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Dennis J. Block

Jonathan M. Hoff

H. Esther Cochran

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Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals

DENNIS J. BLOCK, JONATHAN M. HOFF AND H. ESTHER COCHRAN*

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I. INTRODUCTION

The mid-1990's has witnessed substantial merger and acquisition activity. The total dollar volume of domestic mergers and acquisitions announced for the years 1990 up to and including 1996 was $2.225 trillion.[1] The total for 1996 alone was $658.8 billion.[2] Various factors have encouraged both friendly and hostile combinations. These include continued positive responses from the equity markets as consolidations are announced; increased corporate profits in a relatively strong economy marked by low inflation, which encourages companies to combine in an effort to increase revenue growth; the ease of obtaining credit as well as the availability of value-inflated stock to finance acquisitions; growing pressure by institutional investors on boards of directors to increase shareholder value; and the relative laxity with which the government has addressed anti-trust issues in the merger context. Further, an increasing number of companies are combining in hopes of obtaining synergies to expand market share as inexpensively as possible in order to compete effectively in an increasingly consolidated national and international marketplace. As a consequence of this increased merger and acquisition activity, corporations wishing to protect shareholder interests from untimely or ill-advised acquisitions should be prepared in advance to respond to unsolicited takeover proposals.

A target's board of directors may employ various defensive measures against an unsolicited acquisition proposal or offer. Some measures

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* Weil, Gotshal & Manges LLP.

1. Charles V. Bagli, *Conditions Are Right for a Takeover Frenzy*, N.Y. TIMES, Jan. 2, 1997, at C3.

2. *Id.*

can best be implemented prior to the receipt of an unsolicited bid. Other techniques may be employed in response to a threatened or actual hostile bid after it has been made. Although courts traditionally grant broad latitude to boards of directors in most circumstances, some courts, particularly those in Delaware, have engaged in a more searching inquiry into the deliberative process behind and motivations underlying a target board's decision to act defensively. Such higher level of scrutiny stems from the perception that a potential conflict of interest exists where the target's board may be faced with a choice between maintaining control of the corporation or realizing an immediate premium over market value for shareholders. This Article will discuss a range of defensive measures available to targets of unsolicited takeover proposals in light of the enhanced scrutiny under which most courts evaluate the adoption of such measures.

II. JUDICIAL STANDARD OF REVIEW OF DIRECTOR ACTION

In making business decisions, corporate directors are subject to fiduciary duties requiring them to act in the best interests of the corporation and its shareholders. These fiduciary obligations include the duty of care and the duty of loyalty. The duty of care is simply the duty, when acting on the corporation's behalf, to act with the degree of care a reasonable person would employ in similar circumstances.[3] The duty of loyalty is the duty to place the interests of the corporation and shareholders ahead of any self-interest.[4] When addressing duty of loyalty questions, courts generally require that the transaction at issue be "entirely fair" to the corporation.[5]

The Business Judgment Rule In the Takeover Context. In determining whether a board of directors has fulfilled its fiduciary duty of care, courts typically apply the business judgment rule. Under the business judgment rule, directors' actions generally carry a presumption of regularity. That is, directors are presumed to have acted "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[6] Thus, the business judgment rule acts as a judicial presumption that protects a board's actions from chal-

3. *See* DENNIS J. BLOCK ET AL., THE BUSINESS JUDGMENT RULE, 52-55 (4th ed. 1993 & Supp. 1995) [hereinafter BLOCK, THE BUSINESS JUDGMENT RULE].

4. *Id.* at 124-25.

5. *See, e.g.*, Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994); *In re* Tri-Star Pictures, Inc., *Litig.* 634 A.2d 319 (Del. 1993); U.S. West, Inc. v. Time Warner, Civ. A. No. 14555, 1996 WL 307445 (Del. Ch. June 6, 1996).

6. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987). *Accord* Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 360-61 (Del. 1993), *modified*, 636 A.2d 956 (Del. 1994).

lenge unless the plaintiff demonstrates that the board has not satisfied the presumptive elements of the rule. To overcome the presumption of regularity, a plaintiff must show that the board acted with "gross negligence."[7] Courts generally find gross negligence only in egregious cases, either where there is no rational basis for the board's action, the board acted in bad faith, the board engaged in self-dealing, or the board failed to obtain and consider information reasonably available before acting.[8]

In the context of defensive measures implemented in anticipation of or in response to an unsolicited takeover threat, however, courts generally follow the law of Delaware, America's preeminent corporate jurisdiction.[9] Thus, courts review board action under the "enhanced scrutiny" standard articulated by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*[10] The *Unocal* court adopted this standard upon observing that, in taking steps to defeat or deter an unsolicited offer, there exists the "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[11] Under *Unocal*'s enhanced scrutiny standard, when a board undertakes measures in anticipation of or in response to a possible takeover attempt, the burden shifts to the board to demonstrate that (1) it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed"[12] and (2) that the defensive measure adopted was "reasonable in relation to the threat posed."[13] The board receives the benefit of the business judgment rule only if it satisfies both elements of the test.

The *Unocal* court stated that target directors will have satisfied the first step of their fiduciary obligations under the enhanced scrutiny test "by showing good faith and reasonable investigation."[14] The court also noted that evidence demonstrating good faith and reasonable investigation is "materially enhanced" by factors such as the presence of a majority of independent directors.[15] It should be noted that directors may rely on independent financial advisors and counsel in deliberating takeover

7. *See* Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985).

8. *See* BLOCK, THE BUSINESS JUDGMENT RULE, *supra* note 3, at 63-72.

9. Under the Internal Affairs Doctrine, corporate law issues are governed by the law of the state of incorporation. *See generally* Kamen v. Kemper Fin. Serv., Inc., 500 U.S. 90 (1991). Delaware is the state of incorporation for many corporations. Consequently, its corporate law is highly developed. Many states follow or consider Delaware law in formulating, developing and refining their state corporate law.

10. 493 A.2d 946 (Del. 1985).

11. *Id.* at 954.

12. *Id.* at 955.

13. *Id.*

14. *Id.*

15. *Id.*

proposals, provided that the directors exercise reasonable care in selecting advisors who are competent in the matters for which they are consulted and who are not subject to a disqualifying conflict of interest.[16]

While the *Unocal* court did not define what constitutes good faith and reasonable investigation, the Delaware Supreme Court addressed the issue in a subsequent case. In *Mills Acquisition Co. v. MacMillan, Inc.*,[17] the court stated that, in conducting such an investigation, the board should engage in an analysis which considers

> among various proper factors, the adequacy and terms of the offer; its fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; the impact of both the bid and the potential acquisition on other constituencies, provided that it bears some reasonable relationship to general shareholder interests; the risk of nonconsummation; the basic stockholder interests at stake; the bidder's identity, prior background and other business venture experiences; and the bidder's business plans for the corporation and their effects on stockholder interests.[18]

In satisfying the second step of the *Unocal* standard—the requirement that the defensive measure adopted be "reasonable in relation to the threat posed"—*Unocal* requires that the directors balance "the nature of the takeover bid and its effect on the corporate enterprise" with the defensive tactic undertaken.[19] In that regard, the *Unocal* court stated that "a board may reasonably consider the basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor."[20] The court found the defensive measure at issue in *Unocal*, a discriminatory exchange offer, was reasonably related to the takeover bid, because

> the board's decision to offer what it determined to be the fair value of the corporation to the 49% of its shareholders, who would otherwise be forced to accept highly subordinated "junk bonds," is reasonable and consistent with the directors' duty to ensure that the minority stockholders receive equal value for their shares.[21]

Judicial Application of Unocal. The *Unocal* enhanced scrutiny test has become the governing standard followed by most courts in review-

16. *See* DEL. CODE ANN. tit. 8, § 141 (1991 & Supp. 1996); Dennis J. Block & Jonathan M. Hoff, *Outside Advisors, Director Disinterestedness*, N.Y.L.J., Oct. 19, 1995 at 5.

17. 559 A.2d 1261 (Del. 1989).

18. *Id.* at 1282 n.29; *see also* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1153 (Del. 1989); Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 68 (Del. 1989); Unocal Corp., v. Mesa Petroleum Co., 493 A.2d 946, 955-56 (Del. 1985).

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

20. *Id.* at 955-56.

21. *Id.* at 957.

ing corporate defensive responses to unsolicited takeover bids. Among other defensive measures implemented by targets in response to a hostile bid, the enhanced scrutiny standard has been applied to stock repurchase programs,[22] shareholder rights plans,[23] discriminatory rights plans,[24] self-tender offers,[25] and restructuring plans.[26] While *Unocal* imposes a higher level of scrutiny than that of the traditional business judgment rule analysis, courts applying the *Unocal* standard have remained deferential to business determinations made by directors, particularly where independent directors participate in the decision-making process. This judicial deference was demonstrated by the Delaware Supreme Court in *Paramount Communications Inc. v. Time, Inc.*[27] There, the court considered, among other things, a number of subjective and intangible elements in determining whether the Time board of directors satisfied *Unocal*'s requirements in responding to a hostile tender offer by Paramount Communications.

Time involved an attempt by Paramount to acquire Time in a cash tender offer, interfering with a previously announced proposed friendly merger between Time and Warner Communications.[28] In response to the Paramount bid, the Time board recast the proposed Warner merger into an acquisition for cash by Time of approximately 50% of Warner's common stock to be followed by a second step stock-for-stock merger.[29] In addition to considering the financial inadequacy of Paramount's unsolicited offer, the court allowed Time, the target, to argue that Paramount's offer was inconsistent with Time's long-term business strategy, involved a significant degree of uncertainty that "skewed a comparative analysis," was designed to confuse or upset the shareholders' vote on a proposed merger with Warner, and did not provide the best "strategic 'fit'" with Time's policy and culture.[30]

While the court began its analysis by discounting the differences between long-term versus short-term strategy, in finding that the Paramount bid posed a threat to Time's corporate policy and effectiveness, the court relied heavily on arguments by Time that its board had devel-

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22. *See, e.g.*, Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995).

23. *See, e.g.*, *id.*

24. *See, e.g.*, *In re* Santa Fe Pacific Corp. Litig. [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,845 (Del. Ch. May 31, 1995).

25. *See, e.g.*, AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103 (Del. Ch. 1986).

26. *See, e.g.*, Henley Group, Inc. v. Santa Fe S. Pacific Corp., 13 DEL. J. CORP. L. 1152 (Del. Ch. Mar. 11, 1988).

27. 571 A.2d 1140 (Del. 1989).

28. *Id.* at 1144-47.

29. *Id.* at 1148.

30. *Id.* at 1153-54.

oped long-term business plans that would be compromised by a Time-Paramount combination.[31] The court appeared to be reluctant to challenge a reasonably-informed, long-term corporate strategy, and determined that it would not require a board to accept a hostile takeover bid if the board determined that such an acceptance would compromise those long-term plans:

> 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 deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.[32]

In light of *Time*, then, directors are well-advised to consider not only the adequacy of a hostile tender offer after it has been made, but also to adopt the pre-offer business practice of periodically discussing and considering long-term corporate strategy.

