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THE POISON PILL: A PANACEA FOR THE HOSTILE CORPORATE TAKEOVER

The corporate community has recently been bombarded with a blitzkrieg of hostile takeover¹ activity.² This dramatic surge in takeover battles is a direct result of the myriad of coercive tactics that corporate raiders³ have developed and employed enabling them to gain control of virtually any corporation.⁴ Some of the most prolific weapons in the raider's arsenal include the partial tender offer,⁵ the creeping tender offer,⁶ the front-end loaded two tiered tender offer,⁷

1. A hostile takeover is an unsolicited attempt by a raider to acquire control of a subject company ("target") through acquisition of some or all of the target's outstanding shares. 1 M. LIPTON & E. STEINBERGER, TAKEOVERS & FREEZEOUTS § 1.01[1] (1987). "Most commonly, takeover bids are made directly to shareholders of the target as a cash tender offer or as an exchange offer of raider securities for target stock." *Id.*

2. Although takeover activity has increased dramatically over the last five years, mergers and acquisitions are by no means a new phenomenon. They trace back at least to 1897-1901, which is considered the first great merger movement in American history, followed by a second-wave in 1925-30, and the conglomerate mergers of the late 1960's. P. STEINER, MERGERS 1-6 (1975). "In the mid-1970's, the takeover game began to change, with fewer deals for stock, more for-cash or combinations of cash and stock, and some extremely large deals." Reiser, *Corporate Takeovers: A Glossary of Terms and Tactics*, 89 CASE AND COM. 35 (1984). Despite this earlier activity, however, it was not until the 1980's that the American corporate community experienced its first billion-dollar battles for corporate control. *Id.* "In 1983 [alone], the number of corporate mergers rose to over 2,500, the highest activity since 1974." *Id.* In 1985, the number of mergers climbed to 2,755 and by December 1, 1986, 2,806 mergers and buyouts worth nearly \$130 billion had already occurred that year. *Going After The Crooks*, TIME, Dec. 1, 1986, at 52, col. 3.

3. A raider is known for his "hostile" takeover attempts. *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1254 (S.D.N.Y. 1985).

4. See *infra* notes 5-9 for a detailed discussion of the various tactics that corporate raiders have employed to gain control of a target corporation.

5. In a partial tender offer, the raider makes an offer for less than all of the target's shares but does not state any intention to purchase the remaining shares. M. LIPTON & E. STEINBERGER, *supra* note 1, § 1.07[3]. "The obvious economic advantage of the partial tender offer, is that it requires less of a cash commitment by the offeror to acquire control of the target company." *Id.* § 1.07[3][b]. "The offeror may be willing to live with the minority shareholders, thus obviating the need for a second step [transaction]." *Id.* The "holders of the target's shares are, therefore, faced with the choice of accepting the takeover premium or risking abuse at the hands of the new majority shareholder, should the takeover bid succeed." Note, *Protecting Shareholders Against Partial And Two Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1967 (1984) [hereinafter Note, *Protecting Shareholders*]. "Although the costs of refusing to tender are defined less precisely in the case of partial tender offers than in that of two-tiered tender offers, the coercive effect is nonetheless substantial." *Id.*

6. A creeping tender offer occurs when a raider gradually buys enough stock to obtain control of a target. Reiser, *supra* note 2, at 36. The SEC Advisory Committee on Tender Offers considers such practice unfair to shareholders. *Id.* For further dis-

the bust-up or bootstrap bid⁸ and greenmail.⁹ Each ingenious strategy permits the raider to reap tremendous profits at the expense of the target corporation, its shareholders and its employees.¹⁰ In response to these hostile attacks, directors of target corporations have implemented an array of defensive measures¹¹ including shark repellants,¹² golden parachutes,¹³ white-squire arrangements,¹⁴ lock-up

ussion, see generally Note, *Developments In Corporate Takeover Techniques: Creeping Tender Offers, Lockup Arrangements and Standstill Agreements*, 39 WASH. & LEE L. REV. 1095 (1982).

7. In a front-end two-tiered bid, the raider makes a first-step cash offer for approximately half of the target's shares and then "squeezes out" the remaining shareholders in a lower priced "back-end" merger. Lipton & Brownstein, *Takeover Responses and Directors' Responsibilities-An Update*, 40 BUS. LAW 1403, 1412 (1985). "Because shareholders fear being caught in the second, less lucrative tier of the squeezeout merger, they are driven into tendering in the first tier." *Id.* "The two-tiered system thus coerces target shareholders into tendering at a higher rate." *Id.* See also Brudney & Chirelstein, *Fair Shares In Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 336-40 (1974); Note, *Two-Tiered Tender Offers And The Poison Pill: The Propriety Of A Potent Takeover Defense*, 17 PAC. L.J. 891, 894-95 (1986) [hereinafter Note, *Potent Takeover Defense*].

8. A bootstrap bid, typically used by a raider with limited financial resources, refers to a situation in which the raider seeks to finance an acquisition by selling off pieces of the acquired company. See M. LIPTON & E. STEINBERGER, *supra* note 1, § 1.04[8]. See also Lipton and Brownstein, *supra* note 7, at 1411-12.

9. Greenmail refers to a raider acquiring a large portion of a target's stock, threatening a takeover, and then selling the shares back to the company at a highly inflated price. Reiser, *supra* note 2, at 44. In short, it is a form of corporate blackmail. *Id.* For further discussion, see Lipton & Brownstein, *supra* note 7, at 1413-14.

10. See Lowenstein, *Pruning Deadwood In Hostile Takeovers: A Proposal For Legislation*, 83 COLUM. L. REV. 249, 307 (1983) (asserting that corporate raiders are exploiting the unequal bargaining position of the target shareholders); Rosenzweig and Orens, *Tipping The Scales—The Business Judgment Rule in the Anti-Takeover Context*, 14 SEC. REG. L.J. 23, 34 (1986) (asserting that every raider is operating to make a profit).

11. A defensive measure may take one of two forms. "First the [measure] may be responsive and possible only after an offer is made." Note, *Potent Takeover Defense*, *supra* note 7, at 892 n.8. "Second, a defensive [measure] may also be a precautionary measure taken by a corporation that is fearful of becoming a target." *Id.* For a detailed discussion of the various defense options available to a target faced with a hostile takeover bid, see 1 A. FLEISCHER, *TENDER OFFERS: DEFENSES, RESPONSES AND PLANNING* 103-48, 291-387 (1983).

