



1999

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Michael B. Regan

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Recommended Citation

Michael B. Regan, *Dead End: Delaware's Response to the Recent Innovation in Corporate Antitakeover Measures, the So-Called Dead Hand Poison Pill, in Carmody v. Toll Brothers, Inc.*, 44 Vill. L. Rev. 643 (1999).

Available at: <https://digitalcommons.law.villanova.edu/vlr/vol44/iss4/3>

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1999]

Notes

DEAD END: DELAWARE'S RESPONSE TO THE RECENT INNOVATION IN CORPORATE ANTITAKEOVER MEASURES, THE SO-CALLED "DEAD HAND" POISON PILL, IN *CARMODY v. TOLL BROTHERS, INC.*

I. INTRODUCTION

The merger and acquisition boom of the 1980s has prompted many companies to take defensive positions and to prepare for unsolicited takeovers.¹ Over the past fifteen years, companies have made shareholder rights plans, more commonly known as "poison pills," their weapon of choice.² Should events proceed towards a hostile takeover, a poison pill allows the shareholders of a target company, except for the hostile bidder, to purchase common stock of the target company at a sizeable discount from then-market prices, thereby diluting the hostile bidder's holdings and greatly increasing the cost of the acquisition.³

1. See Shawn C. Lese, Note, *Preventing Control from the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175, 2175 (1996) (stating that companies have sought more powerful means to forestall takeovers). "Unsolicited" refers to those takeovers initiated by the acquiring company against the will of the target company's board of directors, as opposed to "friendly" or "uncontested" takeovers in which the board of directors allows the purchase by the acquiring company. See Robert A. Prentice, *Front-End Loaded, Two-Tiered Tender Offers*, 39 CASE W. RES. L. REV. 389, 393 (1989) (noting variations in takeovers).

2. See Kenneth J. Bialkin & Robert G. Wray, *Legal Developments: Poison Pills*, THE M & A LAWYER, May 1998, at 12 (discussing widespread use of poison pills); *To Die For: Poison Pills*, THE ECONOMIST, Feb. 24, 1996, at 79 (stating that poison pills became common in merger boom of 1980s). By May 1998, over 2,000 companies had adopted poison pills, up from approximately 1,800 as of May 1997. See Bialkin & Wray, *supra*, at 12.

When corporations first introduced poison pills, critics characterized them as "doomsday machines" that would effectively end all contests for control of public corporations. See ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE § 5.02, at 5-15 (1995) (discussing reaction to emergence of poison pills); see also *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985) (noting prediction of Security and Exchange Commission (SEC) that poison pills would "deter . . . virtually all hostile tender offers"). The Delaware Supreme Court disagreed with these critics, however, upholding the adoption of poison pills because pills would neither preclude hostile tender offers nor interfere greatly with proxy contests. See *id.* (allowing use of poison pills in limited situations).

3. See Bialkin & Wray, *supra* note 2, at 12 (describing operation of poison pill). Poison pills encourage a hostile bidder to negotiate with the target company's board of directors because of limitations on the hostile bidder's ability to redeem the pill without the board's consent. See Meredith M. Brown & William D. Regner, *Shareholder Rights Plans: Recent Toxopharmacological Developments*, INSIGHTS, Oct.

Although largely successful when introduced, earlier versions of the poison pill allowed a hostile bidder to remove the defense by electing its own directors to the target company's board.⁴ In recent years, a number of companies have responded to this tactic by adopting shareholder rights plans that include continuing director provisions, also known as "dead hand" provisions.⁵ Dead hand provisions only allow redemption of the poison pill rights by directors who were on the board before the pill's adoption or who were subsequently elected with the recommendation of the other continuing directors.⁶

1997, at 2 (discussing purpose of shareholder rights plan); John Elofson, *Should Dead Hand Poison Pills Be Sent to an Early Grave?*, 25 SEC. REG. L.J. 303, 329-30 (1997) (stating that with "dead hand" poison pill, raider has powerful incentive to negotiate, thus giving board more time to consider offer, search for alternative course of action and extract higher price from raider). A bidder's crossing of a specified stock ownership threshold without board approval exemplifies a "hostile acquisition event" that would trigger a poison pill. *See id.*

4. *See* Elofson, *supra* note 3, at 305 (discussing importance of combined proxy contest and tender offer to hostile bidder); Daniel A. Neff, *The Impact of State Statutes and Continuing Director Rights Plans*, 51 U. MIAMI L. REV. 663, 671 (1997) (stating that hostile bidders attempting takeover frequently include proxy contest to remove target's board of directors).

The redemption feature of poison pills explains why courts have upheld them and provides the raider's best hope for overcoming this defense. *See* FLEISCHER & SUSSMAN, *supra* note 2, § 5.05, at 5-82 to 83 (noting importance of redemption feature of poison pill). All current poison pills provide that the board has the power to redeem the rights for some nominal payment prior to the occurrence of a triggering event. *See id.* § 5.05, at 5-82 (discussing operation of redemption feature of poison pill).

5. *See* Brown & Regner, *supra* note 3, at 3 (stating that companies have adopted dead hand provisions "in order to address the perceived vulnerability resulting from the fact that a pill may be dismantled by replacing the target's board of directors"); Elofson, *supra* note 3, at 307 (stating that dead hand poison pills have enjoyed increased popularity with target companies because they render raiders' joint proxy contests and tender offers ineffective).

Continuing director provisions have been named dead hand provisions because "people who are no longer directors . . . are trying to rule from the grave." Steven Lipin, *J & J Goes to Court to Disarm Cordis of an Unusual "Pill,"* WALL ST. J., Oct. 27, 1995, at B2 (noting origin of name for this type of shareholder rights plan).

6. *See* FLEISCHER & SUSSMAN, *supra* note 2, § 5.05, at 5-89 (discussing which directors are considered "continuing" directors); Brown & Regner, *supra* note 3, at 3 (describing continuing director feature of dead hand poison pill); Elofson, *supra* note 3, at 310 (defining continuing director).

In effect, a hostile bidder cannot circumvent the poison pill by waging a proxy contest to elect directors committed to redeeming a pill because the bidder's nominees, if elected, would not be "continuing directors" and thus would lack the power to redeem the pill. *See* Brown & Regner, *supra* note 3, at 3 (discussing impact of continuing director provision). Some rights plans contain a more conservative form of dead hand provision that limits the period during which the pill may be redeemed by continuing directors only. *See id.* (noting milder type of dead hand poison pills).

The validity of dead hand provisions in poison pills has caused much debate.⁷ Dead hand poison pills, however, have received little judicial scrutiny.⁸ In fact, for a while there were only two decisions that had squarely addressed the validity of dead hand provisions, each coming to a different result.⁹ Thus, both scholars and practitioners have eagerly awaited the Delaware courts' answer to this question.¹⁰ Recently, the Delaware Court of Chancery responded by rendering its decision in *Carmody v. Toll Brothers, Inc.*,¹¹ holding that the dead hand poison pill is subject to legal challenge because it violates the Delaware General Corporation Law and/or the fiduciary duties of the board of directors who adopted the plan.¹² This response to dead hand poison pills in Delaware could potentially result in far-reaching consequences for the market in corporate control.¹³

This Note focuses on the fate of the dead hand poison pill under Delaware law. Part II of this Note discusses the legal standard with which

7. See Brown & Regner, *supra* note 3, at 3 (discussing arguments for and against dead hand provisions). Opponents of continuing director provisions have argued: (1) that they polarize the board by creating a class of directors that can redeem the pill and one that cannot; (2) that continuing director provisions disenfranchise shareholders; (3) that current directors should not have the power to limit the discretion of future directors; and (4) that an important justification of poison pills is that shareholders, through their power to elect directors, retain ultimate control over their use. See *id.* On the other hand, supporters of these provisions have argued: (1) that current directors already have the power to limit the discretion of future directors (*e.g.*, by entering the corporation into contracts); (2) that dead hand provisions do not preclude shareholders from electing directors of their choice; and (3) that the adoption of continuing director provisions, in states with pill authorization statutes, falls within the powers granted to directors by such statutes. See *id.*

8. See Neff, *supra* note 4, at 671 (stating that "[n]either courts nor commentators have yet considered in much detail the permissibility of continuing directors provisions").

9. Compare *Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482, 485-86 (Sup. Ct. 1988) (holding that continuing director provision violated New York corporate law by restricting power of board of directors without placing such restriction in certificate of incorporation), with *Invacare Corp. v. Healthdyne Techs., Inc.*, 968 F. Supp. 1578, 1581-83 (N.D. Ga. 1997) (holding that dead hand provision did not render poison pill inconsistent with Georgia law).

10. See Brown & Regner, *supra* note 3, at 5 (stating that previous dead hand poison pill cases left unanswered central question of whether Delaware courts will uphold their validity); see also Neff, *supra* note 4, at 673 (noting that plaintiffs in Delaware courts have raised objections to continuing director provisions on several occasions, but no clear holding has emerged).

11. No. 15983, 1998 WL 418896 (Del. Ch. Jul. 24, 1998).

12. See *id.* at *1.

13. See Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 511-12 (1997) (noting importance of eventual answer to questions on distribution of power between shareholders and board of directors). The question becomes one of balancing shareholder voting rights, a fundamental principle of corporate law, against the board's interest in maintaining its power indefinitely. See *id.*

courts analyze continuing director rights plans.¹⁴ Part III examines the Delaware Court of Chancery's decision in *Carmody*, which held that "dead hand" poison pills are subject to legal challenge.¹⁵ Part IV advocates that *Carmody* comports with the underpinning principles of Delaware corporate law.¹⁶ Finally, Part V of this Note concludes by discussing the probable impact of the *Carmody* decision.¹⁷

II. BACKGROUND

A. Case Law on Dead Hand Poison Pills

Courts have had mixed reactions to continuing director provisions in dead hand poison pills.¹⁸ The first case to directly address the validity of a continuing director provision was *Bank of New York Co. v. Irving Bank Corp.*¹⁹ There, the New York Supreme Court struck down a poison pill that only allowed the board to redeem the rights if: (1) there was a majority of the continuing directors; or (2) if the new directors immediately succeeded continuing directors and (a) were elected by a two-thirds majority or (b) were not elected during the pendency of a merger proposal.²⁰ According to the court, this element of the plan violated section 620 of the New York Business Corporation Law that requires all restrictions on a board's power to be placed in the certificate of incorporation.²¹ More

14. For a discussion of the legal standard under which courts analyze continuing director provisions, see *infra* notes 18-60 and accompanying text.

