

St. John's Law Review

Volume 60
Number 1 *Volume 60, Fall 1985, Number 1*

Article 4

June 2012

Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholders: Toward a Shareholder Approval Rule

Virginia G. Goelz

Follow this and additional works at: <https://scholarship.law.stjohns.edu/lawreview>

Recommended Citation

Goelz, Virginia G. (1985) "Internal Transfers of Control Under Poison Pill Preferred Issuances to Shareholders: Toward a Shareholder Approval Rule," *St. John's Law Review*. Vol. 60 : No. 1 , Article 4. Available at: <https://scholarship.law.stjohns.edu/lawreview/vol60/iss1/4>

This Note is brought to you for free and open access by the Journals at St. John's Law Scholarship Repository. It has been accepted for inclusion in St. John's Law Review by an authorized editor of St. John's Law Scholarship Repository. For more information, please contact selbyc@stjohns.edu.

NOTES

INTERNAL TRANSFERS OF CONTROL UNDER POISON PILL PREFERRED ISSUANCES TO SHAREHOLDERS: TOWARD A SHAREHOLDER APPROVAL RULE

The rise in number of tender offers¹ for control of publicly-held corporations² has engendered widespread debate over the proper role of corporate management in takeover struggles.³ The

¹ See Note, *The Developing Meaning of "Tender Offer" Under the Securities Exchange Act of 1934*, 86 HARV. L. REV. 1250, 1251 (1973) [hereinafter cited as Note, *Developing Meaning*]. Tender offers typically occur when an acquirer publicly offers shareholders of a targeted company a price, above market value, at which they may tender their shares. *Id.*; see also 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS 106 (1978) (tender offer defined). Tender offers provide a means of "determining when and under what terms . . . corporate assets [will] be sold." Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 266 (1984). Partial and two-tier tender offers facilitate the change in control of a corporation. See Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 727 (1982). In a partial tender offer, the acquirer offers to purchase a controlling interest in a corporation, but less than all of its shares. See Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1965 n.9 (1984) [hereinafter cited as Note, *Protecting Shareholders*]. A two-tier tender offer consists of an offer to buy a set number of shares at a premium price, followed by an offer to buy the remaining shares at a lower price than was paid in the first tier. See *id.* at 1965 n.10. Tender offers are frequently executed without the approval of the target company's board of directors. See Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions*, 132 U. PA. L. REV. 647, 650 (1984).

² See Greene & Junewicz, *supra* note 1, at 649-50, 652-53; Lowenstein, *supra* note 1, at 257. The number of significant tender offers increased from eight in 1960 to more than 100 in 1966. See Greene & Junewicz, *supra* note 1, at 650 n.3. In the 1982 fiscal year there were 94 tender offers. *Id.* Tender offers have gained popularity because stock values have not kept pace with inflation and the corresponding rise in the underlying value of many corporations' assets. See Lowenstein, *supra* note 1, at 258. Additionally, banks today are more willing to provide financing to acquirers of corporations. See Toy, *The Raiders*, BUS. WK., Mar. 4, 1985, at 80-84. For a discussion of characteristics that make corporations attractive as targets, see E. ARANOW & H. EINHORN, TENDER OFFERS FOR CORPORATE CONTROL 1-9 (1973).

³ See ECONOMIC REPORT OF THE PRESIDENT, TRANSMITTED TO THE CONGRESS, TOGETHER WITH THE ANNUAL REPORT OF THE COUNCIL OF ECONOMIC ADVISORS 206 (Feb. 1985) [hereinaf-

debate frequently concerns the propriety of tender offers in general⁴ and the legality of defensive devices used by corporate man-

ter cited as ECONOMIC REPORT]; Sommer, *Hostile Tender Offer is Critical Issue for Congress*, 7 LEGAL TIMES 19 (1985) [hereinafter cited as Sommer, *Critical Issue*]; see also Note, *The Propriety of Judicial Deference to Corporate Boards of Directors*, 96 HARV. L. REV. 1894, 1908-10 (1983) (courts differ on standard of review in defense-of-control situations).

At one time, target management had an advantage in protecting itself against tender offers, because under state regulations, management had enough time to fight off unwanted offerors. See Sommer, *Critical Issue*, *supra*, at 19-23. However, under the applicable federal law today, tender offers proceed more quickly and management has less time to respond to them. See *Edgar v. Mite Corp.*, 457 U.S. 624, 639, 645-46 (1982); Greene & Junewicz, *supra* note 1, at 653; A.A. SOMMER, JR., *Hostile Tender Offers: Time for a Review of Fundamentals*, in TENDER OFFERS 253-56 (M. Steinberg ed. 1985).

⁴ See Sommer, *Critical Issue*, *supra* note 3, at 19, col. 1. Critics argue that tender offers place undue emphasis on short term earnings and result in a decline in competitiveness. Lipton, *Takeover Bids in the Target's Boardroom: A Response to Professors Easterbrook and Fischel*, 55 N.Y.U. L. REV. 1231, 1233 (1980) (quoting E. HERMAN, CORPORATE CONTROL, CORPORATE POWER 100-01 (1981)); Toy, *supra* note 2, at 82; Drucker, *Taming the Corporate Takeovers*, Wall St. J., Oct. 30, 1984, at 30, col. 3. But see *Advisory Committee on Tender Offers, Securities and Exchange Commission, Report of Recommendations xvii* (1983) (little evidence that management emphasizes short term results at expense of long-term growth) [hereinafter cited as *Advisory Committee Report*]; Toy, *supra* note 2, at 83 (European companies are overprotected and complacent since takeovers are infrequent in Europe). It has also been suggested that takeovers are often motivated by greenmail, the practice of purchasing a bidder's stock holdings at a premium to prevent a takeover by that bidder. See Norris, *Enough Greenmail*, N.Y. Times, March 3, 1985, at E21, col. 1; see also *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 n.3 (Del. 1985) (court upheld selective stock repurchase to defeat greenmailer). Additionally, critics contend that the expansion of debt in the economy, a result of takeover activity, will magnify business cycles and could cause bankruptcies. See Sommer, *Critical Issue*, *supra* note 3, at 19, col. 2; Toy, *supra* note 2, at 82. Finally, critics argue that dislocations in the economy also result from takeover activity. See Sommer, *Critical Issue*, *supra* note 3, at 19, col. 2; Saul, *Hostile Takeovers: What Should Be Done?*, 5 HARV. BUS. REV. 22 (1985).

Commentators in favor of tender offers argue that they create efficiency in the marketplace by making management more accountable. See Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841, 843-44 (1981); Toy, *supra* note 2, at 82, 89-90; Icahn, *Stop the Oppression of Shareholders*, N.Y. Times, May 22, 1983, at 2F, col. 2. These proponents maintain that shareholders are among the ultimate beneficiaries of tender offers. See Gilson, *supra*, at 841-42; Toy, *supra* note 2, at 80. But see Sommer, *Critical Issue*, *supra* note 3, at 24-25 (dispelling "myths" that takeovers benefit shareholders and society).

The SEC Advisory Committee found insufficient evidence to support the statement that "takeovers are per se beneficial or detrimental" to the economy, corporations, or shareholders. See *Advisory Committee Report*, *supra*, at xvii. The Committee suggested that federal regulations favor neither the acquirer nor the acquiring company. See *id.* at 15. Currently, federal regulations are oriented toward full disclosure and consumer protection and away from promoting or discouraging tender offers. See *Schreiber v. Burlington Northern, Inc.*, 105 S. Ct. 2458, 2463 (1985); *Edgar v. Mite Corp.*, 457 U.S. 624, 633 (1982); L. ARANOW & H. EINHORN, *supra* note 2, at 67-68. See generally Greene & Junewicz, *supra* note 1, at 654-55 & n.38 (summary of the Securities Exchange Act of 1934 provisions relating to disclosure).

agers to thwart such takeovers.⁵ Generally, courts have upheld management actions under the business judgment rule⁶ based on

⁵ See Harrington, *If It Ain't Broke, Don't Fix It: The Legal Propriety of Defenses Against Hostile Takeover Bids*, 34 SYRACUSE L. REV. 977, 977-80 (1983); Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51, 51 (1982). Many commentators suggest that shareholders should have a greater role in determining the propriety of defenses to tender offers. See, e.g., Gilson, *supra* note 4, at 876; Greene & Junewicz, *supra* note 1, at 731; Harrington, *supra*, at 1024-25. Greater shareholder participation in such decisions would alleviate the concern that shareholders may be hurt by takeover defenses that deprive them of the ability to tender their shares at a profit or depress the value of their shares if the offer fails. See Greene & Junewicz, *supra* note 1, at 702-03.