12. Shark repellent provisions were one of the earliest defensive tactics employed by potential targets to discourage takeover bids. Wander & LeCoque, *Boardroom Jitters: Corporate Control Transactions and Today's Business Judgment Rule*, 42 BUS. LAW. 29, 44 (1986) [hereinafter *Today's Business Judgment Rule*]. These provisions are designed to make the corporation less vulnerable to a hostile takeover by making it more difficult for a raider to obtain control of the corporation. *Id.* Examples of such provisions include: staggered terms for the board of directors, supermajority provisions, cumulative voting, and fair price amendments. *Id.* When directors "have attempted to enact these provisions without shareholder approval, however, the courts generally have not responded favorably." *Id.* See, e.g., *Joseph E. Seagram & Sons v. Conoco, Inc.*, 519 F. Supp. 506, 514 (D. Del. 1981). *But see* *Treco, Inc. v. Land of Lincoln Savings & Loan*, 572 F. Supp. 1451, 1460 (N.D. Ill. 1983) (directors' amendment of by-laws, to increase percentage of shareholder-vote required to amend by-laws, upheld as within protections of business judgment rule). For a more complete discussion of shark repellents, see generally WINTER, STUMPF & HAWKINS, *SHARK REPELLENTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTI-*

arrangements,¹⁵ defensive repurchases,¹⁶ fair price amendments,¹⁷ the Jonestown defense,¹⁸ and the Pac-Man defense.¹⁹ These tactics are adopted in order to defeat what the target's directors consider an insufficient bid, or to oppose a tender offer²⁰ that they perceive as

TIONER (1983).

13. Golden Parachutes are executive employment contracts which contain provisions that give huge salary or severance payouts to top management should a hostile takeover attempt succeed. Reiser, *supra* note 2, at 40. Such provisions protect key people in management from quitting during a takeover battle or from being fired after the company is acquired. *Id.* "The rationale for these agreements is that they allow executives of the company to perform their duties in the best interests of the company without worrying about how the outcome of a hostile takeover will affect their jobs and compensation." *Today's Business Judgment Rule*, *supra* note 12, at 58.

14. A white squire arrangement is when a target company issues its stock to a group or entity that is friendly to the board (a "white squire"). *Today's Business Judgment Rule*, *supra* note 12, at 51. "Examples of white squires include subsidiaries of the target, employee stock ownership plans, and persons friendly to the target." *Id.*

15. "A lock-up is a defense tactic designed to inhibit or deter competition from third parties by providing a favored party with a percentage of ownership or voting control of a target company." Hoenig, *Corporations II: Takeovers And Defensive Tactics*, ANN. SURV. OF AM. LAW 73, 75 (1985). "While a lock-up may take many forms, it generally involves a consummated or executory stock purchase, an option to purchase stock, or an option to purchase the target company's most valuable asset or "crown jewel" upon the triggering of a certain event, such as the acquisition of a set percentage of the target's shares by a hostile raider." *Id.* For further discussion, see *Today's Business Judgment Rule*, *supra* note 12, at 51-56.

16. "In order to prevent the raider from acquiring control, the target may repurchase its own shares on the open market. The repurchase not only removes available shares from the market, but also causes the target's stock price to increase, resulting in a greater acquisition cost for the raider." Note, *Anti-Takeover Maneuvers: Developments in Defense Tactics and Target Actions for Injunctive Relief*, 35 Sw. L.J. 617, 628 (1981). "If the shares are merely held as treasury stock, however, the target's outstanding stock is decreased and the raider must acquire a proportionately less amount to obtain control." *Id.* Hence, the target corporation should use the repurchased shares for valid corporate programs such as pension or employee stock plans. *Id.* For a further and more complete discussion, see generally Bradley & Rosenzweig, *Defensive Stock Repurchases*, 99 HARV. L. REV. 1378 (1986); Israels, *Limitations on the Corporate Purchase of Its Own Shares*, 22 Sw. L.J. 755 (1968).

17. "A fair price amendment to a corporate charter generally requires supermajority approval for certain business combinations and sets minimum price criteria for mergers." *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1349 n.3 (Del. Super. Ct. 1985).

18. The Jonestown defense occurs when a target company implements suicidal tactics, such as liquidation, to avoid being taken over by a raider. Reiser, *supra* note 2, at 44. This defense is "[n]amed after [the] Rev. Jim Jones, who ordered members of his cult to drink ... Kool-Aid laced with cyanide as a defense against a congressional investigation." *Id.*

19. "The 'Pac-Man' defense is generally a target company countering an [un solicited] tender offer by making its own tender offer for stock of the would-be acquiror." *Moran*, 500 A.2d at 1350 n.6. In essence, the target is attempting to gain control of the raider before the raider gains control of the target. *Id.* Thus far, courts have sustained this defense as within the protection of the business judgment rule and have determined that it is not manipulative under section 14(e) of the Williams Act. See, e.g., *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982) (target company's tender offer not manipulative, even if deliberately made to inhibit offeror's tender offer).

20. A tender offer is a publicly made invitation, addressed to all of the target's

contrary to the firm's best interests.

One of the newest, most innovative, and effective defensive weapons against a hostile takeover²¹ is the poison pill.²² The poison pill, which exists in a variety of forms,²³ is generally designed to make a takeover prohibitively expensive through the issuance of a special class of stock or rights as a dividend (the "poison pill"), which the raider must "swallow" to acquire control of the target.²⁴ Additionally, the poison pill may create uncertainties regarding the ultimate success and cost of a transaction, may deter partial bids and market accumulations by providing benefits to stockholders other than the raider, and may increase the directors' bargaining power against a corporate raider.²⁵ Because the poison pill is enacted without shareholder approval,²⁶ courts are divided as to the validity

shareholders, to tender their shares for sale at a specified price. Note, *Potent Takeover Defense*, *supra* note 7, at 893. Generally, cash or other securities are offered to the shareholders as consideration for their shares and such consideration usually represents a premium over the current market price of the target's stock. *Id.* Additionally, the Securities and Exchange Commission has formulated an eight factor test designed to guide the courts in determining what constitutes a tender offer. The factors are: (1) an active and widespread solicitation of the target's shareholders; (2) the "solicitation is 'for a substantial percentage of the issuer's stock,'" (3) the "offer to purchase is at a premium" over the existing market price; (4) the "terms of the offer are 'firm rather than negotiable'" (5) the "offer [is] 'contingent on the tender of a fixed minimum number of shares'"; (6) the "offer is 'open for only a limited period of time'"; (7) the "offerees are subjected to pressure to sell their stock;" (8) "public announcements of a purchasing program ... precede or accompany a rapid accumulation" of large amounts of the target company's stock. *Brascan Ltd. v. Edper Equities Ltd.*, 477 F. Supp. 773, 791 n.13 (S.D.N.Y. 1979). Most courts apparently have accepted these criteria. See, e.g., *S.E.C. v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 950 (9th Cir. 1985) (applying eight factors to find no tender offer); *Milstein v. Huck*, 600 F. Supp. 254, 263 (E.D.N.Y. 1984) (applying eight factor test to non-conventional tender offers). For a more detailed discussion of tender offers, see generally *Andre, Unconventional Offers Under The Williams Act: The Case For Judicial Restraint*, 11 J. CORP. L. 499 (1986).