15. For a discussion of the decision of the Delaware Court of Chancery in *Carmody v. Toll Bros., Inc.*, see *infra* notes 61-108 and accompanying text.

16. For a discussion of the propriety of the *Carmody* ruling, see *infra* notes 109-144 and accompanying text.

17. For a discussion of the impact of *Carmody*, see *infra* notes 145-150 and accompanying text.

18. See Brown & Regner, *supra* note 3, at 3 (discussing dearth of case law on dead hand poison pills). The continuing directors feature of poison pills has largely evaded judicial review. See Lese, *supra* note 1, at 2192 (noting lack of authority on validity of dead hand poison pills). That parties negotiate pill redemption as part of the contest's resolution, preventing the issue from reaching the courthouse, might explain this lack of precedent. See *id.* That hostile bidders sometimes abandon their efforts after the target company takes some action, such as the sale of a valuable subsidiary or division, which dissuades the hostile bidders from proceeding with the acquisition, further explains the lack of case law. See *id.*

19. 528 N.Y.S.2d 482 (Sup. Ct. 1988).

20. See *id.* at 486 (enjoining use of rights plan).

21. See *id.* at 485 (stating that board of directors lacked authority to adopt provision restricting action of future board). Section 620 of the New York Business Corporation Law states:

A provision in the certificate of incorporation otherwise prohibited by law because it improperly restricts the board in its management of the business of the corporation, or improperly transfers to one or more shareholders or to one or more persons or corporations to be selected by him or them, all or any part of such management otherwise within the authority of the board under this chapter, shall nevertheless be valid: (1) If all the incorporators or holders of record of all outstanding shares, whether or not having voting power, have authorized such provision in the certifi-

importantly, however, the court was concerned about the discriminatory nature of the plan.²² Because the court ultimately eliminated the plan, it seemed to mark the end of the use of dead hand poison pills.²³

Recently, however, in *Invacare Corp. v. Healthdyne Technologies, Inc.*,²⁴ the United States District Court for the Northern District of Georgia upheld a continuing director provision, ruling that the provision did not render a poison pill inconsistent with Georgia law.²⁵ As a result, this case may rekindle interest in the defense tactic even though the decision relies

cate of incorporation or an amendment thereof; and (2) If, subsequent to the adoption of such provision, shares are transferred or issued only to persons who had knowledge or notice thereof or consented in writing to such provision.

N.Y. BUS. CORP. LAW § 620(b) (McKinney 1986).

22. See *Bank of New York*, 528 N.Y.S.2d at 485. The court stated:

The evil of [the provision] is not that it deprives a Board of certain powers; it is that it is selective in the deprivation. In other words, the present Board members could have the powers, if they were reelected to the Board, but the insurgents would not if they were elected by the same plurality. Those new members of the Board approved by the current Board would have the powers, but those not so approved would not.

Id. at 485.

According to the court, the discriminatory features of the continuing directors provision restricted the power of Irving Bank's board of directors. See *id.* (discussing pill's effect on power of board). In particular, the court criticized the provision's selectivity in depriving certain boards of their directorial powers and found that the provision discriminated among different directors depending on the circumstances of their election. See *id.* at 483-84; see also Robert Todd Lang & Robert L. Messineo, *Recent Developments in Takeovers and Pending Proposals for Regulatory Changes in Acquisitions and Mergers*, 609 PLI/CORP. 909, 934 (1988) (stating that *Bank of New York* court's conclusion that pill would put incumbent board in preferred position against insurgent slate clearly influenced court's decision). The court concluded that the provision "effectively limit[ed] the powers of a future board which is not a continuation of the present board or which is not approved by it, while still leaving those powers to a board which is approved." *Bank of New York*, 528 N.Y.S.2d at 484. Because the certificate of incorporation did not enumerate this, the court held that the provision violated New York law. See *id.* at 485 (explaining board's lack of authority to adopt provision restricting action of future board).

23. See Gordon, *supra* note 13, at 533 (stating that recent compilations of target defense tactics failed to mention defense).

24. 968 F. Supp. 1578 (N.D. Ga. 1997).

25. See *id.* at 1579-83 (holding that board had authority to implement plan involving poison pill without amendment to certificate of incorporation or by-laws and adoption of by-law requiring removal of poison pill would violate Georgia statute that vests in legislature discretion to determine terms and conditions of shareholders' rights plans). In this case, the acquirer (Invacare) initiated a hostile bid for the target (Healthdyne), a Georgia corporation. See *id.* at 1579. In order to remove the poison pill that blocked Invacare's ability to proceed with a tender offer, it started a proxy contest to replace the target's directors. See *id.* The target's poison pill contained a continuing director provision that meant the new directors could not redeem the pill even if the acquirer succeeded in electing its slate. See *id.*

upon peculiar features of Georgia law.²⁶ In upholding the continuing director provision of the poison pill, the district court ruled that Georgia corporate law provides directors with broad latitude and that Invacare's proposed continuing director provision attempted to limit the discretion of Healthdyne's board to set the terms and conditions of its shareholder rights plan.²⁷ According to the court, the continuing director provision neither interfered with shareholder voting rights nor impermissibly limited the authority of future boards.²⁸ Also, in *Invacare*, the court distinguished *Bank of New York* by noting that New York corporate law contains a general prohibition on restrictions against the board of directors' power to manage the corporation.²⁹ Further, the court acknowledged that "the concept of continuing directors is integral to a takeover defense and is not contrary to public policy in Georgia."³⁰

B. Analysis of Dead Hand Poison Pills Under Delaware Law

Although Delaware plaintiffs have raised objections to continuing director provisions on several occasions, thus far, no clear holding has

26. See Gordon, *supra* note 13, at 533 (noting that in all likelihood this decision will popularize use of continuing directors provisions).

27. See *Invacare*, 968 F. Supp. at 1580 (stating that Georgia law provides directors with broad discretion). Section 624 of the Georgia Corporate Code states: [N]othing contained in Code Section 14-2-601 shall be deemed to limit the board of directors' authority to determine, in its sole discretion, the terms and conditions of the rights, options, or warrants issuable pursuant to this Code section. Such terms and conditions need not be set forth in the articles of incorporation.

GA. CODE ANN. § 14-2-624(c) (1994).

28. See *Invacare*, 968 F. Supp. at 1578 (rejecting Invacare's arguments that continuing directors provision violated board members' fiduciary duties and interfered with shareholders' voting rights).

29. See *id.* at 1580 (noting that Georgia law has no such express limitation on board's power). The court emphasized that the *Bank of New York* case involved a New York statute that provided that "[a] restriction of the board's power to manage the business of the corporation is invalid unless (1) all of the incorporators or all of the shareholders of record have authorized such provision on the certificate of incorporation" *Id.* at 1580. The court stated that the Georgia Business Corporation Code had no such express limitation within its statutory scheme. See *id.* (noting that Georgia law does not require that articles of incorporation set forth conditions and restrictions of rights agreement).

30. *Id.* at 1581. For example, the Georgia Fair Price statute provides that where a vote is needed to approve a business combination, that business combination must be:

(1) Unanimously approved by the continuing directors, provided that the continuing directors constitute at least three members of the board of directors at the time of such approval; or (2) Recommended by at least two-thirds of the continuing directors and approved by a majority of the votes entitled to be cast by holders of voting shares, other than voting shares beneficially owned by the interested shareholder who is, or whose affiliate is, a party to the business combination.

GA. CODE ANN. § 14-2-1111 (1994).

emerged.³¹ In ascertaining how the Delaware courts should proceed regarding the fate of the dead hand poison pill, one should consider three different issues: (1) the board's statutory power to adopt such a provision, (2) the board's fiduciary duty; and (3) the limitation on shareholder voting rights.³²

1. *The Board's Statutory Power*

As a fundamental rule, a board of directors cannot act beyond its statutory power.³³ Under Delaware law, directors are elected by a plurality of shareholders, the board manages the business and affairs of the corporation and board action requires a majority vote at a meeting at which a quorum is present.³⁴ Under Delaware General Corporate Law section 141(d), the power to create voting power distinctions among directors exists only where there is a classified board and where the certificate of incorporation expresses those voting power distinctions.³⁵ Also, section 141(d) reserves the "right to elect 1 or more directors who shall . . . have such [greater] voting powers" for the stockholders, not to the directors or a subset thereof.³⁶ Thus, absent express language in the charter, a board lacks authority to create directors with less power than other directors of

31. *See, e.g.,* Davis Acquisition Inc. v. NWA Inc., No. CIV.A. 10761, 1989 WL 40845, at *1 (Del. Ch. Apr. 25, 1989) (declining to resolve arguments about rights plan that could not be redeemed for period of 180 days following election of board with majority of noncontinuing directors); Prime Computer, Inc. v. Allen, 1988 WL 5277, at *1 (Del. Ch. Jan. 22, 1988) (mem.) (holding that preliminary injunction against consent solicitation by-law adopted by target company rendered decision on dead hand plan's legality unnecessary); *see also* Sutton Holding Corp. v. DeSoto, Inc., No. 12051, 1991 WL 80223, at *1 (Del. Ch. May 14, 1991) (holding analogous provision probably amounted to intentional attempt to coerce exercise of shareholder franchise, thus constituting violation of directors' duty of loyalty).

32. *See* Gordon, *supra* note 13, at 536 (discussing issues Delaware courts would consider when determining validity of dead hand poison pill).

33. *See id.* at 536-37 (discussing limitations on director power under Delaware corporate law).