Defensive strategies range from the sale of a corporation's valuable property or "crown jewel," e.g., *Mobil Corp. v. Marathon Oil Corp.*, 669 F.2d 366, 367 (6th Cir. 1981) (sale of valuable mineral rights), *cert. denied*, 455 U.S. 982 (1982); *Marshall Field & Co. v. Icahn*, 537 F. Supp. 413, 421 (S.D.N.Y. 1982) (sale of assets at price below market value), to the "Pac Man defense," a counter tender offer by the target company, e.g., *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 625 (D. Md. 1982) (target company made offer to buy acquiring company's stock); see Lowenstein, *supra* note 1, at 249-50. A target corporation may also issue shares to a friendly third party, see, e.g., *Treadway Co. v. Care Corp.*, 638 F.2d 357, 380-81 (2d Cir. 1980) (issuance of shares upheld under business judgment rule); see E. ARANOW & H. EINHORN, *supra* note 2, at 247-49, to employees, see, e.g., *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984) (stock option plan upheld), or to an employee stock option ownership plan (ESOP), see 1 A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING* 95-101 (rev. perm. ed. 1984). See generally E. ARANOW & H. EINHORN, *supra* note 2, at 234-76 (overview of substantive defense tactics); E. ARANOW, H. EINHORN, & G. BERLSKEIN, *DEVELOPMENTS IN TENDER OFFERS FOR CORPORATE CONTROL* 193-202 (1977) (examination of defensive tactics) [hereinafter cited as *TENDER OFFERS*]. For a practitioner's guide to defensive strategies, see P. DAVEY, *DEFENSES AGAINST UNNEGOTIATED CASH TENDER OFFERS* 6-25 (1977); 1 A. FLEISCHER, *supra*, at 291-387; M. LIPTON & E. STEINBERGER, *supra* note 1, at §§ 1.9, 6.1-6.6.

⁶ See, e.g., *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir.) (courts will not interfere with business judgment of corporate directors), *cert. denied*, 454 U.S. 1092 (1982); *Gimbel v. Signal Co.*, 316 A.2d 599, 609-15 (Del. Ch.) (business judgment rule favors director's decision unless shareholder can prove fraud or inadequate sale price), *aff'd*, 316 A.2d 619 (Del. 1974); Greene & Junewicz, *supra* note 1, at 653 (courts unreceptive to challenges to business judgment rule). See generally Brudney, *The Independent Director—Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 614 n.50 (1982) (variations on business judgment rule).

Commentators often divide the obligations owed by corporate managers into a duty of care and a duty of loyalty. See, e.g., *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1599-1604 (1978); Harrington, *supra* note 5, at 987-90. The duty of care involves application of the standard of reasonableness, see *Corporate Director's Guidebook*, *supra*, at 1601, while the duty of loyalty involves the standard of good faith, see Harrington, *supra* note 5, at 989; Arsh, *The Business Judgment Rule Revisited*, 8 HOFSTRA L. REV. 93, 115-18 (1979). Under the business judgment rule, if the plaintiff proves that a director's actions arose from bad faith or a conflict of interest, the burden shifts to management to demonstrate the fairness and reasonableness of the transaction. See *Treadway Co. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980); 1 A. FLEISCHER, *supra* note 5, at 194-95; see also Note, *Protecting Shareholders*, *supra* note 1, at 1969 (initial burden of proving director's bad faith always on plaintiff). The director or officer will usually try to show that the board's action was motivated primar-

an unwillingness to substitute the courts' judgment for that of corporate directors presumed to be acting in the best interests of the corporations.⁷ Defensive devices adopted in anticipation of hostile tender offers have also gained a significant degree of acceptance in the courts.⁸ Such devices frequently involve an amendment to the corporate charter or bylaws.⁹

ily by a proper business purpose. See *Cheff v. Mathes*, 41 Del. Ch. 494, 499, 199 A.2d 548, 554-55 (1964); Note, *Protecting Shareholders*, *supra* note 1, at 1969. Commentators criticize the business judgment rule because it can easily be circumvented by directors "advised by knowledgeable counsel." Cohn, *Tender Offers and the Sale of Control: An Analogue to Determine the Validity of Target Management Defensive Measures*, 66 IOWA L. REV. 475, 499-500 (1981); see Lowenstein, *supra* note 1, at 314; Lynch & Steinberg, *The Legitimacy of Defensive Tactics in Tender Offers*, 64 CORNELL L. REV. 901, 926 (1979).

⁷ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971); Greene & Junewicz, *supra* note 1, at 711-12. Courts try to avoid giving directors the "Hobson's choice . . . between accepting any tender offer . . . above market, or facing the likelihood of personal liability if they reject it." *Pogostin v. Rice*, 480 A.2d 619, 627 (Del. 1984).

⁸ See, e.g., *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 124 (Del. 1977) (scaled voting); *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip op. at 2, 4 (Del. Ch. 1983) (preferred stock issuance to shareholders gave them 80% supermajority and redemption privilege); *Seibert v. Milton Bradley Co.*, 380 Mass. 656, 660, 405 N.E.2d 131, 135 (1980) (75% supermajority). Pre-tender offer defensive strategies include the use of lock-ups, issuing of stock into friendly hands, defensive acquisitions, and stock repurchases. See Coffee, *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 COLUM. L. REV. 1145, 1147-48 & n.3 (1984); Harrington, *supra* note 5, at 984-85. See generally 1 A. FLEISCHER, *supra* note 5, at 3-144 (pre-tender offer strategies discussed).

⁹ See Gilson, *The Case Against Shark Repellent Amendments: Structural Limitations on the Enabling Concept*, 34 STAN. L. REV. 775, 777 (1982); Harrington, *supra* note 5, at 984-85 & n.37; Comment, *Corporate Takeover Battles—Shark Repellent Charter and By-law Provisions that Deter Hostile Tender Offers or Other Acquisitions—A Comprehensive Examination*, 27 HOW. L.J. 1683, 1689-90 (1984). Defensive antitakeover amendments, also known as shark repellent amendments, render a corporation less desirable to potential acquirers by making it difficult for them to achieve control in a takeover attempt. See Black & Smith, *Antitakeover Charter Provisions: Defending Self-Help for Takeover Targets*, 36 WASH. & LEE L. REV. 699, 699-700 (1979); Greene & Junewicz, *supra* note 1, at 703. State statutes usually require shareholder approval of shark repellent amendments. *Id.*; Friedenber, *Jaws III: The Impropriety of Shark-Repellent Amendments as a Takeover Defense*, 7 DEL. J. CORP. L. 32, 48 (1982); Gilson, *supra*, at 779. For a list of sources concerning antitakeover shark repellent amendments, see Gilson, *supra*, at 777 n.6.

