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# Professor Coates Is Right. Now Please Study Stockholder Voting.

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We live today in the Poison Pill Era. The stockholder rights plan, commonly known as the “poison pill,” has profoundly affected every aspect of mergers and acquisitions practice. In the days before poison pills, boards of directors faced with tender offers could do little more than exhort their stockholders not to tender or cobble together a transactional alternative. The board had no direct role in the process. Now, armed with a pill, a board of directors can interpose itself between the target corporation’s stockholders and the offeror and prevent the acquirer from buying shares. Put simply, a board with a pill has the power to block a tender offer.

This revolutionary development prompted the inevitable question: Are pills a good thing? An army of scholars attempted to answer this question, and the primary evidence on which they relied were “event studies,” statistical analyses that sought to determine whether pills increased or decreased stockholder wealth. To assess pill impact, the studies asked whether the adoption of a pill, all other things being equal, affected a firm’s stock price. The conflicting and ambiguous results of these studies have fueled nearly two decades of debate.

Enter Professor John C. Coates IV and his excellent article, *Empirical Evidence on Structural Takeover Defenses: Where Do We Stand?*<sup>2</sup> Professor Coates believes that the predominant conclusion drawn by practitioners, scholars and other commentators from event studies has been that poison pills and other antitakeover amendments (“ATAs”) decrease firm value. He responds with a simple thesis: their conclusion is wrong. In his words, “prior empirical studies of takeover defenses do not support the belief that defenses either increase or decrease firm value on average.”<sup>3</sup> Professor Coates’s article defends this thesis.

We agree with Professor Coates’s rejection of event studies,

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1. The authors are members of the Delaware bar and practice with the firm of Richards, Layton & Finger. The views expressed in the article are solely those of the authors and do not necessarily represent the views of Richards, Layton & Finger or its clients. The authors wish to thank the Honorable Jack B. Jacobs and Samuel C. Thompson, Jr., for their helpful comments on earlier drafts of this article.

2. 54 U. MIAMI L. REV. 783 (2000).

3. *Id.* at 786.

although primarily for reasons that he does not mention. First, we follow the repeated instruction of the Delaware courts that market value does not determine firm value, which means that market evidence from event studies cannot provide a normative justification for pills. Second, we question the impact that pills can have on firm value, except to the extent that some portion of a stock's market value is attributable to takeover speculation; we, therefore, doubt the validity of studies that fail to quantify this portion of a stock's value and incorporate it in their analysis of the effects (or non-effects) of pill adoption. Third, we submit that the market may not understand fully or internalize evolving Delaware jurisprudence regarding pills and that market participants may instead rely on a potentially misleading montage of anecdotal accounts in which victories for potential acquirers have figured more prominently than they should. Finally, we agree with Professor Coates that as a practical matter, all Delaware corporations effectively have poison pills in place. We suggest, in light of the effectiveness and practical omnipresence of poison pills, that scholars shift their attention away from studying what is now a fundamental feature of the corporate law landscape and focus instead on stockholder voting, which has become the pivotal issue in takeover disputes. Professor Coates's fine article provides strong support for such a result.

#### I. THE TREATMENT OF MARKET EVIDENCE UNDER DELAWARE LAW.

Professor Coates begins his article with a comprehensive overview of the many statistical flaws in event studies, and he concludes from this that event studies should not be used to justify pills.<sup>4</sup> His statistical critique appears careful and well-crafted. It certainly is convincing. From a Delaware law perspective, however, discounting event studies is nothing new. Event studies focus solely on market value, yet the Delaware courts consistently have held that market value does not determine firm value.<sup>5</sup> The Delaware cases also make clear that market value does not

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4. See *id.* at 788.

5. See *Smith v. Van Gorkom*, 488 A.2d 858, 875-76 (Del. 1985); see also *Cede & Co. v. Technicolor, Inc.*, 684 A.2d 289, 301 (Del. 1996) (explaining that "the market price of shares may not be representative of true value") (citation and quotation omitted); *Rapid-American Corp. v. Harris*, 603 A.2d 796, 806 (Del. 1992) (stating that "the Court of Chancery long ago rejected exclusive reliance upon market value in an appraisal action"); *Bell v. Kirby Lumber Corp.*, 413 A.2d 137, 141 (Del. 1980) (explaining that "market value may not be taken as the sole measure of the value of the stock"); *Chicago Corp. v. Munds*, 172 A.2d 452, 455 (Del. Ch. 1934) (finding that "[t]here are too many accidental circumstances entering into the making of market prices to admit them as sure and exclusive reflectors of fair value"). The Delaware courts are even more skeptical of market value when a corporation's stock price is inflated by a tender offer, proposed transaction or auction. See *Cooper v. Pabst Brewing Co.*, C.A. No. 244, slip op. at 21 (Del. Ch. June 8, 1993) (explaining that following an announcement of a tender offer or during an auction the market price

establish an unvarying standard for director behavior. As former Chancellor William T. Allen explained, “[d]irectors may operate on the theory that the stock market valuation is ‘wrong’ in some sense, without breaching faith with shareholders. No one, after all, has access to more information concerning the corporation’s present and future condition.”<sup>6</sup> For purposes of Delaware law, therefore, evidence of market value from event studies cannot provide a normative justification for poison pills.

## II. THE UNCERTAIN LINK BETWEEN MARKET EVIDENCE AND FIRM VALUE.

We also question the value of market evidence from event studies in assessing the benefits of pills because it is far from clear in what sense a poison pill could affect the value of a firm, other than by nudging the price paid for its stock in the market. The adoption of a pill, after all, does not change the intrinsic nature of the firm’s business. It does not add any assets or liabilities to the company’s balance sheet. It does not increase or decrease cash flow. It also does not alter any variable typically used in valuation metrics. A comparable company analysis will not be affected. The value derived from a comparable transaction analysis will not change. From the perspective of the ongoing business, therefore, the adoption of a pill is meaningless. Event studies, thus naturally, would not show any effect.