The Delaware Supreme Court again demonstrated the substantial degree of latitude afforded to directors in implementing defensive measures to hostile bids in *Unitrin, Inc. v. American General Corp.*[33] There, the court articulated a two-step approach to applying the *Unocal* test. First, the court stated that the defensive measure adopted must not be "coercive or preclusive."[34] Then, provided that if the defensive measure falls within a "range of reasonableness," it will be upheld.[35]

In *Unitrin*, the Delaware Chancery Court upheld the refusal to redeem a shareholder rights plan, but preliminarily enjoined a repurchase program implemented by Unitrin, the target of a hostile takeover offer by American General Corporation.[36] The chancery court's rationale for issuing the injunction was that the repurchase program was not "necessary" to protect Unitrin shareholders from an inadequate offer.[37] The Delaware Supreme Court reversed the injunction order, holding that the chancery court's application of *Unocal* placed too heavy a burden on the board of directors.[38]

The supreme court found that the repurchase program was not coercive, as it did not force a management-sponsored alternative on the Uni-

31. *Id.* at 1154.
32. *Id.*
33. 651 A.2d 1361 (Del. 1995).
34. *Id.* at 1387.
35. *Id.* at 1388.
36. *Id.* at 1371.
37. *Id.* at 1376.
38. *Id.* at 1390-91.

trin shareholders.[39] Further, the court found that the program was not preclusive, as it would only "inhibit" and not "doom" American General's ability to wage a proxy fight to obtain control of Unitrin's board of directors.[40] Thus, the only remaining issue was whether the defensive measure fell within a range of reasonably proportional responses to American General's hostile offer. In remanding the issue of reasonableness to the Court of Chancery, the Supreme Court did not formulate a test to determine reasonableness, but instead recommended that the Chancery Court consider various issues:

> In considering whether the Repurchase Program was within a range of reasonableness the Court of Chancery should take into consideration whether: (1) it is a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover context; (2) as a defensive response to American General's offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat (i.e., assuming the threat was relatively "mild," was the response relatively "mild"?); (3) with the Repurchase Program, the Unitrin Board properly recognized that all shareholders are not alike, and provided immediate liquidity to those shareholders who wanted it.[41]

Thus, while the *Unitrin* court emphasized that boards do not have "unlimited discretion" to defeat hostile takeover threats "by any draconian means available,"[42] it stated that the

> choice of the term draconian in *Unocal* was a recognition that the law affords boards of directors substantial latitude in defending the perimeter of the corporate bastion against perceived threats. . . .[If] a board reasonably perceives that a threat is on the horizon, it has broad authority to respond with a panoply of individual or combined defensive precautions.[43]

Directors' Actions Which Implicate The Sale Of The Corporation. Directors also have been held to assume special duties when they have made a decision to sell the corporation, and a change of control is imminent. In that context, under the Delaware Supreme Court's decision in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[44] the board's fiduciary obligations must be exercised to maximize shareholder value. Defensive measures and the motivations underlying them are deemed to be moot in this context because "[the] directors' role [changes] from defenders of the corporate bastion to auctioneers charged with getting

39. *Id.* at 1388.
40. *Id.*
41. *Id.* at 1389.
42. *Id.* at 1383 (citing *Unocal*, 493 A.2d at 955).
43. *Id.* at 1388 n.38.
44. 506 A.2d 173 (Del. 1986).

the best price for the stockholders."[45] The *Revlon* duty thus requires the board of directors to create a level playing field in which all bidders are treated equally so that shareholders will be able to obtain the highest possible price under the circumstances for their shares.[46]

Revlon does not, however, preclude disinterested directors from exercising business judgment in determining the most appropriate way to advance the shareholders' interests when a sale of the company is involved. Instead of conducting a formal auction of the corporation, the board can agree to structure a merger agreement such that other potential bidders become aware of the proposed transaction and are not precluded from proposing a transaction superior to that approved by the board. In *In re Fort Howard Corp. Shareholders Litigation*,[47] for example, a merger agreement between the corporation and a management leveraged buyout group prohibited a special committee of outside directors from soliciting potential acquirors, but permitted the committee to "negotiate with, and provide information to, any potential acquirer who contacted the Company" for thirty business days (the equivalent of forty-three calendar days).[48] The merger agreement further provided that if a competing bidder outbid the management group, the management group would be entitled to a termination fee of up to $67.8 million, or approximately $1 per share.[49] The court upheld this "market check" provision, finding that the company's press release announcing the merger agreement "ma[d]e clear . . . that the Company ha[d] the right and would entertain alternative proposals and would cooperate with any such person in the development of a competing bid."[50]

Nevertheless, *Revlon* duties are triggered only under limited circumstances. In *Paramount Communications, Inc. v. Time Inc*,[51] the Delaware Supreme Court stated that a board of directors assumes the obligation to conduct a *Revlon* auction (1) "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company"[52] and (2) when a corporation "abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company."[53] In *Time*, the court found that the proposed stock-for-stock merger between Time

45. *Id.* at 182.
46. *Id.* at 184.
47. 14 DEL. J. CORP. L. 699 (Del. Ch. Aug. 8, 1988).
48. *Id.* at 712.
49. *Id.*
50. *Id.* at 713.
51. 571 A.2d 1140 (Del. 1989).
52. *Id.* at 1150.
53. *Id.*

and Warner Communications did not make a "'sale' of Time 'inevitable.'"[54] Further, the court found that the proposed merger did not invoke *Revlon* duties "simply because" the agreement "might be construed as putting a corporation either 'in play' or 'up for sale'."[55] The court then found that Time's subsequent recasting of its merger agreement with Warner from a share exchange to a share purchase agreement did not provide "a basis to conclude that Time had either abandoned its strategic plan or made a sale of Time inevitable."[56] Thus, finding that the Time board's reaction to Paramount's hostile tender offer did not constitute "an abandonment of the corporation's continued existence,"[57] the court stated that the defensive response was subject only to a *Unocal* analysis.[58]

The Delaware Supreme Court clarified its holding in *Time* in *Paramount Communications Inc. v. QVC Network Inc.*[59] *QVC* arose out of a decision by Paramount Communications Inc.'s board of directors to enter into a merger agreement with Viacom Inc., pursuant to which Viacom would acquire Paramount through a tender offer followed by a second-step merger. The merger agreement also contained a "no-shop" provision, a termination fee and a stock option agreement, which, according to the court, were "designed to make it more difficult for a potential competing bid to succeed."[60]

After Paramount and Viacom announced their proposed merger, QVC made a tender offer to acquire Paramount—which offer exceeded the value to be received by Paramount shareholders in the Paramount-Viacom transaction—and filed suit for injunctive relief.[61] Paramount and Viacom then negotiated an amended merger agreement that offered greater value to Paramount shareholders than the original merger agreement, but did not modify the "no-shop" provision, the termination fee, or the stock option agreement.[62] QVC responded by increasing its offer.[63]

The Delaware Supreme Court rejected Paramount's arguments that the Paramount board's actions should be governed only under the *Unocal* standard, as the court had held in *Time*.[64] Rather, the court found

54. *Id.* 1151.
55. *Id.*
56. *Id.*
57. *Id.* at 1150.
58. *Id.* at 1151.
59. 637 A.2d 34 (Del. 1994).
60. *Id.* at 38-39.
61. *Id.* at 40.
62. *Id.*
63. *Id.* at 41.
64. *Id.* at 42.

that *Revlon* duties were triggered when the Paramount board entered into the merger agreement with Viacom.[65] The court distinguished its decision in *Time*, noting that, in that case, no change of control in the proposed stock-for-stock merger between Time and Warner took place because Time was to be "owned by a fluid aggregation of unaffiliated stockholders both before and after the merger."[66] Thus, according to the court, the Time-Warner merger did not itself impede Time's shareholders from benefitting from an acquisition of their shares at a premium at some point in the future.[67] In *QVC*, on the other hand, the Paramount-Viacom transaction would have resulted in a change of control from public shareholders to Viacom's single controlling shareholder—Sumner Redstone—who had the ability to preclude Paramount's other shareholders from ever receiving a premium for their shares. The court determined that the "no-shop" provision, the stock option agreement and the termination fee in the Paramount-Viacom transaction were not "reasonable and in the best interests of the Paramount shareholders"[68] because "[when] a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority stockholders."[69] The court found that the defensive measures designed to deter a competing bid—the "no-shop" provision, the termination fee, and the stock option agreement—inhibited the Paramount board's ability to negotiate with other potential bidders to obtain the highest possible value for Paramount's stock.[70] Accordingly, the court held that the board had not complied with its obligations under *Revlon*.[71]

Mills Acquisition Co. v. MacMillan, Inc.[72] provides another example of board conduct which was held to violate *Revlon* duties. In *MacMillan*, management directors took an active role in securing a favorable bidding position via a lock-up option for one bidder, KKR, over a disfavored bidder, Maxwell, in connection with the sale of MacMillan. In enjoining the option, the court placed substantial weight on the fact that the inside directors (who would own twenty percent of the surviving company under the KKR proposal), and not the independent directors, controlled the bidding process.[73] The *MacMillan* court reiterated the

65. *Id.*
66. *Id.* at 46.
67. *Id.* at 47.
68. *Id.* at 48.
69. *Id.* at 42.
70. *Id.* at 48-49.
71. *Id.* at 51.
72. 559 A.2d 1261 (Del. 1989).
73. *Id.* at 1279-80.

principles articulated in *Revlon*, stating that the lock-up agreement "must confer a substantial benefit upon the stockholders."[74] The purpose of such an agreement must be to secure a final offer that "materially [enhances] general stockholder interests."[75] The court found that the MacMillan directors violated their duties under *Revlon*, stating that the auction was "clandestinely and impermissibly skewed in favor of KKR"[76] and that there was no "board planning and oversight to insulate the self-interested management from improper access to the bidding process."[77] The court went on to state that when "the intended effect [of a lock-up agreement] is to end an active auction, at the very least the independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."[78]

In re RJR Nabisco, Inc. Shareholders Litigation,[79] on the other hand, provides an example of board conduct that satisfies *Revlon* duties in the change of control context. In *RJR*, an RJR management group informed the RJR board that it was interested in conducting a leveraged buyout of the corporation.[80] After RJR's board issued a press release announcing the proposed buyout, a rival bidder, KKR, announced its intention to make a tender offer for RJR as part of a proposed two-step merger.[81] A special committee of RJR's independent directors then conducted an auction, from which the committee received three bids.[82] After the special committee determined that the KKR bid and the management group's bid were the two most viable of the three bids, the committee weighed the relative benefits of each, and determined that the two bids were "substantially equivalent" from a financial perspective and fair to the RJR shareholders.[83] The special committee recommended that the RJR board accept the KKR bid, however, because, among other factors: KKR was offering a greater equity interest than the management group; KKR would retain RJR's tobacco business and a substantial part of RJR's food businesses, while the management group would retain only the tobacco business; issues arose under RJR's debt indentures in connection with the management group proposal but not in

