

THE ART OF WAR: The Evolution of Corporate Takeover and Defense Strategies for the Next Millennium – Part I ¹

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I. INTRODUCTION

“War is nothing but a duel on an extensive scale” – *Clausewitz, Vom Kriege (On War)*²

WAR. In this age of civilization, no longer do warriors strap on medieval armor or wield military weaponry in battles of attrition. Rather, present day corporate mercenaries – smoothly dressed investment bankers and shrewd lawyers who sell their services to the highest bidder, have replaced the warriors and ruthless mercenaries of days past. These corporate mercenaries have honed their skills on the corporate battlefield, devising and revising their takeover tactics and defensive strategies to the point where, in many cases, the outcome of a battle is decided before the first move is made.

The strength of an army in days past was determined largely by the size and skill of its army. Similarly, in present times, the size of a corporation’s “army” is largely determined by the amount of financial capital its investment bankers can raise – either to mount an offensive or to erect defensive measures to ward the oncoming attacks of a corporate assailant. In days past, the outcome of a battle would largely depend on the tactics and strategical acumen of an army’s general. Similarly, the present day Mergers and Acquisitions (“M&A”) lawyer has the responsibility of advising a corporation’s leaders and devising a wartime strategy for both offense and defense.

The wars of days past have evolved to take place on the corporate battlefield with lawyers and investment bankers supplanting the traditional roles of general, warrior, and tactician. Our goal in this paper is to offer the reader a brief overview of takeover techniques and defense strategies which corporations have used, and will use in the future. In specific, the article focuses on the primary tool utilized in most corporations’ defensive scheme: the poison pill and the “dead hand” provisions in poison pills. To this end, first, we will describe the roles that investment bankers, M&A lawyers, and the Board of Directors play in the fight for corporate control. Second, we will briefly describe the history and evolution of corporate takeover tactics. Third, we will describe the evolution and current state of various defense strategies, with a focus on the evolution and deployment of the poison pill as the most effective defensive measure that a corporation can take.

¹ This is the first in a series of articles that will be published by the authors relating to corporate takeover and defense strategies.

² CARL VON CLAUSEWITZ, ON WAR 101, (Routledge & Kegan Paul Ltd. trans., Penguin Books 1982) (1908).

II. ROLES OF INVESTMENT BANKERS, LAWYERS, and BOARD OF DIRECTORS

A. Investment Bankers

An investment banker often plays the role of financier and advisor to impending mergers and acquisitions. Investment bankers can address and evaluate a corporation's strengths and weaknesses in its respective industry. Typically, the investment banker will be consulted to provide a fairness opinion as to the proposed takeover transaction. The board of directors is able to rely upon the expert advice of financial advisors in evaluation of a proposed merger and often the investment banker provides additional information for which the board of directors can utilize in their independent judgment. Courts have commented favorably when reviewing the actions of directors in using investment bankers for evaluation of a prospective merger.³

However, the directors often impose restrictions on the investment banker's conduct and/or diligence in its preparation of the fairness evaluation. The result of these restrictions may lead to a fairness opinion that does not adequately support the analysis used by the board in its decision. This scenario occurred in the *Paramount* and *QVC* matter, wherein management for Paramount imposed limitations on the fairness diligence, leading to a fairness opinion that did not protect the decision by the Paramount board to reject the hostile offer by QVC.⁴ The Securities and Exchange Commission (SEC) has recently required detailed disclosure of the limitations imposed by the board on an investment banker in its preparation of a fairness opinion.

B. M&A Lawyers

The lawyer plays several roles within the takeover context. These roles include providing information to the directors that allows them to comply with legal rules and obligations and to protect themselves from future liability. The lawyer will also serve as a validation function by being present in boardroom meetings, which aides in a court's decision as to whether the board's action was informed. The lawyer provides the strategy in advising the target or acquirer how to accomplish the takeover or initiate the proper defense to a takeover. As one commentator has noted, "[W]hat the directors and officers typically want and what the lawyer gives is advice as to how exposure to attacks by shareholders or other constituencies may be limited and what may be done to limit directors' and officers' liability through indemnification and insurance."⁵ Essentially, lawyers ensure management's compliance with fiduciary duties, such as the business judgment rule and the enhanced scrutiny test that will be discussed in greater detail below. Lawyers, in the M&A context, have often been referred to as "gatekeepers," since the lawyer, by virtue of his position as an indispensable facilitator or mediator of certain action, exercises power to enforce legal rules and norms over certain actors – thereby facilitating corporate transactions.⁶

C. Board of Directors

³ See *NCR Corp. v. American Telephone and Telegraph Co.*, 761 F.Supp. 475, 494 (S.D. Ohio, 1991).

⁴ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

⁵ Ronald M. Loeb, *Towards a More Meaningful Role for the Corporate Lawyer in Corporate Governance*, Advanced Securities Law Workshop 491, 494 (Harvey L. Pitt, chair, Practising Law Institute 1995).

⁶ See generally, Lorne & Calcott, *Administrative Actions against Lawyers before the SEC*, 50 BUS. LAW. 1293 (1995).

Directors owe a fiduciary duty to the shareholders of a corporation. This fiduciary duty is applicable to a director's decisions. The Board of Directors plays a pivotal role in the takeover context. There are three judicial standards of review (in regards to the Board's duty) that have been articulated by the Delaware Supreme Court. The question not easily answered is which standard of review is the director's decision measured against. These standards of review include the traditional business judgment rule, the enhanced scrutiny review enunciated in *Unocal*, and the entire fairness review.

1) *Legal Duties of a Corporation's Board of Directors*

a) Traditional Business Judgment Rule

Under the traditional business judgment rule, there is a presumption that the directors' decisions were made on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.⁷ In cases where the traditional business judgment rule is applicable, directors' decisions are protected unless the movant is able to carry the burden of proof in showing that the board of directors has not met its duty of care or loyalty. The burden of proof in demonstrating that a board of directors has not met its duty of care is whether the conduct of the board has risen to the level of gross negligence, as announced by the Delaware Supreme Court in *Smith v. Van Gorkom*⁸ (in the context of a proposed merger, directors must inform themselves of all information reasonably available to them and relevant to their decision to recommend the merger). To show that the board of directors has breached the duty of loyalty, the movant must prove that directors were engaged in "self-dealing" transactions. However, when the traditional business judgment rule applies, the Court will give great deference to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute its views for those of the board if the directors' decision can be attributed to any rational business purpose.⁹

b) Enhanced Scrutiny Test

The enhanced scrutiny test arises when the board adopts defensive mechanisms in response to an alleged threat to corporate control or policy and approval of a transaction involving a sale of control and/or a break-up of the company.¹⁰ Under these circumstances, the courts will review the board of directors' decisional process and the reasonableness of the directors' action. The enhanced scrutiny standard differs from the traditional business judgment rule, since the directors must prove its decisional process and action meet the enhanced scrutiny standard. The presumption that the directors' decisions and actions are in the best interests of the company does not apply to the enhanced scrutiny standard. Rather, the standard is weighed under a two-prong test, wherein, the board must first show that it had reasonable grounds for

⁷ *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987).

⁸ 488 A.2d 858, 873 (Del. 1985).

⁹ See *Paramount*, 637 A.2d at 34.

¹⁰ See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); see also *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985) (directors' duty in the sale of control is defined as achieving the highest value reasonably available to stockholders).

believing that a danger to corporate policy existed, and second, the board must show that the defensive measure selected was reasonable in relation to the threat posed.¹¹ If the board establishes the two-prong test, then the board's actions will receive the protection of the business judgment rule.

c) Entire Fairness Standard

The entire fairness standard applies when an actual conflict of interest affecting a majority of the board arises in approving a transaction. The entire fairness review requires a judicial determination that the transaction is entirely fair to stockholders.¹² This scenario may arise when directors are on the board of both entities involved in a transaction, such as a leveraged buy-out or hostile takeover.¹³ In reviewing the transaction to determine whether it satisfies the entire fairness standard, the court will consider the decisional process, the fair dealing, and fair price.¹⁴ The fair price in a non-self dealing transaction is a price that a reasonable seller, under all circumstances, would regard as within a range of fair value that such seller could reasonably accept.¹⁵

Though a transaction may initially fall under one standard of review, changes in the transaction may impose a different standard of review. For example, a friendly merger between two parties may invoke the traditional business judgment standard. However, if an unsolicited third party offer occurs, the transaction will then be reviewed under the enhanced scrutiny standard.

III. TAKEOVER TACTICS

“Two motives lead men to War: instinctive hostility and hostile intentions” – *Clausewitz*¹⁶

Why have takeover artists been publicly maligned the past few decades when their efforts clearly benefit shareholders in the form of increased stock prices? It is not hard to see why when legendary corporate raiders such as Sir James Goldsmith state: “Takeovers are for the public good, but that's not why I do it. I do it to make money.” This unapologetic tone towards takeovers endears the raider class to a precious few.