Professor Gilson places shark repellent amendments into three categories. See *id.* at 780. The first category "imped[es] transfer[s] of control of the board of directors." *Id.* For example, staggering the board or limiting the ability of shareholders to call special meetings or act by written consent may cause an undesirable delay in the transfer of control. *Id.* at 781-82; see Friedenber, *supra*, at 41-42. The second category erects "barriers to second-step transactions." Gilson, *supra*, at 783. Supermajority provisions that require anywhere from a two-thirds to 95% shareholder vote to approve second-step transactions such as mergers or tender offers fall within this category. *Id.* The provisions normally contain an exception to the supermajority requirement; however, that exception operates in the event that continuing directors negotiate a friendly takeover. *Id.* at 785. The third category con-

Recently, several courts have approved the issuance of "poison pill" preferred rights to shareholders of potential target corporations prior to the announcement of any tender offers for the corporations.¹⁰ The rights in these cases were designed to be triggered in the event of a change in control.¹¹ When exercised, they would either cause massive dilution of the stock of the acquiring corporation or would otherwise make the acquisition extremely expensive.¹² Additionally, upon issuance of the poison pills, the respective boards of directors received greatly increased power to negotiate with bidders for corporate control.¹³ Nevertheless, the

cerns "[f]air price and compulsory redemption provisions." *Id.* at 786. These provisions focus on the rights of minority shareholders subsequent to a tender offer and ensure that minority shareholders are treated fairly in a second-step transaction by guaranteeing that their shares will be purchased at a price that equals or exceeds the price paid in the tender offer. *See id.* at 787-88; Friedenberg, *supra*, at 44-45; *see also* Smith, *Fair Price and Redemption Rights: New Dimensions in Defense Charter Provisions*, 4 DEL. J. CORP. L. 1, 12-27 (1978) (practical considerations of implementing fair price provision and redemption rights provision).

¹⁰ *E.g.*, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985) ("poison pill" issued by directors upheld by Delaware Supreme Court); *Horwitz v. Southwest Forest Indus.*, 604 F. Supp. 1130, 1136 (D. Nev. 1985) (injunction preventing directors' action on stock purchase rights plan denied); *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1247 (Del. Ch.) (prospective rights plan held initially valid), *aff'd*, [current] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985). Poison pill issuances to shareholders may be designed to create redemption privileges allowing nontendering shareholders to compel the acquirer to purchase their shares for a designated price or for no less than that paid by tendering shareholders. *See* Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions Under Delaware Law*, 11 SEC. REG. L.J. 291, 300-01 (1984). Poison pills may also be structured to enable shareholders to convert their shares into stock of the acquiring entity. *See generally* Lewin, *Tactic That's 'Poison' to Bids*, N.Y. Times, Feb. 22, 1985, at D1, col. 3 (list of corporations that have issued various poison pills); Fleischer & Golden, *Poison Pill*, Nat'l L.J., Feb. 24, 1986, at 26, col. 1 (variations in poison pill plans). In the *Household* case, Household International's poison pill fell into this category because a would-be acquirer would have to swallow the rights in the event of a freeze-out merger. *See Household*, 500 A.2d at 1349; Ferrara & Phillips, *Opposition to 'Poison Pill' Warrants is Mounting*, 7 LEGAL TIMES 13 (1984).

¹¹ *See, e.g.*, *Horwitz v. Southwest Forest Indus.*, 604 F. Supp. 1130, 1132 (D. Nev. 1985) (rights activated by tender offer for 30% or acquisition of 20% of shares by entity); *Moran v. Household, Int'l, Inc.*, 500 A.2d 1346, 1348-49 (Del. 1985) (same); *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1251 (Del. Ch.) (rights triggered when any person acquires 20% of stock), *aff'd*, [current] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985); Note, *Protecting Shareholders*, *supra* note 1, at 1964-65.

¹² *See, e.g.*, *Household*, 500 A.2d at 1349 (holders of 1/100 of a share of preferred stock able to purchase \$200 worth of acquirer's stock for \$100); *Revlon*, 501 A.2d at 1243 (triggering event plus tender offer for less than \$65 allows holder to exchange one share common stock for \$65); Ferrara & Phillips, *supra* note 10, at 13, col. 2-3.

¹³ *See, e.g.*, *Revlon*, 501 A.2d at 1244.

courts held that the boards were not required to secure shareholder approval before issuing the rights,¹⁴ on the theory that "blank-check" preferred statutes in the particular states obviate the need for shareholder approval.¹⁵ These blank-check statutes authorize boards to issue various types of preferred stock at their own discretion.¹⁶

It is submitted that the issuance of poison pill rights accomplishes an internal transfer of control of the corporation from shareholders to the directors. Therefore, it is suggested that shareholder approval should be required in such instances. This Note will examine the shift in control upon the issuance of a poison pill and will suggest that a rule requiring shareholder approval should apply when rights are issued either before or after a tender offer is announced.

THE TREND TO UPHOLD THE *Household* VARIETY OF RIGHTS PLANS

The lead case on the legality of poison pill preferred rights is *Moran v. Household International*.¹⁷ Perceiving a vulnerability to hostile takeover attempts, the board of directors of Household International created a poison pill¹⁸ designed to render a partial or two-tier hostile tender offer for the company virtually impossible.¹⁹ The poison pill or "rights plan" implemented by the board consisted of the issuance of warrants, or "rights," as a dividend, which would trade with common stock and would not be independently

¹⁴ See *Household*, 500 A.2d at 1348; *Revlon*, 501 A.2d at 1251.

¹⁵ See, e.g., *Household*, 500 A.2d at 1348; *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip op. at 8 (Del. Ch. Aug. 25, 1983); see Note, *Protecting Shareholders*, *supra* note 1, at 1937.

¹⁶ See, e.g., DEL. CODE ANN. tit. 8, § 151 (1983); N.Y. BUS. CORP. LAW § 502 (McKinney 1963); 1 MODEL BUSINESS CORP. ACT ANN. § 6.02 (3d ed. 1985); see 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5284.1 (perm. ed. 1971); Finkelstein, *supra* note 10, at 299. See generally Note, *Protecting Shareholders*, *supra* note 1, at 1973-75 (board power to issue blank-check stock should be expansive).

¹⁷ 500 A.2d 1346 (Del. 1985); see *Horwitz*, 604 F. Supp. at 1136; Hertzberg, *Delaware Court Upholds the Use of 'Poison Pills'*, Wall St. J., Nov. 20, 1985, at 2, col. 3.

Prior to the Delaware Supreme Court's decision in *Household*, there were few cases concerning poison pills. See, e.g., *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707 (5th Cir. 1984); *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip op. (Del. Ch. Aug. 25, 1983).

¹⁸ See *Household*, 500 A.2d at 1349.

¹⁹ See *id.* at 1352; Ferrara & Phillips, *supra* note 10, at 13, col. 1. In a letter to its shareholders, Household stated that the plan would "deter any attempts to acquire your company in a manner or on terms not approved by the Board." Ferrara & Phillips, *supra* note 10, at 13, col. 1.

transferable.²⁰ The rights would separate from the common stock and become exercisable if "triggered" by a twenty percent accumulation of Household's common stock or by an offer to purchase thirty percent of the stock.²¹ Once the rights were triggered, Household shareholders would be entitled to purchase non-redeemable preferred stock at an initially uneconomical price of one-hundred dollars per one one-hundredth of a share.²² However, the rights would be redeemable by Household for fifty cents per right at any time prior to a twenty percent triggering event.²³ In the event of a business combination with Household, the holder of a right would be entitled to purchase two-hundred dollars worth of the common stock of the surviving company for one-hundred dollars, the exercise price of the right.²⁴ This "flipover," if it occurred, would result in severe dilution of the acquirer's stock.²⁵

Attacked by a group of potential bidders, the plan was upheld in the Delaware Supreme Court. The court placed on the plaintiffs the burden of proving that the board either acted in bad faith or for purposes of entrenchment.²⁶ Household's board had the burden of showing that the action was reasonable in relation to the perceived threat of two-tier tender offers.²⁷ The court dismissed the plaintiff's contention that issuance of the rights caused an unlawful transfer of power from the shareholders to the board by reasoning

²⁰ See *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1066 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985); Ferrara & Phillips, *supra* note 10, at 13, col. 1.