74. *Id.* at 1284.
75. *Id.* at 1286.
76. *Id.* at 1281.
77. *Id.* at 1282.
78. *Id.* at 1286.
79. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,194 (Del. Ch. Jan. 31, 1989), *appeal refused*, 556 A.2d 1070 (unpublished opinion, text available at 1989 Del. LEXIS 42 and 1989 WL 16907) (Del. Feb. 2, 1989).
80. *See id.* at 91,703.
81. *See id.*
82. *See id.* at 91,703-04.
83. *Id.* at 91,708.

connection with the KKR proposal; KKR—but not the management group—was willing to provide for the preservation of benefits for employees who would be terminated due to business divestitures; and further negotiations, the committee believed, could result in either party withdrawing from the bidding process.[84] The RJR board followed the committee's recommendation and accepted the KKR bid.[85]

In upholding the committee's determination to accept one of two substantially equivalent offers, the court found that the committee had satisfied its *Revlon* duty to achieve the best possible value for shareholders.[86] The court acknowledged that the committee could have obtained more information by conducting another round of bidding, but stated that seeking the additional information could have resulted in one of the parties walking away.[87] The *RJR* court concluded that a determination of the proper amount of information a board must have before accepting a bid is a business decision entitled to the protection of the business judgment rule: "[T]he 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."[88]

Revlon and its progeny demonstrate that, in the sale of control context, directors retain discretion under the business judgment rule to undertake a sale of the corporation in a manner in which they determine will best serve shareholder interests. Moreover, directors have discretion to make an objective and informed decision that the highest bid received does not necessarily translate into the best transaction for the shareholders.[89] It is essential, however, that when inside directors have a significant interest in the outcome of an auction, the independent directors should control the bidding process and conduct the negotiations so that bidders can compete for control of the company on a level playing field.

III. Types of Defensive Measures Available to Directors

While *Unocal* and *Revlon* subject boards of directors to a higher standard of review in the takeover context, those decisions do not disable a board of directors' ability to implement defensive measures. The following are examples of defensive measures that (1) a board of directors may adopt or propose in the absence of an actual takeover situation

84. *See id.*
85. *See id.*
86. *See id.* at 91,714.
87. *See id.*
88. *Id.*
89. *See* Block, The Business Judgement Rule, *supra* note 3, at 266-87.

so as to provide the board the flexibility to respond to an actual hostile threat or (2) can be implemented in response to a hostile bid after it has been made.

Structural Defenses. In carrying out its fiduciary duties, the board of directors must act to promote and protect the shareholders' best interests. This duty requires that the board consider and balance shareholders' immediate value and return on investment with long-term value and return on investment. Because directors have access to information that may be unavailable to shareholders, the board may properly enact measures intended to prevent shareholder vulnerability to inadequate or coercive hostile bids by ensuring that the target board of directors is a necessary participant in the takeover situation.

For example, the board can adopt by-law provisions or the shareholders can approve charter provisions intended to deter unfair or coercive hostile takeover tactics. Courts are particularly deferential to defensive amendments to the corporate charter or by-laws where shareholder approval is obtained.[90] Charter amendments introduced for shareholder vote after a takeover proposal has surfaced, however, may be more difficult to adopt than similar amendments proposed in the absence of a specific takeover proposal. The following illustrate defensive charter and by-law provisions that serve as structural defenses to hostile takeover attempts:

(1) Longer board terms and staggered board elections, in which only a portion of the directors are elected each year, make hostile bids more difficult. The theory behind implementing longer board terms as a defensive strategy is that even a raider acquiring all or a majority of the target's shares will not immediately gain control of the corporation because the existing board members must first serve their terms. In that regard, staggered board elections make a proxy fight in aid of a tender offer difficult because only a minority of the target's directors will be elected in any given year. Consequently, two or more annual meetings are necessary to gain control of the board.

(2) Provisions limiting removal of directors "for cause only" also thwart hostile takeover attempts by making it more difficult for a raider to remove the target's incumbent board.

(3) Cumulative voting rights encourage minority representation on the board of directors by permitting shareholders to apportion their individual votes in any fashion they choose when electing directors. Eliminating cumulative voting rights deters hostile takeover attempts by making

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90. *See, e.g.*, Henley Group, Inc. v. Santa Fe S. Pacific Corp., 13 DEL. J. CORP. L. 1152 (Del. Ch. Mar. 11, 1988); Torchmark Corp. v. Bixby, 708 F. Supp. 1070 (W.D. Mo. 1988); Siegman v. Tri-Star Pictures, Inc., 15 DEL. J. CORP. L. 218 (Del. Ch. May 5, 1989).

it more difficult for raiders to gain seats on the target corporation's board. Most states do not require but permit cumulative voting, and generally require a corporate charter or by-law provision to grant cumulative voting rights.

(4) By-law provisions requiring shareholders to give advance notice of intent to elect directors or to submit proposals at a shareholder meeting protect against unexpected hostile bids or attempts to gain control of the target's board. While no court has ruled on the length of time that constitutes an unreasonable advance notice requirement, such requirements should be "reasonable to allow time to set and publicize a record date for the meeting, to prepare proxy materials, and to allow shareholders to gain information to make an informed judgment before the meeting."[91] Courts afford liberal discretion to directors in adopting advance notice requirement by-laws. Generally, directors must only ensure that a shareholder vote is held "within a finite and relatively short period,"[92] and should not manipulate the corporate machinery to deprive shareholders of their franchise.[93] For example, in *Blasius Industries v. Atlas Corp.*, a nine percent shareholder sought to expand the board from seven to fifteen members and to elect eight directors to fill the newly created vacancies in order to implement a recapitalization that would include large dividends for shareholders.[94] The board responded by adopting a by-law amendment enlarging the board's size to nine and appointing two new directors, thereby ensuring that the nine percent shareholder would not gain control of the board.[95] The court set aside the board's expansion as "an unintended breach of the duty of loyalty."[96] While the court declined to adopt a "*per se* rule invalidating, in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote,"[97] it concluded that the board in *Blasius* could not meet "the heavy burden of demonstrating a compelling justification for such action."[98] The court emphasized that "Delaware courts have long exercised a most sensitive and protective regard for the free and effective exercise of voting rights."[99]

91. Georgia-Pacific Corp. v. Great N. Nekoosa Corp., 727 F. Supp. 31, 33 (D. Me. 1989); *see also* R.D. Hubbard v. Hollywood Park Realty Enter., Inc., 1991 Del. Ch. LEXIS 9 (Del. Ch. Jan. 14, 1991).

92. *Georgia-Pacific*, 727 F. Supp. at 34.

93. *See, e.g.*, Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988); Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).

94. *See Blasius*, 564 A.2d at 654.

95. *See id.* at 655-56.

96. *Blasius*, 564 A.2d at 663.

97. *Id.* at 662.

98. *Id.* at 661.

99. *Id.* at 659 n.2.

(5) Charter or by-law provisions that limit shareholders' ability to call a special meeting provide additional protection against a hostile bid. For example, charter provisions can limit the ability to call special meetings to directors. Alternatively, by-law provisions can limit the subject matter for which shareholders may call special meetings and can require shareholders to provide advance notice of intent to call such a meeting. In addition, charter provisions can be adopted to require a supermajority of shareholders to call a special meeting. Similarly, charter provisions disallowing a shareholder vote via written consent in lieu of holding a meeting serve to prevent bidders from taking immediate action affecting corporate control and pressuring a board into taking precipitous action. (6) Fair price charter provisions can require a bidder to pay all shareholders the highest cash price it paid for any shares it acquired at any time in a two-tier front-end loaded merger. Fair price provisions prevent discriminatory pricing in the second step of a merger that tends to pressure the target's shareholders into selling their shares in the first step. These provisions generally do not apply if a supermajority of the target's shareholders or the board approves the merger or the stock acquisition. (7) Charter provisions that require more than a simple majority for shareholder approval of any merger or acquisition or to amend protective charter or by-law provisions also serve as a defensive mechanism. Such provisions are usually accompanied by a provision requiring a supermajority vote to amend the supermajority provision. A variation of the supermajority provision is one requiring a majority of the minority shareholders to approve a merger. Under this variation, if the bidder holds more than fifty percent of the outstanding shares in a target, a majority of the remaining shareholders must approve any business consolidation.

Shareholder Rights Plans. One of the most common defensive measures that the board of directors can adopt without a shareholder vote is the shareholder rights plan, colloquially referred to as the "poison pill." While boards typically adopt shareholder rights plans before a tender offer, they also can be implemented after a bid has surfaced. Shareholder rights plans are designed to make a target less attractive to corporate raiders by giving the target's other shareholders the right to purchase the target's stock cheaply prior to the acquisition or merger, or in the final acquired or merged company after a successful hostile takeover. Should a hostile bid surface, rights plans provide the target's board with additional time to deliberate on the course of action that will best promote the shareholders' interest by providing a period of time during which a hostile bidder will be unwilling to complete a hostile takeover and trigger the rights plan.

Shareholder rights plans involve the issuance of rights or warrants to shareholders that entitle the holder (other than the owner of a specified percentage of the target's voting stock) to purchase shares of the target corporation's common or preferred stock at either a designated exercise price or a price set by formula. Whether designated or set by formula, the exercise price is usually significantly higher than the target's current market price because it is intended to reflect the anticipated long-term value of the stock during the term of the warrant (typically ten years). Because the exercise price is "out of the money," the warrants are not expected to be exercised. The actual "poison" in the "poison pill," however, is typically found in so-called "flip over" and "flip in" provisions of shareholder rights plans.[100]

Flip over provisions give shareholders the right to buy shares of the entity acquiring the target corporation at a designated price, often half of the bidder's current market price, if the bidder obtains control of the target and completes a merger. The surviving corporation is obligated to honor the rights and sell its shares at the designated cheap price. The intended and almost inevitable effect of such a plan is to dilute the acquirer's equity to a "devastating" level.[101] Flip in provisions allow shareholders other than the acquiror to exercise a right to buy target stock cheaply when a bidder acquires a designated percentage (usually an amount between ten and twenty percent) of the target's outstanding stock. Flip in provisions are also triggered when an acquirer engages in a merger in which the target corporation is the surviving corporation or engages in self-dealing transactions, such as obtaining loans from the target at below-market interest rates. As with flip over provisions, flip in provisions operate on the theory that a bidder will be reluctant to trigger the rights plan due to the consequent dilution of its equity if the rights plan takes effect. In practice, a flip in provision is virtually always accompanied by a flip over provision.

Because a bidder will not want to risk triggering the rights, it generally will not exceed the flip in trigger or complete an attempted takeover unless the target's board of directors first redeems or amends the rights plan to permit the bidder's acquisition. Thus, because the bidder is forced to negotiate any such redemption or amendment with the target's board, the target board's bargaining power in connection with the proposed acquisition increases substantially. This increased bargaining power often results in higher takeover premiums for the target's shareholders where the target is ultimately sold.