21. There are two polar positions in the debate concerning hostile takeovers. *Dynamics Corp. of America v. CTS Corp.* 794 F.2d 250, 253 (7th Cir. 1986) [hereinafter *Dynamics Corp. I*]. "One views hostile takeovers as a bad thing, on a variety of grounds such as [the fact] that they make managers of companies that are potential targets of takeover bids worry too much about short-term financial results and the fact that they promote absentee ownership and control." *Id.* "The other pole is that all resistance to takeover attempts is bad ... [because] [t]he market price of publicly traded stock impounds all available information [concerning] the value of the stock, and anyone who offers a higher price ... thereby offers an unequivocal benefit to the shareholders of the target firm" *Id.*

22. The poison pill, which was invented by Martin Lipton, has been adopted by more than 300 major American corporations. *Legal Times*, Nov. 17, 1986, at 14, col. 1.

23. See *infra* notes 32-73 and accompanying text for a detailed discussion of the various types of poison pills.

24. See SEC Office of Chief Economist, *A Study in the Economics of Poison Pills*, [1985-1986] Fed. Sec. L. Rep. (CCH) 83,971 (March 5, 1986) [hereinafter *Economics of Poison Pills*].

25. *Fleischer & Golden, Poison Pill*, NAT'L L.J. Feb. 24, 1986, at 17, col.2.

26. "In this regard, several companies have recently timed the announcement of the adoption of a poison pill in close proximity to the annual shareholders' meeting to

of the poison pill, as well as the directors' authority to implement it.²⁷

Part I of this Comment discusses the variety of available poison pill plans and their effectiveness in deterring hostile takeovers.²⁸ Part II analyzes both the Delaware and Illinois corporation statutes and concludes that each grants a target corporation's directors the requisite authority to implement a poison pill plan.²⁹ Part III considers state fiduciary law and argues that generally, under the traditional business judgment rule, the directors' issuance of a poison pill should not constitute a breach of their fiduciary duty to the shareholders.³⁰ In conclusion, Part IV of this Comment demonstrates that if properly implemented, the poison pill not only deters those tender offers that management considers to be in direct opposition to the target's best interests but also enables the shareholders to realize increased profits on the tender of their stock.³¹

obviate the risk of a proxy contest at an annual meeting." *Today's Business Judgment Rule*, *supra* note 12, at 46 n.71.

27. See *Dynamics Corp. of America v. CTS Corp.*, 635 F. Supp. 1174 (N.D. Ill. 1986), *modified*, 638 F. Supp. 802 (N.D. Ill. 1986), *rev'd in part, vacated in part, and remanded with directions*, 805 F.2d 705 (7th Cir. 1986) [hereinafter *Dynamics Corp. II*] (holding that the CTS's second rights plan was plausibly related to the goal of shareholder wealth maximization as required by Delaware law); *Moran v. Household Inc.*, 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, Int'l 500 A.2d 1346 (Del. Super. Ct. 1985) (holding that the directors adopted the poison pill plan pursuant to statutory authority and that the plan did not strip shareholders of their rights to receive tender offers); *Huffington v. Enstar Corp.*, C.A. No. 7543, slip op. (Del. Ch. Apr. 18, 1984) (LEXIS, States library, Del. file) (holding that the poison pill amendments enacted by the directors when takeover fever gripped the industry could be considered legitimate exercises of discretion designed to protect the stockholders against a less than arms-length sale). *But see Dynamics Corp. I*, 794 F.2d 250 (7th Cir. 1986) (holding that CTS's poison pill plan allowed management to take shareholders hostage and therefore was properly enjoined); *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229 (S.D.N.Y. 1986) (holding that poison pill plan impermissibly prevented shareholders from receiving tender offers); *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) (holding that board exceeded its authority as matter of New Jersey law when it adopted poison pill plan); *Unilever Acquisition v. Richardson-Vicks*, 618 F. Supp. 407 (S.D.N.Y. 1985) (holding that because poison pill plan reduced transferability of shares and shareholders' ability to vote, it required shareholder approval which had not been obtained); *Asarco Inc. v. Court*, 611 F. Supp. 468 (D.N.J. 1985) (holding that directors lack power under New Jersey law to issue classes of shares which have differing voting rights within the same class or to modify previously issued classes of shares so as to confer different voting rights upon shares within that class).

28. See *infra* notes 32-73 and accompanying text for a detailed discussion of the various types of poison pills.

29. See *infra* notes 74-123 and accompanying text for a detailed analysis of both the Delaware and Illinois corporation statutes.

30. See *infra* notes 124-42 and accompanying text for a detailed discussion of the business judgment rule.

31. See *infra* notes 143-58 and accompanying text for an example of the effectiveness of a properly implemented poison pill plan.

I. POISON PILL PLANS

In June of 1983, Lenox, Inc. introduced the original poison pill plan, commonly referred to as the convertible preferred stock dividend plan ("preferred dividend plan").³² Under this plan, the target corporation issues convertible preferred stock as a pro rata dividend to all holders of its common stock.³³ This preferred dividend possesses special redemption and conversion features. If a raider acquires a certain percentage of the target's voting stock³⁴ and does not consummate a second step merger within a specified period of time, the redemption privilege entitles all holders of the preferred dividend, other than the raider, to redeem those shares for cash.³⁵ The redemption price equals the highest price that the raider paid for the target's stock within a given period of time.³⁶ Moreover, in the event of a second step freeze out merger, the conversion privilege permits all preferred dividend holders, other than the raider, to convert that preferred stock into an equal amount of preferred stock of the raider. This stock in turn is convertible into shares of the raider's common stock having a value at the time of conversion equal to the highest price paid by the raider for the target's shares.³⁷ Thus, the redemption and conversion privileges allow shareholders to decline tendering their shares yet still receive the tender offer

32. In response to Brown-Forman Distillers Corporation's takeover attempt, Lenox, Incorporated issued convertible preferred stock as a dividend to its shareholders. WINTER, STUMPF & HAWKINS, *supra* note 12, at 395-96. The terms of this preferred stock provide that upon a second stage business combination, the preferred stock is convertible into shares of the acquiror's voting common stock. *Id.* at 346. To deter takeover attempts, the preferred stock was designed so that if fully converted upon a business combination, holders of existing control blocks of the acquiror would suffer significant dilution. *Id.* In addition, the conversion price guarantees the target's shareholders that they will not receive less than the price paid in the first stage of the tender offer. *Id.*

33. See *Telvest, Inc. v. Olsen*, C.A. No. 5798, slip op. (Del. Ch. March 5, 1979) (LEXIS, States library, Del. file) (holding that a convertible preferred stock dividend must be issued to shareholders on pro rata basis).