²¹ See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1348 (Del. 1985). The rights would be "triggered" even if an acquirer merely achieved the right to purchase or vote 20% of Household's common stock or "announc[e] formation of a group of persons holding 20% to act together." *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1066 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). The group proviso prevents persons acting in concert from taking control while individually remaining below the 20% threshold. See *id.* at 1080.

²² See *Household*, 500 A.2d at 1349.

²³ See *id.* at 1349. The triggering devices of the plan encourage negotiation with the board. See *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1066 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). The board could redeem the rights if an acquirer with whom the board chose to deal were to announce an offer to purchase 30% of Household stock. See Note, *Protecting Shareholders*, *supra* note 1, at 1965. The board could also refuse to redeem in any event. *Id.* Should the acquirer choose to proceed with a business combination, it would be forced to swallow the poison pill. *Id.*

²⁴ See *Household*, 500 A.2d at 1349.

²⁵ See *id.*

²⁶ See *id.* at 1356-57.

²⁷ See *id.* at 1356. The *Household* court determined that the rights plan was a reasonable defensive mechanism to protect the company against coercive acquisition techniques. See *id.*

that successful hostile tender offers could still be launched.²⁸

A rights plan similar to Household's was at issue before the District Court of Nevada in *Horwitz v. Southwest Forest Industries, Inc.*²⁹ Southwest Forest's board had issued rights which, in the event of a merger, would entitle the holder of a right to purchase one-hundred dollars worth of the acquirer's stock for fifty dollars.³⁰ The court denied the plaintiff's motion for a preliminary injunction, holding that the plaintiff was unable to demonstrate probable success on the merits since he would likely be unable to show bad faith, self-dealing or an abuse of discretion by the board.³¹ The court believed that management's actions were sound under the business judgment rule and that the rights plan was probably legal.³²

In *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*,³³ a rights plan issued by Revlon, Inc., designed to strengthen the board's bargaining position, was held valid absent other considera-

²⁸ See *id.* at 1354. The *Household* court distinguished between governance structure and value structure. See *id.* The court reasoned that there was little change in the governance structure of the corporation since "[t]he [b]oard has no more discretion in refusing to redeem [r]ights than it [has] in enacting any defensive mechanism." *Id.* The court also concluded that Household's rights plan caused less harm to the value structure of the corporation than other defensive devices that increase the debt of a corporation. See *id.* The court dismissed plaintiff's contention that the rights plan constituted a sham by observing that the rights can and will be exercised. See *id.* at 1352.

²⁹ 604 F. Supp. 1130 (D. Nev. 1985).

³⁰ See *id.* at 1132. Like Household International, Southwest Forest could redeem its rights for a nominal amount before certain triggering events occurred. See *id.*; *supra* note 23 and accompanying text.

³¹ See *Horwitz*, 604 F. Supp. at 1136. The *Horwitz* court noted that the trend in other jurisdictions indicated that Southwest Forest's conduct was "probably legal in the absence of improper motive or intent." *Id.* As a practical matter, the court feared that to remove the rights from the New York Stock Exchange and from Southwest Forest stock certificates would confuse the company's management as well as investors. See *id.* at 1135-36. Therefore, the balance of the equities in this proceeding for a preliminary injunction weighed in favor of Southwest Forest, according to the court. *Id.*

³² See *id.* at 1136. The court recognized that a board may be justified in building up a company from within, rather than through takeovers. See *id.* at 1135; *Panter v. Marshall Field & Co.*, 646 F.2d 271, 296 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981). Judge Reed stated "[i]t is not the consensus of the courts and commentators that the promotion of active competition among would-be acquirers of a corporation is the sole aim of corporate law." *Horwitz*, 604 F. Supp. at 1135 (citing *Jewel Cos. v. Pay Less Drug Stores Northwest*, 741 F.2d 1555, 1568-69 (9th Cir. 1984)). *But see* *MacAndrews & Forbes Holding, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250-51 (Del. Ch.) (defensive lock-up that ended bidding for target illegal), *aff'd*, [current] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985); Note, *Lock-up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1077-81 (1983) (courts should encourage competitive bidding).

³³ 501 A.2d 1239 (Del. Ch. 1985).

tions.³⁴ The issuance of the rights, however, was determined to be invalid because the Revlon board breached its fiduciary duties to shareholders when it implemented a lock-up agreement that effectively terminated further bidding for the corporation in an active bidding market.³⁵

SHORTCOMINGS OF THE PRIMARY PURPOSE TEST

Courts frequently have inquired into a board of directors' motivations to determine the validity of a defensive issuance of stock.³⁶ If the primary purpose of a board's action is to maintain control of the corporation, the action will not be sustained, despite the deference afforded the board under the business judgment rule.³⁷ The burden of proving that the board acted with an improper purpose generally lies with the plaintiff.³⁸ In certain in-

³⁴ See *id.* at 1247. The *Revlon* court determined that directors have a duty to defend their corporation against a takeover attempt that they believe is adverse to the interests of the corporation and its shareholders. See *id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)). *Revlon's* rights plan involved the issuance of a right, which when triggered allowed all holders except the hostile bidder to exchange one share of common stock for \$65 in notes. See *Revlon*, 501 A.2d at 1243. The rights were triggered when a person acquired 20% of the company unless the person promptly purchased all of the company's remaining shares for at least \$65 each. *Id.* The board could redeem the rights for a nominal amount prior to the triggering event. *Id.* at 1243-44.

³⁵ See 501 A.2d at 1247-48. The court burdened the board with proving the rationality of actions taken in connection with the lock-up agreement. See *id.* at 1250. Because the lock-up agreement terminated bidding for *Revlon* in an active market and relieved the directors of certain damaging consequences of the defensive devices that they had adopted, the court determined that the directors had failed to demonstrate the rationality of their actions and thus were not protected by the business judgment rule. See *id.*

³⁶ See, e.g., *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (stock issuance to directors and officers not invalid if proper corporate goal is principal purpose); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 359, 230 A.2d 769, 775 (1967) (stock issuance to third party must not be for improper purpose); A. FLEISCHER, *supra* note 5, at 184.

³⁷ See, e.g., *Yasik v. Wachtel*, 17 A.2d 309, 313 (Del. Ch. 1941) (breach of duty for directors to issue shares for improper purpose such as enabling person or group to take voting control from shareholders); TENDER OFFERS, *supra* note 5, at 200. In *Treadway Cos. v. Care Corp.*, it was determined that the directors did not act improperly in issuing stock to a white knight and were therefore protected under the business judgment rule. See 638 F.2d 357, 381 (2d Cir. 1980); see also *Northwest Indus. v. B.F. Goodrich Inc.*, 301 F. Supp. 706, 711-12 (N.D. Ill. 1969) (board was protected under business judgment rule when plaintiff was unable to prove board's desire to remain in office was sole or primary motive). At least one commentator has speculated that the "primary purpose test" lies somewhere between the business judgment rule and fairness tests of state law. See Gutman, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 16 SEC. L. REV. 325, 357 n.162 (1984). For an overview of the business judgment rule, see *supra* notes 6-7.

³⁸ See *Northwest Indus. v. B.F. Goodrich Inc.*, 301 F. Supp. 706, 712 (N.D. Ill. 1969); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 360, 230 A.2d 769, 776-77 (1967); Har-

stances, however, the defendant directors are required to justify their actions by showing that the board's decision to adopt a defensive mechanism was reasonable.³⁹

Commentators have criticized the motivational or "primary purpose test," suggesting that its application is impractical when a board acts with mixed motives.⁴⁰ It is submitted that in the area of rights plans, the primary purpose test is even more problematic. In *Household*, for example, the court required the board to show that it had reasonable grounds to believe a danger to corporate policy and effectiveness existed.⁴¹ A showing that the board feared a harmful takeover and sought to prevent coercive two-tier tender offers was deemed sufficient to satisfy this burden.⁴² It is suggested

ington, *supra* note 5, at 1005. *But see, e.g.,* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 266-67 (2d Cir. 1984) (management failed to show that stock issuance to ESOP was designed to benefit employees, and not simply to entrench management). *See generally* A. FLEISHER, *supra* note 5, at 196 (courts sometimes inconsistent in allocating burden of proof under primary purpose test).