A. History and methodology of takeover strategy – Outlined below is a brief legal and factual history of various takeover methodologies

In the evolutionary stages of takeovers, the minority shareholder wielded as much power as the majority shareholders, since courts viewed shareholders rights as embedded in contract

¹¹ *Unocal*, 493 A.2d at 955.

¹² *See* *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

¹³ *See* *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334.

¹⁴ *See* *Kahn v. Lynch Communication Sys. Inc.*, 638 A.2d 1110 (Del. 1994).

¹⁵ *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

¹⁶ *CLAUSEWITZ*, *supra* note 2, at 102.

and property.¹⁷ Therefore, all parties were required to consent to a change in the corporate charter that permitted any shareholder from blocking the proposed change.¹⁸ Likewise, the property doctrine allowed any shareholder to prevent a merger.¹⁹ Some states responded to the unanimous consent rule by passing legislation authorizing corporations to engage in fundamental transactions, such as a sale of assets and consolidations.²⁰

1. *The Tender Offer*

The tender offer appeared some time in the 1960's and quickly became the favored method of acquirers. The tender offer allowed acquirers to negotiate with minority shareholders and gain a "toe-hold" in a corporation. The acquirer would then obtain a shareholder list and make a tender offer on an amount of share which would give the acquirer effective control of the corporation. The acquirer would leave the offer to the minority shareholders open for a limited period of time. This forced many shareholders into making shotgun decisions on whether to accept the tender offer. This tactic eventually came to be known as the "Saturday Night Special."²¹ The effect of the short period of time the offer was opened, average of approximately seventeen days, allowed the acquirer to squeeze out remaining shareholders at a lower price, once the time period expired and the acquirer gained control of the corporation.²²

2. *The Front-End-Loaded Two-Tier Tender Offer*

The two-tier tender offer emerged as an innovation to the partial tender offer and the one hundred percent tender offer. The two-tier offer, quite obviously, involved two parts: the front-end offer and the back-end offer. The front-end offer usually consisted of the purchasing of a percentage of the stock for a premium over the current stock price. The back-end offer for the remaining outstanding shares was at a diminished price, since the minority shareholders bargaining power substantially diminished once the acquirer gained control of the corporation. This allowed the acquirer to effectively takeover a corporation without paying as much as would be required in a one hundred percent tender offer. This also created a problem with shareholders accepting the front-end offer for fear they would receive less consideration if squeezed out on a back-end offer.²³ Critics attacked the two-tier offer as being coercive.²⁴ Proponents argued that the two-tier offer created a blended price that still reflected a premium over the market price of the stock.²⁵ However, in order to receive this blended price, the shareholder must tender all of his or her shares in the front-end offer.

¹⁷ See William J. Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 AM. B. FOUND. RES. J. 69.

¹⁸ See *id.*

¹⁹ See VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 376 (2d ed. 1886).

²⁰ See, e.g., Act of May 27, 1896, ch. 932, 57, 58, 1896 N.Y. Laws 994.

²¹ See PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURINGS* 40 (1996).

²² See Hayes & Taussig, *Tactics of Cash Takeover Bids*, HARV. BUS. REV., Mar./Apr. 1967 at 135, 141.

²³ See generally, Martin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979).

²⁴ Dale Arthur Oesterle, *The Negotiation Model of Tender Offer Defenses and the Delaware Supreme Court*, 72 CORNELL L. REV. 117 (1986).

²⁵ See, e.g., C. Steven Bradford, *Stampeding Shareholders and Other Myths: Target Shareholders and Hostile Tender Offers*, 15 J. CORP. LAW 417 (1990).

3. Governmental Anti-Takeover Measures

The United States Congress enacted the Williams Act in 1968, as an amendment to the Securities Exchange Act of 1964, in the hope of deterring the effects of tender offers.²⁶ The Act was to ensure informed decisions by shareholders of target corporations and to balance the scales between acquirers and the target shareholders.²⁷ However, the Williams Act failed to accomplish its purpose, since courts have held that the back-end of a two-tier offer is not part of a tender offer, and therefore, will not receive protection under the Williams Act.²⁸

To assist in the protection of target shareholders from acquirers and accomplish the intent of the Williams Act, anti-takeover statutes were enacted by several states. The anti-takeover statutes regulated the two-tier offers. The impetus for these anti-takeover statutes was the perception that bargaining power had shifted too far toward acquirers, and that the Williams Act did not go far enough in recalibrating the balance.²⁹ The anti-takeover statutes consisted of the control share acquisition statute, which allowed management to delay a hostile tender offer until the offer was approved by a majority of stockholders, the fair price provision, which required acquirers to provide equal consideration to shareholders in the back-end of a two-tier offer, redemption rights provision, which provided all shareholders with a right to demand the tender offer price for all shares owned, and the delayed control restrictions which prohibited the merger between the target and acquirer for a period of time, unless the merger was approved by the target corporation's board.³⁰

As the business environment evolved, corporations, during the 1980's, faced a frenzied hostile takeover environment.³¹ The furious acquisition climate was primarily financed through junk bonds – high yield sub-investment grade securities.³² Corporate raiders lacking independent resources used junk bonds to finance hostile takeovers.³³ Therefore, many companies found themselves the subjects of hostile acquisition attempts in an extremely short time frame.³⁴ In addition, raiders developed a number of takeover tactics that had deleterious effects on a target corporation, including the “bust up” takeover bid³⁵ and the “street sweep.”³⁶

²⁶ 15 U.S.C. § 78a (2000).

²⁷ See 113 Cong. Rec. 854 (1967).

²⁸ See Richard A. Booth, *The Problem with Federal Tender Offer Law*, 77 CAL. L. REV. 707 (1989).

²⁹ See Guhan Subramanian, *A New Takeover Defense Mechanism: Using an Equal Treatment Agreement as an Alternative to the Poison Pill*, 23 DEL. J. CORP. L. 375 (1998).

³⁰ See *id.* at 391-92.

³¹ See Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54 (1989) (noting that in the early 1980's, hostile takeovers were a fundamental and recognized part of the American corporate environment).

³² See 1 ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSES § 5.04[A], at 5-35 (5th ed. Supp. 1997).

³³ See *id.*

³⁴ See *id.* The SEC and the courts allowed raiders to make hostile tender offers contingent on obtaining financing through junk bonds. See *id.*

³⁵ See *id.* A “bust up” takeover was implemented by a raider who would find third parties to commit in advance to purchase portions of the target corporation following the completion of the raider's tender offer, thereby breaking up the company. See *id.*

³⁶ See FLEISCHER & SUSSMAN, *supra* note 32, § 5.04[A], at 5-36. A “street sweep” was implemented by a buyer buying up large blocks of shares of the target corporation in a very short time, and then applying pressure to break up the corporation or engaging in some other restructuring business deal. See *id.*

Corporations were likened to castles under siege, and directors, defenders of the “corporate bastion.”³⁷

Corporate directors searched fervently for a defensive measure to reduce their susceptibility to these harmful tactics and provide adequate time to act in the event of a hostile acquisition.³⁸ The most potent defensive measure implemented by corporations at the time was a shareholders’ rights plan, commonly referred to as a poison pill.³⁹ Poison pills provided corporations with an adequate defense against the coercive hostile techniques developed by raiders during the 1980’s by allowing corporations to “just say no” to a hostile acquirer’s tender offer.⁴⁰ In response, however, raiders developed techniques to circumvent poison pills, namely coupling a tender offer with a voting contest to remove the target board, install a new slate of directors, and subsequently redeem the poison pill, thus circumventing the obstacle to the hostile acquisition.⁴¹ In response to this tactic, more potent forms of the poison pill were developed, such as the continuing directors provision, referred to as the dead hand poison pill,⁴² and more recently, the no-hand poison pill.⁴³

4. *The Practice of Greenmail*

Arbitrageurs and raiders often used the tactic of Greenmailing in order to turn a quick profit. The term “greenmail” refers to the practice of acquiring a large block of a target corporation’s stock with the expectation that the target corporation will then repurchase the shares at a premium over the market value. If the readers of this article have ventured to view the motion picture *Wall Street*, a classic example of greenmailing exists when the fictional raider, Gordon Gekko, acquires and then sells shares of a target corporation for a premium when there was no intent to make a tender offer for the target corporation. The effects and turmoil caused by a known greenmailer were also observed in *Mesa’s* takeover battle of Unocal that created the enhanced scrutiny test for a board’s informed decision-making (this was headed up by the infamous raider, T. Boone Pickens).⁴⁴

This practice of paying a potential acquirer to sell its interest was common in the 1980’s. Further examples include Texaco’s purchase of stock from the Bass brothers for \$1.2 billion, or roughly three percent above the previous closing price; and Disney’s purchase of Saul Steinberg’s stake for \$325 million dollars, plus a \$28 million dollar expense payment.