Less common shareholder rights plans include put plans, back-end

100. *See* BLOCK, THE BUSINESS JUDGMENT RULE, *supra* note 3, at 519-24.
101. *See generally* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985).

or debt provision plans, and disproportionate voting provision plans. Put plans give the target's shareholders the right to sell their shares back to the target at a designated price or at a price set by formula if a bidder buys a majority, but not all, of the target's shares. These plans give shareholders the option of selling back to the target, thereby preventing the second step in a two-tier front-loaded offer from occurring. The back-end provision plan grants shareholders the right to redeem their shares for cash or debt securities either at a price determined by formula or at the highest price at which the hostile bidder acquired its shares once a hostile bidder obtains a triggering percentage of the corporation's outstanding stock. The redemption price generally is significantly higher than the current market value of the stock. Back-end provisions serve as a defensive mechanism by establishing a minimum takeover price. Disproportionate voting provisions are calculated to give large shareholders inferior voting rights. Under these provisions, the target issues a preferred class of stock that grants multiple voting rights to current shareholders. Any shareholder acquiring shares after the date the preferred stock is issued does not obtain the superior voting rights and thereby has diminished voting status.

Two issues arise when a target adopts a shareholder rights plan as a defensive measure to hostile takeover attempts. The first issue is the propriety of adopting a shareholder rights plan. The second issue is the propriety of refusing to redeem an intact rights plan after a hostile bid has been made.[102] As to the first issue, since the Delaware Supreme Court's landmark decision in *Moran v. Household International, Inc.*,[103] it has been well-settled that boards may adopt shareholder rights plans. In *Household*, the court applied *Unocal*'s two-pronged test and found that Household's board exercised proper business judgment in adopting a shareholder rights plan to deter future hostile takeover attempts which the board believed could be unfair or coercive to Household shareholders.

The rights plan at issue in *Household* was a flip over plan that was triggered if a person acquired twenty percent or made a tender offer for at least thirty percent of the company.[104] If a merger occurred under these circumstances, each Household shareholder could exercise its right under the plan to purchase $200 worth of the acquirer's common stock for the $100 exercise price of the right.[105] Applying *Unocal*, the court upheld the rights plan, first finding that the board had reasonable

102. *See* BLOCK, THE BUSINESS JUDGMENT RULE, *supra* note 3, at 523-24.
103. 500 A.2d 1346 (Del. 1985).
104. *Id.* at 1348.
105. *See id.* at 1349.

grounds to believe that the plan would protect Household from "coercive two-tier offers" that posed a threat to "corporate policy and effectiveness."[106] Second, the court found that the directors' concern over the "increasing frequency in the financial services industry of 'boot-strap' and 'bust-up' takeovers" demonstrated that the defensive mechanism was "reasonable in relation to the threat posed."[107] *Household* demonstrates that shareholder rights plans are permissible in the abstract. Boards of directors thus have the flexibility to implement rights plans designed to protect shareholders against unfair, coercive and inadequate tender offers.

The second issue, and the subject of most litigation regarding shareholder rights plans, concerns the board's obligation to redeem an intact rights plan after a hostile bid has been made. This issue typically arises in one of three circumstances.

In one scenario, the target board can refuse to redeem an intact shareholder rights plan and offer its shareholders an economic alternative to tendering through mechanisms such as a restructuring or recapitalization. The economic alternative is intended to allow the target to remain independent while offering shareholders a number of benefits. Shareholders receive not only a short-term gain via dividends, share repurchases or other distribution of corporate assets, but also a continued equity interest in the target's long-term viability. *Unocal*'s two-step analysis, which applies to defensive measures generally, is also applicable in determining whether the board in this situation has fulfilled its fiduciary duties in refusing to redeem a shareholder rights plan in the face of an unsolicited takeover bid.

The *Unocal* standard was applied to a shareholder rights plan in *Gelco Corp. V. Coniston Partners.*[108] In *Gelco*, the court refused to require Gelco, the target, to redeem a shareholder rights plan in the face of a hostile tender offer of twenty-six dollars per share when Gelco was providing an exchange offer restructuring plan in which shareholders would receive a cash and securities package worth twenty-four dollars per share.[109] There, the court stated that Gelco's decision not to redeem its rights plan was "clearly a reasonable response to [a] hostile bid, which the Board, partially based on advice from its investment banker, concluded was inadequate from a financial point of view,"[110] and that the board was reasonably concerned about the bidder's "reputation as a

106. *Id.* at 1356.
107. *Id.* at 1357.
108. 652 F. Supp. 829 (D. Minn. 1986), *aff'd in part and vacated in part on other grounds*, 811 F.2d 414 (8th Cir. 1987).
109. *Id.* at 837.
110. *Id.* at 849.

raider, uninterested in continued operation of the Company."[111]

In *Grand Metropolitan Public Ltd. Co. v. Pillsbury Co.*,[112] on the other hand, the court ordered the target, Pillsbury, to redeem a shareholder rights plan. There, the court found that the restructuring plan Pillsbury offered to its shareholders as an alternative to tendering was not adequate in light of the length of time it would take for shareholders to realize the benefits of the restructuring plan.[113] The Pillsbury restructuring plan would not offer economic benefit to the shareholders for a four to five year period.[114] Furthermore, Pillsbury's financial advisors did not consider the hostile bid inadequate.[115] The court stated that any benefits that could be realized from the restructuring were "subject to economic and competitive conditions which are beyond Pillsbury's control," and that $63, the amount of the hostile bid, which the court did not find inadequate, was "preferable to the possibility of $68 [the purported value of the restructuring plan] if all of the 'ifs' in Pillsbury's plan disappear and its hopes for the future become realities."[116]

In a second scenario, the target board can refuse to redeem an intact rights plan and negotiate a sale of the company to a favored bidder, also known as a "white knight." In this situation, *Revlon* duties are typically implicated. However, provided the target board acts for the purpose of enhancing the bidding process and obtaining the best price for the shareholders, the target may not be required to redeem its rights plan. Thus, in *CRTF Corp. v. Federated Department Stores, Inc.*,[117] the target, Federated, redeemed a shareholder rights plan in connection with an offer by Macy's, but refused to redeem the rights plan in connection with an offer by CRTF.[118] The court denied CRTF's request for a preliminary injunction against use of the rights plan in connection with its offer stating, "[a] Board clearly has the right to use its powers to defeat a coercive . . . bid . . . where the Board believes the offer would not be in the best interests of the shareholders."[119] The court based its decision on its finding that "nothing at this point suggests that the Federated Board is acting with any other motive than to enhance the bidding and to raise the price for the benefit of the shareholders."[120]

111. *Id.* at 850.
112. 558 A.2d 1049 (Del. Ch. 1988).
113. *Id.* at 1057-58.
114. *See id.* at 1057.
115. *See id.*
116. *Id.*
117. 683 F. Supp. 422 (S.D.N.Y. 1988).
118. *Id.* at 433.
119. *Id.* at 440.
120. *Id.* at 441.

In contrast, in *Mills Acquisition Co. v. Macmillan, Inc.*,[121] the court enjoined Macmillan's use of a shareholder rights plan as a defensive measure against a hostile offer by Maxwell when Macmillan granted a lock-up asset option at the end of the auction to another bidding group that included members of Macmillan's management. The losing bidder, Maxwell Communications Corp., then increased its bid, exceeding the winning bid by twenty cents per share, in a tender offer conditioned on the invalidation of the lock-up option. While the court found that the lock-up option was not responsible for Macmillan "not receiving [the losing bidder's] highest bid before the auction gavel fell,"[122] the court nonetheless enjoined the operation of Macmillan's rights plan as an improper defensive measure against Maxwell's increased tender offer.[123] The court found that no corporate purpose would be served by leaving the rights plan in place "because the auction is over and the two highest bids are now on the table."[124] "Stated differently," the court reasoned, "the fact that the auction has concluded should not deprive the shareholders of the opportunity to consider an alternative cash transaction for a fair (indeed higher) price."[125]

In yet a third scenario, the target board may refuse to redeem an intact rights plan without offering its shareholders an economic alternative to tendering. Although there is little experience with this strategy—referred to as the "Just Say No" defense—a recent judicial pronouncement on the issue of a board's obligation to redeem a shareholder rights plan is found in *Moore Corp. Ltd. v. Wallace Computer Services, Inc.*[126] There, the court affirmed the target's ability to "just say no" to a hostile takeover attempt in some circumstances.

In *Wallace*, Wallace Computer Services, the target, refused to entertain Moore Corp.'s offer, despite the fact that greater than 73% of Wallace's shareholders had tendered into the offer and despite the fact that the Wallace board offered its shareholders no economic alternative to tendering.[127] The court found that the board's refusal to redeem the shareholder rights plan satisfied the *Unocal* test.

First, the court found that the Wallace Board was reasonable in concluding that Moore's offer was inadequate, thereby posing a threat to

121. [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,071 (Del. Ch. Oct. 17, 1988), *rev'd on other grounds*, 559 A.2d 1261 (Del. 1989).

122. *Id.* at 91,024.

123. *See id.*

124. *Id.*

125. *Id.*

126. 907 F. Supp. 1545 (D. Del. 1995).

127. *Id.* at 1553.

corporate policy and effectiveness.[128] The court noted that an inadequate, non-coercive tender offer can constitute a threat under *Unocal* not only when the target needs additional time to organize a suitable alternative to the tender offer, but significantly, also when shareholders might tender their shares without completely understanding the economic value of the target's business strategy.[129] The court found that Moore's inadequate offer was a legally cognizable threat for the latter reason: "Moore's tender offer poses a threat that shareholders might tender their shares without appreciating the fact that after substantial capital investment, Wallace is actually witnessing the beginning of the pay-off of its business strategy."[130] The *Wallace* court, following *Time* and *Unitrin*, then concluded that the Wallace board reasonably investigated the adequacy of Moore's tender offer. The court noted that the Wallace board met three times within a two week period to discuss the offer, hired an investment banker to review the financial aspects of the offer and considered Wallace's present and future long-term plans and strategies.[131] Significantly, the court relied on evidence that Wallace was succeeding financially, implying that a target's financial success lends credibility to the future viability of its long-term business strategy, thereby enhancing any demonstration of reasonable investigation. The court stated, "the Wallace Board could reasonably conclude, based on the upward trend in earnings per share, that the company was well-positioned to reap economic benefits in the future, which would support their initial reaction that the Moore offer seemed 'low ball.'"[132]

Second, the court held that the Wallace board's refusal to redeem the shareholder rights plan was "reasonable in relation to the threat posed" because it was neither preclusive nor coercive since it (i) did not absolutely prevent shareholders from realizing a control premium for their stock and (ii) did not deny shareholders the right to elect directors in a proxy contest.[133]

Wallace underscores the necessity for a board of directors to consider a hostile takeover bid and a refusal to redeem a shareholder rights plan in light of the corporation's long-term business strategies. *Wallace* further indicates that if a target demonstrates a likelihood of succeeding financially, courts are more likely to presume that the board's long-term business strategy is in the shareholders' best interests. In these circumstances, courts will likely uphold a refusal to redeem a shareholder rights

128. *Id.* at 1558-60.
129. *See id.* at 1560-61.
130. *Id.* at 1560.
131. *Id.* at 1558.
132. *Id.* at 1559.
133. *Id.* at 1563.

plan, notwithstanding shareholders' positive response to an unsolicited bid, and notwithstanding the target's failure to offer an economic alternative to the hostile offer.