³⁹ *See, e.g.,* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985) (initial burden of coming forward on directors when adoption of defensive mechanism at issue); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (directors must show reasonableness of their action in relation to threat posed); Cheff v. Mathes, 199 A.2d 548, 555 (Del. 1964) (directors must show they reasonably believed corporate policy and effectiveness in danger).

⁴⁰ Friedenber, *supra* note 9, at 66-67; *see, e.g.,* Harrington, *supra* note 5, at 992-93; Lynch & Steinberg, *supra* note 6, at 926-27; Gilson, *supra* note 4, at 829-31. One commentator has recommended that the traditional test—that directors' defensive actions were based on a concern for corporate policy—be replaced by a test of "whether the defensive action is reasonably calculated to benefit shareholders in a market sense, that is, higher values for their securities." Bromberg, *Tender Offers: Safeguards and Restraints - An Interest Analysis*, 21 CASE W. RES. L. REV. 613, 655 (1970).

⁴¹ Moran v. Household Int'l, Inc., 500 A.2d 1346, 1356 (Del. 1985); *see also* MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1243 (Del. Ch.) (board burdened with demonstrating rationality of issuing rights), *aff'd*, [current] FED. SEC. L. REP. ¶ 32,357 (Del. Nov. 1, 1985); Edelman v. Phillips Petroleum Co., No. 7899, slip op. at 7 (Del. Ch. Feb. 12, 1985) (board must demonstrate rational purpose of conduct that shifts internal structure of corporation and transfers power from shareholders to management).

⁴² Moran v. Household Int'l, Inc., 500 A.2d 1346, 1357 (Del. 1985); *see also* MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1244 (Del. Ch.) (rights plan merited protection of business judgment rule since it was designed to strengthen board's bargaining position), *aff'd*, [current] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985). The question of whether partial and two-tier tender offers harm shareholders has been widely debated. Compare Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974) (two-tier offers coercive) with Easterbrook & Fischel, *supra* note 1, at 727-28 (two-tier offers help all shareholders maximize value of shares). The coercive aspects of two-tier and partial tender offers have placed the shareholder in a "prisoner's dilemma." *See* Lowenstein, *supra* note 1, at 254, 307. Shareholders are unable to bargain collectively for a higher price and feel compelled to tender at the relatively advantageous first tier of the tender offer. *See* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946,

that it is difficult to prove that the board acted to solidify management's control, not primarily as a means of protecting shareholders, but rather as an end in itself.⁴³ In early defensive stock issuance cases, courts frequently tried to justify a finding that the plaintiff failed to prove the board acted for an improper purpose by asserting that shareholders received tangible consideration,⁴⁴ such as a benefit to the corporation's employees,⁴⁵ an increase in the corporation's capital,⁴⁶ or an opportunity for the corporation to

956 & n.12 (Del. 1985); Lowenstein, *supra* note 1, at 254, 309. In partial tender offers, shareholders may not wish to risk continued investment in the new entity and may feel compelled to abandon their investment. See Note, *Protecting Shareholders*, *supra* note 1, at 1966-67.

⁴³ See *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip op. at 10 (Del. Ch. Aug. 25, 1983) (management entrenchment may constitute "inevitable byproduct" of preferred stock dividend); cf. Gilson, *supra* note 9, at 805 (shark repellents in general have both purpose and unavoidable consequence of making management more secure). The plaintiff's burden of proof is significant because the plaintiff does not have access to facts probative of a defendant's motivation. See Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 271-72 (1966); Note, *Buying Out Insurgent Shareholders with Corporate Funds*, 70 YALE L.J. 308, 317 (1960).

⁴⁴ See *infra* notes 45-47. Courts have struck down stock issuances when the corporation or its shareholders received no consideration. See, e.g., *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 266 (2d Cir. 1984) ("no real consideration was received from the ESOP for the shares"); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 360, 230 A.2d 769, 777 (1967) (issuance of stock to subsidiary of white knight brought no funds into corporate treasury); *Bowen v. Imperial Theatres, Inc.*, 13 Del. Ch. 120, 122, 115 A. 918, 921 (1922) (directors gave nothing for voting stock to themselves). Some courts have considered a defendant's claim that consideration was received and have rejected it as a pretext when the directors' primary purpose was to manipulate the corporation to entrench their control. See, e.g., *Podesta v. Calumet Indus., Inc.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,433, at 93,552, 93,556 (N.D. Ill. 1978) (determination that employee, tax and financial benefits were pretext); *Ward Foods, Inc. v. Lambert*, 1 DEL. J. CORP. L. 137, 143 (Del. 1972) (plan was adopted to thwart threat to management notwithstanding claims by defendant that plan was designed to improve job satisfaction and corporate competitiveness). A court will generally refrain from determining the adequacy of consideration when it has not sensed an improper purpose. See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980) (adequacy of consideration left to directors unless disproportionate); *Heit v. Baird*, 567 F.2d 1157, 1162 (1st Cir. 1977) ("assessment of the adequacy of consideration received for an issue of stock" is responsibility of board); *Pogostin v. Rice*, 480 A.2d 619, 625 (Del. 1984) (only need "reasonable relationship" between value of options and value of benefits passing to corporation).

⁴⁵ See, e.g., *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (proper purposes for issuing stock include promoting loyalty of key personnel and ensuring that they remain with corporation); *Wyles v. Campbell*, 77 F. Supp. 343, 351 (D. Del. 1948) (issue proper since options based on legal consideration); *Yasik v. Wachtel*, 25 Del. Ch. 247, 250, 17 A.2d 309, 312-13 (1941) (shares issued to employee for valuable consideration).

⁴⁶ See, e.g., *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977) (issue of new shares to officers and directors raised new capital for corporation); see *Lynch v. Steinberg*, *supra* note 6, at 936.

enter into a beneficial business combination.⁴⁷ In cases involving *Household*-type rights plans, however, courts have concluded that a board can act for a proper primary purpose despite the wholesale absence of such independent justification.⁴⁸

IMPOSITION OF A SHAREHOLDER APPROVAL REQUIREMENT

Under traditional corporate law theory, the general authority of the board of directors extends to managing the business and affairs of a corporation.⁴⁹ The shareholders, not management, have the authority to effect radical changes in the power structure of a corporation.⁵⁰ As corporations have grown in size and complexity, however, board authority has expanded to include the formulation of business policy, and a board's managerial function has been characterized as the monitoring of key management executives.⁵¹

⁴⁷ See, e.g., *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382-83 (2d Cir. 1980) (board was moving Treadway toward business combination with Fair Lanes); *Northwest Indus. Inc., v. B.F. Goodrich Co.*, 301 F. Supp. 706, 711 (N.D. Ill. 1969) (officers and directors determined that \$35,000,000 acquisition of joint venture was in best interests of corporation).

⁴⁸ See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (rights plan protects target corporation from coercive acquisition techniques); *National Educ. Corp. v. Bell & Howell Co.*, No. 7278, slip op. at 10 (Del. Ch. Aug. 25, 1983) (preferred stock provides protection from partial or two-tier tender offers).

⁴⁹ See *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (citing DEL. CODE ANN. tit. 8, § 141(a) (1983)); *Glekel v. Gluck*, 30 N.Y.2d 93, 97, 281 N.E.2d 171, 172, 330 N.Y.S.2d 371, 373 (1972) (applying N.Y. BUS. CORP. LAW § 701 (McKinney 1982)); 2 W. FLETCHER, *supra* note 16, § 505, at 515; Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CALIF. L. REV. 1, 87-89, 142-43 (1969) (citing 1 V. MORAWETZ, TREATISE ON THE LAW OF PRIVATE CORPORATIONS 447-48 (2d ed. 1886)).