Event studies theoretically can, however, reveal an impact on a firm’s market value. The validity of event studies then will turn on what exactly the market is valuing. Because pill adoption does not affect the business itself, for market value to change, the market must be according value to something other than the firm’s underlying business. The answer that some economists would give to the question of what the market purportedly is valuing is that stockholders accord value to their ability to receive a control premium. In other words, there is an element of value that exists in a widely-traded public corporation (but not in a

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“may reflect a control premium and other factors connected with the acquirer’s intentions but unrelated to the value of the firm”); *Gibbons v. Schenley Indus., Inc.*, 339 A.2d 460, 466 (Del. Ch. 1975) (explaining that “exceptants may not, in my opinion, be allowed to minimize the fact that Lorillard and Glen Alden, by engaging in a battle to acquire control of Schenley in the mid-1960’s, drove up the market price of the common stock of such corporation beyond its true market value”).

6. *Paramount Communications, Inc. v. Time Inc.*, C.A. No. 10670, slip op. at 49 (Del. Ch. July 14, 1989), *aff’d*, 571 A.2d 1140 (Del. 1990). More recently, the Court of Chancery expressed a hope that “directors and officers can always say that they know more about the company than the company’s stockholders – after all, they are paid to know more.” *Chesapeake Corp. v. Shore*, C.A. No. 17626, slip op. at 74 (Del. Ch. Feb. 7, 2000, *revised* Feb. 11, 2000). The reference to “the company’s stockholders” applies with equal force to the market, which is simply a means by which the composition of the company’s stockholder base changes over time.

privately-held or majority-controlled public corporation) that derives merely from the speculative possibility someday that a takeover bid may emerge. It is this "takeover fluff" that loses some of its loft when a pill is adopted.

Assuming that takeover fluff exists, it still comes as little surprise that event studies would not reveal any discernable effect on market value from the adoption of a poison pill. After all, takeover fluff must be a fragile and highly subjective thing. How much takeover fluff can there be for a company like General Motors or DuPont? How much takeover fluff can there be for a company on a clear day without any takeover threat in the air? How much takeover fluff can there be for shares representing minority positions in a corporation where, unless the board adopts a poison pill, its stockholders are vulnerable to creeping acquisitions, two-tiered coercive tender offers, and other valuing-reducing threats that result from the well-recognized collective action problems faced by holders of diffuse stockholder interests? How reliable can takeover fluff be when it vacillates wildly in a takeover contest based not on some measure of intrinsic change-in-control value but rather based on whatever the highest bid might be on a particular day? Measured across a sample of heterogeneous stocks in an event study, it hardly seems surprising that takeover fluff may aggregate to nothing (or nearly nothing) at all. An event study would thus reveal no overall effect.

Event studies should not fare any better if takeover fluff is assumed both to exist and be significant. In that case, event studies, as historically conducted, still would not reveal any lessons about pill adoption because a study would need to determine the percentage of takeover fluff in the market price of every stock if evaluated before any possible conclusions could be drawn. This would require offering a means for measuring takeover fluff, quantifying the portion of value attributable to takeover fluff, determining the effect that pill adoption has on that element of value, and then considering and interpreting the resulting market impact, if any, in light of those effects. Without this data, conclusions from event studies will be meaningless. If two companies are identical in all respects, except that the market price of Company A consists of 50% takeover fluff while the market price of Company B consists of 0% takeover fluff, then arguably the adoption of a pill could have very different effects on their stock prices and whatever market reaction did take place should be interpreted differently. For Company A, a 1% change in value might imply one thing and a 50% change another. For Company B, any change might be confounding. Because event studies, histori-

cally, have not addressed these issues, assuming they could be addressed, the results of event studies *should* be inconclusive.

### III. THE MARKET'S UNDERSTANDING OF DELAWARE LAW.

We also substantially discount the potential for event studies to reach meaningful conclusions about poison pills because it is not clear that the market, including market professionals, fully understands the evolving standards that govern the use of pills and other defensive measures under Delaware law. In fact, we doubt whether a properly conducted event study would show any reaction to the series of pill decisions that Delaware courts have rendered, despite the changing nature of the Delaware's approach to pills and pill redemption.

Early poison pill decisions indicated that Delaware courts would police the use of poison pills to ensure that they only were employed reasonably. This promise was made expressly in *Unocal Corp. v. Mesa Petroleum Co.*,<sup>7</sup> when the Delaware Supreme Court held that directors who respond defensively must "show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"<sup>8</sup> and that they adopted a defense that was "reasonable in relationship to the threat posed."<sup>9</sup> The Delaware Supreme Court reaffirmed this promise in *Moran v. Household International, Inc.*,<sup>10</sup> when, in holding that poison pills were legal under Delaware law, the court explained that directors still must fulfill their fiduciary duties when relying on a pill and that the propriety of such a use would be judged at the time the pill was used in response to a takeover bid.<sup>11</sup> *Household* indicates that the adoption of a pill is a rather benign event that does not require extensive court oversight.<sup>12</sup> The decision to redeem or not redeem a pill is the real decision that potentially is subject to abuse. How a pill is used in a takeover contest creates the need for judicial review under the *Unocal* standard, and the promise of *Household* was that directors would be held accountable for their use of a pill in responding to a takeover attempt.