34. Usually the raider must acquire between 20 and 30% of the target's stock before the preferred dividend holders can exercise their special redemption and/or conversion privileges. See 5 BALOTTI & FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* 318 (Supp. 1986). *But see* *National Education Corp. v. Bell & Howell Co.*, C.A. No. 7278, slip op. (Del. Ch. Aug. 25, 1983) (LEXIS, States library, Del. file) (preferred dividend holders' conversion and/or redemption privileges did not become exercisable until raider acquired 40% or more of target's outstanding stock).

35. See BALOTTI & FINKELSTEIN, *supra* note 34, at 318. See also Lipton & Brownstein, *supra* note 7, at 1422-23.

36. Note, *Protecting Shareholders*, *supra* note 5, at 1965. "The redemption price is the greater of either the highest price paid for the target's common stock multiplied by the number of common shares into which one preferred share is convertible or the highest price paid for the target's preferred stock" within a one year period. *Id.* at 1965 n.4. "Thus, the redemption price should usually be the same as the tender offer price." *Id.*

37. See Lipton & Brownstein, *supra* note 7, at 1422-23.

price in cash, or its equivalent, if the tender offer succeeds, thereby neutralizing the coercive effects of partial, two-tiered and bootstrap offers.³⁸

Although the preferred dividend plan effectively deters partial, two-tiered and bootstrap takeover attempts, it is not a "show stopper."³⁹ For example, the plan will not inhibit the raider who is willing to acquire all or most of the target's outstanding shares of stock at a fair price.⁴⁰ Further, if the tender offer succeeds, the raider will effectively control the corporation and may eliminate the preferred stock's conversion and redemption features by charter amendment.⁴¹ Some stockholders, however, may refuse to tender their shares in the hope that the takeover attempt will fail. Nevertheless, the holders of these few remaining untendered shares cannot substantially dilute the raider's control of the target so as to ward off a hostile takeover.⁴²

A. The "Springing" Voting Rights Plan

The most controversial and legally vulnerable poison pill plan is the "springing" voting rights plan.⁴³ Under this variant of the pre-

38. See M. LIPTON & E. STEINBERGER, *supra* note 1, § 6.03[3] (asserting that the preferred dividend can be designed to protect shareholders against being frozen out in an unfair second-step merger following a front-end loaded tender offer, enable those shareholders who wish to reject a tender offer and retain their equity interest to do so without loss of liquidity, remove the ability of a raider to stampede the shareholders of a target into tendering their shares in order to protect themselves against loss of the premium or being locked into a minority position, and protect against partial tender offers by bootstrap raiders who do not intend a second step until they can accomplish it using the assets of the company).

39. A "show stopper" refers to a poison pill plan which effectively precludes all hostile takeovers. See *Today's Business Judgment Rule*, *supra* note 12, at 47. Courts have typically enjoined these types of plans because they "allow management to take the shareholders hostage." *Id.*

40. See Note, *Protecting Shareholders*, *supra* note 5, at 1967 (asserting that "a bidder willing and able to acquire 65% of the [target—50% of] the common plus 80% of the preferred stock—can take absolutely any action it wants.").

41. *Id.*

42. If, however, the raider is not willing or able to purchase all or substantially all of the preferred stock there is no way to prevent nontendering shareholders from diluting the raider's ownership power. *Id.* at 1968. For example, if Brown-Forman acquired a controlling interest in Lenox, see *supra* note 32, conversions of Lenox preferred into Brown-Forman common had the potential to reduce the Brown family's control of Brown-Forman from 62% to approximately 30%. See *Wall St. J.*, June 16, 1983, at 2, col. 2.

43. See, e.g., *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407 (S.D.N.Y. 1985) (enjoining the Richardson-Vicks board's springing voting rights plan because under Delaware law, a change in corporate structure of the magnitude caused by the plan, reducing the transferability of a shareholder's ability to vote and the value of his asset, requires shareholder approval, which was not obtained); *Asarco Inc. v. Court*, 611 F. Supp. 468 (D.N.J. 1985) (enjoining Asarco's springing voting rights plan because under New Jersey law a target's directors lack the authority to issue classes of shares which have differing voting rights within the same class or

ferred dividend plan, the target issues non-voting preferred stock as a pro rata dividend to the holders of its common stock.⁴⁴ If a raider subsequently acquires more than a certain percentage of the target's voting stock, all holders of the preferred dividend, other than the raider, are entitled to one or more votes for each share held.⁴⁵ This plan substantially reduces the raider's voting power rendering him unilaterally unable to gain control of the company.⁴⁶ Moreover, because shareholder votes are required in both proxy contests and merger approvals, the springing voting rights plan is an extremely potent pill.⁴⁷

B. The "Flip-Over" Share Purchase Rights Plan

The "flip-over" share purchase rights plan is probably the most common form of poison pill plan in use today.⁴⁸ Under this plan, the target corporation issues "rights" to purchase either common or preferred stock, as a pro rata dividend to its shareholders.⁴⁹ The exercise price of these rights is set substantially higher than the stock's

which modify previously issued classes of shares so as to confer different voting rights upon shares within that class).

44. See *supra* note 33.

45. See, e.g., *Unilever Acquisition Corp.*, 618 F. Supp. at 408 (each holder of the preferred shares was entitled to cast 25 votes per share on all issues on which the common could vote); *Asarco Inc.*, 611 F. Supp. at 471 (once any person or group became the owner of more than 20% of Asarco's stock, then each 1/10 share of the preferred stock, owned by anyone other than the acquiror, would have five votes in all matters submitted to the common stockholders); *Di Rocco v. Roessner*, No. 8107, slip op. (Del. Ch. Aug. 12, 1985) (LEXIS, States library, Del. file) (the new preferred stock was entitled to one vote per share but if any person became the beneficial owner of more than 5% of the new preferred stock or more than 15% of the outstanding voting shares of Cityfed, he was entitled to cast only 1/100th of a vote for each share of the new preferred stock in excess of those percentages).