⁵⁰ See *Wylain, Inc. v. TRE Corp.*, 412 A.2d 338, 334 (Del. Ch. 1979) (shareholders of Delaware corporation have specific right to vote on fundamental corporate structure); *Hodge v. Cuba Co.*, 142 N.J. Eq. 340, 345, 60 A.2d 88, 93 (1948) (directors should seek approval of shareholders to change substantially capital structure of company); *Watson v. Washington Preferred Life Ins. Co.*, 81 Wash. 2d 403, 406, 502 P.2d 1016, 1019 (1972) (en banc) (each shareholder has right to continuation of corporate structure until altered by proper action of shareholders); 15 W. FLETCHER, *supra* note 16, § 7063, at 61; Jensen, *Takeovers: Folklore and Science*, HARV. BUS. REV. Nov.-Dec. 1984, at 110-11 (shareholders hold right to organizational control). See generally Eisenberg, *supra* note 49, at 86-91, 142-45 (delineates roles of shareholders and management).

⁵¹ See Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 MIAMI L. REV. 187, 204-05 (1983); *Corporate Director's Guidebook*, *supra* note 6, at 1603. The Model Business Corporation Act states that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation." 2 MODEL BUSINESS CORP. ACT ANN. § 8.01(b) (3d ed. 1985) (emphasis added). The American Law Institute has suggested that corporate boards have the authority to "initiate and adopt major corporate plans, commitments, and actions [and] [a]ct as to all . . .

While under state law board authority may extend even to the approval of mergers and the sale of substantially all assets,⁵² it is submitted that the board should not have the authority to change unilaterally the structure of the corporation to prevent shareholders from tendering their shares to persons who seek control of the corporation.⁵³ It is submitted that a board of directors issuing a *Household*-type poison pill effects such an unwarranted shift of power.

Courts have held that a board that adopts a poison pill plan effectively seizes the power to bargain in the event of a tender offer.⁵⁴ In *Household*, the Delaware Supreme Court rejected this

corporate matters not requiring shareholder approval." PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS (Tent. Draft No. 3, 1984) § 3.02, at 67.

⁵² See, e.g., DEL. CODE ANN. tit. 8, §§ 251, 271 (1983); N.Y. BUS. CORP. LAW §§ 902, 909 (McKinney 1963 & Supp. 1984).

⁵³ See *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1260 n.6 (S.D.N.Y. 1985) (mem.); *Dumon v. Crown Zellerbach Corp.*, 107 F.R.D. 761, 765 (N.D. Ill. 1985) (court not convinced that poison pill plan does not implicate "legitimate procedures to gain control"). A board's action may be impermissible, even though it is technically legal, when it undermines principles of corporate governance. See *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984); Ferrara & Phillips, *supra* note 10, at 18, col. 2. In the *Norlin* case, Judge Kaufman wrote that:

Our most important duty is to protect the fundamental structure of corporate governance. While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.

744 F.2d at 258. Commentators have suggested that allowing boards to assume a plenary bargaining role could upset the statutory structural scheme that gives management the authority to veto mergers and sales of assets, but not tender offers. See Harrington, *supra* note 5, at 1003; Lowenstein, *supra* note 1, at 266; Masters, 'Poison Pill' Takeover Defense Stirs Controversy, Uncertainty, 6 LEGAL TIMES 1, col. 2 (1983). But see Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 108-09 (1979) (board should have some authority to respond to mergers as tender offers); Mullaney, *Guarding Against Takeovers—Defensive Charter Provisions*, 25 BUS. LAW. 1441, 1461 (1970) (same policies underlying board approval of mergers and tender offers support board veto power in event of both). Some courts have endeavored to safeguard the privilege shareholders enjoy in determining the outcome of tender offers. See, e.g., *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 267 (2d Cir. 1984) (court refused to permit "wholesale wresting of corporate power from the hands of the shareholders, to whom it is entrusted by statute"); *Conoco Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303 (S.D.N.Y. 1981) (directors could not enjoin Seagram's tender offer and thereby "deny [shareholders] their right to pass upon [the tender] offer"); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 361, 230 A.2d 769, 777 (1967) (improper stock issuance "strikes at the very heart of corporate representation"); see also E. ARANOW & H. ENHORN, *supra* note 2, at 195 (defensive amendments to certificates "are contrary to the basic principles of corporate democracy").

⁵⁴ See, e.g., *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1244 (Del. Ch.) (board assumed plenary negotiating authority by issuing rights plan), *aff'd*, [cur-

conclusion by contending that a hostile takeover attempt for a company that has adopted a rights plan could be successful, and that therefore, in adopting a plan the board does not unilaterally transfer corporate power to itself.⁵⁵ However, as long as the board's actions in considering hostile takeover attempts remain within the substantial protection of the business judgment rule, the directors have the exclusive power to accept or reject any tender offers.⁵⁶ Thus, it is submitted that by issuing a rights plan such as the one approved in *Household*, a board of directors unilaterally changes the structure of the corporation by transferring control from the shareholders to itself.⁵⁷ It is suggested that the potential for abuse and the questionable authority of boards to issue *Household*-type rights plans, point to a need for shareholder approval of such plans.⁵⁸

rent] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985); *Asarco Inc. v. M.R.H. Holmes a Court*, 611 F. Supp. 468, 474 (D.N.J. 1985) (poison pill preferred calculated to alter structure of corporation); see Ferrara & Phillips, *supra* note 10, at 13, col. 3; Carney, *Takeover Tussles; The Courts' Tug-of-War With Corporate Boards*, BUS. & SOCIETY REV. 64, 66, 67 (1985); Goldsmith, *Hostile Takeovers Easier to Swallow Than Poison Pills*, WALL ST. J., Feb. 11, 1985, at 16, col. 3.

⁵⁵ See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353-54 (Del. 1985). In *Household*, the Delaware Supreme Court reasoned that in deciding whether to redeem the rights upon a tender offer, Household's board will be held to the fiduciary standards applicable to the adoption of defensive devices, and therefore the board will not be able to reject hostile tender offers arbitrarily. See *id.* at 1354. The Delaware Supreme Court also pointed to the takeover of Crown Zellerbach Corporation by Sir James Goldsmith despite Crown Zellerbach's prior adoption of a rights plan. See *id.* However, it should be noted that the shareholders did not have the opportunity to tender their shares for a premium in connection with Goldsmith's takeover of Crown Zellerbach. See Stewart, *Goldsmith's Move on Crown Zellerbach Prompts 'Poison Pill' Potency Questions*, WALL ST. J., May 16, 1985, at 6, col. 2; see also Dwyer, Dobrzynski, *Who's Afraid of the Poison Pill?*, BUS. WK., Aug. 12, 1985, at 22, col. 3 (poison pill remains a substantial inhibition to takeovers despite Goldsmith's takeover of Crown Zellerbach).

⁵⁶ See *supra* note 55; Ferrara & Phillips, *supra* note 10, at 13, col. 3, & 17, col. 2; *SEC Seeks Antidote for Poison Pill*, 1 SEC. REG. (P-H) ¶ 7.2 (Apr. 4, 1985).

Judicial deference to corporate boards under the business judgment rule undermines the argument that hostile tender offers may be successfully executed once a corporation has adopted a rights plan. See Note, *Protecting Shareholders*, *supra* note 1, at 1069 (directors decisions seldom overturned under fiduciary duty claims); *supra* notes 40-48. But see, e.g., *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1251 (Del. Ch.) (having issued poison pill, board failed in its fiduciary duty to shareholders when it ended bidding and negotiations involving any and all offer for cash), *aff'd*, [current] FED. SEC. L. REP. ¶ 92,357 (Del. Nov. 1, 1985).

⁵⁷ See *Asarco, Inc. v. M.R.H. Holmes a Court*, 611 F. Supp. 468, 474 (D.N.J. 1985). But see *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985) (rights plan effects little change in governance structure).