It should be noted that a hostile bidder may attempt to circumvent a shareholder rights plan by conducting a proxy contest at a special meeting or annual meeting to replace the target board with directors who will redeem the rights plan. Staggered terms for directors and prohibitions on shareholder action by written consent or through special meetings, however, can forestall such a strategy. Additionally, "continuing director" provisions in rights plans can frustrate a hostile bidder's attempt to displace a shareholder rights plan by unseating the incumbent board. Such provisions, sometimes referred to as "Dead Head" provisions, generally limit the power to redeem a shareholder rights plan to "continuing directors," *i.e.*, those directors who were seated at the time the rights plan was adopted or their elected replacements. Alternatively, "continuing directors" may be defined as directors unaffiliated with and seated before the hostile bidder acquired its shares, or directors nominated to replace continuing directors by a majority of the seated continuing directors.

In *Bank of New York Co., Inc. v. Irving Bank Corp.*,[134] the court, applying New York law, enjoined a continuing director provision that permitted redemption of a shareholder rights plan only if (1) continuing directors constituted a majority of the board or (2) any non-continuing directors were seated in direct succession to continuing directors and either were elected by a two-thirds shareholder vote, or no other significant corporate transaction was related to their election.[135] The court in *Irving Bank* invalidated the continuing director provision on the grounds that it constituted an unauthorized restriction on the powers of certain types of duly elected directors.[136]

Issuance of Stock into Friendly Hands. Another defensive measure that a corporation may employ in an effort to protect itself against a hostile takeover attempt involves placing a substantial amount of stock in the hands of persons or entities presumed "friendly" to the incumbent board, such as a "white squire" or an Employee Stock Option Plan ("ESOP").[137]

In "white squire" transactions, the target sells a substantial block of

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134. 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988).

135. *Id.* at 483.

136. *Id.* at 485-86.

137. *See generally* Dennis J. Block, et al., *Hostile Acquisitions and Defensive Strategies: Recent Developments*, *in* CONTESTS FOR CORPORATE CONTROL 1996: THE NEW ENVIRONMENT at 15 (PLI Corp. L. & Practice Course Handbook Series No. B4-7125, 1996) [hereinafter Block, *Hostile Acquisitions*].

stock (often less than twenty percent of the outstanding stock so as to avoid a New York Stock Exchange rule requiring shareholder approval of the issuance of stock in excess of twenty percent) to an investor perceived as friendly to the incumbent board. White squire sales are particularly effective in states which have enacted business combination statutes. Section 203 of the Delaware General Corporation Law, for example, prohibits "business combination[s]" between the company and an "interested shareholder."[138] An "interested shareholder" is defined as a shareholder owning fifteen percent or more of the company's stock for a period of three years after the shareholder obtains his stock.[139] Interested stockholders are exempted from the restrictions of section 203, however, if (1) the board approved the business combination before the interested shareholder acquired that status, (2) the shareholder obtained eighty-five percent of the company's stock in the same transaction in which he obtained over fifteen percent of the outstanding stock (shares owned by management are excluded from the calculation) or (3) the board plus 66-2/3 of the shares not held by the fifteen percent or more shareholder approved the business combination after the interested shareholder acquired his stock.[140] Thus, if the target's management sells at least sixteen percent of its stock to a white squire, thereby preventing a would-be raider from obtaining eighty-five percent of the shares, it may be able to prevent the raider from accomplishing a back-end merger.

White squire sales motivated solely for entrenchment purposes are invalid under *Unocal*. If, however, the stock sale is a reasonable and proportionate response to a hostile takeover bid that could threaten shareholder value, it will be protected by the business judgment rule. In *Carter Hawley Hale Stores, Inc. v. The Limited, Inc.*,[141] a California federal court upheld a plan creating a new class of common stock that was immediately issued to a white squire. There, in response to a tender offer by the Limited for over half of the outstanding shares of Carter Hawley Hale Stores, Inc., Carter Hawley Hale sold convertible preferred stock possessing a vote equivalent to twenty-two percent of its outstanding voting shares to General Cinema.[142] General Cinema, in turn, agreed to vote the shares as recommended by the Carter Hawley Hale

138. DEL. CODE ANN. tit. 8, § 203(a) (1991); *see also* N.Y. Bus. Corp. Law § 912 (McKinney 1986 & Supp. 1997); GA. CODE ANN. §§ 14-2-1110-1133 (1994 & Supp. 1996); VA. CODE ANN. §§ 13.1-725-728 (Michie 1993 & Supp. 1995).

139. DEL. CODE ANN. tit. 8, § 203(c)(5) (1991).

140. *See* section 203(a).

141. No. 84-2200-AWT (C.D. Cal. Apr. 17, 1984).

142. *See id.*

board.[143] The court upheld the sale to General Cinema, stating that, "this was a prudent exercise of business judgment. . . . Once the Board determines that it believes the unfriendly offer is not adequate for its shareholders, . . . it has the obligation to take such actions as it feels is necessary to protect the rights of the shareholders."[144]

Employee Stock Ownership Plans. A target can also protect itself from a hostile takeover attempt by issuing common stock to an employee stock ownership plan ("ESOP").[145] ESOPs are governed by The Employee Retirement Income Security Act of 1974, as amended ("ERISA").[146] As a defensive mechanism, ESOPs operate on the assumption that ESOP shares are likely to be voted or tendered in accordance with management's interests. Under ERISA, the board of directors of the corporate sponsor appoints a trustee of the ESOP.[147] The trustee could be an officer or director of the target corporation or a corporate trustee. Under ERISA, the trustee has a fiduciary duty to act in the best interests of ESOP participants.[148] Where shares of the target corporation are purchased with a loan (either from the target corporation or from a financial institution guaranteed by the target corporation), a leveraged ESOP holds shares allocated to participant accounts, and unallocated shares are held in a suspense account pending amortization of the ESOP loan. Generally, all voting decisions and decisions whether to tender with respect to allocated shares are passed through to plan participants as "named fiduciaries" under ERISA.[149] The ESOP document directs the trustee to follow the directions or non-directions of the participants. Many ESOPs also pass through voting and tendering decisions with respect to unallocated shares by providing that the voting or tendering of unallocated shares is to be directed by the participants, as named fiduciaries, in proportion to their directions on allocated shares.

The Department of Labor has taken the position in *Reich v. NationsBank of Georgia*, a litigation against NationsBank[150] arising from a self-tender offer, that a trustee has a fiduciary duty (1) to override

143. *See id.*

144. *Id.*

145. ESOPs present a number of complex tax and ERISA issues in addition to implications in contests for corporate control. *See* Susan P. Serota, *New Techniques, Special Features and Enhanced Incentives in Utilizing ESOPs, in* TAX STRATEGIES FOR CORPORATE ACQUISITIONS, DISPOSITIONS, SPIN-OFFS, JOINT VENTURES, FINANCINGS, REORGANIZATIONS, AND RESTRUCTURINGS 1996, at 959, 1022 (PLI Tax & Estate Planning Course Handbook Series No. J4-3684).

146. 29 U.S.C. §§ 1001-1461 (1994).

147. *See* section 1103(a).

148. *See* section 1109.

149. *See* section 1103(a)(1).

150. *See* Employee Benefits Cas. (BNA) 1345, (N.D. Ga. Mar. 29 1995), *available in* 1995 Westlaw 316550.

the directions of participants with respect to unallocated shares if the trustee would not have reached the same result[151] and (2) to affirmatively make a decision with respect to allocated shares with respect to which no direction was received.[152] In *NationsBank*, the Department did not contest the failure of the trustee to override the directions of participants with respect to directions received on allocated shares, notwithstanding that the statutory provisions of ERISA with respect to directions by named fiduciaries make no distinction between allocated and unallocated shares.[153]

In a decision of first impression, the United States District Court for the Northern District of Georgia agreed with the Department of Labor in finding that participants have an inherent conflict of interest in acting as named fiduciaries of unallocated shares.[154] The court's analysis was very conclusory in assuming, as a given fact, that current participants could not act in the best interests of future participants (including themselves) as the ultimate beneficiaries of the unallocated shares.[155] The court also agreed with the Department of Labor that the trustee could not rely on a "non-direction" with respect to allocated shares.[156] The decision is being appealed to the Eleventh Circuit Court of Appeals. Subsequent to the filing of the complaint, the Department of Labor, in a letter (the "Lanoff" letter), modified its position with respect to unallocated shares and non-directions regarding allocated shares.[157] In the Lanoff letter, the Department stated that a trustee of a collectively bargained plan must follow plan provisions with respect to directions or non-directions (whether of allocated or unallocated shares) unless the trustee could affirmatively determine that to do so would constitute a breach of ERISA. The letter states that a trustee cannot ignore such directions merely because the trustee would have reached a different result. Rather, the trustee has the burden of demonstrating that following such provisions would result in a violation of ERISA. It is unclear what effect this letter will have on the pending *NationsBank* case.

It is generally accepted that when ESOP shares are voted or directed by employees, the stock is assumed to be held in hands friendly to the incumbent board. Since hostile takeover attempts tend to raise

151. *See id.* at *4.
152. *See id.*
153. *See id.* at *5.
154. *See id.* at *6.
155. *See id.*
156. *See id.* at *7.
157. *See* Letter from Olena Berg, Assistant Secretary of Labor, to Ian Lanoff (Sept. 28, 1995) (on file with author). *See also* Robert N. Eccles & David E. Gordon, 4 ERISA LITIG. *Rep.* 1, 4 (1995).

concerns about job security, employees are generally believed to elect job security and vote their ESOP shares in accordance with management's wishes. This position is not inconsistent with acting to maximize the future value of a leveraged ESOP to plan participants, as an acquirer generally would terminate a leveraged ESOP in order to reduce prospective benefits. Furthermore, an independent trustee necessarily has to take into consideration lost prospective benefits under an ESOP if a voting or tendering decision is made by the trustee. Accordingly, by issuing stock to an ESOP, the target's board of directors may enhance its opportunity to receive the support of a significant percentage of the target's outstanding shares should a proxy or change of control contest arise.