³⁷ See *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1388 (Del. 1995).

³⁸ See FLEISCHER & SUSSMAN, *supra* note 32, § 5.04[A], at 5-36.

³⁹ See Shawn C. Lese, *Preventing Control From the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175 (1996).

⁴⁰ See Neil C. Rifkind, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: “Just Say No” After Moore v. Wallace*, 78 B.U. L. REV. 105, 106 (1998).

⁴¹ See Shawn C. Lese, *Preventing Control from the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175, 2175 (1996).

⁴² See *id.* at 2175-76.

⁴³ See *infra* Part IV for further analysis on defensive measures.

⁴⁴ *Unocal*, 493 A.2d. at 946.

From the perspective of incumbent management, a greenmail payment may be viewed as a small price to pay to avoid the turmoil and expense of a prolonged takeover contest. Critics argue, however, that the payment of greenmail unfairly discriminates against other shareholders and clearly represents a management-entrenchment device. The popularity of anti-greenmail provisions has declined with the introduction of a federal greenmail tax. In addition, companies have come to realize that a strict anti-greenmail provision might actually reduce the flexibility required to deal with a hostile raider.

IV. DEFENSE STRATEGIES

In days past, corporations who grew weary of being trounced upon and threatened by corporate raiders developed defense strategies to combat raiders and various other corporate assailants. Many of the defensive measures were designed to make the target company unattractive to a potential corporate raider. A select few, such as the Pac-Man defense, touted the mantra of “the best defense is a good offense” and vied to turn the tables on a corporate assailant. However, few CEOs had a strong conviction towards employing these defensive measures, but if they did not employ them, corporate assailants would continue to have the upper hand in negotiations. Thus, initially taken as a reactionary measure towards corporate raiders, the takeover defense (in its many forms) has grown to encompass a multitude of defense tactics for a variety of situations.

A. Takeover Defenses in Brief

The key to a good defense in regard to warding off an unwanted acquirer offer is advance preparation. The best anti-takeover measures are a combination of a resolute management and board of directors, a high stock price and good shareholder relations.

As offenses mounted by corporations become more and more sophisticated, defensive measures must become more sophisticated as well so as to fend off these unwanted offers. Three major defensive measures have been developed over the years to ward off potential takeover bids: poison pills, shark repellents, and golden parachutes. There are several minor ones as well, which will be briefly described below. However, the discussion below will primarily focus on the poison pill, as this has been the most significant and effective anti-takeover defense measure to surface over the past three decades. In response to the raider’s hostile takeovers, management has fought back and, with the help of tacticians, has leveled the playing field by creating a variety of defensive strategies. The defensive strategies are not able to fully prevent all hostile takeovers, but they have been able to provide protection to a target corporation’s management in negotiating with a hostile bidder.

Each one of the above stated defenses will be examined briefly with special attention being paid to the poison pill and its many variations.

1. Shark Repellents

Corporations and their advisers have identified a number of defensive mechanisms – loosely referred to as “shark repellents” – that can be embedded in either a corporate charter or

corporate bylaw. These mechanisms were developed before the poison pill came into being and share a common purpose. They were intended to make an unfriendly takeover more difficult and costly. The hope was that the mere presence of a shark repellent would have a deterrent effect. It was the development of the shark repellent that ultimately led to the evolution of the poison pill.

Though the poison pill has become the dominant weapon in a corporation's defensive strategy, shark repellents still have an important role to play. The poison pill does not, for example, prevent an acquirer from gaining board control through a proxy contest at an annual or special meeting or a consent solicitation. Accordingly, shark repellents are an excellent supplement to the poison pill and contribute to a corporation's overall defensive strategy. In other words, shark repellents and poison pills are not mutually exclusive defensive countermeasures.

There are three basic distinctions between different types of shark repellents. Some require shareholder approval, while others can be put in place by the board of directors without shareholder approval. This distinction generally parallels the split between provisions that must be enacted through charter amendment and those that can be enacted by an amendment to the bylaws.⁴⁵

The law of the state in which a company is incorporated, along with its existing corporate charter and bylaws, determine what may be enacted as a bylaw without shareholder approval. Generally, only the more procedural rules may be accomplished through bylaws. Most forms of the shark repellent require amendments to a company's corporate charter, which in turn requires a shareholder vote. In contrast to a poison pill, the decision to implement shark repellents is not without risk. If a company is already in a dubious position, seeking shareholder approval for defensive measures may prove disastrous. An unwelcome proxy contest may result, and the shareholders may reject the shark repellent. Not only would this leave the company unprotected, it might also generate unwelcome attention from hostile bidders.

2. *The Pac-Man Defense*

A more aggressive approach for a target corporation is to go on the offensive. In other words, the target corporation of a hostile bid can turn around and bid for the potential acquirer. In essence, by using this "defense," the hunter becomes the hunted. This tactic was used on several occasions in the early 1980's – Cities Service counteroffered for Boone Pickens' Mesa Petroleum in 1982; Houston Natural Gas counteroffered for Coastal Corporation in 1984; and American Brands swallowed KKR's Beatrice spin-off, E-H holdings, in 1988.

The fundamental message of a Pac-Man counterattack is that a particular business combination may in fact make strategic sense, however, it may be more strategically sensible to reverse the direction of the acquisition. Additionally, there is also a defensive element to the counteroffer. The tactic sends a strong message that the original hostile bid will be opposed at all costs. In addition, the possibility that the bidder may itself be put in play can encourage the

⁴⁵ BRUCE WASSERSTEIN, *BIG DEAL* 701 (1998).

bidder to withdraw. However, the Pac-Man defense should only be used as a last-ditch defense mechanism because if both sides proceed with their respective offers for one another's companies, shareholders of each company will receive cash for their stock, in effect squeezing the equity out of the companies (due to the leverage required to generate the cash required to purchase the opposing company's stock). The result of this defense is that the two companies will be saddled with extremely high debt-to-equity ratios and insolvency seems to be the inevitable result.

If the Pac-Man defense is carried out, a circular ownership structure will result. One company might own a majority of the other, and vice versa. What happens in this case? Under many state statutes, including Delaware corporate law, a subsidiary is not permitted to vote stock it holds in its parent. These types of provisions arguably mean that neither side can control the other. Accordingly, the stock essentially becomes non-voting and any remaining stockholders will attain control.

3. *Golden Parachutes*

Golden Parachutes are arrangements that provide certain employees, often top level management, special benefits should a hostile takeover be presented and consummated. The benefits are usually equal to three or more times the employee's average annual compensation over the previous five years. This form of takeover protection involves entering into compensation agreements designed to compensate managers for loss of both human capital investments and deferred compensation in the event of a takeover.⁴⁶ Although parachutes have been upheld under state law, their effectiveness can be diminished due to the tax penalties (excise tax) imposed on excessive parachute payments.⁴⁷

4. *Silver or Tin Parachutes*

A silver or tin parachute functions like a golden parachute, but covers more employees. At the extreme, a tin parachute might cover all full-time employees. Like a golden parachute, these arrangements usually guarantee a lump-sum payment, and perhaps continued employee benefits, to a covered employee. The lump-sum payment is typically measured as a multiple of length of service. A tin parachute in most cases is triggered by an employee's termination after a change in control, unless the termination was "for cause."⁴⁸

5. *White Knights*

This refers to an acquirer in a friendly acquisition who rescues the target from a hostile bidder. In most cases, the target will seek out a friendly corporation to bid against the hostile bidder and provide the target greater economic value for its shareholders. White knight

⁴⁶ See generally Scott E. Masten, *Equity, Opportunism, and the Design of Contractual Relations*, 144 J. I. T. E. 180 (1988).

⁴⁷ See *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987) (golden parachute upheld as reasonable in relation to the threat posed).

⁴⁸ WASSERSTEIN, *supra* note 45, at 711.

transactions are often more difficult to accomplish, since regulatory approvals are required and the white knights are usually in the same business as the target.

6. *White Squires*

Taking a different tactical approach from the White Knight approach, a company can issue new shares as a defensive measure. The principal defensive advantage of this approach stems from placing the shares into the friendly hands of a “white squire.” A white squire investment can have three defensive benefits. First, the white squire presumably will vote in line with management. Often these deals are done in combination with a recapitalization and establish a solid management-friendly block. Second, a standstill agreement can be structured so that the white squire shares will not be tendered into a hostile offer. A hostile bidder therefore will be less likely to get the minimum number of shares needed to complete its offer. Finally, simply increasing the number of shares outstanding may make an acquisition more expensive.