⁵⁸ See *supra* notes 49-53; Coffee, *supra* note 8, at 1147-48 n.3. Some issuances of preferred stock or rights are less egregious than others. Compare *Household*, 490 A.2d at 1066

Finally, shareholder approval frequently is required before a board may implement a takeover device designed for use before a tender offer has been announced.⁵⁹ Courts generally have upheld antitakeover amendments when shareholders have validated them.⁶⁰ Rights plans such as Household's, have been analogized to antitakeover amendments that require shareholder approval.⁶¹ It is submitted that because these defensive antitakeover devices are adopted for similar reasons,⁶² poison pills should not be treated differently from them, and therefore, adoption of a rights plan should be subject to validation by the shareholders.⁶³

(dilution of acquirer's stock is devastating) *with Revlon*, 501 A.2d at 1243 (acquirer could overcome rights plan by paying \$65 per share for all shares); *see also Note, Protecting Shareholders*, *supra* note 1, at 1967 (Bell & Howell issuance not a complete bar to certain tender offers). The SEC argued that Household's poison pill constituted a more drastic measure than poison pill plans that act as fair price amendments because the latter only deter bidders who seek to make a two-tier tender offer. *See* Brief of the Securities and Exchange Commission at 7 & n.5, *Amicus Curiae, Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.) *aff'd*, 500 A.2d 1346 (Del. 1985); Block, Barton & Radin, *Business Judgment Rule Changes*, N.Y.L.J. May 28, 1985, at 31, col. 3 n.50.

⁵⁹ *See* Friedenberg, *supra* note 9, at 34-48; A. FLEISCHER, *supra* note 5, at 12.

⁶⁰ *See, e.g.,* Seibert v. Gulton Indus., Inc., No. 5631 (Del. Ch. June 21, 1979) (*reported in* 5 DEL. J. CORP. L. 514, 518 (1980)) (shareholders empowered to enact charter containing supermajority), *aff'd*, 414 A.2d 822 (Del. 1980); Stockholders Comm. for Better Management of Erie Technological Prods., Inc. v. Erie Technological Prods., Inc., 248 F. Supp. 380, 389 (W.D. Pa. 1965) (board's purposes in adopting staggered board immaterial when it obtained shareholder approval); *see also* A. FLEISCHER, *supra* note 5, at 12 (most structural changes such as shark repellants require shareholder approval). *But see* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 12 (Del. Ch. Aug. 25 1983) (defensive issuance of preferred stock upheld); Providence & Worcester Co. v. Baker, 378 A.2d 121, 124 (Del. 1977) (board-instituted scaled voting upheld). Some commentators have suggested that antitakeover amendments affecting the structure of the corporation should require shareholder approval. *See* Green & Junewicz, *supra* note 1, at 731; Lowenstein, *supra* note 1, at 255. Others, however, have argued that shareholder approval may not reflect a shareholder's actual interests since sophisticated shareholders may not be able or willing to sway the votes of other investors. *See* Friedenberg, *supra* note 9, at 78; Gilson, *supra* note 9, at 825. *But see* Harrington, *supra* note 5, at 1025-26 (shareholder vote is not an empty formality).

⁶¹ *See* Bialkin, *Some Strategies to Avoid Unfriendly Acquisitions*, N.Y.L.J., May 28, 1985, at 25, col. 2, & 36, col. 3. The justifications for enacting antitakeover amendments are similar to those that the Delaware court used in validating Household's rights plan: protection of the corporation and its shareholders from coercive acquisition techniques. *See, e.g.,* Friedenberg, *supra* note 9, at 34 (shark repellants protect minority shareholders in event of successful tender offers); Finkelstein, *supra* note 10, at 295-96 (fair price, mandatory bid, and flip-over provisions protect all shareholders).

⁶² *See supra* note 61.

⁶³ It is submitted that had the Household rights plan been placed before the shareholders, its approval would have been unlikely since the Household board initially feared that a fair price amendment would not pass. *See* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1064 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). Generally, management has had increasing difficulty in getting shareholders, particularly institutional investors, to approve various an-

APPLICATION OF THE SHAREHOLDER APPROVAL
RULE IN LIGHT OF RECENT DECISIONS

Several courts recently have enjoined a variety of poison pill preferred plans created to defend against an existing tender offer, basing their decisions primarily on statutory grounds.⁶⁴ It is suggested that by reasoning that an internal transfer of control would occur, these courts could have enjoined defendants from issuing the preferred stock based on the defendants' failure to obtain shareholder consent.

In *Asarco, Inc. v. M.R.H. Holmes A Court*,⁶⁵ the New Jersey District Court enjoined the issuance of a series of preferred shares that would have afforded all shareholders except a 20% holder of common stock or the preferred stock a disproportionately large share of the voting power.⁶⁶ The court held that under New Jersey statutory law⁶⁷ a board may not redistribute voting power within a single class or series of stock.⁶⁸

takeover amendments. See A. FLEISCHER, *supra* note 5, at 14; Greene & Junewicz, *supra* note 1, at 706; Blustein, *Measures to Discourage Takeovers Stir Controversy at Annual Meetings*, Wall St. J., Apr. 18, 1983, at 29, col. 5. Shareholders of Rorer Group Inc. approved a non-binding proposal to rescind Rorer's poison pill, but the board nevertheless rejected the proposal. Hertzberg, *Rorer Group Is Seeking Unit of Pantry Pride*, Wall St. J., Nov. 21, 1985, at 2, col. 2.

⁶⁴ See *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1257-58 (S.D.N.Y. 1985) (rights plan was discriminatory reclassification of common stock, illegal under New Jersey law); *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 410 (S.D.N.Y. 1985) (Delaware statute requires shareholder approval for substantial change in structure of corporation); *Asarco Inc. v. M.R.H. Holmes A Court*, 611 F. Supp. 468, 477-79 (D.N.J. 1985) (New Jersey statute does not give board power to enact proposed rights plan).

⁶⁵ 611 F. Supp. 468 (D.N.J. 1985).

⁶⁶ See *id.* at 471, 477-79. In *Asarco*, the preferred shares, entitled Series C Preferred, were to be issued as a dividend. *Id.* at 471. Each holder of common stock would receive a one-tenth share of Series C Preferred stock. *Id.* In the event a person or group became beneficial owner of more than 20% of *Asarco's* common stock or Series C Preferred stock, each one-tenth share of Series C stock owned by anyone other than the 20% owner would receive five votes in all matters submitted to common stockholders. *Id.* As a result, the 20% owner would have only 4.1% of the vote. *Id.* Disproportionate voting rights would be extinguished by an any and all cash tender offer for a fair price. *Id.* at 472. Defensive devices such as *Asarco's* that discriminate against the acquirer became popular after the Delaware Supreme Court upheld a selective exchange offer by Unocal Corporation which excluded the bidder, Mesa Petroleum Company. See Cohen, *More Firms Using 'Lollipop' Tactics to Fight Takeovers*, Wall St. J., Aug. 20, 1985, at 3, col. 4.

⁶⁷ N.J. STAT. ANN. § 14A:7-2 (West 1969 & Supp. 1985).

⁶⁸ *Asarco*, 611 F. Supp. at 477. The *Asarco* court determined that equality of voting power among shareholders of the same class, or series of a class with more than one series, is a basic concept of corporation law. See *id.* Although conceding that the board had a proper business purpose, the court nevertheless concluded that the stock issuance was unlawful

Despite the significant potential for abuse created by issuance of the preferred stock,⁶⁹ the board's action withstood scrutiny by the court under the primary purpose test because the board was able to show that it sought to ensure that a takeover could be accomplished only under limited circumstances.⁷⁰ The court gave little credence to the plaintiff's argument that shareholders would be better off if bidders were able to make a variety of tender offers for Asarco.⁷¹ It is suggested that under the principles discussed previously, the court could properly have held that the board lacked the authority to effect such a dramatic shift in the control of the corporation without shareholder approval.⁷²

The District Court for the Southern District of New York, applying New Jersey law, leaned toward such a ruling in *Minstar Acquiring Corp. v. AMF Inc.*⁷³ The court stated that "a board of director's assertion of a unilateral right, under the business judgment rule, to act as a surrogate for the shareholder's independent right of alienation of his stock is troublesome."⁷⁴ In *AMF*, the board adopted a rights plan which, upon a change in control, would restrict AMF's ability to incur debt⁷⁵ and would give holders of a nontransferable right the ability, upon exercise, to vote on a merger as a class.⁷⁶ Without deciding whether the board acted with a proper purpose,⁷⁷ the court enjoined the board's action, holding

based on "the language of the statute, the potential for abuse of this power and the radical departure from traditional corporate practice which it represents . . ." *Id.* at 478-79.