34. *See* DEL. CODE ANN. tit. 8, § 216 (1997) (stating requirement for quorum); DEL. CODE ANN. tit. 8, § 141(a) (1997) (stating that certificate of incorporation must state powers and duties of directors); DEL. CODE ANN. tit. 8, § 141(b) (1997) (stating that board decision is by majority vote at meeting at which quorum is present).

35. *See* DEL. CODE ANN. tit. 8, § 141(d) (1997) (stating that voting power distinctions must be expressed in certificate of incorporation). Section 141(d) provides:

The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors.

Id.

36. *Id.*

the corporation.³⁷ Lastly, under Delaware General Corporate Law section 141(a), a dead hand provision cannot impermissibly interfere with the directors' statutory power to manage the business and affairs of the corporation.³⁸ Therefore, a dead hand provision may jeopardize a newly elected board's ability to achieve a business combination by depriving that board of the power to redeem the pill without obtaining the consent of the "continuing directors," who would probably constitute a minority of the board.³⁹

Although the dead hand poison pill appears contrary to Delaware statutory law, the Delaware Supreme Court took an expansive view of the board's statutory authority to fashion takeover defenses in *Moran v. Household International Inc.*⁴⁰ The *Moran* court, relying on the statutory power to

37. See Gordon, *supra* note 13, at 537 (discussing power to create voting distinctions among directors). Also, it is important to note that "Delaware law contains nothing comparable to Georgia's 'sole discretion' statutory provision on which to base an argument for extension of the board's customary power and the grant of superpower with respect to the fashioning of a pill." *Id.*

38. See DEL. CODE ANN. tit. 8, § 141(a) (discussing directors' statutory power to manage business and affairs of corporation); see also, e.g., *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 41-42 (Del. 1994) (recognizing fundamental principle that board has full power to manage and direct business and affairs of Delaware corporation). Section 141(a) provides:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a).

39. See Gordon, *supra* note 13, at 538 (discussing objections to use of dead hand poison pill). The board cannot effectively manage the business and affairs of the corporation because it cannot redeem the pill. See *id.* (discussing pill's interference with board's power to manage corporation). Thus, the dead hand provision impedes the board's ability to make future decisions. See *id.*

40. 500 A.2d 1346 (Del. 1985) (upholding validity of poison pills). The *Moran* court applied the business judgment rule to the adoption of a poison pill in the absence of a specific threat of takeover. See *id.* at 1350 (determining standard of review for pre-planned defensive mechanisms). The Delaware Supreme Court found that the directors reasonably believed Household International ("Household") was vulnerable to coercive acquisition techniques and had adopted a reasonable defense mechanism to protect the corporation. See *id.* at 1356-57 (explaining directors' entitlement to protection of business judgment rule). The court went on to find that Household's board of directors had the authority to adopt the poison pill rights plan and to issue the underlying preferred stock pursuant to sections 157 and 151(g), respectively, of the Delaware General Corporation Law. See *id.* at 1357 (discussing board's statutory authority to adopt poison pill). Other factors considered by the Delaware Supreme Court in examining the Household poison pill plan included that: (1) the plan did not destroy the assets of the issuer; (2) the implementation of the plan neither resulted in an outflow of money from the issuer nor impaired its financial flexibility; (3) the plan did not dilute earnings per share; (4) the plan did not have any adverse tax consequences

issue rights in securities for corporate finance purposes, upheld the use of an anti-takeover measure, the "flip-over" poison pill.⁴¹ The court relied upon the evolutionary conception of corporate law communicated in *Unocal Corp. v. Mesa Petroleum*,⁴² which stated that "corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."⁴³

2. *Fiduciary Duty*

Beyond the statutory issue, a dead hand poison pill is a defensive measure that is subject to analysis under the proportionality test as outlined in *Unocal*.⁴⁴ The first prong of the *Unocal* test requires the target company's board to demonstrate that, based on a reasonable investigation, it has made a good faith determination that the acquiring company's offer posed a threat that justified defensive maneuvers.⁴⁵ The test's second

to the issuer or its stockholders; (5) the plan did not adversely affect the market price of the issuer's stock; and (6) the plan did not prevent proxy contests or stockholders from banding together into a group to solicit proxies. *See id.* at 1354-55.

41. *See id.* at 1356-57 (noting that target board had authority to issue rights and underlying preferred stock). In *Moran*, the flip-over poison pill worked by creating rights that became exercisable upon the announcement of a partial tender offer for 30% of the target's shares. *See id.* at 1348-49 (discussing operation of rights agreement). The board could redeem these rights, however, until a raider acquired 20% of the target's shares. *See id.* (noting redemption provision of rights plan). If the board did not exercise the rights, and a merger occurred, the board could exercise them to purchase \$200 of the common stock of the raider for \$100. *See id.* at 1349 (discussing procurement of acquiring company's shares at reduced price). Therefore, the flip-over poison pill allows target shareholders to purchase shares of the acquiring company in quantities equal to the amount held by them in the target company. *See FLEISCHER & SUSSMAN, supra* note 2, § 5.01, at 5-6 (discussing various types of poison pills). Boards intend this pill "to counteract the coercive effects of a two-tiered tender offer by providing non-tendering shareholders protection against the possibility of an inadequate back-end price." Eloffson, *supra* note 3, at 315 (stating rationale behind flip-over poison pill).

42. 493 A.2d 946 (Del. 1985).

43. *Id.* at 957.

44. *See id.* at 954 (discussing standard that applies to defensive measures). The *Unocal* court asserted that in light of "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty . . . before the protections of the business judgment rule may be conferred." *Id.* at 954.

The business judgment rule is a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Id.* at 954; *see Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987) (defining business judgment rule); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984) (stating that ordinary corporate decision-making enjoys protection of business judgment rule); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (applying business judgment rule).

45. *See Unocal*, 493 A.2d at 955 (stating that incumbent directors must demonstrate "reasonable grounds for believing that a danger to corporate policy and effectiveness existed").

prong requires a showing of the proportionality of the board's response to the threat presented by the change in control.⁴⁶ If the board's actions satisfy the requirements of the *Unocal* test, the court will apply the deferential business judgment rule.⁴⁷ If the pill does not satisfy the *Unocal* test, however, the court will invalidate the provision.⁴⁸ The Delaware Supreme Court rearticulated this test in *Unitrin, Inc. v. American General Corp.*⁴⁹ The court stated that "a court applying enhanced judicial scrutiny should be deciding whether the directors made a *reasonable* decision, not a *perfect* decision."⁵⁰ According to the court, the relevant issue is whether the target board's defensive maneuvers fall within a "range of reasonableness."⁵¹ A defensive action falls outside the range of reasonableness if it can be characterized as "draconian," which the court has defined as "preclusive or coercive."⁵² Thus, after *Unitrin*, a preclusive or coercive defensive action will fail the second prong of the *Unocal* test.⁵³

46. *See id.* (stating that for defensive measure to come within ambit of business judgment rule, board must prove that it was "reasonable in relation to the threat posed").

47. *See id.* at 954-55 (stating that action satisfying both prongs of proportionality test will be reviewed under business judgment rule).

48. *See id.*

49. 651 A.2d 1361 (Del. 1995). The *Unitrin* court overruled a lower court's determination that the target board's actions in defending against a hostile tender offer were "unnecessary" and therefore "disproportionate" under the second prong of the *Unocal* test. *See id.* at 1370. In response to the bidder's tender offer for the stock of Unitrin (the target), the Unitrin board adopted a poison pill and commenced a stock repurchase program. *See id.* at 1370-71.

50. *Id.* at 1385 (quoting *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 34, 45-46 (Del. 1994) (discussing standard of review for defensive measures adopted by board of directors)).

51. *Id.* at 1385-86. The court adopted a range of reasonableness standard because of the board's need for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. *See id.* at 1387 (discussing rationale for standard). *But see* *Moore Corp. v. Wallace Computer Servs., Inc.*, 907 F. Supp. 1545, 1562 (D. Del. 1995) (conceding that range of reasonableness standard is meaningless because courts, when reviewing board's defensive actions, look to whether actions are preclusive or coercive).

52. *Unitrin*, 651 A.2d at 1387. The court stated that "defensive measures which are either preclusive or coercive are included within the common law definition of draconian." *Id.* According to the court, a defensive action is "preclusive" if it deprives "the stockholders of their right to receive tender offers [or] fundamentally restrict[s] proxy contests . . ." *Id.* A defensive act is "coercive" if it is "aimed at 'cramming down' on . . . shareholders a management-sponsored alternative." *Id.* The *Unitrin* court noted judicial restraint as a reason for the adoption of this standard. *See id.* at 1388. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a range of reasonableness, a court must not substitute its judgment for the board's. *See id.*

53. *See id.* at 1387 (stating that preclusive or coercive defensive measure will fail second prong of test).

3. Shareholder Voting Rights

The validity of anti-takeover measures is normally evaluated under the standards set forth in *Unocal* and *Unitrin*.⁵⁴ Where the defensive measures purposefully disenfranchise shareholders, however, the burden of proof is on the board of directors to satisfy the more exacting standard set forth in *Blasius Industries, Inc. v. Atlas Corp.*⁵⁵ Under the *Blasius* standard, "a board's unilateral decision to adopt a defensive measure touching 'upon issues of control' that purposefully disenfranchises its shareholders is strongly suspect under *Unocal* and cannot be sustained without a 'compelling justification.'"⁵⁶ Although the *Blasius* court distinguished its own test from that of the *Unocal* court, later cases treated the *Blasius* standard as a "specific expression" of the *Unocal* test.⁵⁷ The *Blasius* court, addressing the central importance of the shareholder electoral franchise, reasoned that "[t]he shareholder electoral franchise is the ideological underpin-

54. For a discussion of the *Unocal/Unitrin* standard, see *supra* notes 44-53 and accompanying text.

55. 564 A.2d 651 (Del. Ch. 1988). This case is considered to be the primary authority for reviewing directors' actions that affect the stockholder franchise. See Irwin H. Warren & Kevin G. Abrams, *Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests*, 47 BUS. LAW 647, 654 (1992) (discussing judicial framework for reviewing boards' actions that affect stockholder franchise).

