.* at 37-44.

290. *Id.* at 38.

291. *Id.* at 39 (citing *In re* J.P. Stevens & Co., Inc. Shareholders Litig., 542 A.2d 770 (Del Ch. 1982); *In re* Fort Howard Corp. Shareholders Litig., C.A. No. 9991 (Del. Ch. Aug. 8, 1988); and Mills Acquisition Co. v. Macmillan, Inc., C.A. No. 10168 (Del. Ch. Oct. 17, 1988)).

292. *Interco*, C.A. No. 10105, slip op. at 41.

293. *Id.* at 42.

294. *Id.* at 41.

should reverse the traditional burden of proof under the business judgment rule and place on the board the burden of proving the first two prongs in the *Unocal* test. This approach will help to ensure that shareholder wealth maximization remains the primary goal of all defensive tactics. First, the board must prove the plan was adopted in good faith and pursuant to a reasonable investigation into the existing damages. Second, the board must show that its adoption of a poison pill plan was reasonable in relation to the actual threat posed. Satisfying its burden of proof under the first two prongs, the board should then be protected by a presumption of sound business judgment, unless the opposing party can demonstrate that the plan was enacted for purposes of entrenchment. Boards enacting prospective pills should be careful to adopt their plans in accordance with the guidelines set forth in the decisions regarding poison pills.

When faced with an actual tender offer the board should have a duty to react in an informed manner to maximize shareholder wealth. In some cases an auction may provide the highest price and be in the best interests of shareholders; however, a disinterested board of directors should have some latitude in determining the method for achieving these goals. If adopted with the proper guidelines in mind, a rights plan may reinforce the underpinnings of our corporate laws rather than distorting them by providing directors with greater time, opportunity, and bargaining power to exercise their fiduciary responsibilities on behalf of shareholders.

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