Consistent with these promises, a series of early Court of Chancery cases suggested that a target board's ability to use a poison pill would be limited. In these decisions, the Court of Chancery permitted boards to rely on pills to defeat structurally coercive offers, to obtain time to nego-

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7. 493 A.2d 946 (Del. 1985).

8. *Id.* at 955.

9. *Id.*

10. 500 A.2d 1346 (Del. 1985).

11. *Id.* at 1357.

12. See *In re Gaylord Container Corp. Shareholders Litig.*, Consol. C.A. No. 14616, slip op. at 41-42 (Del. Ch. Jan. 26, 2000) (granting summary judgment in favor of directors on challenge that the adoption of a "garden-variety poison pill" constituted a breach of fiduciary duty).

tiate with the initial bidder, or to buy time to develop alternatives or conduct an auction.<sup>13</sup> The Court of Chancery repeatedly questioned, however, whether a pill could be used indefinitely to block an all-cash, all-shares offer.<sup>14</sup>

On three occasions, the Court of Chancery actually required target boards to redeem their poison pills to permit stockholders to choose whether or not to tender into hostile offers. In *City Capital Associates, Limited Partnership v. Interco, Inc.*,<sup>15</sup> the board of directors of a target corporation attempted to use its pill to block an all-cash, all-shares offer so that the board could complete a leveraged restructuring.<sup>16</sup> The Court of Chancery explained that after a target board had completed its efforts to develop alternatives, as the board in *Interco* had, the legitimate role of the poison pill in the context of a noncoercive offer will have been fully satisfied. The only function then left for the pill at this end-stage is to preclude the shareholders from exercising a judgment about their own interests that differs from the judgment of the directors, who will have some interest in the question.<sup>17</sup>

At that point, absent extraordinary circumstances not present in the *Interco* case, it was for the stockholders to decide whether or not to sell

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13. See generally *City Capital Assocs. Ltd. Partnership v. Interco Inc.*, 551 A.2d 787, 797-98 (Del. Ch. 1988) (explaining that a pill could be used to defend against "structurally coercive offers" or to enable "an active negotiator . . . to extract a higher or otherwise more valuable proposal, or . . . to arrange an alternative transaction"). See, e.g., *MAI Basic Four, Inc. v. Prime Computer, Inc.*, C.A. No. 10428, slip op. at 13 (Del. Ch. Dec. 20, 1988) (finding "[o]f particular significance . . . the fact that without the [pill and other] anti-takeover devices being in place, plaintiff will not increase its offer"); *Doskocil Cos. v. Griggy*, C.A. No. 10095, slip op. at 5-6 (Del. Ch. Oct. 7, 1988) (stating that "[w]here the board has determined that the offered price is inadequate and has decided to conduct an auction for the company, it may be appropriate to keep the rights in place in order to allow time for higher bids to be made"); *Tate & Lyle PLC v. Staley Continental, Inc.*, C.A. No. 9813, slip op. at 22 (Del. Ch. May 9, 1988) (finding that "the rights plan is obviously serving a useful purpose in allowing the Board to seek a more realistic offer").

14. As then Vice Chancellor, now Justice Berger observed,

It is difficult to understand how, as a general matter, an inadequate all cash, all shares tender offer, with a back end commitment at the same price in cash, can be considered a continuing threat under *Unocal*. . . . [W]here there has been sufficient time for any alternative to be developed and presented and for the target corporation to inform its stockholders of the benefits of retaining their equity position, the "threat" to the stockholders of an inadequate, non-coercive offer seems, in most circumstances, to be without substance.

*Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 289 (Del. Ch. 1989); accord *Grand Metropolitan, PLC v. Pillsbury Co.*, 558 A.2d 1049, 1056 (Del. Ch. 1988) (holding that in all-cash, all-shares offer, "[w]hatever danger there is relates solely to the shareholders and that concerns price only"). See also *MAI Basic Four*, slip op. at 11 ("the tender offer is for all cash and there is nothing about it which would indicate that it is coercive to stockholders").

15. 551 A.2d 787 (Del. Ch. 1988).

16. See *id.* at 789-90.

17. See *id.* at 798 (footnote omitted).

their shares in the tender offer.<sup>18</sup> The Court of Chancery followed a similar approach in *Grand Metropolitan PLC v. Pillsbury Co.*,<sup>19</sup> in which the court ordered a target board to redeem its stockholder rights plan in the face of a premium offer where the board had ample time to develop an alternative or conduct an auction, and where the respective options were “sufficiently developed to permit an informed shareholder choice.”<sup>20</sup> The Court of Chancery also enjoined a poison pill in *Mills Acquisition Co. v. MacMillan, Inc.*,<sup>21</sup> where the target board of directors conducted an auction and obtained the two highest bids available.<sup>22</sup> The court observed that the pill had served its purpose and its only remaining function at that point was to protect the board’s chosen transaction and “deprive the shareholders of the opportunity to consider an alternative cash transaction for a fair (indeed higher) price.”<sup>23</sup>

In *Paramount Communications, Inc. v. Time, Inc.*,<sup>24</sup> however, the Delaware Supreme Court laid the foundation for a very different approach to *Unocal*. There, Warner Communications Inc. and Time, Inc. had agreed to a stock-for-stock merger that did not offer a premium to either company’s stockholders.<sup>25</sup> Two weeks before the scheduled stockholder vote on the merger, Paramount Communications announced an all-cash, all-shares tender offer for Time at a substantial premium to Time’s market price. The Time board rejected the offer as inadequate, elected to continue with its business combination with Warner, and restructured the combination as a cash and securities acquisition of Warner by Time.<sup>26</sup>

In subsequent litigation, Paramount and various Time stockholders argued that the Time board’s decision to ignore the Paramount offer and recast the Time-Warner transaction as a cash acquisition of Time was an unreasonable defensive response under *Unocal*.<sup>27</sup> The Delaware Supreme Court agreed that *Unocal* applied but upheld the Time board’s decision.<sup>28</sup> In doing so, the court significantly expanded the deference paid to directors under each prong of *Unocal*. On the first prong, the court criticized certain Court of Chancery decisions that it read as sug-

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18. *See id.* at 799-800.