In *Blasius*, the board of Atlas (the target company) attempted to prevent a loss of control resulting from a consent solicitation that would place a majority of new directors on its board. See *Blasius*, 564 A.2d at 651.

56. *Stroud v. Grace*, 606 A.2d 75, 91-92, 92 n.3 (Del. 1992) (discussing standard of review for defensive measures that disenfranchise shareholders). This is the upshot of the doctrinal development of protection of shareholder voting rights following *Blasius*. See *id.* (noting increase in safeguards for shareholder voting).

57. See *Stroud*, 606 A.2d at 92 n.3 (stating that tests are not mutually exclusive because both recognize inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise); *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278, 285-86 (Del. Ch. 1989) (holding that *Blasius* test is meant to be specific expression of *Unocal* test rather than separate, more stringent standard); see also Randall S. Thomas, *Judicial Review of Defensive Tactics in Proxy Contests: When is Using a Rights Plan Right?*, 46 VAND. L. REV. 503, 523 (1993) (arguing that "[w]hile the rhetoric of the various tests . . . differs, the courts have reached similar results under all of them, and they seem increasingly to be using the *Unocal* framework to analyze incumbent defensive tactics in proxy contests").

Although "[m]any of the litigants and the courts . . . have treated the *Blasius* standard as requiring a more searching and critical judicial inquiry than the *Unocal* framework," the Delaware courts have recognized that "*Blasius* may be viewed as a reformulation and not necessarily an extension of *Unocal* in the context of shareholder voting rights." Warren & Abrams, *supra* note 55, at 669 (discussing relationship between *Unocal* and *Blasius* standards). Such commentators reason that:

[B]y inquiring into both the incumbent directors' motives and the practical effect of their tactics on the insurgents' proxy or consent solicitation, *Blasius* parallels the two-prong *Unocal* inquiry into the target directors' reasonable perception of a threat to a valid corporate interest, and the proportionality of their response to the threat.

Id.

ning upon which the legitimacy of directorial power rests.”⁵⁸ Thus, there are special considerations present in matters involving the integrity of the shareholder voting process that are not present in any other context in which directors exercise delegated power.⁵⁹ As a result, courts will not apply the deferential business judgment rule when reviewing board actions designed to interfere with shareholder voting rights.⁶⁰

III. *CARMODY V. TOLL BROTHERS, INC.*

A. *Case Background*

1. *Background Leading to Adoption of the Plan*

In *Carmody*, a shareholder of Toll Brothers, a Pennsylvania-based Delaware corporation that designs, builds and markets single family luxury homes, challenged the corporation’s dead hand poison pill.⁶¹ Toll Brothers has performed very successfully since its inception in 1967.⁶² After going public in 1986, Toll Brothers continued to enjoy increased revenues, and it expects that trend to continue, based on the company’s ongoing expansion, its backlog of home contracts and a continuing strong industry demand for luxury housing in the regions it serves.⁶³

58. *Blasius*, 564 A.2d at 659 (emphasizing importance of shareholder electoral franchise); see *Unitrin*, 651 A.2d at 1378 (“This Court has been and remains assiduous in its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising stockholders.”); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 42 (Del. 1994) (noting that Delaware has consistently acted to protect stockholders from unwarranted interference with voting rights).

59. See *Blasius*, 564 A.2d at 659 (discussing importance of shareholder voting process); see also *Lese*, *supra* note 1, at 2197 (discussing judicial review of actions that infringe on shareholder electoral franchise).

60. See *Blasius*, 564 A.2d at 659 (“[T]he deferential business judgment rule does not apply to board acts taken for the primary purpose of interfering with a stockholder’s vote, even if taken advisedly and in good faith.”).

61. See *Carmody v. Toll Brothers, Inc.*, No. 15983, 1998 WL 418896, at *1 (Del. Ch. Jul. 24, 1998) (noting that Toll Brothers operates in thirteen states and five regions in United States). Brothers, Bruce Toll (Chief Executive) and Robert Toll (Chief Operating Officer) founded Toll Brothers in 1967. See *id.* They own approximately 37.5% of Toll Brothers’ common stock. See *id.*

62. See *id.* (noting that as of June 3, 1997, Toll Brothers had issued and outstanding 34,196,473 common shares that traded on New York Stock Exchange).

63. See *id.* (discussing Toll Brothers’ ongoing expansion in luxury housing market).

The home building industry is highly competitive.⁶⁴ Inherent in this market is the risk of a hostile takeover.⁶⁵ Thus, the board of directors of Toll Brothers adopted a poison pill in order to protect against this risk.⁶⁶

2. *The Rights Plan*

The adopted Rights Plan of Toll Brothers would operate as follows: there would be a dividend distribution of one preferred stock purchase right (a "Right") for each outstanding share of common stock as of July 11, 1997.⁶⁷ The Rights would become exercisable and would trade separately from the common shares after the "Distribution Date," which is defined as the earlier of (a) ten business days following a public announcement that an acquirer has acquired, or obtained the right to acquire, beneficial ownership of fifteen percent or more of the company's outstanding common shares (the "Stock Acquisition Date"), or (b) ten business days after the commencement of a tender offer or exchange offer that would result in a person or group beneficially owning fifteen percent or more of the company's outstanding common shares.⁶⁸ The dilutive mechanism of the Rights is "triggered" by defined events.⁶⁹ Should one of these events occur, each Rights holder (except the acquirer and its affiliates and associates) is entitled to buy two shares of Toll Brothers common

64. *See id.* (noting that for some time house construction industry has consolidated through acquisition process). Over the last ten years it has evolved from one where companies served purely local and regional markets to one where regional companies have expanded to serve markets throughout the country. *See id.* This consolidation was accomplished by home builders in one region acquiring firms located in other regions. *See id.*

65. *See id.* (discussing hostile market). "For example, D.R. Horton (a Texas firm) acquired Regency Development (an Alabama firm), Kaufman and Broad (a California firm) acquired Oppal Jenkins Group (a New Mexico firm) and Toll Brothers acquired Geoffrey H. Edmonds & Associates (a Phoenix, Arizona firm)." *Id.* at *1 n.3.

66. *See id.* at *1 (discussing reasons board of directors adopted rights plan). The Rights Plan was adopted on June 12, 1997, when Toll Brothers' stock was trading at approximately \$18 per share—near the low end of its established price range. *See id.* The company announced that it had adopted the Rights Plan to protect its stockholders from "coercive or unfair tactics to gain control of the Company" by placing the stockholders in a position of having to accept or reject an unsolicited offer without adequate time. *Id.*

67. *See id.* at *2 (discussing operation of Rights Plan). "Initially, the Rights would attach to the company's outstanding common shares, and each Right would initially entitle the holder to purchase one thousandth of a share of a newly registered series Junior A Preferred Stock for \$100." *Id.*

68. *See id.* (defining distribution date of rights). Once exercisable, the Rights remain exercisable until their Final Expiration Date, which is June 12, 2007, ten years after the adoption of the Plan, unless the Rights are earlier redeemed by the company. *See id.*

69. *See id.* (discussing events that would "trigger" Rights Plan). One trigger event is the acquisition of 15% or more of Toll Brothers' stock by any person or group of affiliated or associated persons. *See id.*

stock or other securities at half price.⁷⁰ As a result, this so-called “flip in” feature of the Rights Plan would substantially dilute the value of the hostile acquirer’s holdings.⁷¹

The Rights also have a standard “flip over” feature that is triggered if, after the Stock Acquisition Date, the company is made a party to a merger in which Toll Brothers is not the surviving corporation, or in which it is the surviving corporation and its common stock is changed or exchanged.⁷² In either event, each Rights holder becomes entitled to purchase common stock of the acquiring company, again at half price, thereby impairing the acquirer’s capital structure and massively diluting the interest of the acquirer’s other stockholders.⁷³

James Carmody, individually and on behalf of shareholders of Toll Brothers, alleged that the purpose and effect of the company’s Rights Plan, as with most poison pills, was to make any hostile acquisition of the company prohibitively expensive, in order to deter such acquisitions, unless the target company’s board approved the acquisition proposal.⁷⁴ Substantively, the dead hand provision prevented any directors of Toll Brothers, except those who were in office on the plan’s date of adoption (June 12, 1997) or their chosen successors, from redeeming the Rights

70. *See id.* (noting entitlement of each rights holder). The value of the stock received when the Right is exercised is equal to two times the exercise price of the Right. *See id.*

71. *See id.* The “flip-in” feature of a rights plan is triggered when the acquirer crosses the specified ownership threshold, regardless of the acquirer’s intentions with respect to the use of the shares. *See* FLEISCHER & SUSSMAN, *supra* note 2, § 5.01, at 5-7 (discussing various types of poison pills). When the threshold is crossed, the rights vest in all shareholders other than the acquirer, and as a result, those holders become entitled to acquire additional shares of voting stock at a substantially discounted price, usually about half of the market price. *See id.* (discussing features of flip-in poison pill).

72. *See Carmody*, 1998 WL 418896, at *2 n.5 (discussing “flip-over” feature of Rights Plan). Commonly, rights plans contain a “flip-over” feature entitling target company shareholders (other than the acquirer) to purchase shares of the acquiring company at a reduced price. *See* FLEISCHER & SUSSMAN, *supra* note 2, § 5.01, at 5-7 (discussing various types of poison pills). That feature is activated when, after a “flip-in” triggering event, the acquirer initiates a triggering event, such as a merger, self-dealing transaction, or sale of assets. *See id.*

73. *See Carmody*, 1998 WL 418896 at *2 (noting dilutive feature of “flip-over” aspect of Rights Plan).