⁶⁹ *Id.* at 478. The *Asarco* court recognized that corporate control could easily be manipulated through readjustment of intra-class voting rights by the issuance of blank-check preferred stock. *Id.*

⁷⁰ *See id.* at 474. The board's objective of limiting the circumstances under which takeovers could be accomplished necessarily entailed solidifying management control under the preferred stock issuance. *Id.* at 470-71. Under the issuance, were Holmes A Court to acquire 80% of both common stock and Series C Preferred Stock, or substantially all shares other than those held or controlled by Asarco, Holmes A Court would have held only 38.3% of the vote. *Id.* at 471. In effect, management would have had veto power over almost any tender offer. *Id.* As with the *Household* variety of poison pill plans, it is difficult to determine whether management has become entrenched as a means of protecting the company from harmful takeovers or as an end in itself. *See supra* notes 40-48 and accompanying text.

⁷¹ *Asarco*, 611 F. Supp. at 474.

⁷² *See supra* notes 49-58.

⁷³ *See* 621 F. Supp. 1252 (S.D.N.Y. 1985) (mem.).

⁷⁴ *Id.* at 1260 n.6. According to the court, "the [r]ight of a shareholder to sell his stock is a private transaction between a willing seller and a willing purchaser and in no way implicates the business judgment rule." *Id.*

⁷⁵ *See id.* at 1256.

⁷⁶ *See id.* at 1259.

⁷⁷ *Id.*

that the nontransferability feature violated New Jersey law in several respects.⁷⁸ The court determined that a shareholder vote was required to effectuate the change in structure and voting rights that AMF's board sought to accomplish unilaterally.⁷⁹ Consequently, this decision supports the corporate norm theory that only the shareholders should have the authority to make a fundamental change in the corporate power structure in connection with contests for control.⁸⁰

Finally, in *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*,⁸¹ the District Court for the Southern District of New York granted a preliminary injunction restraining the issuance of a preferred stock on the ground that the preferred rights plan was illegal under Delaware Law.⁸² In *Unilever*, under the threat of a takeover, the board of Richardson-Vicks approved the issuance of preferred stock enabling the holder of a single share to cast twenty-five votes on all matters before the common stockholders.⁸³ Upon the transfer of a preferred share, however, the transferee could exercise only five of the twenty-five votes for a period of thirty-six months.⁸⁴

⁷⁸ See *id.* at 1257-59.

⁷⁹ See *id.* at 1259. The *AMF* court held that the nontransferability rights unlawfully discriminated against shareholders who purchased shares of AMF after the record date of the rights dividend. *Id.* at 1257-58. The court determined that under New Jersey law shareholder approval was necessary for this reclassification of common stock. *Id.* at 1258 & n.4 (citing *Asarco v. M.R.H. Holmes A Court*, 611 F. Supp. 468 (D.N.J. 1985)). The court also held that the alienability of the underlying common stock was unreasonably restrained because a shareholder could not transfer the right with common stock and thus the right would lose most of its value upon the transfer of common stock. See *AMF*, 621 F. Supp. at 1258.

⁸⁰ See 621 F. Supp. at 1259; *supra* notes 49-53. The *AMF* decision highlights the possibility that anomalies will result through the use of the primary purpose test to scrutinize defensive tactics triggered by a change in control. Compare *AMF*, 621 F. Supp. at 1261 (triggering event raises inference board acted to entrench itself) with *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (directors must show defensive mechanism is "reasonable in relation to threat posed" (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985))) and *Asarco Inc. v. M.R.H. Holmes A Court*, 611 F. Supp. 468, 474 (D.N.J. 1985) (directors must show reasonableness of their action when defensive device is designed to alter structure of the corporation). Inconsistencies in the application of the primary purpose test in connection with defensive devices which are triggered by a change in control illustrate the inherent shortcomings of the primary purpose test in this context. See *supra* notes 40-48 and accompanying text.

⁸¹ 618 F. Supp. 407 (S.D.N.Y. 1985).

⁸² *Id.* at 409-10.

⁸³ *Id.* at 408. In *Unilever*, the preferred stock was distributed as a dividend at the rate of one new share of preferred for each five shares of common. *Id.*

⁸⁴ *Id.* The Richardson family controlled over one-third of the stock in Richardson-

The court declared that under Delaware law, board actions that might fundamentally change the structure of a corporation are not protected by the business judgment rule.⁸⁵ Thus, without considering the issue of the board's good faith,⁸⁶ the court determined that the issuance was unlawfully discriminatory,⁸⁷ that it impermissibly stripped shareholders of their ability to transfer voting power,⁸⁸ and that it contravened the corporation's certificate of incorporation.⁸⁹ The court concluded that shareholder approval was required to change the structure of the corporation by reducing both the value of the shares and the transferability of voting rights to the degree contemplated under the stock issuance.⁹⁰ Thus, it is submitted that the *Unilever* court came close to approving a shareholder ratification requirement based on an internal shift in control of Richardson-Vicks.

CONCLUSION

While the preferred issuances in *Asarco*, *AMF* and *Unilever* resulted in somewhat technical violations of state law relating to the transferability of shares and discrimination among sharehold-

Vicks. *Id.* Thus, under the rights plan, if Unilever was able to acquire all non-Richardson shares, the Richardson family would have absolute voting control for the next three years. *Id.*

⁸⁵ *Id.* at 409. The court in *Unilever* specifically cited, as a basic principle of Delaware law, the rule that "action of the board which is calculated to alter the structure of the corporation and results in a fundamental transfer of power from one corporate constituency to another, is not shielded by the business judgment rule." *Id.* (citing *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985)). It is submitted, however, that this "basic principle" has again become an issue after the Delaware Supreme Court's ruling in *Household*. See *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985).

⁸⁶ *Unilever*, 618 F. Supp. at 409.

⁸⁷ *Id.* at 409-10. The court in *Unilever* determined that the issuance would discriminate among shareholders of the same issue of stock because voting rights consequently depend on when shares were purchased. See *id.* at 409.

⁸⁸ *Id.* According to the *Unilever* court, after issuance a common shareholder would be "unable to transfer two-thirds of his voting power." *Id.*

⁸⁹ *Id.* at 409-10. The *Unilever* court remained unpersuaded by *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), in which the Delaware Supreme Court permitted a board to make an exchange offer to all shareholders other than the purported greenmailer. See *id.* at 956-59; see also *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1258 (S.D.N.Y. 1985) (New Jersey courts would not follow *Unocal* decision). The court held *Unocal* inapplicable because the Richardson-Vicks preferred plan effectively discriminated among holders of a series of shares by creating two classes within one series despite a provision in the certificate of incorporation requiring that "[a]ll shares of any one series of preferred stock shall be identical with each other in all respects." *Unilever*, 618 F. Supp. at 410.

⁹⁰ *Unilever*, 618 F. Supp. at 410.

ers, these cases support the notion that shareholders should have a voting role in determining fundamental structural changes in the corporation. It is suggested therefore, that shareholder approval should be required when a corporation issues preferred shares to shareholders as a defense either to a perceived or to an announced tender offer, and thereby effects an internal transfer in control from shareholders to the board. Shareholder approval of poison pill rights plans would serve to legitimize the power that the board, as negotiator, has to prevent almost any acquisition of the company and thereby return to the shareholders the authority to determine the fate of their corporation.

Virginia G. Goelz