46. Another variant of the poison pill preferred dividend plan which also substantially reduces the raider's voting power is the supermajority voting rights plan. See *Telvest, Inc. v. Olson*, C. A. No. 5798, slip op. (Del. Ch. March 5, 1979) (LEXIS, States library, Del. file). Under this plan, preferred stock is issued as a dividend to the target's common shareholders. *Id.* at 5. Once a raider acquires 20% or more of the target's stock, the holders of the preferred dividend become entitled to vote as a class and the affirmative vote of the holders of not less than 80% of the outstanding preferred stock shall be required for the approval or authorization of any business combination. *Id.* at 6. Hence, the sole effect of a supermajority voting rights plan is to raise the percentage required to approve certain mergers. For a discussion on the validity of the supermajority voting rights plan, see *infra* notes 97-106 and accompanying text.

47. See *Economics of Poison Pills*, *supra* note 24, at 88,045.

48. *Today's Business Judgment Rule*, *supra* note 12, at 45.

49. See e.g., *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229 (S.D.N.Y. 1986); *Dynamics Corp. I*, 637 F. Supp. 406 (N.D. Ill. 1986), *aff'd*, 794 F.2d 250 (7th Cir. 1986); *Crown Zellerbach Corp. v. Goldsmith*, 609 F. Supp. 187 (S.D.N.Y. 1985); *Horwitz v. Southwest Forest Indus., Inc.*, 604 F. Supp. 1130 (D. Nev. 1985); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. Super. Ct. 1985). See also *Lipton & Brownstein*, *supra* note 7, at 1424.

current market price.⁵⁰ Furthermore, the flip-over plan allows the target corporation to redeem the rights at a nominal price at any time before a fixed number of days following a raider's acquisition of a specified percentage of its stock.⁵¹ Unless redeemed, the rights typically extend for five to ten years.⁵²

Upon the occurrence of a "triggering event," the rights become exercisable, separate certificates representing the rights are issued to all shareholders, and the rights are then capable of being traded separately from the common stock.⁵³ In the event of a merger or other business combination transaction after the rights are exercisable, the flip-over provision of the poison pill entitles all holders of the dividend, other than the raider, to purchase, for the exercise price, common stock of the raider with a fair market value equal to twice that of the exercise price.⁵⁴ This flip-over results in severe dilution of the raider's stock.⁵⁵

The flip-over plan, however, like the preferred dividend plan,⁵⁶ does not effectively prohibit all hostile takeovers. For example, this plan does not compel a raider to accomplish a second step acquisition because the rights flip-over only in the event of a merger or other business combination transaction.⁵⁷ Further, despite the plan,

50. The exercise price is typically set at a price that conservatively approximates management's view of the stock value in five or ten years. See Lipton & Brownstein, *supra* note 7, at 1424. This price ranges anywhere from 200 to 300% of the current market price of the target's stock. *Id.* Furthermore, because the exercise price of the rights is "out of the money" when issued, the rights do not dilute the target's earnings per share and historically have not had any materially negative impact on the market price of the company's common stock. BALOTTI & FINKELSTEIN, *supra* note 34, at 323.

51. See, e.g., *Crown Zellerbach Corp.*, 609 F. Supp. at 188 (rights were redeemable at 50¢ per right during the period from the date that they are first exercisable to the date of their expiration); *Horwitz*, 604 F. Supp. at 1132 (target's rights redeemable for the nominal price of 25¢ each); *Moran*, 500 A.2d at 1349 (rights were redeemable by the board for 50¢ per right).

52. See Lipton & Brownstein, *supra* note 7, at 1424.

53. Typically, there are two triggering events that can activate the rights. The first is the announcement of a tender offer for 30% of the target's shares and the second is the acquisition of 20% or more of the target's shares by any simple entity or group. See *Amalgamated Sugar Co.*, 644 F. Supp. at 1229; *Crown Zellerbach Corp.*, 609 F. Supp. at 188; *Horwitz*, 604 F. Supp. at 1132; *Moran*, 500 A.2d at 1348. *But see Dynamics Corp. I*, 637 F. Supp. 406, 407 (N.D. Ill.) *aff'd*, 794 F.2d 250 (7th Cir. 1986) (flip-over provision occurred upon the acquisition of target in a merger, business combination, or the sale of all or the majority of its assets); *R.D. Smith & Co., Inc. v. Preway*, No. 86-C-641-C, slip op. (W.D. Wis. 1986) (LEXIS, Genfed library, Dist. file) (flip-over provision is triggered if target is acquired by or merged into another company, or if target's assets or earning power are sold while there is a 25% shareholder).

54. For example, the rights holder can exercise each right to purchase \$200 of the common stock of the tender offeror for \$100. See *Moran*, 500 A.2d at 1349. Thus, the effect of this type of rights plan is to enable the holders of the rights to purchase shares of the acquiror's common stock at a 50% discount.

55. See *Economics of Poison Pills*, *supra* note 24, at 88,044.

56. See *supra* notes 32-42 and accompanying text.

57. *Fleischer & Golden*, *supra* note 25, at 26, col. 1

a hostile raider can also acquire control of a firm with a creeping acquisition strategy as did Sir James Goldsmith in taking control of Crown Zellerbach.⁵⁸ Moreover, the flip-over plan does not deter a proxy contest and may even fail to prevent a merger if the raider acquires a substantial number of rights.⁵⁹ Basically, the flip-over plan is only effective if the raider accomplishes or must accomplish a second-step acquisition. In that event, the raider's rights become void and he suffers a substantial dilution of his stock. This threat of substantial dilution may also deter a raider from attempting a bust-up or bootstrap bid.⁶⁰

C. The "Flip-In" Rights Plan

In an effort to limit the corporate raider's ability to circumvent the flip-over plan, target corporations' directors have implemented a "flip-in" provision in conjunction with the flip-over plan.⁶¹ This type of poison pill generally contains two types of flip-in provisions. The self-dealing flip-in provision provides that if the raider engages in one or more self-dealing transactions⁶² with the target after a triggering event has occurred, the rights become exercisable for the target's common stock having a market value equal to twice that of the exercise price.⁶³ If a raider acquires a certain percentage of the target's common stock, the percentage-based flip-in provision enables the holders of the rights to purchase, at the exercise price, shares of

58. Sir James Goldsmith acquired over 50% of Crown Zellerbach's shares on the open market and took control of the board of directors. *Economics of Poison Pills*, *supra* note 24, at 88,044 n.2. He was able to negotiate the sale of most of Zellerbach's assets, because the Zellerbach poison pill plan did not prohibit such sales. *Id.* Subsequent poison pill plans, however, have not permitted such sales. *Id.*

59. Even if the raider acquires 90% of the rights, the SEC has determined that the bidder would have to pay premiums of between 18 and 36% of the target's market value to accommodate the exercise of the remaining 10% of the rights. *Id.* at 88,045. Clearly, this is a serious deterrent.