74. *See id.* The target board’s “leverage” comes from another critical feature found in most rights plans: the directors’ power to redeem the rights at any time before they expire, on such conditions as the directors “in their sole discretion” may establish. *See id.* (noting board’s power to redeem rights). In this respect, Toll Brothers’ Rights Plan is similar to the “standard model” rights plan. *See id.* (stating similarity between Toll Brothers’ poison pill and most other poison pills). This Rights Plan is distinctive because it authorizes only a specific, defined category of directors to redeem the Rights. *See id.* (stating difference between Toll Brothers’ poison pill and most other poison pills). The focus of this lawsuit is the legality of the “continuing director” or dead hand feature of the Rights Plan. *See id.*

until they expire on June 12, 2007.⁷⁵ According to the complaint, this dead hand provision had a twofold practical effect.⁷⁶ First, it made any unsolicited offer for the company less likely by eliminating a proxy contest as a useful way for a hostile acquirer to gain control because even if the acquirer wins the contest, its newly elected directors could not redeem the Rights.⁷⁷ Second, the dead hand provision disenfranchised, in a proxy contest, all shareholders that wanted the company to be managed by a board empowered to redeem the Rights by depriving those shareholders of any practical choice except to vote for the incumbent directors.⁷⁸ Given these effects, Carmody claimed that the only purpose that the dead hand provision could serve was to discourage future acquisition activity that would result in an adverse effect on the company's stock.⁷⁹

B. *The Delaware Court of Chancery's Analysis*

The critical issue on this motion to dismiss under Delaware Court of Chancery Rule 12(b)(6) was whether a dead hand provision in a poison pill rights plan was subject to legal challenge on the basis that it was invalid as ultra vires or as a breach of fiduciary duty, or both.⁸⁰ The court held that the dead hand feature of the rights plan was subject to legal challenge on both statutory and fiduciary grounds and that because the complaint stated legally cognizable claims for relief, the pending motion to dismiss

75. *See id.* at *3 (discussing dead hand feature of Rights Plan). The Rights Agreement's definition of a "Continuing Director" is:

(i) any member of the Board of Directors of the Company, while such person is a member of the Board, who is not an Acquiring Person, or an Affiliate [as defined] or Associate [as defined] of an Acquiring Person, or a representative or nominee of an Acquiring Person or of any such Affiliate or Associate, and was a member of the Board prior to the date of this agreement, or (ii) any Person who subsequently becomes a member of the Board, while such Person is a member of the Board, who is not an Acquiring Person, or an Affiliate [as defined] or Associate [as defined] of an Acquiring Person, or a representative or nominee of an Acquiring Person or of any such Affiliate or Associate, if such Person's nomination for election or election to the Board is recommended or approved by a majority of the Continuing Directors.

Id.

76. *See id.*

77. *See id.* (noting that unsolicited offer will be more unlikely due to dead hand provision).

78. *See id.* (noting that dead hand provision will disenfranchise shareholders).

79. *See id.*

80. *See id.* A motion to dismiss under Court of Chancery Rule 12(b)(6) will not be granted unless the Court is reasonably certain that the plaintiff would not be entitled to relief under any set of facts that could reasonably be inferred from the complaint. *See id.* (citing *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1105 (Del. 1985)). In that procedural setting, the truth of all well-pleaded allegations in the complaint is assumed. *See id.* (citing *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 38 (Del. 1996)). Thus, on this motion the focus of the inquiry is not whether the Rights Plan is invalid, but rather, the focus is only whether the complaint states one or more cognizable claims of legal invalidity. *See id.*

had to be denied.⁸¹ The Delaware Court of Chancery began its analysis by easily disposing of Toll Brothers' threshold arguments that (a) the claims were not ripe and (b) even if ripe, the claims must be dismissed because they were derivative.⁸² The Delaware Court of Chancery then turned to the most critical issue in the case—the validity under Delaware law of the dead hand feature of the Toll Brothers rights plan.⁸³

In the end, the court concluded that the complaint's three reasons why the dead hand provision violated Delaware statutory law were legally

81. *See id.* at *1 (holding that dead hand feature is subject to legal challenge on both statutory and fiduciary grounds).

82. *See id.* at *6 (disposing of defendant's ripeness and derivative arguments).

Toll Brothers' argued that the plaintiff's claims were not ripe and could not become ripe for adjudication, unless and until (i) a specific acquisition is proposed to which the Continuing Directors object and (ii) the Continuing Directors refuse to redeem the Rights so as to enable the shareholders to consider the acquisition proposal and decide whether or not to accept it. *See id.* at *5. The court agreed with the plaintiff's contention that the "dead hand" provision has a present depressing and deterrent effect upon the shareholders' interests, in particular, the shareholders' present entitlement to receive and consider takeover proposals and to vote for a board of directors capable of exercising the full array of powers provided by statute, including the power to redeem the poison pill. *See id.* at *6. The court reasoned that the plaintiff's claims of statutory and equitable invalidity are ripe for adjudication because of their alleged current adverse impact. *See id.*; *see also* Moran v. Household Int'l, Inc., 490 A.2d 1059, 1072 (Del. 1985) (dismissing similar ripeness argument).

In addition, Toll Brothers argued that the invalidity claims were derivative and should be dismissed under Chancery Court Rule 23.1, because the plaintiff failed to make a pre-suit demand on the board or plead facts that would excuse a demand. *See Carmody*, 1998 WL 418896, at *7. Delaware Court Chancery Rule 23.1 states:

In a derivative action brought by 1 or more shareholders or members to enforce a right of a corporation . . . the complaint shall allege that the plaintiff was a shareholder or member at the time of the transaction of which the plaintiff complains or that the plaintiff's share or membership thereafter devolved on the plaintiff by operation of law. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff's failure to obtain the action or for not making the effort.

DEL. R. CH. CT. 23.1 (1997). The court determined that the plaintiff's claims were individual, not derivative. *See Carmody*, 1998 WL 418896, at *7 (discussing defense to derivative claim). The court reasoned that because the shareholders' right to vote is a contractual right and an attribute of the Toll Brothers shares, the claimed wrongful interference with that right stated an individual cause of action. *See id.* (deciding claims were individual); *see also* Lipton v. News Int'l, Plc, 514 A.2d 1075, 1079 (Del. 1986) (stating that interference with shareholder voting rights states individual cause of action). Even if the claims were derivative, the court determined that the complaint's allegations were sufficient to excuse compliance with the demand requirement of Delaware Chancery Court Rule 23.1. *See Carmody*, 1998 WL 418896, at *7 (noting claim satisfies requirements for demand excusal).

83. *See Carmody*, 1998 WL 418896, at *8 (stating critical issue of case is validity of dead hand provision under Delaware law).

sufficient claims.⁸⁴ First, under Delaware General Corporate Law section 141(d), the power to create voting power distinctions among directors exists only where there is a classified board and where those voting power distinctions are expressed in the certificate of incorporation.⁸⁵ The Toll Brothers rights plan, violated this law because it “confer[ed] the power to redeem the pill only upon some, but not all, of the directors.”⁸⁶ Second, the right to elect directors with greater voting powers is reserved to the shareholders under section 141(d).⁸⁷ Because the continuing directors have the exclusive power to redeem the pill, the statutorily protected shareholder right to elect directors who would have this power is violated.⁸⁸ Third, Delaware General Corporate Law section 141(a) gives directors the statutory power to manage the business and affairs of the corporation.⁸⁹ This power may be violated because the dead hand provision would jeopardize a newly elected future board’s ability to achieve a business combination by depriving that board of the power to redeem the

84. *See id.* at *9 (“[T]he complaint states legally sufficient claims that the ‘dead hand’ provision of the Toll Brothers Rights Plan violates 8 Del. C. §§ 141(a) and (d).”).

85. *See id.* (discussing power to create voting distinctions under § 141(d)).

86. *Id.* at *9. Under Delaware law, if one category or group of directors is given distinctive voting rights not shared by the other directors, those distinctive voting rights must be set forth in the certificate of incorporation. *See* DEL. CODE ANN. tit. 8, § 141(d) (1997) (requiring voting power distinctions to be set forth in certificate of incorporation). The complaint alleged that this distinction was not set forth in the certificate of incorporation. *See Carmody*, 1998 WL 418896, at *9 (discussing dead hand pill’s non-compliance with Delaware statutory law).

87. *See Carmody*, 1998 WL 418896, at *9 (“[Section] 141(d) mandates that the ‘right to elect 1 or more directors who shall . . . have such [greater] voting powers’ is reserved to the stockholders”) Absent express language in the charter, nothing in Delaware law suggests that some directors of a public corporation may be created less equal than other directors, and certainly not by unilateral board action. *See* Gordon, *supra* note 13, at 537 (discussing power to create voting distinctions under Delaware law).

88. *See Carmody*, 1998 WL 418896, at *9 (“Vesting the pill redemption power exclusively in the Continuing Directors transgresses the statutorily protected shareholder right to elect the directors who would be so empowered.”).

89. *See id.* at *10.

pill.⁹⁰ The court stated that its statutory analysis and result were consistent with and supported by *Bank of New York*.⁹¹

90. *See id.* (noting that replacing board could make pill redemption legally impossible). The dead hand poison pill interferes with the board's power to protect the corporation's (and its shareholders') interests in a takeover transaction that is one of the most fundamental and important in the life of a business enterprise. *See Gordon, supra* note 13, at 538 (stating that "[s]uch interference turns on its head the very rationale of the poison pill, which is to protect the board against alleged encroachments on that power from a hostile bid").