19. 558 A.2d 1049 (Del. Ch. 1988).

20. *Id.* at 1060.

21. C.A. No. 10168 (Del. Ch. Oct. 10, 1988, *revised* Oct. 18, 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

22. *See id.*

23. *Id.*, slip op. at 50.

24. 571 A.2d 1140 (Del. 1989).

25. *See id.*

26. *See id.* at 1146-47.

27. *See id.* at 1142.

28. *See id.*



gesting "that an all-cash, all-shares offer, falling within a range of values that a shareholder might reasonably prefer, cannot constitute a legally recognized 'threat' to shareholder interests."<sup>29</sup>

The Delaware Supreme Court then revealed a three-part typology of possible threats that a tender offer might raise. These included:

- (i) *opportunity loss* . . . [where] a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management [or, we would add, offered by another bidder];
- (ii) *structural coercion*, . . . the risk that disparate treatment of non-tendering shareholders might distort shareholders' tender decisions; and . . .
- (iii) *substantive coercion*, . . . the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value.<sup>30</sup>

Applying this framework, the Supreme Court found that:

the Time board reasonably determined that inadequate value was not the only legally cognizable threat that Paramount's all-cash, all-shares offer could present. Time's board concluded that Paramount's eleventh hour offer posed other threats. One concern was that Time shareholders might elect to tender into Paramount's cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce.<sup>31</sup>

Based on this "record evidence," the court deferred to the Time board's conclusion that the Paramount offer constituted a threat.<sup>32</sup> *Time* thus introduced into Delaware law the threat of substantive coercion, defined as the ability of a board of directors to justify defensive measures based on the board's belief that stockholders might tender into a hostile offer out of "ignorance or a mistaken belief" about the value of the board's chosen alternative.

The Delaware Supreme Court in *Time* also significantly expanded the deference paid to directors under the second prong of *Unocal*. On that issue, the court stressed that:

Delaware law confers the management of the corporate enterprise to the stockholders' duly elected board representatives. The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals. That duty may not be delegated to the stockholders. Directors are not obliged to abandon a

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29. *Id.* at 1152 (citing *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103 (Del. Ch. 1986); *Grand Metropolitan, PLC v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988); *City Capital Assocs. Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988)).

30. *Time*, 571 A.2d at 1153 n.17 (bracketed alterations in original; quoting Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 *BUS. LAW.* 247, 267 (1989)).

31. *Id.* at 1153.

32. *See id.* at 1154.

deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.<sup>33</sup>

This holding, combined with explicit criticism of “*Interco* and its progeny” elsewhere in the opinion, effectively overruled the line of Court of Chancery cases indicating that, at some point, stockholders should be able to decide whether to sell their shares in a tender offer.<sup>34</sup> Ironically, the Delaware Supreme Court then upheld the Time board’s decision to continue with the Time-Warner transaction because it was “not aimed at ‘cramming down’ on its shareholders a management-sponsored alternative, but rather had as its goal the carrying forward of a pre-existing transaction in an altered form.”<sup>35</sup> The court did not elaborate on how the recast Time-Warner transaction, which went forward as a tender offer by Time for Warner that Time’s stockholders were powerless to stop, differed from other “cram downs.” The court simply held that “the response was reasonably related to the threat.”<sup>36</sup> A strong reading of this analysis suggested that so long as a board proffered a business plan that had some rational basis, a board of directors could reject a premium tender offer, continue with its business plan, and its decision would be respected by a Delaware court. The possible implications of the *Time* decision were not lost on commentators who read the case as recognizing the ability of a target board to “just say no” to a premium tender offer.<sup>37</sup>

In *Unitrin, Inc. v. American General Corp.*,<sup>38</sup> the Delaware Supreme Court appeared to build on and broaden the deferential approach to defensive action that it had adopted in *Time*.<sup>39</sup> On the first prong of the two-part *Unocal* test, the *Unitrin* court expanded the concept of substantive coercion that the *Time* court had introduced.<sup>40</sup> In *Time*, the Delaware Supreme Court had allowed the directors of Time to rely on a perceived threat of substantive coercion based on their fear that stockholders would not fully understand the value of an extraordinary strategic combination that would have transformed the nature of Time as a company. In *Unitrin*, by contrast, the Delaware Supreme Court permitted the directors of Unitrin, Inc. to invoke the doctrine of substantive coercion based on alleged stockholder confusion about the value of Uni-

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33. *Id.* (citations omitted).

34. *See id.* at 1153.

35. *Id.* at 1154-55 (footnote omitted).

36. *Id.* at 1155.

37. *See, e.g., Law Firm Views on Impact of Paramount/Time Decision*, 4 INSIGHTS 34 (May 1990).

38. 651 A.2d 1361 (Del. 1995).