Although there are defensive benefits in using the white squire defense, finding an appropriate white squire can be difficult. With a potential hostile acquirer in the wings, a squire must be willing to face the possibility of becoming a minority shareholder in an unsettled situation. In addition, from the target’s perspective, a number of restrictions are necessary to ensure that the squire remains friendly. A squire, therefore, must be willing to make a sizable long-term investment with limited prospect for control.⁴⁹ Warren Buffett is considered by many to be the most renowned white squire investor in the past two decades. An example of Buffett’s tactics was observed in 1987 when Buffett prevented noted raider, Ron Perelman, from buying a large block of stock in the investment bank formerly known as Salomon Brothers.

7. *The Leveraged Buy-Out (“LBO”)*

In a leveraged buy-out, the management of a corporation repurchases stock held by public shareholders, thereby turning a public corporation into a private corporation. Directors and management who may already have substantial shares are able to purchase additional stock during the LBO transaction. The effect of an LBO is to focus the target stock into the hands of the board of directors and other shareholders who desire to gain control of the corporation. The shares of the public holders are replaced largely by debt, with the remaining equity closely held by managers or an LBO promoter. This type of transaction was exemplified in the infamous takeover battle of RJR Nabisco. In the Nabisco battle, management attempted a LBO. However, the plan failed and RJR Nabisco was ultimately taken over by KKR (Kohlberg, Kravis & Roberts) through the use of junk bonds as a financing tool.⁵⁰

Furthermore, a leveraged buyout can be both a takeover defense and a method of opting out of the control market.⁵¹ The LBO allows managers to avoid being ousted by an acquirer by

⁴⁹ *Id.* at 727.

⁵⁰ See generally BRYAN BURROUGH & JOHN HELYAR, BARBARIANS AT THE GATE: THE FALL OF RJR NABISCO (1990).

⁵¹ See John C. Coffee, Jr., *Shareholders versus Managers: The Strain in the Corporate Web*, 85 MICH. L. REV. 1, 70-71 (1986).

making their own offer for the target. If the LBO is successful, the managers will effectively prevent being ousted through a hostile takeover. The successful LBO will also create effective constraints on management since the shares will be closely held. Additionally, the highly leveraged capital structure will be an effective monitoring mechanism because the corporation has a duty to make interest and principal payments, which restricts self-interested retention of earnings by managers.⁵² Furthermore, financed debt associated with LBOs is often provided with restrictions on management as to specific activities which assist in the monitoring of management's actions.

8. *Use of an ESOP (Employee Stock Ownership Plan) as a Takeover Defense*

The issuance of common stock to a newly formed ESOP may be a valid response to a hostile tender offer. Although not used frequently, for companies with ESOPs already in place, the issuance of common stock to the ESOP can be an effective takeover defense. The existence of an ESOP makes consummation of a tender offer or a successful proxy fight by a hostile bidder much more difficult. The trust agreement for the ESOP may provide that the unallocated stock (in the ESOP) will be voted proportionately to the votes cast by employees with respect to the allocated shares and that unallocated shares will be tendered into a tender or exchange offer in the same proportion as allocated shares.

9. *Miscellaneous Defensive Tactics – Voter Franchising and Protection of Merger Agreements*

Another means of protection used by corporations, is the adoption and retention of a shareholder voting franchise. The shareholder vote is the principle that legitimizes directorial powers.⁵³ If shareholders do not agree with the policies of the board, they have the power to vote them out.⁵⁴ When the purpose of board action is to interfere with or frustrate the shareholder vote, a compelling justification must be shown to sustain that action.⁵⁵

The question of who has the authority to run the corporation is raised when the board acts with the primary purpose of preventing the effectiveness of a shareholder vote.⁵⁶ The conflict between the board and the shareholders arises where board action is “designed principally to

⁵² See Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323, 325 (1986).

⁵³ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988). See generally Morgan N. Neuwirth, *Shareholder Franchise—No Compromise: Why the Delaware Courts Must Proscribe all Managerial Interference with Corporate Voting*, 145 U. PA. L. REV. 423, 425 (1996) (noting that the “shareholder vote is at the heart of the economic principles that drive corporate efficiency, as well as the fiduciary principles that legitimate managerial exercise of power over the vast amount of assets that management does not own”).

⁵⁴ See *Unocal*, 493 A.2d at 959 (noting that “[i]f the stockholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out”); see also *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (noting that the board of a Delaware corporation may not take action with the purpose of perpetuating itself in office).

⁵⁵ See *Blasius*, 564 A.2d at 658; see also *Paramount*, 637 A.2d at 34 (recognizing that “[b]ecause of the overriding importance of voting rights, this Court and the Court of Chancery have consistently acted to protect stockholders from unwarranted interference with such rights”).

⁵⁶ See *Blasius*, 564 A.2d at 559-60.

interfere with the effectiveness of a shareholder vote.”⁵⁷ Under this scenario, such a decision “may not be left to the directors’ business judgment.”⁵⁸ In *Blasius*, the board was faced with a consent solicitation by a shareholder who held a nine percent interest in the corporation.⁵⁹ The board responded by adding two new directors, thereby preventing shareholders from electing a majority of new directors nominated by the insurgent shareholder.⁶⁰ The court held that a compelling justification must be shown for such board action.⁶¹ The court further held that the board’s belief did not justify the board’s action because a “majority of the shareholders . . . could view the matter differently than did the board.”⁶²

In *Kidsco v. Dinsmore*, the board amended the corporation’s bylaws in order to delay a shareholder meeting for twenty-five days in response to an insurgent’s combined tender offer and proxy contest.⁶³ The court found that the bylaw change was not enacted for the primary purpose of interfering with the shareholder franchise, but was done to allow the board to present a competing bidder’s offer to the shareholders without the distraction of a proxy contest.⁶⁴ Furthermore, the court noted that the bylaw amendment did not preclude a shareholder vote, but only delayed it.⁶⁵ This case demonstrates that board actions that have an effect on the shareholder franchise will only be subject to the *Blasius* standard if such actions were taken with the primary purpose of impeding the shareholder franchise.⁶⁶

During merger discussions, both acquirers and sellers insist on certain safeguards from interference from a third-party bidder. Measures of protection include stock options and bust-up fee arrangements. The Delaware Supreme Court has been critical of these arrangements. However, it has noted in some instances that if the arrangements had the rational business purpose of protecting the stock merger agreement and were adopted to prevent either party to a merger agreement from being put into play, then these measures have been seen as valid.⁶⁷ Bust-up fees compensate a bidder for its fees and expenses in connection with making a proposal. The *QVC* Court rejected an unreasonable bust-up fee, but failed to provide guidance as to what is

⁵⁷ *See id.*

⁵⁸ *See id.*; see also *Aprahamian v. HBO & Co.*, 531 A.2d 1204, 1206-07 (Del. Ch. 1987) (invalidating a board’s decision to postpone shareholder meeting on eve of election where insurgent shareholder had proxies representing majority of shares).

⁵⁹ *See Blasius*, 564 A.2d 651 (Del. Ch. 1988).

⁶⁰ *See id.* The maximum number of board members was 15, so by adding two members of their own choosing, the current board ensured a continuing majority. *See id.*

⁶¹ *See id.* at 661-62.

⁶² *See id.* at 663.

⁶³ *See Kidsco, Inc. v. Dinsmore*, 674 A.2d 483, 490 (Del. Ch. 1995).

⁶⁴ *See id.* at 496.

⁶⁵ *See id.*

⁶⁶ *See Stahl v. Apple Bancorp, Inc.*, No. CIV.A. 11,510, 1990 Del. Ch. LEXIS 121, at 24 (Del. Ch. Aug. 9, 1990). The court noted that: the approach taken in *Blasius* . . . is appropriate when board action appears directed primarily towards interfering with the fair exercise of the franchise (e.g., moving a meeting date; adopting a bylaw regulating shareholder voting, etc.). The stock rights plan may or may not have that effect, but it does not represent action taken for the primary purpose of interfering with the exercise of the shareholders’ right to elect directors. *Id.*

⁶⁷ *See Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989); compare with *Paramount*, *supra* note 4, at 34.

considered reasonable.⁶⁸ Bust-up fees of two percent have been deemed reasonable for large and small transactions, with bust-up fees occasionally being higher for smaller transactions.