60. Bust-up or bootstrap bids are used almost exclusively by corporate raiders who lack an abundance of financial resources. *See supra* note 8. Hence, any threat of dilution of their paltry financial base will likely deter such hostile raiders.

61. *See, e.g., Dynamics Corp. I*, 637 F. Supp. 406 (N.D. Ill. 1986), *aff'd*, 794 F.2d 250 (7th Cir. 1986); *Amalgamated Sugar Co. v. NL Indus.*, 644 F. Supp. 1229 (S.D.N.Y. 1986); *R.D. Smith & Co., Inc. v. Preway, Inc.*, No. 86-C-641-C, slip op. (W.D. Wis. 1986) (LEXIS, Genfed library, Dist. file).

62. What constitutes a self-dealing transaction is usually defined in the rights agreement itself.

63. *See, e.g., R.D. Smith & Co., Inc.*, No. 86-C-641-C, slip op. (if a 25% or more shareholder engages in a self-dealing transaction with the company, the flip-in provision is triggered and the rights of all shareholders except the 25% shareholder flip-in to an entitlement to purchase common stock of the company with a value equal to twice the exercise price); *Moravek v. FNB Bancorp, Inc.*, No. 86 C 4571, slip op. (N.D. Ill. July 9, 1986) (LEXIS, Genfed library, Dist. file) (shareholders may purchase additional shares of FNB stock at a discount if any entity or individual acquires more than 15% of FNB's outstanding stock).

the target having a fair market value of twice that amount.⁶⁴ Flip-in plans that contain one or both⁶⁵ of the flip-in provisions prohibit the raider, who caused the rights to separate from the target's common stock, from exercising his rights.⁶⁶

In addition, the raider will suffer a significant dilution of both his economic and voting interests because the self-dealing and percentage-based flip-in provisions grant shareholders the right to purchase additional target stock at a discount.⁶⁷ These provisions, then, severely penalize the raider who acquires a controlling interest in the target without effecting a second step merger. Under the flip-in plan, the target's shareholders are also protected from the raider who attempts to obtain effective control of the target and who then attempts to "freeze-out" the remaining shareholders in a second step merger.⁶⁸ Consequently, when combined with the share purchase rights plan, the flip-in pill will effectively deter all coercive,

64. See, e.g., *Amalgamated Sugar Co.*, 644 F. Supp. at 1232 (if NL Industries was the surviving entity in a merger with a 20% shareholder and if any one of numerous business transactions occurred or if an acquiring person's stake or the 20% shareholder's stake in NL was increased by 1% the flip-in provision came into play and all rights holders, except the acquiring person were entitled to purchase \$100 worth of NL common stock for \$50, and the acquiring person's rights became void).

65. The poison pill plan adopted by Preway, for example, contained both a self-dealing flip-in provision and a percentage based flip-in provision. See R.D. Smith & Co. v. Preway, Inc., No. 86-C-641-C, slip op.(W.D. Wis. 1986) (LEXIS, Genfed library, Dist. file).

66. This provision is necessary for the flip-in provision to accomplish its purpose. If the raider was not excluded from participation, the flip-in provision would have no deterrent value and would amount to no more than a massive stock split. See Fogg & Sterling, *Stockholder Rights Plans: The So-Called "Poison Pill"*, in *ACQUISITIONS AND MERGERS* 821 (1986).

67. For example, in *Dynamics Corp. I*, 637 F. Supp. 406, 407 (N.D. Ill.), *aff'd*, 794 F.2d 250 (7th Cir. 1986), *Dynamics Corp.*, a 9.7% shareholder in CTS announced a tender offer for up to 1,000,000 CTS shares. *Id.* In response, the CTS board adopted a poison pill plan which contained both a flip-in and flip-over provision. *Id.* Under the flip-in provision, CTS shareholders received a dividend distribution of one right per share. *Id.* When any person or group acquired 15% or more of CTS common stock, the flip-in provision occurred and all holders of the CTS stock, other than the acquiror, were entitled to purchase a unit of CTS securities, consisting of a fractional share of CTS common stock and debentures for a 25% discount. *Id.*

According to the terms of its offer, DCA was required to purchase 1,000,000 shares of CTS stock. *Id.* Upon so doing, DCA would have held 1,544,600 of the 5,650,800 outstanding shares of CTS Corp. stock, or 27.5%. After the flip-in provisions were triggered, however, 1,849,000 flip-in shares and up to \$80,000 in debentures would be issued to all other shareholders. *Id.* Assuming all other CTS Corp. shareholders would have exercised their right, Dynamics Corp. would then own 1,554,600 or 7,499,800 shares, or 20.7% of CTS whose own value would be decreased because of the new debt issue. *Id.* According to CTS's own calculations in adopting the plan, this dilution would have imposed an economic loss of approximately 24 million dollars on Dynamics Corp. if it completed its acquisition. *Id.*

68. If the raider attempts to "squeeze out" the minority shareholders in a second step merger by offering them an inequitable price for their stock, the stockholders can exercise their "rights" and purchase shares of the target at a discount, thereby diluting the raider's ownership interest in the target. See, e.g., *Dynamics Corp. I*, 637 F. Supp. at 406.

underpriced tender offers.

D. The "Back-End" Rights Plan

The "back-end" rights plan⁶⁹—sometimes called a note purchase rights plan or fair price rights plan—grants a target's shareholders the right, upon the occurrence of a triggering event, to put their common shares to the target in exchange for a package of securities having a current market value in excess of the current market value of the target's common stock.⁷⁰ The back-end plan is probably the most prohibitive defense to hostile takeovers because once implemented, the back-end plan makes it virtually impossible to acquire a company at less than the target management's stipulated price.⁷¹ Further, the back-end plan guarantees that the target's

69. Back-end rights differ from share purchase rights in three significant ways: (1) back-end rights enable the holder to "put" common stock to the company in exchange for a fixed amount of debt, rather than enabling the holder to purchase additional common stock upon the payment of a fixed exercise price; (2) the value of the consideration issued in exchange for the common stock usually reflects the board's estimation of the corporation's current rather than long-term intrinsic value; and (3) the right to exchange common stock for notes is usually limited to a brief period of time. See BALOTTI & FINKELSTEIN, *supra* note 34, at 324.8.