39. *See id.*

40. *See id.* at 1373-74.

trin on a stand-alone basis, despite the fact that the stockholders obviously had purchased shares in Unitrin and could sell their shares at any time in the open market.<sup>41</sup> The *Unitrin* court also broadened the operative test under the second prong of *Unocal*. As the court read prior case law, Delaware decisions historically had invalidated only defensive responses that either were preclusive or coercive.<sup>42</sup> The Delaware Supreme Court then held that so long as a defensive measure was not preclusive or coercive, it would be upheld if it fell within a "a range of reasonableness."<sup>43</sup> In making this change, the court made clear that it intended to grant a substantial degree of leeway to target directors:

The *ratio decidendi* for "range of reasonableness" standard is the need of the board of directors for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's.<sup>44</sup>

After announcing these principles, the *Unitrin* court upheld the decision of the Unitrin directors to adopt a repurchase program that forced any insurgent that wished to elect new directors to obtain the affirmative vote of holders controlling more than a 74% supermajority of Unitrin's outstanding stock.<sup>45</sup>

The potential risk for stockholders in *Unitrin's* deferential approach became clear when the United States District Court for the District of Delaware applied the *Unitrin* test in *Moore Corp. v. Wallace Computer Services, Inc.*<sup>46</sup> After Wallace Computer Services, Inc. rejected its merger proposal, Moore Corporation Limited launched an all-cash, all-shares tender offer for Wallace at a substantial premium over the Wallace's unaffected trading price.<sup>47</sup> Moore also commenced a proxy solicitation to elect new Wallace directors that would consider its offer.<sup>48</sup> Because of Wallace's defensive profile, which included a poison pill, a classified board, and a prohibition on stockholder-called special meetings or action by written consent, Moore needed to prevail in proxy contests at two successive annual meetings in order to replace a majority of

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41. *See id.* at 1384.

42. *See id.* at 1388-90.

43. *Id.* at 1388.

44. *Id.* (citations omitted).

45. *See id.* at 1383.

46. 907 F. Supp. 1545 (D. Del. 1995).

47. *See id.* at 1550-51.

48. *See id.*

Wallace's directors.<sup>49</sup> Faced with this prospect, Moore filed suit to compel Wallace to redeem its pill.<sup>50</sup> At the time of the hearing on Moore's motion for a preliminary injunction, 73.4% of Wallace's shareholders had tendered their shares into Moore's offer.<sup>51</sup>

Applying *Unocal* and *Unitrin*, the *Moore* court found that the Wallace board had properly identified a threat to corporate policy and effectiveness from the Moore offer and that the directors' decision to retain the pill indefinitely fell within a range of reasonableness.<sup>52</sup> The court accepted the Wallace board's identification of a threat of substantive coercion in light of the facts that the board (i) met on multiple occasions to review the terms of the offer and assess its merits, (ii) retained Goldman Sachs as its investment banker, (iii) had Goldman Sachs prepare an analysis using projections based on past growth and historical data provided by Wallace management, and (iv) collectively considered Wallace's "current business plans and strategies, its financial projections, its current financial results and future projections, and the opinion of Goldman in arriving at its decision that the . . . offer was inadequate."<sup>53</sup> Based on these factors, the court deferred to the board's conclusion "that Moore's tender offer poses a threat . . . that shareholders, because they are uninformed, will cash out before realizing the fruits of the substantial technological innovations achieved by Wallace."<sup>54</sup>

After finding that Moore's offer constituted a threat, the court turned to the second prong of *Unocal*. The court found the Wallace's board's response – leaving Wallace's shareholder rights plan in place indefinitely – proportional in light of the threat perceived.<sup>55</sup> Applying *Unitrin*, the court found that the pill was not coercive because the "retention of the pill will have no discriminatory effect on shareholders."<sup>56</sup> The court also found that the pill was not preclusive, because it would "have no effect on the success of [a] proxy contest."<sup>57</sup> With these issues resolved, the court noted that to uphold the pill, the court "must merely be satisfied that it fell within a 'range of reasonableness.'"<sup>58</sup> Based on the board's argument that "[s]hareholders, at the time of the Moore offer, were unable to appreciate the upward trend in Wallace's earnings," the court concluded that "[g]iven this situation, the Wallace

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49. *See id.* at 1550-51.

50. *See id.* at 1551.

51. *See id.* at 1553.

52. *See id.* at 1563.

53. *Id.* at 1558.

54. *Id.* at 1560-61.

55. *See id.* at 1563.

56. *Id.*

57. *Id.*

58. *Id.*

Board's response can hardly be deemed unreasonable."<sup>59</sup> The effect of this decision was to permit the directors to block Wallace's offer for two years.

If *Moore* truly represents Delaware law, then it is difficult to conceive of a situation when a Delaware court would order a target board to redeem a poison pill to permit stockholders potentially to accept a premium tender offer. Two recent decisions by the Court of Chancery, however, suggest that the *Moore* court may have misread *Unitrin* and that the doctrine of substantive coercion was not intended to provide an ever-ready justification for defensive action.

In *Chesapeake Corp. v. Shore*,<sup>60</sup> the Court of Chancery examined in detail the development of substantive coercion, its theoretical underpinnings and the risks inherent in an overly deferential approach to the doctrine.<sup>61</sup> As a threshold matter, the court noted that:

Substantive coercion can be invoked by a corporate board in almost every situation. There is virtually no CEO in America who does not believe that the market is not valuing her company properly. Moreover, one hopes that directors and officers can always say that they know more about the company than the company's stockholders – after all, they are paid to know more. Thus, the threat that stockholders will be confused or wrongly eschew management's advice is omnipresent.<sup>62</sup>

The court trenchantly observed that because substantive coercion can be so readily invoked, "the use of this threat as a justification for aggressive defensive measures could easily be subject to abuse."<sup>63</sup>

The court also criticized the theory for tending to ascribe "rube-like qualities to stockholders."<sup>64</sup> As the court explained, "[i]f stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time for deliberation . . . ?"<sup>65</sup> The court further noted that the doctrine permits directors to make "fundamental investment decisions for the company's owners," yet the directors bear no risk if they erroneously block a premium offer and the stock price drops.<sup>66</sup> The court also questioned why "the threat of substantive coercion seems to cause a ruckus in boardrooms most often in the context of tender offers at . . .