Toll Brothers offered two arguments in response to the statutory invalidity claims. *See Carmody*, 1998 WL 418896, at *11. First, they contended that the Rights Plan did not facially preclude or interfere with proxy contests as a means to gain control or coerce shareholders to vote for or against any particular director slate. *See id.* Second, Toll Brothers argued that the dead hand provision is analogous to a delegation to a special committee, consisting of the "continuing directors," of the power to redeem the pill. *See id.* The court found that neither contention had merit. *See id.* The first contention was basically an argument that the Rights Plan does not violate any fiduciary duty of the board. *See id.* (characterizing arguments in response to statutory invalidity claim). According to the court, the fiduciary duty argument is unresponsive to the statutory invalidity claim. *See id.* The second argument rested upon an analogy that has no basis in fact. *See id.* (stating that "special committee" analogy ignores fundamental structural differences between creation of special committee and operation of dead hand provision). The court noted that the board's actions did not create a special committee having the exclusive power to redeem the pill. *See id.*

91. *See id.* at *10 (discussing consistent case law). In *Bank of New York*, the court found that the continuing director provision violated the New York Business Corporation Law requirement that restrictions upon the board's powers are invalid, unless all the incorporators or all shareholders of record authorize the inclusion of the limitations or restrictions in the certificate of incorporation. *See Bank of New York Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482, 485 (Sup. Ct. 1988) (holding that board was without authority to adopt provision restricting action of future board). The *Carmody* court recognized that the underlying intent of the Delaware and New York statutes was the same because both statutes require that limitations upon the directors' power be expressed in the corporation's charter. *See Carmody*, 1998 WL 418896, at *10 (discussing similarities between Delaware and New York statutory law). Like the poison pill in *Bank of New York*, it is alleged that Toll Brothers' pill is invalid because the certificate of incorporation does not contain any limitation upon the power of the board. *See id.* (noting similarity between Toll Brothers' pill and dead hand pill struck down in New York).

The court also distinguished *Invacare Corp. v. Healthydyne Tech., Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997), a case that Toll Brothers relied upon. *See Carmody*, 1998 WL 418896, at *11 n.38. In *Carmody*, the court stated:

[T]he [*Invacare*] court held that the Georgia Business Corporation Code had no statutory requirement mandating that limitations on the directors' power be expressed in the certificate of incorporation. That court noted that the Georgia statute gave the board "sole discretion" to determine the terms and conditions of a rights plan, and that the Official Comment stated that the board's discretion is limited only by its fiduciary obligations to the corporation. The court also found that the Georgia Fair Price statutory provision, which required unanimous approval by the "continuing directors" or recommendation by at least two thirds of the "continuing directors" and approval by a specified percentage of shareholder votes, supported the conclusion that "Georgia corporate law embraces the concept of continuing directors as part of a defense against

Next, the Delaware Chancery Court concluded that the complaint stated a legally sufficient claim that the dead hand provision purposefully interferes with the shareholder voting franchise without any compelling justification, and is therefore unlawful under the *Blasius* standard.⁹² The court found that “[t]he disenfranchisement would occur because even in an election contest fought over the issue of a hostile bid, the shareholders will be powerless to elect a board that is both willing and able to accept the bid.”⁹³ The court took into account the Delaware Supreme Court’s rationale for upholding the validity of the poison pill in *Moran v. Household International Inc.*⁹⁴ In *Moran*, the court reasoned that the effect of the poison pill upon a proxy contest would be minimal, and if the board refused to redeem the pill, the shareholders could then elect directors who would redeem it.⁹⁵ The *Carmody* court also relied upon the primacy of the shareholder vote in the scheme of Delaware corporate jurisprudence.⁹⁶ The court described the primacy of shareholder vote as the “ideological underpinning upon which the legitimacy of directorial power rests.”⁹⁷

hostile takeovers.” The relevant Delaware corporate statutory scheme, like New York’s, differs materially from that of Georgia.

Id. (citations omitted).

92. *See Carmody*, 1998 WL 418896, at *11 (concluding there is legally cognizable claim that dead hand provision purposefully interferes with shareholder voting). Where the defensive measures purposefully disenfranchise shareholders, the board will be required to satisfy the more exacting *Blasius* standard, which the Delaware Supreme Court has articulated as follows:

A board’s unilateral decision to adopt a defensive measure touching “upon issues of control” that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a “compelling justification.”

Id. at *12 (quoting *Stroud v. Grace*, 606 A.2d 75, 92 (Del. 1992)).

93. *Id.* at *12 (discussing pill’s effect of coercing shareholders to vote for incumbent directors that have full statutory power). *See also* Gordon, *supra* note 13, at 540 (stating that claim that directors have unilaterally “create[d] a structure in which shareholder voting is either impotent or self defeating” is claim of purposeful disenfranchisement).

94. *See Carmody*, 1998 WL 418896, at *12 (discussing rationale for upholding validity of poison pill); *see also* *Moran v. Household Int’l Inc.*, 500 A.2d 1346, 1355 (Del. 1985) (upholding validity of poison pills).

95. *See Carmody*, 1998 WL 418896, at *12 (“In *Moran*, the Supreme Court upheld the adoption of a poison pill, in part because its effect upon a proxy contest would be ‘minimal,’ but also because if the board refused to redeem the plan, the shareholders could exercise their prerogative to remove and replace the board.”).

The court also looked to *Unocal* where the Delaware Supreme Court reiterated the view that the safety valve that justifies a board being allowed to resist a hostile offer that a majority of the shareholders might prefer is because the shareholders always have their ultimate recourse to the ballot box. *See id.* (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) (“If the shareholders are displeased with the action of their elected representatives, the powers of corporate democracy are at their disposal to turn the board out.”)).

96. *See id.*

97. *Id.* at *12; *see* *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1378 (Del. 1995) (stating that defensive actions designed to thwart essence of corporate democracy by disenfranchising stockholders require close judicial scrutiny); Para-

Finally, the court concluded that the complaint stated a legally cognizable claim that the inclusion of the dead hand provision in the rights plan was an unreasonable defensive measure in violation of the board's fiduciary duty.⁹⁸ Under *Unocal*, a fiduciary duty claim requires enhanced judicial scrutiny.⁹⁹ Thus, the board has the burden of establishing for the court that (1) "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and (2) that its "defensive response was reasonable in relation to the threat posed."¹⁰⁰ Enhanced scrutiny is not satisfied by resting on a defense motion attacking the pleadings.¹⁰¹ Only conclusory complaints may be dismissed early.¹⁰² The court, however, found that the complaint was "far from conclusory."¹⁰³ Under *Unitrin*, a defensive measure is unreasonable if it is either coercive or preclusive.¹⁰⁴ The court found that the complaint sufficiently alleged that the plan was coercive because the complaint stated that the dead hand provision forced shareholders to vote for incumbent directors if shareholders wanted to be represented by a board with full statutory authority.¹⁰⁵ The court also found that the complaint sufficiently alleged that the plan was preclusive.¹⁰⁶ It was preclusive, according to the complaint,

mount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 42 (Del. 1994) (noting that Delaware courts consistently act to protect stockholders from unwarranted interference with voting rights).

In support of this proposition, the *Carmody* court quoted former Chancellor William T. Allen:

Provisions in corporate instruments that are intended principally to restrain or coerce the free exercise of the stockholder franchise are deeply suspect. The shareholder vote is the basis upon which an individual serving as a corporate director must rest his or her claim to legitimacy. Absent quite extraordinary circumstances, in my opinion, it constitutes a fundamental offense to the dignity of this corporate office for a director to use corporate power to seek to coerce shareholders in the exercise of the vote.

Carmody, 1998 WL 418896, at *12 (quoting *Sutton Holdings Corp. v. DeSoto, Inc.*, No. 12051, 1991 WL 80223, at *2 (Del. Ch. May 14, 1991)).

98. See *Carmody*, 1998 WL 418896, at *13.

99. See *id.* Enhanced judicial scrutiny is, by its nature, fact-driven and requires a factual record. See *id.* (discussing standard of review for fiduciary duty claims).

100. *Id.* at *13 (citing *Unocal*, 493 A.2d at 955 (discussing board of directors' burden of proof)).

101. See *id.* (stating that enhanced scrutiny "will usually not be satisfied by resting on a defense motion merely attacking the pleadings" (quoting *In re Santa Fe Pacific Corp.*, 669 A.2d 59, 72 (Del. 1995))).

102. See *id.* (stating that only "conclusory complaints without well-pleaded facts may be dismissed early under Chancery Rule 12" (quoting *In re Santa Fe Pacific Corp.*, 669 A.2d at 72)).

103. *Id.*

104. See *id.* (discussing standard under *Unitrin*).

105. See *id.* (stating that complaint alleges that dead hand provision "disenfranchises shareholders by forcing them to vote for incumbent directors or their designees if shareholders want to be represented by a board entitled to exercise its full statutory prerogatives").

106. See *id.*

because it made a bidder's ability to wage a successful proxy contest and to gain control either "mathematically impossible" or "realistically unattainable."¹⁰⁷ Thus, the court concluded that the allegations were sufficient to state a claim that Toll Brothers' rights plan was disproportionate and unreasonable under the *Unocal/Unitrin* standard.¹⁰⁸

IV. CRITICAL ANALYSIS

The Delaware Chancery Court held that a dead hand poison pill rights plan was subject to legal challenge on the basis that it violated the Delaware General Corporation Law and/or the fiduciary duties of the board of directors who adopted the plan.¹⁰⁹ This Note suggests that the Delaware Chancery Court was correct in its ruling because the result is consistent with underpinning principles of Delaware corporate law. First, the Delaware Chancery Court correctly interpreted Delaware statutory law with respect to dead hand poison pills.¹¹⁰ Second, dead hand poison pills infringe on the shareholder electoral franchise.¹¹¹ Finally, the dead hand provision violates the fiduciary duty of the board of directors.¹¹²

A. *Dead Hand Poison Pills Violate Statutory Power*

Dead hand poison pills fail on many statutory grounds relevant to the powers and restrictions conferred upon boards of directors.¹¹³ Under a dead hand poison pill, only certain directors will be qualified to exercise the power to redeem a pill.¹¹⁴ Under Delaware law, however, director

107. *Id.* The complaint alleges that the provision makes an offer for Toll Brothers much more unlikely because it eliminates the use of a proxy contest as a possible means to gain control; thus, any directors elected in such a contest would be unable to redeem the pill. *See id.* Also, it was alleged that the dead hand pill made "future contests for corporate control of Toll Brothers prohibitively expensive and effectively impossible." *Id.*

108. *See id.* (concluding that allegations were sufficient to state claim that plan was disproportionate and unreasonable).

109. *See id.* at *1 (holding that dead hand feature of rights plan is subject to legal challenge on both statutory and fiduciary grounds).