An additional factor to consider is the effect of state anti-takeover statutes. A block of ESOP stock might serve to defeat a hostile bid by preventing a raider from obtaining sufficient shares to complete a merger if a state anti-takeover statute prevents "interested shareholders" from entering into a business combination with the company without board approval, or without acquiring a very high percentage of the company's outstanding shares, including ESOP shares.[158] In such a case, if ESOP plan participants agree with management, the hostile bidder may not be able to acquire enough shares to effect a takeover. Section 203 of the General Corporation Law of Delaware demonstrates the effectiveness of the ESOP as a protective mechanism to hostile takeover attempts. Stock is not "outstanding" stock, and thus is excluded from the eighty-five percent calculation needed to approve a business consolidation with an "interested" shareholder, if it is owned by management or is owned by an employee benefit plan where the employee participants do not have pass-through tender rights, i.e., "the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer."[159] Conversely, stock held by an ESOP with effective pass-through provisions are considered outstanding. Thus, if an ESOP with effective pass-through provisions holds more than fifteen percent of all outstanding shares after a tender, a business combination with the acquirer would be effectively blocked. Consequently, corporations incorporated in Delaware are motivated to grant pass-through voting and tendering rights to ESOP plan participants on both allocated and unallocated shares so that ESOP shares will be included in the eighty-five percent calculation and so that interested shareholders will be less likely to secure the shares necessary to complete an unsolicited business combination.

158. *See, e.g.*, DEL. CODE ANN. tit. 8, § 203 (1991).

159. Del. Code Ann. tit. 8, § 203(a)(21).

Importantly, the application of Section 203 to pass-through rights on unallocated shares in an ESOP has not been the subject of any court decisions to date. Arguably, a well-designed ESOP with appropriate pass-through provisions should qualify. The Eleventh Circuit's decision in the *NationsBank* case will be closely watched because of its indirect bearing on this issue. However, because of the recent change in the Department of Labor's position on pass-through directions in the Lanoff letter, a single adverse decision should not be considered determinative until the Delaware Supreme court decides a case under section 203 on the merits.

Generally, even in the hostile takeover context, ESOPs are afforded business judgment rule protection provided the target board reasonably believed the ESOP transaction at issue would serve the corporation's best interest. If business judgment rule protection is not applicable, the ESOP transaction must satisfy the fairness test, which governs transactions and decisions not protected by the business judgment rule. In that regard, ESOPs should be implemented to serve legitimate corporate purposes, such as providing retirement benefits, supplementing employee compensation, promoting employee morale and loyalty, and improving employee productivity.[160] ESOPs created "solely as a tool of management self-perpetuation" have been invalidated.[161] Another indicator of legitimate corporate purpose is the proximity of the adoption of the ESOP to the hostile bid. While not dispositive, an ESOP adopted on short notice shortly after a hostile bid has been made may be suspect and will be subject to close scrutiny. The extent to which the corporation benefits from the ESOP transaction (for example, in the form of increased productivity) also indicates whether the motivation underlying the transaction was to entrench the board or promote the corporation's best interest.

For example, in *Shamrock Holdings, Inc. v. Polaroid Corp.*,[162] the Delaware Chancery Court upheld an ESOP implemented before the emergence of a hostile tender offer under the "entire fairness standard." That case involved Polaroid's sale of $300 million of voting preferred stock to a white squire, Corporate Partners, during the pendency of an unwanted all-cash for all-shares tender offer for Polaroid by Shamrock Holdings. Before Shamrock made its tender offer, but after it expressed an interest in effecting a business combination with Polaroid, the Polar-

160. *See, e.g.*, RCM Sec. Fund, Inc. v. Stanton, 928 F.2d 1318, 1333 (2d Cir. 1991); Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 266 (2d Cir. 1984); NCR Corp. v. American Tel. & Tel. Co., 761 F. Supp. 475, 496 (S.D. Ohio 1991); Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257, 272 & n.16 (Del. Ch. 1989).

161. *Norlin Corp.*, 744 F.2d at 266.

162. 559 A.2d 257 (Del. Ch. 1989).

oid board of directors implemented an ESOP that would hold approximately fourteen percent of Polaroid's outstanding shares.[163] The court outlined several important factors to be considered in evaluating the fairness of the Polaroid ESOP transaction. First, the court considered the source of the funding for the ESOP transaction, and concluded that ESOPs funded and controlled by employees, rather than the corporation, are considered "shareholder neutral" and establish a "strong indicia of fairness."[164] Second, the court considered whether the ESOP's effect on the corporation would enhance or impair corporate productivity.[165] Noting that ESOPs generally increase employee productivity, the court said that any "hidden costs" that might affect productivity must also be considered.[166] The court found, however, that a possible pay cut did not constitute a hidden cost, as there was no evidence that it would result in decreased productivity.[167] Third, the court examined the potential antitakeover effect of the ESOP.[168] The court found that, in light of the applicable Delaware statute provisions, the ESOP "may mean that a potential acquirer will have to gain the employees' confidence and support in order to be successful in its takeover effort," but concluded that there had been "no showing that such support is or would be impossible to obtain."[169]

Finally, the court considered the dilutive effect of the ESOP transaction. Recognizing that the transaction diluted the shares held by public stockholders and could result in a reduction in earnings per share, the court nevertheless decided that "a minimal reduction in earnings per share is fair where, as here, it is necessary in order to promptly implement a large ESOP that is intended to increase corporate earnings."[170] In finding the Polaroid ESOP fair, the court appeared to place the greatest emphasis on the source of funding for and control over the ESOP. Even while acknowledging that the motivation underlying the adoption of the ESOP was, at least in part, to avert a hostile takeover, the court concluded that the ESOP was "designed to . . . and [is] likely to add value to the company" and "[did] not prevent the stockholders from receiving or considering alternatives."[171]

In contrast, in *NCR Corp. v. American Telephone & Telegraph*

163. *See id.* at 267-69.
164. *Id.* at 271.
165. *See id.* at 272.
166. *See id.*
167. *See id.*
168. *See id.*
169. *Id.* at 274.
170. *Id.*
171. *Id.* at 276.

Co.,[172] the court formulated a two-part test for determining the applicability of business judgment rule protection to ESOP transactions: (1) the target's board of directors must adopt the ESOP in the belief that it will serve the corporation's best interests and (2) the directors' belief must be reasonable. The court concluded that while NCR's board adopted the ESOP in the good faith belief that it would serve the best interests of the corporation, that belief was not reasonable because the board was not adequately informed.[173] The court declined to enumerate any particular issues a board must consider in adopting an ESOP, but instead considered the "totality of the circumstances" under which the NCR board adopted ESOP.[174]

The court then analyzed the ESOP under the fairness test. Noting that the ESOP was "motivated, at least in part, by the legitimate corporate purpose" of employee compensation, the court went on to state that the board's overwhelming concern in implementing the ESOP was entrenchment of NCR's incumbent management, and not employee benefits.[175] Accordingly, the court declared NCR's ESOP to be unfair, invalid, and unenforceable.[176]

Notwithstanding cases such as *NCR*, ESOPs adopted in close proximity to a hostile bid are not *per se* invalid. As the court in *RCM Securities Fund, Inc. v. Stanton* stated, an "ESOP may contemplate future control" of the target.[177] The issue is not whether a hostile bid was a factor in the decision to adopt the ESOP, but whether the ESOP was adopted for the primary purpose of benefiting the corporation. Thus, ESOPs adopted pursuant to a long-term plan, or that were the subject of discussion before a hostile bid was made, will likely be upheld on the theory that the motivation underlying the transaction was not the unwanted takeover attempt, but other legitimate business purposes.[178]

In *Danaher Corp. v. Chicago Pneumatic Tool Co.*, for example, the court upheld an ESOP funded within days of a hostile takeover attempt, notwithstanding the fact that the target's CEO was the trustee of the plan.[179] The target's board had discussed the possibility of adopting an ESOP for a year prior to the hostile takeover attempt and the funding was authorized four months prior to the beginning of the hostile stock

172. 761 F. Supp. 475 (S.D. Ohio 1991).

173. *See id.* at 491-95.

174. *Id.* at 492.

175. *Id.* at 496.

176. *Id.* at 500.

177. 928 F.2d 1318, 1333 (2d Cir. 1991).

178. *See, e.g.*, Danaher Corp. v. Chicago Pneumatic Tool Co., 633 F. Supp. 1066 (S.D.N.Y. 1986).

179. *See id.* at 1068-69.

acquisitions.[180] The court stated, "[t]here is every indication that [the funding] was undertaken because the Board and management . . . believed it would be a good thing for their corporation."[181] Similarly, in *British Printing & Communication Corp. PLC v. Harcourt Brace Jovanovich, Inc.*,[182] the court upheld contributions made to an ESOP pursuant to a recapitalization plan that was adopted in response to a hostile bid. Finding that a pre-existing ESOP had been adopted prior to the hostile bid, the court concluded that the ESOP aspect of the recapitalization plan was intended to increase employee productivity.[183]

Strategies Involving Economic Alternatives. A target can also combat a hostile takeover attempt by offering its shareholders an economic alternative to tendering through a recapitalization or restructuring. Such economic alternatives are intended to provide immediate shareholder value and, if the target remains independent, shareholders also retain a long-term equity interest in the company.

Recapitalizations involve altering a corporation's capital structure. One of the most common forms of recapitalization is the merger recapitalization. A merger recapitalization involves a merger and a subsequent conversion of the shareholders' common stock into cash and common stock in the newly formed corporation. Alternatively, a target can engage in a reclassification recapitalization, in which the target, among other things, converts its current common stock into preferred stock that shareholders can redeem for cash and new common stock. In both cases, shareholders profit in the short-term via an immediate cash payment, and benefit in the long-term by retaining an equity interest in the corporation. By recapitalizing, a target can further make itself unattractive to a bidder by including provisions in its financing transaction documents that restrict the sale of corporate assets to pay off corporate debt, requiring any would-be acquirer to have cash reserves to pay corporate obligations.

Corporate restructuring often involves the sale of corporate divisions or assets. One of the most common forms of defensive restructuring includes spin-offs and split-offs. In a spin-off, the target creates an independent entity out of one of its subsidiaries or businesses, or places a portion of its most valuable assets in a newly-created corporation. The target then distributes shares in the new entity to its shareholders. In a split-off, the target sells off corporate assets or businesses, and distributes the proceeds to its shareholders.

180. *Id.*
181. *Id.* at 1071.
182. 664 F. Supp. 1519 (S.D.N.Y. 1987).
183. *See id.* at 1531.