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59. *Id.*

60. C.A. No. 17626 (Del. Ch. Feb. 7, 2000, revised Feb. 11, 2000).

61. *See id.*

62. *Id.*, slip op. at 74.

63. *Id.*

64. *Id.*, slip op. at 76.

65. *Id.* (emphasis added).

66. *Id.*

substantial premiums.”<sup>67</sup> The court observed that stockholders regularly sell into the market at levels below what insiders believe to be the true value of the company, yet directors ironically only take steps to protect stockholders from themselves when a premium offer surfaces.<sup>68</sup>

Finally, and most importantly, the *Chesapeake* court recognized that a license for boards to invoke substantive coercion “without a serious examination of the legitimacy of that defense would undercut the purpose the *Unocal* standard of review was established to serve.”<sup>69</sup> The fundamental teaching of *Unocal* is that enhanced judicial scrutiny of boards facing takeover threats is necessary because of an inherent conflict of interest between stockholders and management.<sup>70</sup> In light of these concerns, the *Chesapeake* court concluded that “[t]he only way to protect stockholders is for courts to ensure that the threat [of substantive coercion] is real and that the board asserting the threat is not imagining or exaggerating it.”<sup>71</sup>

Applying these principles, the *Chesapeake* court found that the target board of directors in that case had “not come close to demonstrating that it identified [a threat of substantive coercion] at any time ‘after a reasonable investigation’ and ‘in good faith’” before taking defensive action in response to an unsolicited tender offer and proxy contest.<sup>72</sup> The target directors failed to introduce any persuasive evidence to demonstrate that they had considered a threat of stockholder confusion when they adopted their defensive response, and the court instead suggested that the threat was concocted one month later when the board retained more experienced advisors.<sup>73</sup> The court also found that the directors slighted or totally disregarded key issues, including the makeup of the target company’s stockholder profile, thorough coverage of the target by analysts, ample information in public disclosures and the self-proclaimed credibility of management and its ability to provide additional information to stockholders.<sup>74</sup> *Chesapeake* marks the first time since *Time* that a Delaware court has meaningfully analyzed and then rejected a target board’s assertion of substantive coercion.<sup>75</sup>

Another recent decision by the Court of Chancery indicates that the

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67. *Id.*, slip op. at 77.

68. *See id.*

69. *Id.*, slip op. at 78.

70. *See Unocal*, 493 A.2d at 954-55 (adopting the enhanced scrutiny standard “[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its stockholders” when responding to a threat to corporate control).

71. *Chesapeake*, slip op. at 74-75.

72. *Id.*, slip op. at 85 (emphasis added).

73. *See id.*

74. *See id.*

75. *See generally id.*, slip op. at 74-88.

Delaware courts still stand by the promise of *Household* that a board's decision to employ a rights plan during a takeover contest will be reviewed carefully. In *In re Gaylord Container Corp. Shareholders Litigation*,<sup>76</sup> the Court of Chancery granted summary judgment in favor of directors and against a class of stockholders who claimed the board had breached its fiduciary duties by adopting a "garden-variety poison pill."<sup>77</sup> The board had adopted the pill as part of a careful process of evaluating its takeover preparedness and not in response to any particular threat.<sup>78</sup> The *Gaylord* court noted expressly that "in the event of a concrete battle for corporate control, the board's decision to keep the pill in place in the face of an actual acquisition offer will be scrutinized again under *Unocal*."<sup>79</sup> The court elsewhere warned that "[i]n the event of an actual offer, it may well be that the *Gaylord* board's decision to use the defensive measures to block the stockholders from considering the transaction could be deemed unreasonable under [*Unocal*]."<sup>80</sup> This point was so important that the court later reiterated its caveat: "[i]t bears re-emphasis that the conclusion that the adoption of this approach by a disinterested board on a clear day was proper does not necessarily validate, for example, similar action by an interested board designed to preclude a particular bidder from mounting a proxy fight or consent solicitation effort."<sup>81</sup> The triple repetition of this point is a strong reaffirmation of the promise of *Household*.

In light of these shifting approaches, to the extent that takeover fluff adds value to the price of a company's stock and to the extent that judicial decisions and their implications are internalized by the market, one logically would expect that a carefully designed study would show some measurable difference between the trading price of a company with a virtually impregnable defensive profile – i.e., a combination of a staggered board, the elimination of stockholder action by written consent, and the inability of stockholders to call special meetings – and the trading price of comparable companies with defensive profiles that provide some effective mechanism for stockholders to receive takeover bids. One also would expect that a carefully designed study would reveal some fluctuation in the market prices of Delaware corporations in light of the ebb and flow of Delaware decisional law. Given these assumptions (i.e., the existence of takeover fluff and a market that is perfectly efficient regarding both takeover fluff and Delaware decisional

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76. Consol. C.A. No. 14616 (Del. Ch. Jan. 26, 2000).

77. *Id.*, slip op. at 41.

78. *See id.*

79. *Id.*, slip op. at 42.

80. *Id.*, slip op. at 3.

81. *Id.*, slip op. at 44 n.70.

law), one might expect a marginal decrease in market price after *Household* in light of the court's decision to uphold the legitimacy of the pill, mitigated by the promise to police the actual use of pills in takeover contests. After *Time*, after *Unitrin* and, most significantly, after *Moore*, one might expect further decreases as the promise of *Household* appeared to grow more and more ephemeral. After the recent decisions in *Chesapeake* and *Gaylord*, one might expect an increase in market price, based on the inference that the *Moore* court had misread *Time* and *Unitrin* and that *Chesapeake* and *Gaylord* reflect current Delaware law. As discussed below, however, we doubt that such a study would show that the market reacted to any of these decisions as one might expect.