B. The Poison Pill

The primary defensive tool in modern day corporate law, and subject of much legal debate, is the “poison pill.” A kind of trap, the poison pill makes an unfriendly takeover prohibitively expensive. Numerous corporations to fortify their defensive arsenal in hostile takeover attempts have adopted the poison pill.⁶⁹ The poison pill was regarded initially as a “show-stopper” that would prevent all hostile acquisitions, since it was the first defensive measure to provide a board with adequate power to level the playing field with a raider’s bid for control.⁷⁰ While there is no precise definition of the term poison pill,⁷¹ it generally denotes a right distributed to shareholders that is triggered by certain specified events involving a hostile acquisition of the target company.⁷² The typical pill provides shareholders with the right to acquire an additional share for each share held when the poison pill is triggered, at a substantial discount.⁷³ The poison pill is generally triggered when the hostile acquirer announces a tender offer for the corporation or obtains an amount of stock in the target corporation over a prescribed threshold.⁷⁴

Most poison pill plans generally contain “flip-in” and “flip-over” features.⁷⁵ The “flip-in” provision is triggered when the acquirer purchases stock in excess of the threshold or upon announcement of a tender offer.⁷⁶ The “flip-in” feature vests in all shareholders except for the hostile acquirer.⁷⁷ Shareholders are entitled to purchase additional shares at a substantial discount, generally at half of the current market value of the stock.⁷⁸

The “flip over” feature is triggered when after a flip-in event occurs, the target corporation becomes involved in a business combination or substantial asset sale with any other person or entity.⁷⁹ This entitles shareholders of the target corporation, other than the hostile acquirer, to obtain a right to buy shares of stock in the hostile acquirer’s company at half the

⁶⁸ *See id.*

⁶⁹ *See* Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 510 (1993) (noting that approximately half of the major United States corporations have shareholders’ rights plans). *See also* Subramanian, *supra* note 29, at 376 (noting that “[f]ifteen years after their first appearance in corporate boardrooms, poison pills currently provide the centerpiece for more than half of the Fortune 500 companies’ takeover defenses”). By 1997, more than 1700 corporations had adopted shareholders’ rights plans. *See id.* at 398.

⁷⁰ *See* Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 DUKE L.J. 54, 55 (1989) (noting that in the early 1980’s, hostile takeovers were a fundamental and recognized part of the American corporate environment).

⁷¹ *See id.* at 58.

⁷² *See* FLEISCHER & SUSSMAN, *supra* note 32, § 5.01[B], at 5-6.

⁷³ *See* Yablon, *supra* note 70, at 58.

⁷⁴ *See* Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1369 n.6 (Del. 1995).

⁷⁵ *See* FLEISCHER & SUSSMAN, *supra* note 32, § 5.01[B], at 5-7.

⁷⁶ *See id.*

⁷⁷ *See id.*

⁷⁸ *See id.*

⁷⁹ *See* FLEISCHER & SUSSMAN, *supra* note 32, § 5.01[B], at 5-7.

price of its market value.⁸⁰ The poison pill, also referred to as a Shareholder rights plan, has the ability to be enacted by the board of directors without shareholder approval.⁸¹ Further, the power to redeem, or extinguish, the poison pill is vested in the board of directors as well.⁸² This power to redeem the rights provides the board with significant leverage in negotiations with a potential acquirer.⁸³

1. *The Poison Pill's Strategic Impact*

The poison pill acts by diluting the economic and voting rights of a hostile acquirer that has obtained stock in excess of a predetermined threshold amount.⁸⁴ The poison pill acts as the ultimate deterrent by dissuading hostile acquirers from obtaining an amount of stock in excess of the threshold because of the dilution factor when the pill is triggered.⁸⁵ Proponents of the poison pill claim the pills benefit shareholders by protecting them from coercive tactics of hostile acquirers, such as two-tiered tender offers.⁸⁶ Proponents also assert the pill is beneficial, since it will provide the board of directors with additional time to consider the tender offer or seek alternatives.⁸⁷ Opponents of poison pills assert that incumbent management benefits by wresting control of the corporation away from shareholders.⁸⁸ Provided below is the evolution of the Poison Pill and an analysis of the judicial history of the Poison Pill.

2. *Evolution of the Poison Pill*

The first-generation poison pill was developed by Marty Lipton in 1982. This type of pill, which evolved out of a series of “special power” preferred stock called “blank check preferred,” involved the distribution of a preferred stock as a dividend to shareholders. In a takeover of the issuer in which the issuer was merged into the acquirer, each share of preferred stock would be converted into forty shares of the acquiring company. The pill would thereby

⁸⁰ See Lese, *supra* note 41, at 2180; see also Neil C. Rifkind, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After Moore v. Wallace*, 78 B.U. L. REV. 105, 109 (1998).

⁸¹ See Lese, *supra* note 41, at 2181; see also Rifkind, *supra* note 80, at 111 (noting that “[t]he great power of poison pills derives from the board’s ability to adopt them without shareholder approval”).

⁸² See Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When Is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 512 (1993); see also Lese, *supra* note 41, at 2181 n.30 (citing RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 744 (2d ed. 1995) (noting that a board may redeem the rights at any time prior to a bidder’s acquisition over the threshold percentage of shares at a price of \$.01 per right).

⁸³ See FLEISCHER & SUSSMAN, *supra* note 32, § 5.01[B], at 5-8 (noting that “one of the fundamental attributes of the pill is that it can be adopted by a board of directors without a stockholder vote and the board alone has the power to redeem it”).

⁸⁴ See *Unitrin*, 651 A.2d at 1369 n.6.

⁸⁵ See Rifkind, *supra* note 80, at 109; see also Thomas, *supra* note 82, at 512 (noting that a poison pill with “flip in” and “flip over” features prevents potential acquirers from accumulating large amounts of the target’s stock because of the inevitable dilution that will result if the bidder obtains more shares than the threshold level).

⁸⁶ See Lese, *supra* note 41, at 2184-86.

⁸⁷ See FLEISCHER & SUSSMAN, *supra* note 32, § 5.01[A], at 5-5; see also Subramanian, *supra* note 29, at 398 (noting that the poison pill has been praised because of the protection it provides shareholders from coercive tender offers).

⁸⁸ See Thomas, *supra* note 82, at 506 (explaining that shareholders ability to express their dissatisfaction with the incumbent board may be eliminated by permitting the use of the poison pill against proxy contests).

substantially dilute the ownership interest of the acquirer.⁸⁹

As originally conceived, preferred stock plans had several disadvantages. First, the preferred stock could only be redeemed after an extended period of time, typically ten years. This severely limited the flexibility available to an issuer if it later decided to pursue a merger. Second, the preferred stock had a negative impact on an issuer's balance sheet because credit rating agencies often treated preferred stock as long-term debt when assessing a company's strength.⁹⁰

The second-generation pill – called a “rights plan” or “flip-over pill” (see below for further discussion on this) – was designed to address these problems. Under a flip-over plan, a company would issue rights to its shareholders. If the company were involved in a merger or other business combination not approved by its board, the rights entitled its shareholders to purchase stock in the surviving company at a substantial discount. The targeted shareholders could thus “flip over” to become acquiring shareholders, diluting the acquirer in the process.⁹¹ A third-generation pill – the “flip-in, flip-over” – was developed to address some weaknesses in the second-generation flip-over pill. This is the most common type of poison pill currently in use. Though endless variations exist, this type of pill generally has certain standard features. The pill is implemented through a special dividend of one stock purchase right per outstanding common share. This purchase right is dormant until a triggering event. Typical triggering events include the acquisition of fifteen percent of the company's voting stock without prior board approval or a hostile tender offer for thirty percent or more of the company's voting stock. When the rights activate, all holders (except for the hostile acquirer/investor who triggers the rights) become entitled to purchase additional stock in the issuing company at a substantial discount. This is referred to as the “flip-in.”⁹²

Additionally, if the issuing company (the Target company) takes part in any business combination or asset sale after the triggering event, all rights holders other than the triggering investor may buy voting securities of the surviving corporation at a substantial discount. In certain circumstances, this right allows target shareholders to buy stock in the bidder. This is referred to as the “flip-over.”⁹³ Two features make the flip-in, flip-over pill a potent defense against most hostile acquirers. First, the flip-in right is fully activated by a single step – the acquisition of stock in excess of a specific amount. Second, the flip-in rights are discriminatory. The acquirer who triggers the flip-in is not given the opportunity to purchase target shares at the discount rate.⁹⁴

Further, both the flip-in and flip-over provisions impose considerable dilution on a hostile raider. If the threshold is crossed and the rights are exercised, the value of the hostile acquirer's investment in the target company will decrease dramatically.

⁸⁹ See WASSERSTEIN, *supra* note 45, at 690.

⁹⁰ *See id.*

⁹¹ *See id.* at 691.

⁹² *See id.* at 692.