70. For example, in *Dynamics Corp. II*, 805 F.2d 705 (7th Cir. 1986), after its first poison pill plan was enjoined, see *Dynamics Corp. I*, 794 F.2d 250 (7th Cir. 1986), CTS Corp. instituted a new shareholder rights plan under which each CTS shareholder received a dividend of a right to exchange shares of CTS stock of one-year notes with a principal amount of \$50 and bearing interest at 10% per annum. The rights become exercisable and trade separately from CTS common stock only if a person or group acquires beneficial ownership of 28% or more of CTS common stock, and will be distributed to all CTS shareholders, other than the acquiror, five days after the date of the triggering event. *Id.* at 707. Distribution of the rights is postponed for 120 days if an acquiring person purchases 28% pursuant to a publicly announced intention to buy all outstanding CTS shares for \$50 or more in cash, and the rights are completely extinguished if such a sale is completed within the plan. *Id.* At any time prior to the distribution event or a fully negotiated sale, the CTS Corp. may have the rights for 5¢ per share. *Id.* See *Minstar Acquiring Corp. v. AMF, Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985) (when a person or group acquired 30% or more of AMF common stock without having proposed a plan to acquire all the remaining shares on terms which are deemed fair by the AMF board, each right entitled the holder to exchange one share of AMF common stock for a "unit" comprised of 1/2 of a share of a new series of AMF stock and \$5 and 75¢ principal share of 14.5% subordinated debentures due in 1995); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 177 (Del. Super. Ct. 1986) (each right entitled the holder to exchange one common share of Revlon stock for a \$65 principal Revlon note at 12% interest, whenever anyone acquired beneficial ownership of 20% or more of Revlon's shares, unless the purchaser acquired all the company's stock for cash at \$65 or more per share); *Edelman v. Phillips Petroleum*, Nos. 7899:7972, slip op. (Del. Ch. June 3, 1986) (LEXIS, States library, Del. file) (after a person or group acquires 30% or more of Phillips' common stock, the rights permit the holder to "put" each share of common stock to the company in exchange for one year 15% Senior Notes with a principal amount of \$62).

71. *Economics of Poison Pills*, *supra* note 24, at 88,045. Back-end plans are almost never adopted prior to the commencement of a control contest because they place a price on the company when no sale is planned. BALOTTI & FINKELSTEIN, *supra* note 34, at 324.8.

shareholders will receive a preselected fair price for all their shares if the raider fails to consummate a second step merger within a specified time after a change of control.⁷²

The back-end plan, then, adds a deterrent lacking in a flip-over plan, to a raider who intends to gain control of the target without formally combining the companies.⁷³ Moreover, if a raider consummates a second step merger, but at less than the preselected price, the back-end plan entitles the stockholders to the difference between the fair price and the price that is actually paid. Thus, the back-end plan gives the target's board of directors the power to ensure their shareholders that they will receive the fair value of their investment in the company in the event of an inadequate, coercive, two-tiered bid.

II. STATE CORPORATION ACTS

Regardless of its form, the starting point for any inquiry concerning the validity of a target's poison pill plan is the business corporation act of the state of the target's incorporation. The law of the state of incorporation ordinarily determines the rules that govern the "internal affairs" of a corporation.⁷⁴ Because Delaware law so liberally governs a corporation's internal affairs, the vast majority of this nation's large, publicly traded companies are incorporated in Delaware.⁷⁵ Delaware has thus become the preeminent state in corporation law and is the state to which other states, including Illinois, turn for guidance in resolving corporate disputes.⁷⁶ Consequently, the validity of the poison pill must first be established under the Delaware corporation statute (the "Delaware statute"),⁷⁷ and then, for the purposes of this Comment, the Illinois Business Corporation Act.⁷⁸

A. *The Delaware Corporation Statute*

Ordinarily, in order to change the certificate of incorporation in

72. See *supra* note 70 for various examples of the back-end plan.

73. See *supra* notes 56-60 and accompanying text for a discussion of the inadequacies of the flip-over plan.

74. L. SOLOMON, R. STEVENSON, JR. & D. SCHWARTZ, *CORPORATIONS LAW AND POLICY* 123 (1982). Although the term has no clear definition, "internal affairs" are in general those matters bearing on the relationships among the participants in the corporation. *Id.* For the most part this means the relationships between shareholders, officers and directors. *Id.*

75. See Herzel and Richman, *Delaware's Preeminence By Design* ix (1986) (forward to BALOTTI & FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS* (1986)).

76. *Id.*

77. DEL. CODE ANN. tit. 8, § 101 (1983).

78. ILL. REV. STAT. ch. 32, ¶ 1.01 (1985).

matters affecting shareholder rights, the corporation's directors must submit the proposed amendments to the shareholders at an annual or special meeting.⁷⁹ Sections 102(a)(4)⁸⁰ and 151(a)⁸¹ of the Delaware statute, however, permit a corporation's directors to authorize and issue blank check preferred stock⁸² at their discretion, provided that the power to issue such stock is reserved in the corporate charter. These blank check provisions enable the directors to solicit capital in accordance with prevailing market conditions, without the delays that charter amendments and shareholder votes inevitably cause.⁸³ Moreover, the directors may determine, at issuance, what, if any, rights, privileges, preferences or restrictions the blank

79. See DEL. CODE ANN. tit. 8, § 242 (1983). See also *Telvest, Inc. v. Olson*, C. A. No. 5798, slip op. (Del. Ch. March 8, 1979) (LEXIS, States library, Del. file).

80. Section 102(a)(4) states in relevant part:

(4) If the corporation is to be authorized to issue more than 1 class of stock, the certificate of incorporation shall set forth the total number of shares of all classes of stock which the corporation shall have authority to issue and the number of shares of each class, and shall specify with respect to each class those shares that are to have a par value and the par value of each share of each such class, the number of shares of each class that are to be without par value, and a statement of the designations and the powers, preferences and rights, and the qualifications limitations or restrictions thereof, which are permitted by § 151 of this title in respect of any class or classes of stock or any series of any class or stock of the corporation and the fixing of which by the certificate of incorporation is desired, and an express grant of such authority as it may then be desired to grant to the board of directors to fix by resolution or resolutions any thereof that may be desired but which shall not be fixed by the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 102(a)(4) (1983).