Before explaining our reasons for doubt, we note that the focal point of any such study should not be on poison pills but on the overall defensive profiles of target companies and the resulting ability of target corporation stockholders to receive takeover bids. *Moore* shows that it is the combination of a staggered board, the elimination of stockholder action by written consent, and the inability of stockholders to call special meetings that closes off the routes by which an acquirer can circumvent a poison pill. It is these key variables that distinguish companies, not the mere presence or absence of a pill. A study that focused on these variables would have much to commend it, and it appears that Professor Coates may be headed towards this type of research himself.<sup>82</sup> Moreover, there may already be some evidence to support the view that a company's defensive profile in the aggregate has an impact on stock price. For example, one recently reported study by Professor Robert Daines suggested that companies incorporated in Delaware command a market premium of approximately 5% compared to companies incorporated elsewhere.<sup>83</sup> The difference may stem in part from Delaware's balanced approach to takeover disputes, which contrasts with the stringent anti-takeover laws of pro-management states. Another study further supports this view by suggesting that a state's adoption of a restrictive, pro-management takeover statute has a statistically significant negative impact on the stock price of firms incorporated in that state.<sup>84</sup>

We would not be surprised, however, if the results of such a study failed to reveal a statistically significant relationship between defensive profile and stock price. A healthy degree of skepticism is warranted

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82. See Coates *supra* note 2, at 792-94.

83. See Steven Lipin, *Firms Incorporated in Delaware Are Valued More by Investors*, WALL ST. J. Feb. 28, 2000, at C21.

84. See Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation Takeover Legislation*, 25 J. FIN. ECON. 291, 321 (1989) (finding that "on average, the initial press announcement of a state takeover law is associated with a small but statistically significant decrease in the stock prices of firms incorporated in the state").



both because of the questionable existence of takeover fluff and the difficulties in measuring it, and because the key assumption in any such study would be that the holdings of Delaware cases are disseminated effectively throughout and internalized by the market. Experience with market professionals suggests that this assumption will not hold. Instead, the market appears to rely on anecdotal accounts – something largely akin to the generalizations of the popular press – to judge the impact of poison pills and their effectiveness. Thus, in addition to accepting the Delaware law position that the stock market does not perfectly determine value, we doubt that the market is informationally efficient when it comes to assessing the likely outcome of cases brought by bidders or stockholders that seek to compel a target board of directors to redeem a defensive measure such as a poison pill in support of a takeover attempt. Rather than incorporating infallibly the outcome of every Delaware takeover case into a jurisprudential valuation metric, the market appears to operate based on the popular impressions of major decisions, in which victories for insurgents figure prominently. The market thus remembers the landmark holding in *Unocal* and the adoption of the *Unocal* test but forgets that the bidder in *Unocal* lost, not only in the market but also before the Delaware Supreme Court. The market likewise recalls the resounding and headline-grabbing decisions in *Interco* and *Grand Metropolitan* but forgets that court's nearly immediate criticism of those cases in *Time* and the numerous decisions that have upheld the use of poison pills by target directors.

Auction contests offer a similar example of what appears to be anecdotal market memory. Here, the market appears to recall the original decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,<sup>85</sup> with its "auctioneer" language and "level playing field" metaphors. The market similarly recalls *Paramount Communications Inc. v. QVC Network Inc.*,<sup>86</sup> which appeared to confirm and revitalize the original *Revlon* holding. At the same time, the market understandably has overlooked the numerous Delaware opinions that have refused to recognize *Revlon* as a separate doctrine and instead equated so-called "*Revlon* duties" with the ordinary duties of directors.<sup>87</sup> The market also seems to

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85. 506 A.2d 173 (Del. 1986).

86. 637 A.2d 34 (Del. 1994).

87. See, e.g., *Mills Acquisition v. Macmillan, Inc.*, 559 A.2d 1261, 1288 (Del. 1989) (finding "[t]here are no special and distinct '*Revlon* duties'"); *Goodwin v. Live Entertainment, Inc.*, C.A. No. 15765, slip op. at 42 (Del. Ch. Jan. 25, 1999) (describing *Revlon*'s teachings as "a contextually-specific application of the directors' duty to act in accordance with their fiduciary obligations"), *aff'd*, 741 A.2d 16 tbl. (Del. 1999); *In re Lukens Inc. Shareholders Litig.*, C.A. No. 16102, slip op. at 20 (Del. Ch. Dec. 1, 1999) (explaining that "'*Revlon* duties' refer only to a director's performance of his or her duties of care, good faith and loyalty in the unique factual circumstance of a sale of control over the corporate enterprise"); *Wells Fargo & Co. v. First*

have overlooked the Delaware courts' creation in the auction context of a double-level of business judgment deference, in which Delaware courts defer not only to a decision made by directors based on the information reasonably available<sup>88</sup> but also to a decision made by directors about the amount of information they needed to make their decision.<sup>89</sup> Another fruitful area of research might be to survey market makers, investment bankers, proxy solicitors, mergers and acquisitions attorneys, and representative stockholders to determine to what extent information about Delaware case law, defensive profiles, and the potential for successful takeover bids actually permeates the market.