Another way to defeat a hostile bidder is for a target's management to take a controlling or significant interest in the target by having the target repurchase shares from the public. Shareholders typically benefit from a repurchase plan not only from the value of the target's bid, but also from the increased value of the outstanding stock after the repurchase plan is implemented. Share repurchases can also be implemented as part of a recapitalization or restructuring strategy, or can be combined with a white squire strategy.[184]

Repurchase, recapitalization and restructuring plans are generally upheld under the business judgment rule. In *Polk v. Good*,[185] the Delaware Supreme Court upheld a corporation's repurchase of a block of its shares at a three percent premium above market price, stating:

> Unless the primary or sole purpose was to perpetuate the directors in office, such an acquisition will be sustained if, after reasonable investigation, a board has a justifiable belief that there was a reasonable threat to the corporate enterprise. When properly accomplished, such matters are protected by the business judgment rule.[186]

AC Acquisitions Corp. v. Anderson, Clayton & Co.,[187] however, illustrates that coercive repurchase plans will not be upheld. *Anderson, Clayton* involved a "front-end loaded" self-tender offer by Anderson, Clayton for 65.5 percent of its stock at sixty dollars per share, made in response to a hostile tender offer for all of Anderson, Clayton's shares at a concededly fair fifty-six dollars per share.[188] The court enjoined the self-tender offer, stating that it was not "reasonable in light of the 'threat' posed" because an Anderson, Clayton stockholder, "acting with economic rationality, has no effective choice as between the contending offers as presently constituted," and thus failed the second prong of the *Unocal* test.[189] According to the court, the self-tender failed the proportionality requirement of *Unocal* because it created a situation in which "no rational shareholder could afford not to tender into the Company's self-tender offer," since the value of Anderson, Clayton stock would be materially less than sixty dollars per share following consummation of the self-tender.[190] Noting its "obvious entrenchment effect," the court found the transaction "coercive," and enjoined it on the grounds that it constituted a "breach of a duty of loyalty."[191]

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184. *See, e.g.*, In re Newmont Mining Shareholders Litig., 1988 WL 73750 (Del. Ch. July 15, 1988).

185. 507 A.2d 531 (Del. 1986).

186. *Id.* at 536-37.

187. 519 A.2d 103 (Del. Ch. 1986).

188. *Id.* at 112.

189. *See id.* at 113-14.

190. *Id.* at 113.

191. *Id.* at 113-14.

Sale of the Company. A target of a hostile takeover attempt can offer its shareholders the economic alternative of selling to a favored bidder, often called a "white knight." Various techniques are invoked to enhance the likelihood of success of a white knight transaction.

"Lock-up" and "leg-up" options are stock options granted by the target that confer an advantage on a favored bidder in order to facilitate the favored bid. Lock-ups and leg-ups are used to entice the white knight, and assist in promoting the white knight's bid by making the target more expensive to a competing bidder. In a leg-up option, the target gives the white knight the option to purchase a block of the target's stock (typically between ten and twenty percent) at the white knight's offering price. This requires a disfavored bidder, if successful in topping the favored bidder's price, to purchase the additional shares represented by the option, while also giving the favored bidder a profit.

A lock-up option, on the other hand, gives the white knight an advantage by transferring to the white knight a block of stock sufficient to give it control of the target. Another common form of lock-up agreement is the crown jewel asset option. If a target is concerned about an imminent hostile takeover, it can provide a third party (the white knight) the option to buy the target's most valuable assets or businesses (the "crown jewels") at a favorable, yet supportable, price. This kind of option may make the target significantly less attractive to a competing bidder because the target no longer owns these valuable assets.

Under *Revlon*, when the target board has made a decision to sell the corporation, lock-up, leg-up, and crown jewel options may only be used to protect and benefit the shareholders. Accordingly, a lock-up agreement must be used to facilitate, and not foreclose, competition in the sale of the company. While *Revlon* and its progeny do not invalidate lock-up agreements, those decisions appear to subject boards of directors entering into such agreements to increased obligations. *Mills Acquisition Co. v. MacMillan, Inc.*,[192] for example, expanded on *Revlon* by demonstrating that, when the target's management is making a bid and occupies seats on the board, lock-up options may be subject to an even higher level of judicial scrutiny. The *MacMillan* court reiterated the principles articulated in *Revlon*, stating that lock-up agreements "must confer a substantial benefit upon the stockholders,"[193] and their purpose must be to secure a final offer that "materially [enhances] general stockholder interests."[194] The court went on to state that when "the intended effect [of a lock-up agreement] is to end an active auction, at the very least the

192. 559 A.2d 1261 (Del. 1989).
193. *Id.* at 1284.
194. *Id.* at 1286.

independent members of the board must attempt to negotiate alternative bids before granting such a significant concession."[195]

In *QVC Network Inc. v. Paramount Communications Inc.*,[196] the court found that a lock-up option given by Paramount to Viacom did not satisfy the *Revlon* test. In *QVC*, the lock-up option at issue gave Viacom the right to purchase almost twenty percent of Paramount stock for approximately $1.6 billion, which Viacom could opt to pay with a subordinated note instead of cash. Additionally, the lock-up option contained a put provision that permitted Viacom to require Paramount to pay Viacom the difference between the share option price and the market price of Paramount's stock at the time the option was triggered, with no cap limiting the maximum dollar value of the put. The court enjoined the lock-up on the grounds that the note and put provisions were "potentially 'draconian'" to Paramount and "unusual[ly] and highly beneficial" to Viacom.[197]

"Window shop" or "no shop" provisions are often included in merger agreements involving the sale of the target company. These provisions prohibit a target corporation from soliciting offers from bidders after an agreement is reached with an acquirer, but permit the target to consider unsolicited offers, provide information to later bidders upon request, and accept later offers under certain circumstances. These provisions usually permit the target board to consider firm competing bids and terminate the merger agreement if the target directors are obliged to do so in order to comply with their fiduciary duties.[198]

Again, in *Paramount Communications Inc. v. QVC Network Inc.*,[199] the court invalidated a no shop provision that, when combined with other defensive provisions, prevented the directors "from carrying out their fiduciary duties in considering unsolicited bids or in negotiating for the best value reasonably available to the stockholders."[200] The no shop provision at issue prohibited Paramount from "solicit[ing], encourag[ing], discuss[ing], negotiat[ing], or endors[ing] any competing transaction" with another bidder unless (i) it made "an unsolicited written, bona fide proposal, . . . not subject to any material contingencies relating to financing," and (ii) "Paramount['s] board determine[d] that discussions or negotiations with the third party [were] necessary" for the board to fulfill its fiduciary obligations.[201] In finding that the no shop

195. *Id.*
196. 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994).
197. *Id.* at 49, 39.
198. *See* Block, *Hostile Acquisitions*, *supra* note 137, at 21.
199. 637 A.2d 34 (Del. 1994), *aff'g* 635 A.2d 1245 (Del. Ch. 1993).
200. *Id.* at 49 n.20.
201. *Id.* at 39.

provision prevented the directors from carrying out their fiduciary duties, the court stated that "where a board has no reasonable basis upon which to judge the adequacy of a contemplated transaction, a no-shop restriction gives rise to the inference that the board seeks to forestall competing bids."[202]

In *Cinerama, Inc. v. Technicolor, Inc.*,[203] on the other hand, the court upheld a no shop provision that prohibited the corporation from soliciting competing bids where the corporation's board retained the power to "provide information to, and engage in discussions with, competing bidders."[204] The court found that the allegation that the no-shop clause "inhibit[ed] [the] board's ability to negotiate with other potential bidders" was "not supported by the record."[205]

Change of Control Employment Contracts. "Golden parachutes" can also serve as a defensive measure. Golden parachutes are employment contract provisions that guarantee high ranking executives significant employment, cash payment, or stock benefits in the event of a change in corporate control. These contractual provisions are intended to ensure that valued management will remain with the company even in the face of uncertainty and instability resulting from a hostile takeover situation. The effectiveness of golden parachutes as a defensive tactic, however, is arguable since golden parachutes generally represent a small fraction of the total dollar amount a bidder will expend in acquiring a target, and an even smaller fraction of the target's worth.[206]

Golden parachute arrangements are usually subject to a reasonableness standard, which most courts evaluate under the business judgment rule. Considerations include the amount of compensation; disinterested director approval; and the factors that trigger the golden parachute, such as a change in control, termination, or a change in duties. Generally, provided no conflict of interest is found, golden parachute arrangements will be upheld.[207] Further, the Tax Reform Act of 1986 imposes tax penalties on "excess parachute payments," which are defined as those payments "contingent on a change of control" that are equal to or greater than three times the employee's average annual taxable compensation for the five years prior to the time of the change of control.[208] Any excess parachute payments found are subject to a twenty percent excise

202. *Id.* at 49 n.20. (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279, 1288 (Del. 1989)).
203. 663 A.2d 1156 (Del. 1995).
204. *Id.* at 1173.
205. *Id.* (citation omitted).
206. *See* BLOCK, THE BUSINESS JUDGMENT RULE, *supra* note 3, at 637-40.
207. *See* Buckhorn, Inc. v. Ropak Corp., 656 F. Supp. 209 (S.D. Ohio), *aff'd*, 815 F.2d 76 (6th Cir. 1987); *see also* BLOCK, THE BUSINESS JUDGMENT RULE, *supra* note 3, at 658.
208. *See* 26 U.S.C. § 280G (1994); 26 U.S.C. § 4999 (1994).

tax payable by the employee, and are not deductible by the corporation. However, those payments reflecting reasonable compensation for personal services actually rendered will not be subject to the parachute payment tax penalties.[209] Thus, golden parachute arrangements should be carefully drafted to reflect reasonable compensation for services rendered to the corporation.

"Tin parachutes," severance agreements covering a larger number of less senior executives or employees, can also serve to deter hostile bids, provided the aggregate compensation value is significant. Like golden parachute agreements, tin parachute arrangements generally are subject to the business judgment rule provided they are implemented in good faith and with a rational business basis.[210]

Defensive Acquisitions. A target can also make defensive acquisitions to make itself unattractive to would-be buyers or to create anti-takeover impediments.[211] Alternatively, the target might acquire a business that is at odds with the raider's business goals.

State Regulation. State anti-takeover statutes often provide in-state corporations with additional protection against takeover attempts. State anti-takeover statutes passed after *Edgar v. MITE Corp.*[212] are sometimes referred to as "second-generation" statutes. In *Edgar*, the Supreme Court struck down an Illinois anti-takeover statute intended to hinder or prevent a hostile bidder from acquiring shares in the target corporation. The Court found such statutes to be an unconstitutional burden on interstate commerce.[213]

State statutes of the second-generation variety generally provide protection by making unsolicited takeover attempts more difficult or costly. For example, these statutes place voting restrictions on a would-be raider's shares, require in fair price provisions that the acquiror pay the same cash price for shares acquired in an initial tender offer as in a back-end merger or inhibit a would-be raider from conducting a back-

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209. *See* 26 U.S.C. § 280G(b)(4).

210. *But see* Black & Decker Corp. v. American Standard Inc., 682 F. Supp. 772 (D. Del. 1988), where the court enjoined the amendment of a series of retirement plans and the creation of a new severance plan that incorporated a tin parachute payment of $130 million in employee benefits following a change in corporate control. The definition of a change in control exempted a management and employee-backed recapitalization plan, but not a competing tender offer. *See id.* at 776. The court found that the directors' conduct triggered the *Revlon* duty to sell the company to the highest bidder and that the $130 million benefit afforded the management and employee-backed recapitalization plan over the competing tender offer improperly placed the two bidders on unequal footing and thus constituted a breach of fiduciary duty. *See id.* at 786-87.

211. *See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (where Time assumed approximately $10 billion of debt in a $13 billion acquisition of Warner).

212. 457 U.S. 624 (1982).

213. *See id.* at 640-46.

end merger.[214] While most state statutes operate to protect in-state corporations, some statutes regulate takeover attempts of out-of-state corporations having a significant number of in-state shareholders or operations.