110. For a further discussion of the Delaware statutory issues that arise with respect to dead hand poison pills, see *supra* notes 33-43 and accompanying text.

111. For a further discussion of the law that applies to defensive measures that disenfranchise shareholders, see *supra* notes 54-60 and accompanying text.

112. For a further discussion of the board's fiduciary duties to the corporation and its shareholders, see *supra* notes 44-53 and accompanying text.

113. *See Brown & Regner, supra* note 3, at 3 (stating arguments against validity of poison pills). The main statutory arguments against the validity of dead hand provisions are that they create two classes of directors and that current directors should not have the power to limit the discretion of future directors. *See id.* (reviewing statutory arguments against dead hand poison pills).

114. *See Bialkin & Wray, supra* note 2, at 2 (discussing power to redeem dead hand poison pill); Elofson, *supra* note 3, at 309-10 (discussing mechanics of dead hand pills).

Under a dead hand poison pill, only directors in place at the time of the pill's adoption or who were subsequently elected with the recommendation of the other

qualifications can only be established in the certificate of incorporation or the bylaws of the corporation, neither of which are tactically available in the case of a dead hand poison pill.¹¹⁵ Thus, a dead hand pill gives voting rights to some directors and not others.¹¹⁶ Absent express language in the certificate, however, a board is without authority to create directors with different levels of power.¹¹⁷

Proponents of dead hand poison pills argue that current directors do in fact have the power to limit the discretion of future directors due to their ability to legally bind the corporation in contracts.¹¹⁸ This power,

continuing directors can redeem the pill. See Bialkin & Wray, *supra* note 2, at 2 (discussing continuing director qualifications).

115. See DEL. CODE ANN. tit. 8, § 141(b) (1997) (stating director qualifications can only be stated in articles or bylaws). Section 141(b) states:

The board of directors of a corporation shall consist of 1 or more members. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors.

Id.

Establishing director qualifications in the certificate or bylaws would not be tactically available in this case because even though the various statutory elements may be altered by the articles, or in some cases the bylaws, a dead hand poison pill is unlikely to obtain shareholder approval as a certificate amendment and, if adopted as a bylaw, would presumably be subject to both shareholder power and the power of a successor board to amend bylaws. See Gordon, *supra* note 13, at 537 (discussing reasons for lack of director qualifications in articles or bylaws for dead hand poison pills).

116. See Brown & Regner, *supra* note 3, at 2 (stating that dead hand poison pills create two classes of directors).

The power to create voting distinctions among directors, however, appears to be available only in the case of a classified board and only when specified in the certificate of incorporation. See DEL. CODE ANN. tit. 8, § 141(d) (1997) (discussing voting distinctions among directors). Section 141(d) states:

The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors.

Id.

117. See Gordon, *supra* note 13, at 537 (stating that under Delaware law directors are created equal). In contrast to Georgia's "sole discretion" statutory provision, Delaware General Corporation Law does not provide for the extension of a board's power in fashioning a pill. See *id.* (noting peculiar feature of Georgia law that changes statutory analysis).

118. See Brown & Regner, *supra* note 3, at 2 (stating that board may have some power to limit discretion of future board as incidental consequence of corporate contract). For example, a board can enter a corporation into a covenant that contains a loan agreement that restricts the corporation's right to issue dividends. See *id.* (noting board's power to bind corporation under certain contracts).

however, is subject to constraint.¹¹⁹ Agreements limiting the discretion of a future board would violate that board's statutory power to appoint and remove officers and to direct the management of the corporation.¹²⁰ Thus, the dead hand poison pill is objectionable because its very purpose is to interfere with a future board's power to manage by limiting the future board's discretion.¹²¹ Also, because the future board cannot redeem the pill, the dead hand poison pill directly interferes with the future board's core statutory power to manage the business and affairs of the corporation in the best interests of the corporation and its shareholders.¹²² This interference is at odds with the very rationale of the poison pill, which is to

119. See Gordon, *supra* note 13, at 537. For example, a board cannot limit its discretion or the discretion of a future board to fire a chief executive officer or to enter into a contract that would eliminate that discretion due to potential damages that would result from the chief executive officer's termination. See *id.* at 538 (noting extent to which board can limit discretion of future board); see also, e.g., *Grimes v. Donald*, CIV.A. No. 13358, 1995 WL 54441, at *9 (Del. Ch. Jan. 11, 1995) (holding that although board may delegate powers subject to possible review, it may not abdicate them), *aff'd*, 673 A.2d 1207 (Del. 1996).

120. See DEL. CODE ANN. tit. 8, § 142(b) (1997) (giving board power to appoint and remove officers). Section 142(b) states:

Officers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body. Each officer shall hold office until such officer's successor is elected and qualified or until such officer's earlier resignation or removal. Any officer may resign at any time upon written notice to the corporation.

Id. Section 141(a) gives the board power to direct management of the corporation. See DEL. CODE ANN. tit. 8, § 141(a) (1997). Section 141(a) states:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Id.; see *Chapin v. Benwood Found., Inc.*, 402 A.2d 1205, 1210 (Del. Ch. 1979) (holding that directors of Delaware corporation may not delegate to others those duties that lay at heart of management of corporation), *aff'd sub nom.*, *Harrison v. Chapin*, 415 A.2d 1068 (Del. 1980); *Abercrombie v. Davies*, 123 A.2d 893, 899 (Del. Ch. 1956) (discussing prejudice against agreements that remove from directors their duty to use own best judgment on management matters).

121. See Gordon, *supra* note 13, at 538 (discussing statutory objections to dead hand poison pills).

The board's purpose in adopting a dead hand provision is to protect the current board's incumbency. See *id.* (discussing rationale behind adoption of dead hand pill). The entrenchment actions of the current board constitute unwarranted interference with a future board's power to manage. See *id.* (recognizing limitation on future board's discretion).

122. See *id.* (stating that dead hand poison pill will interfere with future board's capacity to accomplish business combination).

protect the board's power to manage the corporation.¹²³ Also, a dead hand provision may make it impossible for a future board "to select . . . a time frame for the achievement of corporate goals," and in this way would violate fundamental principles of Delaware corporate law.¹²⁴ For these reasons, the Delaware Chancery Court was correct when it found that the complaint stated legally sufficient claims that the dead hand provision of the Toll Brothers rights plan violated Delaware General Corporate Law.¹²⁵

B. *Dead Hand Poison Pills Infringe on Shareholder Voting Rights*

In addition, the Delaware Court of Chancery was correct in ruling that the complaint stated a legally cognizable claim that the dead hand poison pill purposely disenfranchised shareholders without any compelling justification and was therefore unlawful under the *Blasius* standard.¹²⁶ The strongest defense of the use of a poison pill is that the shareholders ultimately have the option of electing a new board if they are unsatisfied with the judgment of the present board.¹²⁷ This defense is consistent with the Delaware Supreme Court's rationale for upholding poison pills.¹²⁸ A board's decision to adopt a dead hand pill disenfranchises shareholders because it strips shareholders of their right to participate in proxy contests, and this may allow them to elect a board that would further their interests.¹²⁹ Indeed, a continuing director provision corrupts the free

123. *See id.* (stating that dead hand provision is inconsistent with rationale supporting poison pills); *see also* Lese, *supra* note 1, at 2176 (stating that dead hand pills are effective deterrents of hostile takeovers).

124. *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154 (Del. 1989) (confirming primacy of business judgment of board of directors). The failure to select a time frame for the achievement of corporate goals is a violation of the board's fiduciary duties. *See id.* (discussing management of corporate enterprise).

125. *See Carmody v. Toll Brothers, Inc.*, No. 15983, 1998 WL 418896, at *9 (Del. Ch. Jul. 24, 1998) (holding that complaint stated legally sufficient claims that dead hand provision violated Delaware statutory law).

126. *See id.* at *11 (holding that complaint states legally cognizable claim that dead hand provision purposely interferes with shareholder voting franchise without any compelling justification).

127. *See Gordon, supra* note 13, at 539 (discussing poison pill's effect on shareholder voting).

128. *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 959 (Del. 1985) (recognizing importance of ability of displeased shareholders to elect new board); *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1357 (Del. 1985) (drawing the line at poison pill that "fundamentally restricts proxy contests").

129. *See Gordon, supra* note 13, at 540 (discussing disenfranchisement effect of dead hand provisions in poison pills). The fact that reelected incumbent directors might change their view or that the pill eventually will expire are not answers to this issue. *See id.* (discussing disenfranchisement effect). In addition, the coercive structure that may lead shareholders to reelect incumbents (because only they can redeem the pill) may also give incumbents a false sense of support for their policies. *See id.* (same).

choice that is closely associated with the idea of voting.¹³⁰ In previous cases, Delaware courts have found disenfranchisement where the timing of elections was manipulated.¹³¹ Therefore, a defensive mechanism that renders shareholder voting worthless constitutes disenfranchisement.¹³²

Proponents of dead hand poison pills have argued that they defend against a raider's coercive dealings and thus are necessary to protect shareholders.¹³³ Under this view, the board's primary purpose in using the provision against a hostile bidder's proxy contest is to protect shareholders from the coercive impact of a tender offer, rather than thwarting the solicitation.¹³⁴ This risk of coercion, however, is minimal.¹³⁵ When shareholders are faced with a takeover attempt that utilizes a joint tender offer and voting contest, they simply would not vote for the dissident unless they freely supported its agenda.¹³⁶ Thus, dead hand provisions serve no pur-

130. *See id.* (stating that shareholders will be forced to vote for directors with full power). The shareholders' free choice can be corrupted in three ways: "first, where the shareholders vote against the acquirer's slate because only continuing directors have the power to redeem the pill and accomplish a near-term transaction; second, where the shareholders vote only for some of the acquirer's candidates but for a majority of incumbent candidates for the same reason (and with the hope of sending a signal); and third, where in response to this strategic dilemma, the acquirer runs only a partial slate." *Id.* at 540 n.122.