⁹³ *See id.*

⁹⁴ *See id.*

3. *Judicial History of the Poison Pill*

The Delaware Supreme Court has established the authority of a board of directors to adopt poison pills.⁹⁵ The *Moran* Court determined that, under Delaware law, the board of directors has the authority to establish a shareholders' rights plan with a poison pill provision as a pre-planned defensive measure.⁹⁶ The Delaware Supreme Court has also upheld the board of director's power to adopt a poison pill in response to a hostile tender offer.⁹⁷

As previously discussed above, standards of review applicable to the adoption or retention of defensive measures by a board of directors was addressed in *Unocal*.⁹⁸ In instances where the board adopts a defensive measure, it must satisfy the enhanced scrutiny standard set forth in *Unocal* before the business judgment rule applies.⁹⁹ Directors do not have the authority to defeat any perceived threat by whatever "draconian" means available.¹⁰⁰ In *Moran*,¹⁰¹ the adoption of a poison pill was determined to be a proportionate response to the threat of a hostile takeover, since it did not "strip stockholders of their rights to receive tender offers" and it did not "fundamentally restrict proxy contests."¹⁰² The decision of the board to redeem the pill, as the *Moran* Court noted, is subject to the same fiduciary duties as the decision to adopt the shareholders' rights plan.¹⁰³ The *Moran* Court, further stated, that the defensive measures adopted would not have a preclusive effect unless the opportunity to conduct a proxy contest was not a viable alternative.¹⁰⁴

4. *The Modern Day Poison Pill – "Dead Hand" Provisions*

With hostile acquirers inventing methods for overcoming and circumventing the poison pill, the defensive measures available to target corporations have evolved. Namely, the continuing directors provision, most commonly known as the dead hand poison pill, and the no-hand poison pill, were developed to counter new offensive strategies developed by hostile acquirers.¹⁰⁵ However, certain aspects of these next generation poison pills have been the subjects of recent judicial scrutiny.

⁹⁵ See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 181 (Del. 1986); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1351 (Del. 1985); see also Yablon, *supra* note 70, at 55.

⁹⁶ See *Moran*, 500 A.2d at 1350-51.

⁹⁷ See *Revlon*, 506 A.2d at 180.

⁹⁸ See *Unocal*, 493 A.2d at 954-55.

⁹⁹ See *id.*; see also Rifkind, *supra* note 80, at 121-22 (explaining that the enhanced scrutiny test was developed "because of directors' strong entrenchment motive when adopting defenses against an unsolicited offer").

¹⁰⁰ *Unocal*, 493 A.2d at 955.

¹⁰¹ 500 A.2d at 1346.

¹⁰² *Id.* at 1357.

¹⁰³ See *Moran*, 500 A.2d at 1357.

¹⁰⁴ See *Unitrin*, 651 A.2d at 1388. The court noted that a proxy contest remains a viable alternative unless "success would either be mathematically impossible or realistically unattainable." *Id.* at 1388-89. Similarly, in *Moore Corp. Ltd. v. Wallace Computer Serv. Inc.*, 907 F.Supp. 1545 (D. Del. 1995), the federal district court of Delaware determined that the retention of a poison pill was not preclusive because it would "have no effect on the success of the proxy contest." *Moore*, 907 F.Supp. at 1563 (D. Del. 1995).

¹⁰⁵ See Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 531-32 (1997).

The dead hand provision provides that a poison pill can only be redeemed by directors who were in place when the poison pill was adopted, or who were elected with the approval of such directors or their approved or designated successors (i.e. “continuing directors”).¹⁰⁶ This type of provision is intended to prevent a hostile bidder from gaining control over the board of directors through a tender offer or proxy contest, removing and then replacing unfavorable board members with new ones, and then having these new directors redeem or remove the poison pill.

The no-hand poison pill prevents all directors of the target board of directors from redeeming the poison pill and effectuating a sale of the corporation.¹⁰⁷ These provisions severely limit a hostile acquirer’s chances of succeeding in a takeover attempt that combines a tender offer with a proxy contest. Obviously, the effect of the dead hand and no-hand pills are extremely preclusive. These versions of poison pills limit the power of a successful hostile bidder by preventing redemption of the poison pill with a new board of directors.¹⁰⁸ Therefore, if a dead hand poison pill is triggered and shareholders favor the hostile acquirer’s proposal, the shareholders will have no option but to re-elect the incumbent board members, since only they are empowered to redeem the rights plan and effectuate the proposal.¹⁰⁹

a. *Bank of New York Case*

In *Bank of New York Co. v. Irving Bank Corp.*,¹¹⁰ the Supreme Court of New York enjoined the use of a continuing directors provision as an invalid exercise of the Board of Directors’ authority under New York corporate law.¹¹¹ The decision was based upon statutory grounds, noting that a board is without authority to limit the power of a future board if such a restriction is not contained in the certificate of incorporation.¹¹² The court recognized that the incumbent board, or those new directors approved by it, would have the power to redeem the rights plan if reelected by a plurality of shareholders, “but the insurgents would not if they were elected by the same plurality.”¹¹³ The court held the provision was tantamount to “illegal discrimination” by the incumbent board and that the board of directors of the target corporation (Irving Bank) did not have statutory authority to amend Irving Bank’s rights plan to include a dead hand provision.¹¹⁴

The validation of the dead hand pills have been questioned in Delaware cases involving continuing directors provisions. However, the rulings did not directly address this issue.¹¹⁵ In

¹⁰⁶ *Id.* at 532.

¹⁰⁷ *See, e.g.,* *Mentor Graphics, Inc. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 35 (Del. Ch. 1998) (discussing the no-hand poison pill provision adopted by the Quickturn board of directors in the face of Mentor’s hostile tender offer).

¹⁰⁸ *See* Lese, *supra* note 41, at 2191.

¹⁰⁹ *See* Gordon, *supra* note 105, at 540.

¹¹⁰ 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988).

¹¹¹ *See Bank of New York*, 528 N.Y.S.2d at 486.

¹¹² *See id.* at 485.

¹¹³ *See id.*

¹¹⁴ *See id.*

¹¹⁵ *See* Daniel A. Neff, *The Impact of State Statutes and Continuing Director Rights Plans*, 51 U. MIAMI L. REV. 663, 673-74 (1997) (discussing judicial decisions in Delaware which had the opportunity to address the dead hand feature of a shareholders’ rights plan).

Sutton Holding Corp. v. Desoto, Inc.,¹¹⁶ the Court of Chancery indicated that a continuing directors provision was suspect.¹¹⁷ The *Sutton* Court suggested that the adoption of the continuing directors provision was a breach of the board's fiduciary duty of loyalty. However, this suggestion was made only in dicta.¹¹⁸ The issue was that a raider, who had the support of the shareholders, would trigger the continuing directors provision, rendering any new board members powerless to redeem the poison pill.¹¹⁹ In *Davis Acquisition Inc. v. NWA, Inc.*,¹²⁰ NWA's board of directors enacted a rights plan with "flip-in" and "flip-over" features, but also containing a provision that the rights could not be redeemed by anyone other than the incumbent board of directors for 180 days.¹²¹ Plaintiffs argued the provision interfered with a proxy contest because shareholders would be discouraged from voting for a new board, since it would have less power than the incumbent board of directors, and thereby,¹²² impermissibly interfering with shareholder voting rights and limiting the power of future boards.¹²³ The *Davis* Court, however, did not resolve the question of the dead hand provision's validity.¹²⁴

b. *Invacare Case*

However, the continuing directors provision has been upheld in a Georgia federal district court in *Invacare Corp. v. Healthdyne Technologies, Inc.*¹²⁵ *Invacare* was the first decision to address the validity of dead hand provisions since *Bank of New York*. In *Invacare*, the hostile bidder made an all-cash, all-shares tender offer for Healthdyne, and then announced it would propose a new slate of directors at the annual shareholder meeting.¹²⁶ *Invacare* further sought a preliminary injunction declaring the continuing directors provision of the Healthdyne rights plan invalid.¹²⁷ The *Invacare* Court relied on Georgia corporate law¹²⁸ in rejecting *Invacare's* claim, which provides the board of directors with the sole discretion to issue rights and determine the terms and conditions of those rights.¹²⁹ The Court opined that the continuing directors provision

¹¹⁶ No. CIV.A. 12,051, 1991 Del. Ch. LEXIS 85 (Del. Ch. May 14, 1991), reprinted in 17 DEL. J. CORP. L. 363 (1991).

¹¹⁷ *Id.* at 3. At issue was a provision, prompted by the acquirer's proxy contest, that the target's pension plans could not be terminated or amended for five years following a change in control of the corporation. *Id.* at 2.

¹¹⁸ *Id.* at 4.

¹¹⁹ See *Sutton*, 1991 Del. Ch. LEXIS 85, at 5, n.3

¹²⁰ No. CIV.A. 10,761, 1989 Del. Ch. LEXIS 39 (Del. Ch. Apr. 25, 1989), reprinted in 15 DEL. J. CORP. L. 156 (1990).