The Delaware anti-takeover statute, for example, inhibits would-be acquirers from conducting business consolidations. It imposes a three-year waiting period on such transactions, unless the acquirer acquired over eighty-five percent of the corporation's stock in the transaction in which he became an interested party, the transaction is approved by the board of directors and two-thirds of the shares not held by the acquirer after the interested shareholders acquires his shares, or the transaction is approved by the board prior to the interested shareholder's acquisition.[215] In comparison, New York's anti-takeover statute prohibits business consolidations between the corporation and an interested shareholder holding twenty percent or more of the corporation's stock for five years after the interested shareholder's acquisition.[216] Additionally, after five years, fair price provisions restrict an interested shareholder's ability to conduct back-end mergers and other consolidations unless first approved by a majority of the disinterested shareholders.[217] Many state anti-takeover statutes are a variation of the Delaware and New York statutes, changing only the percent required to become an "interested shareholder," or the waiting period required between the time the shares are acquired and the time the business consolidation is instituted. For example, Wisconsin, Virginia, and Georgia define "interested shareholder" as a ten percent shareholder, with Wisconsin and Virginia imposing a three-year moratorium, and Georgia imposing a five-year moratorium on such business consolidations.

IV. NORFOLK SOUTHERN CORPORATION v. CONRAIL INC.

Unocal and *Revlon* are Delaware cases establishing Delaware, not federal or other states', standards for addressing a target's use of defensive tactics. States are free to formulate statutes and develop case law deviating from the *Unocal* and *Revlon* standards. Recently pending before the U.S. District Court for the Eastern District of Pennsylvania

214. *See, e.g.*, MD. CODE ANN. CORPS. & ASS'NS § 3-202 (1993 & Supp. 1996) (fair price statute requiring acquirors of a corporation's stock to meet a statutory fair price before causing a merger or other business combination under certain statutorily defined circumstances); 15 PA. CON. STAT. ANN. § 1910 (1995) (cash-out statute requiring acquirors of 20 percent of the outstanding stock of a corporation to give shareholders the right to sell their shares to the acquiror for fair value, as defined by the statute).

215. *See* DEL. CODE ANN. tit. 8, § 203 (1991).

216. *See* N.Y. Bus. Corp. Law § 912(c)(2) (McKinney 1986 & Supp. 1997).

217. *See* section 912(c)(3).

was *Norfolk Southern Corporation v. Conrail Inc.*,[218] a case involving Norfolk Southern Corporation's attempt to acquire Conrail Inc. and challenge a merger agreement between Conrail and CSX Corporation.

In mid-October, 1996, Conrail and CSX entered into a merger agreement valued at $7.8 billion, or eighty-six dollars per share. Shortly thereafter, Norfolk Southern made a tender offer for Conrail valued at $9.1 billion, or $100 per share, which offer was rejected by the Conrail board of directors. Norfolk Southern subsequently increased its offer to $110 per share.

Norfolk Southern alleged that the board of directors of Conrail, a Pennsylvania corporation, breached its fiduciary duties (1) by refusing to redeem a shareholder rights plan in favor of Norfolk Southern's tender offer, (2) by failing to approve the Norfolk Southern tender offer under the Pennsylvania Business Combination Statute, (3) by providing for a termination fee of $300 million and a stock option with CSX in connection with the Conrail/CSX merger agreement, and (4) by agreeing to a no shop provision that significantly limited Conrail's ability to entertain other takeover proposals. Norfolk Southern moved to preliminarily enjoin the Conrail/CSX merger, arguing, in part, that a board of directors considering competing offers by potential acquirers should accept the offer that gives shareholders the best price for their shares. At issue was whether the Pennsylvania Business Corporation Law exempts the Conrail board's actions from the standards articulated in *Unocal* and *Revlon* with respect to the competing tender offers by Norfolk Southern and CSX.

The Pennsylvania statutes at issue grant to the board of directors significant discretion in responding to tender offers and fundamental changes.[219] Comments to the statute explain that decisions regarding merger and takeovers, including decisions regarding shareholder rights plans, will be subject to "the generally applicable business judgment rule . . . and not to some special rule created for situations involving a potential change of control."[220]

The comments further suggest that sections 1715(a) and (b) limit the board's fiduciary obligations to the corporation, and excuse directors from the obligation to consider the interests of any particular group, such as shareholders, as "dominant or controlling."[221] The comments state, "[r]ejected by this subsection, therefore, are cases such as *Revlon, Inc. v.*

218. C.A. No. 96-CV-7167 (D. Pa. Nov. 19, 1996) (order denying preliminary injunction).

219. *See* 15 PA. CON. STAT. ANN. §§ 1502, 1715 (1995).

220. 15 PA. CONS. STAT. § 1502(a)(18) (committee comment (1988)).

221. 15 PA. CONS. STAT. § 1715(b) (committee comment (1988)).

MacAndrews & Forbes, Inc."[222] The comments also state that section 1715(c) of the Pennsylvania statute bars a determination that boards of directors must redeem shareholder rights plans when change of control issues are present. The comments to section 1715(c) explain that directors thus "have the statutory authority to 'just say no' with respect to a potential or proposed acquisition."[223] Further, the comments state that section 1715(c) intends that "directors' business conclusions with respect to the actions covered by the subsection would ordinarily not be subject to review."[224]

In addition, the comments suggest that section 1715(d) rejects *Unocal*'s enhanced scrutiny standard with regard to change of control transactions, stating that "there shall not be any greater obligation to justify, or higher burden of proof with respect to, any act as the board of directors, any committee of the board or any individual director relating to or affecting an acquisition or potential or proposed acquisition of control of the corporation than is applied to any other act as a board of directors."[225] The comments explain that "case law imposing a stricter standard or a heightened level of scrutiny with respect to director actions in these circumstances . . . is rejected by this subsection."[226] Not only does section 1715(d) purport to reject *Unocal*'s enhanced scrutiny standard, according to the comments, it also creates a presumption that decisions made by disinterested directors in the change of control context are made in good faith after reasonable investigation, unless otherwise demonstrated by "clear and convincing evidence."[227]

In denying Norfolk Southern's motion to preliminarily enjoin the Conrail/CSX merger, the court interpreted the Pennsylvania statute to permit the directors of a target corporation to exercise business discretion in taking action to protect a favored bidder, despite the fact that a disfavored bidder is offering a substantially higher near term price for the target's shares.[228] Rejecting the standards articulated in *Unocal* and *Revlon*, the court found that the Pennsylvania statute was

> enacted with the decisions of the Delaware State Courts and particularly Unicol [*sic*] Corporation v. Mesa Petroleum Corporation, and Revlon, Incorporated v. MacAndrews and Forbes Holdings, Incorporated. . . clearly in mind and in order to exclude those in similar

222. 506 A.2d 173 (Del. 1986).
223. 15 PA. CONST. STAT. § 1715(c) (committee comment (1988)).
224. 15 PA. CONST. STAT. § 1715(c) (committee comment (1988)).
225. *Id.* § 1715(d).
226. *Id.* § 1715(d).
227. *Id.* § 1715(d).
228. *See* Steven Lipin and Anna Wilde Mathews, *CSX's Move to Derail Norfolk's Offer Has Conrail Investors Feeling Railroaded*, WALL ST. J., Nov. 11, 1996, at C1.

> decisions that seem to mandate or suggest that the primary or perhaps only consideration in a situation where there is an attempted takeover or a rival competition for a takeover or a merger between corporations is what is the best financial deal for the stockholders in the short term.[229]

Stating that *Unocal* and *Revlon* take a "myopic" view in giving shareholder interests the "highest priority and importance" because they are "at least in theory the owners of the corporation," the court found that *Unocal* and *Revlon* err in replacing the business discretion of corporate boards of directors with that of judges, who presumably are significantly less sophisticated than directors as "practical business managers" of a corporation.[230] *Norfolk Southern* thus demonstrates that, while the standards articulated in *Unocal* and *Revlon* currently predominate as standards for reviewing board action with regard to tender offers, states may formulate statutes designed to give boards of directors the ability to act in the best interests of the corporation, as opposed to the shareholders, as well as statutes designed to protect boards of directors exercising business judgment in good faith with regard to tender offers.

V. Defending Defensive Maneuvers: Advance Preparedness

In today's era of increased shareholder activism, boards of directors should be aware that conduct in response to an unsolicited takeover attempt could be subject to shareholder criticism. For example, in *Moore Corp. Ltd. v. Wallace Computer Serv., Inc.*,[231] certain shareholders conducted a proxy contest to limit the board's ability to retain a shareholder rights plan and restrain other board action intended to avert a hostile takeover attempt. A more recent example is CSX Corporation's attempt to acquire Conrail Inc. in a friendly transaction, while certain shareholders protest that Norfolk Southern's hostile tender offer provides a better price for Conrail shares. Shareholders also complain that the Conrail/CSX proposal involves coercive techniques and exploits Pennsylvania's anti-takeover statute.[232] In light of the trend toward shareholder activism, boards of directors should adopt corporate govern-

229. Norfolk S. Corp. v. Conrail, Inc., C.A. No. 96-CV-7167 at 647-8 (D. Pa. Nov. 19, 1996).

230. Norfolk Southern twice sought to enjoin the merger agreement. The second motion to enjoin was premised on an amendment to the original merger agreement that extended the no-shop exclusivity period to two years from 270 days. The court denied both motions. Norfolk Southern appealed both of the court's orders, which were consolidated in the United States Court of Appeals for the Third Circuit. The Third Circuit affirmed the district court's order on the ground that Norfolk Southern had failed to demonstrate irreparable injury. *See* Norfolk Southern Corp. v. Ferrara, Nos. 96-2025 & 96-2026, Nos. 97-1006 & 97-1009 (3rd. Cir. Mar. 7, 1997).

231. 907 F. Supp. 1545 (D. Del. 1995).

232. *See* Lipin and Mathews, *supra* note 228; Steven Lipin and Anna Wilde Mathews, *Conrail Board Meets Amid Expectations CSX Will Raise Offer*, Wall St. J., Nov. 12, 1996, at C16.

ance practices that will assist them in demonstrating that they have satisfied their fiduciary obligations in the event that the corporation becomes a target and the legality of pre- or post-offer defensive measures is challenged.

In adopting such protective corporate governance practices, the value of directors communicating with each other and with management cannot be overstated. Materials should be distributed before meetings so that directors are prepared to discuss issues. Directors should also periodically discuss long-term corporate strategy and consult with legal and financial advisors in pursuing the corporation's long-term business strategy. Additionally, corporations are also well-advised to seat a majority of independent directors on the board.

Unocal and its progeny demonstrate that target companies have significant latitude to implement defensive strategies in preparation for or in response to unsolicited takeover proposals. While boards of directors are subject to a more exacting judicial scrutiny than that of the traditional business judgment rule where change of control issues exist, provided that directors act reasonably in an effort to protect and promote the best interests of the shareholders, courts will be reluctant to override informed corporate decision-making in that arena.