131. *See, e.g.,* Schnell v. Chris-Craft Indus., 285 A.2d 437, 437 (Del. 1971) (holding management's utilization of corporate machinery and Delaware law for purpose of perpetuating itself in office and, to that end, its advancement of date of stockholders' meeting, for purpose of obstructing legitimate efforts of dissident stockholders in exercise of their rights to undertake proxy contest against management constituted inequitable purposes that would not be allowed); Aprahamian v. HBO & Co., 531 A.2d 1204, 1207 (Del. Ch. 1987) (holding that decision to postpone annual stockholder meeting recommended by special committee appointed by incumbent board disenfranchised stockholders).

132. *See* Gordon, *supra* note 13, at 539 (claiming dead hand poison pills clearly disenfranchise shareholders).

133. *See* Lese, *supra* note 1, at 2203 (discussing justifications for dead hand poison pills set forth by incumbent boards). By retaining the power to revoke the pill, incumbent boards can thwart hostile tender offers. *See id.*

134. *See id.* (recognizing view that board's primary purpose in using dead hand provision is to defend against coercive impact of tender offer). This justification is particularly problematic because Delaware courts have invalidated poison pills when they interfere with proxy contests. *See* Stahl v. Apple Bancorp, Inc., No. 11510, 1990 WL 114222, at *5 (Del. Ch. Aug. 9, 1990) (stating that "the side in control of the levers of power [during a voting contest could not] employ them with respect to an election to coerce its opposition to restrict its legitimate electioneering activities"); Sutton Holding Corp. v. DeSoto, Inc., No. 11221, 1990 WL 13476, at *1 (Del. Ch. Feb. 5, 1990) (invalidating pill that was triggered when shareholder receives proxies from other target shareholders); *see also* Moran v. Household Int'l, Inc., 500 A.2d 1346, 1355 (Del. 1985) (upholding pill's validity because effect of pill upon proxy contests was minimal and there was little change in governance structure of corporation).

135. *See* Lese, *supra* note 1, at 2203 (noting low risk of coercion in takeover attempts).

136. *See id.* at 2204 (discussing reasons shareholders would not be coerced by bidder's joint tender offer).

pose that could justify the abandonment of the shareholder electoral franchise.¹³⁷

C. *Dead Hand Poison Pills Violate Proportionality Standard*

Finally, dead hand poison pills fail to meet the proportionality standards set forth in *Unocal* and *Unitrin*.¹³⁸ Continuing director provisions are coercive because a shareholder who favors a control transaction may be forced into voting for incumbent directors because only incumbent directors have power to accomplish that transaction.¹³⁹ This coercion directly contradicts the rationale behind judicial validation of the poison pill—protection of shareholder choice.¹⁴⁰ The dead hand poison pill is also preclusive because an acquirer cannot maintain a proxy contest to

One reason shareholders would not elect an insurgent espousing an agenda inconsistent with their own is that they do not face the prisoner's dilemma confronting shareholders during a two-tiered tender offer. *See id.* (noting difference between joint and two-tiered tender offers). Two-tiered tender offers are coercive because shareholders who refuse to tender their shares risk receiving a lower payment at the back end of the transaction when they are frozen out. *See id.* In contrast, shareholders voting against a dissident's slate of directors face no detrimental consequences. *See id.* (discussing reasons for absence of coercion in joint tender offer).

A second reason shareholders are protected is that there is no risk that a shareholder who does not support a tender offer will, through his or her ignorance or the insurgent's deception, vote for an insurgent who plans to commence a tender offer. *See id.* (discussing reasons for absence of coercion in joint tender offer). Federal rules governing proxy solicitations mandate that solicitors fully disclose all material information related to their solicitations. *See* 17 C.F.R. § 240.14(a)-101 (1995) (requiring proxy statement to include information relating to any "merger or consolidation of the registrant into or with any other person . . . , [any] acquisition by the registrant . . . or the liquidation or dissolution of the registrant").

137. *See* Lese, *supra* note 1, at 2203 (stating that justifications for dead hand pills set forth by incumbent boards invariably lack substance).

Continuing directors provisions should be prohibited because other means of defense that do not infringe the shareholders' franchise are available. *See id.* (arguing against validity of dead hand provisions). For example, the company could amend its certificate of incorporation or bylaws to permit a classified board. *See id.* at 2204. Other defensive techniques include requiring cause for the removal of directors, fixing the maximum number of directors and requiring a supermajority vote to amend any of these changes. *See id.*

138. For discussion of the proportionality standard as set forth in *Unocal* and rearticulated in *Unitrin*, see *supra* notes 44-53 and accompanying text.

139. *See* Lese, *supra* note 1, at 2207 (discussing coercive effect of dead hand pills on shareholders).

Dead hand pills are coercive because they force shareholders to vote for the incumbent board. *See id.* (discussing dead hand pill's effect of stripping shareholders of their legitimate voting rights). Without the incumbent board to redeem the pill, shareholders cannot take advantage of a favorable merger transaction. *See id.* (emphasizing importance of voting for incumbent board).

140. *See* Moran v. Household Int'l Inc., 500 A.2d 1346, 1355 (Del. 1985) (upholding validity of pill because its effect on proxy contests was minimal and its impact on corporate governance structure was minor).

install directors that are willing and able to accept a bid.¹⁴¹ In any event, the effect of the dead hand pill on shareholder voting and shareholder power is extraordinary.¹⁴² A defensive measure with these effects that violates fundamental ideas of shareholder power (whose only justification is that it protects the shareholders from themselves) is not within the range of reasonableness.¹⁴³ Therefore, the Delaware Chancery Court was correct in ruling that the Toll Brothers complaint stated legally cognizable claims because the dead hand provision was an unreasonable defensive measure.¹⁴⁴

V. IMPACT

The Delaware Chancery Court's analysis of dead hand poison pills entails potentially far-reaching consequences for the market in corporate control.¹⁴⁵ The *Carmody* decision is important because Delaware, the corporate home to more than sixty percent of Fortune 500 companies, is considered to be the leader in corporate jurisprudence.¹⁴⁶ Shareholder

141. See Gordon, *supra* note 13, at 541 (stating that dead hand pill is preclusive because it makes hostile bid "realistically unattainable"). In fact, "[t]he acquirer's only alternative is to elect a partial slate of replacement directors, and to hope that this shareholder signal combined with the new directors' boardroom persuasiveness will change the minds of a sufficient number of continuing directors." *Id.* Otherwise no transaction will be possible. See *id.* (discussing preclusive effect of dead hand poison pills). The unsolicited transaction becomes possible only upon expiration of the poison pill. See *id.* Presumably a board could "refresh" the pill at any time before being voted out of office. See *id.* at 531 (noting ability of board to extend poison pill indefinitely). Such an action, including the duration of the pill, should be subject to separate scrutiny under *Unocal*. See *id.* at 541 (discussing appropriate standard of review for dead hand poison pills).

142. See *id.* at 542 (referring to dead hand pill's disenfranchisement effect, distortion of shareholder voting and inhibition of hostile bids as extraordinary).

143. See *id.* (discussing dead hand pill's lack of reasonableness); see also Lese, *supra* note 1, at 2207 (stating that preclusive and coercive characteristics of continuing director provisions are beyond "range of reasonableness" mandated by *Unitrin*).

144. See *Carmody v. Toll Brothers, Inc.*, No. 15983, 1998 WL 418896, at *13 (Del. Ch. July 24, 1998) (holding that complaint stated legally sufficient claim that dead hand provision violated *Unocal*).

145. See Gordon, *supra* note 13, at 511 (stating that use and limits of poison pill entail potentially far-reaching consequences for market in corporate control because use of poison pills "affects not only scenarios that emerge after making of a hostile bid, but pre-bid strategy as well, including initial decision whether to make bid").

Decisions upholding dead hand poison pills would have a devastating impact on the market for corporate control and would have large scale economic effects. See *id.* at 531 (discussing long-term effects of dead hand pills); Lese, *supra* note 1, at 2211 (stating that upholding dead hand poison pill would cause misallocation of control between board of directors and shareholders).

146. See Dennis J. Block & Jonathan M. Hoff, *Corporate Update: Mergers and Acquisitions*, NEW YORK L.J., Nov. 19, 1998, at 5 (recognizing Delaware's preeminence in corporate jurisprudence); Jef Feeley, *Dead Hand Pills Being Dropped*, NATIONAL L.J., Nov. 9, 1998, at B2 (noting approximate percentage of Fortune 500 companies incorporated in Delaware).

activists and institutional investors will focus on dead hand provisions as they work to persuade companies to remove or modify their poison pills.¹⁴⁷ In fact, as a result of *Carmody*, many corporations have removed the dead hand provision from their poison pills.¹⁴⁸ Otherwise, these companies would face a high risk of an expensive lawsuit over the validity of their dead hand provision.¹⁴⁹ In the meantime, it simply remains to be seen whether other states will follow the approach of the Delaware Court of Chancery, and rule that there is no life after death for corporate directors.¹⁵⁰

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147. See Thomas E.L. Dewey, *Loosening the Grip of the "Dead Hand"*, WALL ST. J., Aug. 24, 1998, at A12 (discussing impact of decision on shareholder activists and institutional investors).

For example, the "Teachers Insurance and Annuity Association College Retirement Equities Fund, a \$240 billion teachers' pension fund, . . . is combing its portfolio of 2,600 companies looking for those with dead hand provisions." See Feeley, *supra* note 146, at B2 (discussing assault on dead hand poison pills). Fund officials plan to put corporate resolutions seeking to drop the defense before shareholders of companies with dead hand pills. See *id.*

148. See Block & Hoff, *supra* note 146, at 5 (stating that many corporations have voluntarily amended their rights plans to eliminate dead hand provision following *Carmody*); Feeley, *supra* note 146, at B2 (stating that most of corporations that have dropped dead hand pill are registered in Delaware).

149. See Feeley, *supra* note 146, at B1 (discussing risks associated with dead hand poison pills).

150. See Dewey, *supra* note 147, at A12 (stating that *Carmody* may prove to be persuasive precedent in courts in other states due to influence of Delaware courts and forcefulness of court's opinion).