¹²¹ *Id.* at 3, reprinted in 15 DEL. J. CORP. L. at 160. This type of dead hand provision, which makes the rights redeemable by the incumbent board only for a short duration (not the life of the rights), has been labeled a diluted continuing directors provision; see also Lese, *supra* note 41, at 2210.

¹²² See *Davis*, 1989 Del. Ch. LEXIS 39, at 4, reprinted in 15 DEL. J. CORP. L. at 160.

¹²³ See *id.*

¹²⁴ See *id.*

¹²⁵ 968 F.Supp. 1578 (N.D. Ga. 1997).

¹²⁶ See *Invacare*, 968 F.Supp. at 1579.

¹²⁷ See *id.*

¹²⁸ GA. CODE ANN. § 14-2-624(a) (1994). Section 14-2-624 (a) provides in pertinent part that "a corporation may issue rights, options, or warrants with respect to the shares of the corporation The board of directors shall determine the terms upon which the rights, options or warrants are issued *Id.* Section 14-2-624(c) provides that [n]othing contained in Code Section 14-2-601 shall be deemed to limit the board of directors' authority to determine, in its sole discretion, the terms and conditions of the rights, options, or warrants issuable pursuant to this Code section. Such terms and conditions need not be set forth in the articles of incorporation. *Id.* § 14-2-624(c).

¹²⁹ See *Invacare*, 968 F.Supp. at 1580; cf. *Gordon*, *supra* note 105, at 535-36 (criticizing the *Invacare* decision as

did not interfere with shareholders' rights to elect a new board, but instead ensured that one or more continuing directors could only redeem the rights plan.¹³⁰

c. Toll Brothers

Eventually, in a case of first impression under Delaware law, the Court of Chancery held that a dead hand provision of a rights plan was subject to legal challenge under Delaware law on both fiduciary and statutory grounds.¹³¹ The *Toll Brothers* Court found the complaint stated a claim upon which relief could be granted and denied the defendants' motion to dismiss.¹³² The Shareholders' Rights Plan adopted by the board contained the standard "flip-in"¹³³ and "flip-over"¹³⁴ features, but also included a dead hand provision.¹³⁵ This dead hand feature provided that the rights issued pursuant to the shareholders' rights plan were redeemable only by the continuing directors.¹³⁶ The Court of Chancery held that the dead hand poison pill provision was subject to legal challenge under Delaware law, since the court claimed the dead hand provision violated Delaware General Corporation Law sections 141(a) and (d).¹³⁷ Second, the Court of Chancery ruled the complaint stated a claim that the dead hand provision of the rights plan was ultra vires, and therefore, invalid.¹³⁸ The Court of Chancery opined that because the dead hand provision interfered with the shareholders' right to elect directors who would have the power to redeem the pill, and because it was alleged this power was not contained in the Toll Brothers certificate of incorporation, the complaint stated a claim that the continuing directors provision was invalid.¹³⁹ Third, since the rights could only be redeemed by the continuing directors, a

"quite a stretch" based on the statutes and legislative history).

¹³⁰ See *id.* The court refused to find that there must be a showing of compelling justification, distinguishing the case from *Blasius* because: the continuing director feature in the Healthdyne rights plan does not infringe on the shareholders' right to elect a new board. The continuing director provision only ensures that the rights plan cannot be redeemed or amended without the consent of at least one of the continuing directors. In this respect, the continuing director provision does not interfere with shareholder voting rights; nor is it coercive. See *id.*

¹³¹ See *Carmody v. Toll Brothers*, 723 A.2d 1180, 1182 (Del. Ch. 1998).

¹³² See *id.*

¹³³ See *id.* The "flip in" provision of the rights plan provides for a: dividend distribution of one preferred stock purchase right (a "Right") for each outstanding share of common stock as of July 11, 1997 . . . initially entitl[ing] the holder to purchase one thousandth of a share of a newly registered series Junior A Preferred Stock for \$100. The Rights would become exercisable, and would trade separately from the common shares, after the "Distribution Date," which is defined as the earlier of (a) ten business days following a public announcement that an acquiror has acquired, or obtained the right to acquire, beneficial ownership of 15% or more of the company's outstanding common shares (the "Stock Acquisition Date"), or (b) ten business days after the commencement of a tender offer or exchange offer that would result in a person or group beneficially owning 15% or more of the company's outstanding common shares. *Id.* The rights were to remain exercisable, unless earlier redeemed by the company, until June 12, 2007, 10 years after the adoption of the Rights Plan.

¹³⁴ See *id.* The "flip over" provision of the rights plan entitled the Rights holders to purchase common stock of the acquiring company at half price if, after the stock acquisition date, the company is made a party to a merger in which Toll Brothers is not the surviving corporation, or in which it is the surviving corporation and its common stock is changed or exchanged. *Id.* at 1183-84.

¹³⁵ See *id.* at 1184.

¹³⁶ See *id.* at 1184. (Under the definition of a "continuing director," any board member that at the time of adoption or any one which the board recommended and approved, who was affiliated or associated with an acquiring person could not redeem the rights.)

¹³⁷ See *id.* at 1191; see DEL. CODE ANN. tit. 8, §§ 141 (a), (d) (1991).

¹³⁸ See *id.*

¹³⁹ See *id.*

newly elected board's power to enter into a business combination would be severely limited, since the board would not have the ability to redeem the rights without the consent of the continuing directors. The Court further reiterated that the shareholder vote is of utmost importance in the system of corporate governance because it is the "ideological underpinning upon which the legitimacy of directorial power rests."¹⁴⁰ With this analysis, the Court of Chancery found the complaint stated a claim that the board breached its fiduciary duty under *Blasius*.¹⁴¹

The Court of Chancery then examined whether the dead hand provision was an "unreasonable defensive measure within the meaning of *Unocal*," and concluded that the complaint stated a legally cognizable claim on this basis.¹⁴² The pleadings alleged the dead hand provision was coercive as it interfered with the shareholders' rights by forcing them to vote for the incumbent directors if they desired a board to have full power.¹⁴³ The complaint further alleged the dead hand provision was preclusive in nature, and since a proxy contest would be of no benefit, any newly elected directors would not have the power to redeem the poison pill.¹⁴⁴

5. *The No-Hand Provision*

After the decision in *Carmody v. Toll Brothers*, and the determination that the dead hand pill was subject to legal challenge, the no-hand provision was challenged to a validation.¹⁴⁵ In *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*,¹⁴⁶ the Court of Chancery held that the no-hand delayed redemption provision adopted by Quickturn's board of directors was invalid on the basis of fiduciary duty.¹⁴⁷ The Delaware Supreme Court also invalidated the no-hand provision, however, their holding was based upon statutory grounds, specifically, that the no-hand provision violated section 141(a).¹⁴⁸

The Court noted that one of the basic principles of Delaware corporate law is that the "board of directors has the ultimate responsibility for managing the business and affairs of a corporation."¹⁴⁹ According to the Court, the no-hand provision would interfere with this fundamental duty of a newly elected board for a period of six months.¹⁵⁰ The Court found that

¹⁴⁰ *Id.* at 1193 (quoting *Blasius*, 564 A.2d at 659).

¹⁴¹ *Id.* at 1194.

¹⁴² *Id.* The court noted that, under the *Unocal* standard, "the board has the burden to satisfy the Court that the board (1) 'had reasonable grounds for believing that a danger to corporate policy and effectiveness existed,' and (2) that its 'defensive response was reasonable in relation to the threat posed.'

¹⁴³ *See Toll Bros.*, 723 A.2d 1180 at 1195.

¹⁴⁴ *See id.*

¹⁴⁵ The term no-hand refers to the fact that no directors can redeem the poison pill, not even the continuing directors. In addition, the particular no hand poison pill provision at issue in *Mentor* was of a limited duration because it did not operate for the entire duration of the poison pill, but only for a period of six months. Therefore, it is referred to as a no-hand delayed redemption provision.

¹⁴⁶ 728 A.2d 25 (Del. Ch. 1998).

¹⁴⁷ *See Quickturn*, 728 A.2d at 28.

¹⁴⁸ *See id.* *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291-93 (Del. 1998); DEL. CODE ANN. tit. 8, § 141(a) (1991).

¹⁴⁹ *Quickturn*, 721 A.2d at 1291-93.