#### IV. PILLS ARE HERE TO STAY, SO LET'S TURN OUR ATTENTION ELSEWHERE.

The bottom line is that Professor Coates is right: Event studies of pills are flawed, although we endorse his conclusion primarily for reasons that he does not identify. Professor Coates also is right on his far

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Interstate Bancorp., C.A. Nos. 14696, 14623, slip op. at 10 n.3 (Del. Ch. Jan. 18, 1996) (observing that "in part '*Revlon* duties' are not distinctive board duties at all, but a changed standard of judicial review"); *In re J.P. Stevens & Co. Shareholders Litig.*, 542 A.2d 770, 781 (Del. Ch. 1988) (rejecting argument that *Revlon* announced a special duty "that arises once it is apparent that a change in control of the corporation is to occur . . . [and] that it is the duty of the board in that setting to keep a 'level playing field' among potential bidders"); *Citron v. Fairchild Camera & Instrument Corp.*, C.A. No. 6085, slip op. at 44 n.17 (Del. Ch. May 19, 1988) (finding it "unnecessary to specifically treat [the plaintiffs' *Revlon* claim]" except to say that the plaintiff's reading of the case as creating special duties was "certainly incorrect"), *aff'd*, 569 A.2d 53 (Del. 1989); *In re Fort Howard Corp. Shareholders Litig.*, Consol. C.A. No. 9991, slip op. at 34 (Del. Ch. Aug. 8, 1988) (describing and rejecting the view that "*Revlon* establishe[d] rules that [come] into play whenever the Company is for sale").

88. See *J.P. Stevens*, 542 A.2d at 783 (explaining that "[i]n [an auction], reasonable directors, exercising honest, informed judgment, might differ as to what course of action would most likely maximize shareholder interests . . . . These are precisely the sort of debatable questions that are beyond the expertise of courts and which the business judgment rule generally protects from substantive review for wisdom."); *Yanow v. Scientific Leasing, Inc.*, C.A. No. 9536, slip op. at 14 (Del. Ch. Feb. 8, 1988) (explaining that "what specific methods corporate directors may use to elicit bids from potential acquirers . . . would appear to be normally a matter of director judgment that necessarily must vary with each case"); *Fort Howard*, slip op. at 35 (stating that "[t]he need to exercise judgment is *inescapably* put on the board at points in an auction process and the validity of the exercise of that judgment is appropriately subjected to a business judgment form of judicial review.")

89. See *In re RJR Nabisco, Inc. Shareholders Litig.*, C.A. No. 10389, slip op. at 54 (Del. Ch. Jan. 31, 1989) (explaining that "the amount of information that it is prudent to have before a decision is made is itself a business judgment of the very type that courts are institutionally poorly equipped to make"); *Citron*, slip op. at 49 (finding that "just how much information prudence requires before a decision is made is itself a question that calls for informed judgment of the kind courts are not well-equipped to make"); *Solash v. Telex Corp.*, C.A. No. 9518, slip op. at 21-22 (Del. Ch. Jan. 19, 1988) (concluding that "[w]hether the benefit of additional information is worth the cost - in terms of delay and in terms of alternative uses of time and money - is always a question that may legitimately be addressed by persons charged with decision-making responsibility.").

more important point — namely, that after *Household* legitimized the adoption of poison pills, all Delaware corporations effectively have had poison pills in place. As Professor Coates explains, any company that is operating without a poison pill can implement a pill if it receives a take-over bid.<sup>90</sup> Although Professor Coates underestimates the time and effort required to educate a board of directors about the implications and operation of a pill so that they would be able to make an informed and independent decision about its adoption,<sup>91</sup> he is correct that the step can be accomplished within the twenty-day time period during which tender offers must be kept open under the federal securities laws.<sup>92</sup> Professor Coates concludes from this:

[P]ill adoption by particular firms rarely has (non-signal) effects on bids, because of the possibility of later adoption. Thus, it is the potential for the pill that achieves the great bulk of the pill's deterrent effect (to the extent it has one). Another way of putting the point is that once the Delaware Supreme Court made it clear in [*Household*] that pills were legitimate to adopt, all Delaware firms (except those few with other governance terms that would impede pill adoption) have had a "shadow pill" in place, witting or not, and takeovers of such firms have thus been restrained by a set of "shadow restrictions" (the expectation of a pill's adoption and subsequent effects) on transfer of control to a hostile bidder. Whether or not the potential for pills has had an impact on bids remains open, precisely because the point being made here has not been reflected in studies of defenses.<sup>93</sup>

This insight both explains why past event studies have failed to detect any stock price impact from pills and indicates that all event studies of contemporaneous stock price performance across companies will fail to detect any impact from pills. Put simply, both sets of companies in any contemporaneous study effectively have pills in place.<sup>94</sup>

In our view, the fundamental lesson to be drawn from this insight is simply that scholars can stop studying pills. This is another way of admitting that we live today in the poison pill era. Because pills are

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90. See Coates, *supra* note 2 at 791.

91. See *id.*

92. See *id.*

93. *Id.*

94. This does not mean that pills do not affect stockholder wealth, only that to the extent some effect exists, it necessarily affects the entire market. Theoretically, in other words, if the market currently has a collective value of \$X, then if *Household* had gone the other way, the market currently would have a value of \$X + \$Y. This suggests that a cross-time study of companies before and after *Household* might detect a value effect in pills. Unfortunately, this also appears impossible, and Professor Coates cogently explains why *Household* cannot be viewed as the "precise moment in the development of Delaware law that could be isolated as the 'event' that resolved the legality of the standard pill in its full operation." *Id.* at n.110. This observation applies equally to the other decisions discussed in the text.

both effective and omnipresent, the tender offer no longer is a viable means of attempting a takeover of a public company. A tender offer currently provides only a means of lending economic credibility to an insurgent slate in a proxy fight or consent solicitation. Stockholder voting is the central issue in today's takeover battles, and scholars should be encouraged to shift their prodigious talents away from pills and tender offers and towards questions of stockholder voting behavior and the impact of defensive measures on the stockholder franchise. Professor Coates's excellent article shows there is much to gain and nothing to lose from such a shift.