¹⁵⁰ *Id.* at 1291.

the no-hand provision “impermissibly circumscribed the board’s statutory power under section 141(a).”¹⁵¹ The Court further found that the no-hand provision would “prevent a newly elected board of directors from completely discharging its fiduciary duties to protect fully the interests of Quickturn and its stockholders.”¹⁵² The Court determined that “no defensive measure can be sustained which would require a new board of directors to breach its fiduciary duty.”¹⁵³ The no-hand provision would prevent a newly elected board from redeeming the plan, even where the board’s fiduciary duty required it to do so “for the benefit of Quickturn and its stockholders.”¹⁵⁴ Therefore, the no-hand provision impermissibly constrained the directors’ ability to fulfill their fiduciary duties, and therefore, was found invalid.¹⁵⁵

Though the *Toll Brothers* decision did not ultimately decide that the dead hand provision violated Delaware law, if read in concert with the decision rendered in *Quickturn* (regarding the no-hand provision), it is likely that the dead hand provision will suffer the same fate in the future.¹⁵⁶

6. Comparison of the No-Hand and “Dead Hand” Provisions

Significant distinctions exist between the dead hand and no-hand poison pill provisions. For example, a dead hand poison pill, such as the *Toll Brothers* provision, creates two classes of directors: those who have the power to redeem the poison pill, and those who do not.¹⁵⁷ In the context of a hostile acquisition, if a hostile acquirer were successful in having a majority of its nominees elected to the target’s board, those directors would not have the power to redeem the poison pill and accomplish a sale of the corporation with any prospective bidder, for the duration of the pill. Therefore, the dead hand provision effectively prevents the sale of the corporation to any potential acquirer. On the other hand, a no-hand poison pill, such as the *Quickturn* provision, would prevent all directors from redeeming the rights plan. In contrast to the *Toll Brothers* dead hand provision, the *Quickturn* provision would empower the newly elected board to redeem the poison pill to effectuate a sale of the target corporation to any bidder other than an “interested person.”¹⁵⁸ Therefore, practically speaking, these provisions would have different effects if triggered: the *Toll Brothers* provision would preclude the sale of the corporation to anyone, while the *Quickturn* provision would preclude a sale to an “interested person.”

Further, the dead hand provision gives the power to redeem the rights to some board

¹⁵¹ *Id.* at 1293.

¹⁵² *Id.* at 1292.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ See *Quickturn*, 721 A.2d at 1293.

¹⁵⁶ In fact, the Delaware Supreme Court has indicated that this discussion may already be moot. Reciting Mentor’s initial argument, the court stated: According to Mentor, the [no-hand provision], like the “dead hand” feature in the Rights Plan that was held to be invalid in *Toll Brothers*, will impermissibly deprive any newly elected board of both its statutory authority to manage the corporation under Delaware corporate law and its concomitant fiduciary duty pursuant to that statutory mandate.

¹⁵⁷ See *Toll Bros.*, 723 A.2d at 1182.

¹⁵⁸ *Quickturn*, 728 A.2d at 25. A much stronger version of the no-hand provision may be employed where the directors of the target corporation may not redeem the poison pill until it expires, thus preventing a sale of the corporation to anyone.

members but not all, while the no-hand provision restricts the authority of all directors to redeem the rights. Although these provisions operate in different manners and have a slightly different impact, there are common elements that render these variations, and all similar variations, invalid: they restrict the power of the board of directors to discharge their statutory duty to manage the affairs of a corporation, and they inhibit the board's ability to uphold its fiduciary duties to the corporation and its shareholders.¹⁵⁹ However, the fate of these latest variations suggest that future modifications of the poison pill interfering with the statutory and fiduciary duties of directors to manage the corporation will in all likelihood be held invalid.

Since the inception of the poison pill as a defensive measure in thwarting hostile bids, corporations have dawned these mechanisms of armor as their means of protection. As discussed, the pill is ever evolving with innovations, such as the chewable pill, which expires after an all-cash offer is made for the target at a premium of at least twenty-five percent over the market price of the target's stock.¹⁶⁰ With the invalidation of the variations of the poison pill and a corporation's desire to afford itself protection from hostile acquirers, new ways to thwart hostile takeover attempts will soon be developed, and until courts invalidate the poison pill, they will continue to be the most widely used form of defense against the hostile takeover.

V. CONCLUSION

Is the poison pill an effective deterrent to unwanted hostile raids? Clearly, in light of the above stated authorities, the newly evolved dead hand (and no-hand) poison pill is a thorn in the side of hostile acquirers. However, with the Delaware Court's decision in *Quickturn*, invalidating the no-hand version of the poison pill, the dead hand poison pill's days may be numbered.

Even so, the standard poison pill/shareholder rights plan still provides an effective first tier defensive measure against unwanted corporate assailants. Many companies who wish to ensure that their long-term strategy comes to fruition and/or wish to protect themselves from unwanted takeover bids are installing poison pills. Presently, with the Nasdaq stock market hitting two year lows, many companies fear that deflated stock prices will make them attractive takeover targets, and thus, are installing shareholder rights plans as a preemptive strike towards unwanted corporate assailants. Recently, Yahoo! installed a shareholder rights' plan in order to "deter coercive takeover tactics, including the accumulation of shares in the open market or through private transactions and to prevent an acquirer from gaining control of Yahoo! without offering a fair and adequate price and terms to all of Yahoo!'s stockholders."¹⁶¹ Even in down markets, takeover activity may increase, thus requiring potential target companies to reevaluate their takeover defensive mechanisms.

¹⁵⁹ See DEL. CODE ANN. tit. 8, § 141(a) (1991); see also Gordon, *supra* note 105, at 538 (recognizing that because a dead hand poison pill provision limits a future boards "capacity to accomplish a business combination (because it cannot redeem the pill), it directly interferes with the future board's core statutory power to manage the business and affairs of the corporation in the best interests of the corporation and its shareholders").

¹⁶⁰ See Jonathan R. Macey, *A Poison Pill that Shareholders Can Swallow*, WALL ST. J., May 4, 1998, at A22.

¹⁶¹ SAN JOSE MERCURY NEWS, March 2, 2001, at C1.

Since the invention of poison pill/shareholder rights plans in 1984, economists and market analysts have debated the economic impact of rights plans on the market price of a company's stock as well as on takeovers and takeover premiums. Every major investment bank that has studied the matter has concluded that adoption of a rights plan has no effect on the stock prices of companies that are not the subject of takeover speculation.¹⁶² Additionally, a recent study of 341 rights plans adopted between January 1, 1998 and October 31, 1998 concluded that the announcement of the adoption of a stockholder rights plan had no effect on the average company's stock price.¹⁶³

Additionally, a 1988 Georgeson & Company Inc. study demonstrated that companies with rights plans received substantially higher premiums than companies without rights plans. According to one published report based on analysis by a major investment bank of 245 deals between 1988 and 1995, each with a market value in excess of \$500 million dollars, the median premium for a company with a rights plan was fifty-one percent, compared to thirty-five percent for companies not having rights plans. In another Georgeson study that analyzed 319 takeover transactions completed between 1992 and 1996, the company's research group found that premiums paid for companies with rights plans averaged eight percentage points higher (a twenty-six percent increase in the premium paid) than premiums for companies without rights plans.¹⁶⁴

Do poison pills hinder shareholder value in a corporation? Opponents of the poison pill who claim that the installation of a poison pill plan does not maximize a shareholder's value in the corporation have been provided considerable evidence (see studies above) to the contrary. The studies conducted above clearly stand for the proposition that installation of a poison pill plan does *not* result in a decrease in the value of a corporation's stock, but may, in fact, increase the value of a corporation's stock through receipt of a takeover premium.

In conclusion, in the modern era, a corporation's defensive arsenal must be examined thoroughly and periodically in order to evaluate its efficacy against state-of-the-art takeover stratagem. Strategy has been referred to as the employment of the battle as the means towards the attainment of the object of the War.¹⁶⁵ The poison pill, as stated above, should form the foundation of any corporation's first tier defensive measures. The poison pill, in tandem with other defensive measures provides the corporation with a solid defensive foundation and a corporation should install these varying defensive measures in order to ensure that its long-term growth plans are allowed to come to fruition, unhindered and unaltered. A takeover or unwanted corporate assailant can seriously impede management's vision for a particular corporation. Thus, the goal of defensive measures are twofold: one, to provide a corporation's management insurance that its long term plan for the company will be carried out, and two, to increase shareholder value in the form of a takeover premium if a takeover is consummated.

¹⁶² Takeover Law and Practice 2001, Edward D. Herlihy, Contests for Corporate Control, PLI Publication, 2001, p. 65.

¹⁶³ Houlihan Lokey Howard & Zukin Stockholder Rights Plan Study, January 1999, at 2.

¹⁶⁴ See Mergers & Acquisitions: Poison Pills and Shareholder Value/1992-1996, November 1997.

¹⁶⁵ CLAUSEWITZ, *supra* note 2, at 241.