81. Section 151(a) states in relevant part:

(a) Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation. Any of the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of any such class or series of stock may be made dependent upon facts ascertainable outside the certificate of incorporation or of any amendment thereto, or outside the resolution or resolutions provided for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by its certificate of incorporation, provided that the manner in which such facts shall operate upon the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of such class or series of stock is clearly and expressly set forth in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors.

Id. § 151(a).

82. Blank check stock is stock whose terms are fixed by board resolution at the time of issuance. Note, *Protecting Shareholders*, *supra* note 5, at 1972 n.54.

83. *Id.* at 1973.

check preferred stock will contain.⁸⁴ Consequently, under the blank check provisions, a target corporation's directors are afforded the requisite authority to issue poison pill preferred stock as a pro rata dividend to all holders of the target's common stock.

Additionally, Section 157 of the Delaware statute grants the target's directors the requisite authority to issue poison pill "rights" in response to a hostile takeover.⁸⁵ Under this section, the target may issue "rights" to its shareholders which entitle them to purchase shares of the target's stock upon the terms and at the prices previously designated in the directors' resolution creating such rights.⁸⁶ Nevertheless, the directors' issuance of such rights is subject to the provisions contained in the certificate of incorporation.⁸⁷ Absent an express prohibition in the certificate of incorporation, a target's directors possess the authority to implement a poison pill rights plan in order to ward off a hostile takeover.⁸⁸

Despite the unambiguousness of the preceding sections of the

84. See *supra* notes 80-81.

85. Section 157 provides:

Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

The terms upon which, including the time or times which may be limited or unlimited in duration, at or within which, and the price or prices at which any such shares may be purchased from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options, and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.

In case the shares of stock of the corporation to be issued upon the exercise of such rights or options shall be shares having a par value, the price or prices so to be received therefor shall not be less than the par value thereof. In case the shares of stock so to be issued shall be shares of stock without par value, the consideration therefor shall be determined in the manner provided in § 153 of this title.

DEL. CODE ANN. tit. 8, § 157(1983).

86. See *supra* note 85.

87. *Id.*

88. See *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. Super. Ct. 1986) (holding that under Delaware law the board clearly has the power to adopt a poison pill plan); *Moran v. Household Int'l Inc.*, 500 A.2d 1346, 1351 (Del. Super. Ct. 1985) (holding that the board of directors possess the requisite authority under Delaware corporation law to implement a poison pill plan). *But see* *Telvest, Inc. v. Olson*, C.A. No. 5798, slip op. (Del. Ch. March 8, 1979) (LEXIS, States library, Del. file) (holding that because the poison pill plan altered the previously existing voting rights granted to OSI's common shareholders by OSI's certificate of incorporation, it must be approved by the shareholders).

Delaware statute, corporate raiders confronted with a particular poison pill plan consistently argue that the target's directors have violated the statute. They contend that the Delaware statute permits the issuance of rights and/or blank check stock for corporate financing purposes only and not to thwart hostile takeovers.⁸⁹ Therefore, raiders argue that the poison pill, having no investment motive, violates the Delaware statute.

Legislative intent and the statute itself, however, indicate that the target's power to issue both rights and blank check stock is more expansive. First, neither the rights provision nor the blank check provisions expressly limit the directors' power to issue either rights or blank check stock.⁹⁰ In fact, the language of those provisions fails to place *any* limitations on the directors. Second, the Delaware statute has traditionally been liberally construed to provide directors with the greatest amount of managerial flexibility.⁹¹ Third, because the Delaware statute grants directors the power to veto mergers⁹² and liquidations,⁹³ both of which result in a transfer of all the corporation's assets to another party, it should be interpreted to permit directors to employ defensive mechanisms, such as the poison pill.⁹⁴ Finally, and most importantly, the target's shareholders have the ultimate control over the directors' ability to issue rights or blank check preferred stock when voting on the charter provisions.⁹⁵ Thus, the Delaware statute "contemplates that substantive limitations on the board's power should be set by the shareholders themselves rather than by courts construing the terms of the statute."⁹⁶

Frequently, a target corporation will attach supermajority voting rights to its preferred dividend plan. These rights entitle all holders of the dividend, other than the raider, to block any merger or consolidation unless four-fifths of the holders assent to such a merger or consolidation.⁹⁷ In *Telvest v. Olsen*,⁹⁸ however, the Dela-

89. See, e.g., *Moran*, 500 A.2d at 1351 (alleging that § 157 is a corporate financing statute and that nothing in its legislative history suggests a purpose that has anything to do with corporate control or a takeover defense).

90. See *supra* notes 80-81, 85. As the Delaware Supreme Court noted in *Unocal*:

[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. Merely because the General Corporation Law is silent as to a specific matter does not mean that it is prohibited.

Unocal Corp. v. Mesa Petroleum Corp. 493 A.2d 946, 957 (Del. Super. Ct. 1985).

91. See Note, *Protecting Shareholders*, *supra* note 5, at 1974.

92. See DEL. CODE ANN. tit. 8, § 251(b) (1983).

93. See DEL. CODE ANN. tit. 8, § 271(a) (Supp. 1986).

94. Note, *Protecting Shareholders*, *supra* note 5, at 1974.

95. See *supra* note 82.

96. Note, *Delaware's Attempt To Swallow A New Takeover Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. L. 569, 577 (1985).

97. See *supra* note 46 for a discussion of the supermajority voting rights plan.

98. C.A. No. 5798, slip op. (Del. Ch. March 8, 1979) (LEXIS, States file, Del. library).

ware chancery court enjoined the issuance of this "piggyback preferred" stock for three reasons.⁹⁹ First, the court determined that because the "preferred" stock was identical to the common stock in every respect but voting rights, it could not be deemed true preferred stock under Section 151 of the Delaware statute.¹⁰⁰ Second, the court held that issuing "piggyback preferred" stock with supermajority voting rights was unlawful under Delaware law because it had the effect of altering the relative voting rights of the target's common shareholders without their approval.¹⁰¹ Finally, the court held that the preferred stock dividend was illegal because it would not have been distributed on a pro rata basis.¹⁰²

The precedential value of the *Telvest* holding, however, was severely limited when the Delaware General Assembly effectively overruled one of the statutory grounds for that decision by amending Section 151(g) of the Delaware statute.¹⁰³ Section 151(g) now autho-

99. *Id.* For a description of the *Telvest* poison pill plan, see *supra* note 46.

100. *Telvest*, No. 5798, slip op. at 12. The Delaware Chancery Court noted that the preferred stock was entitled to a dividend only when the common stock was entitled to a dividend. *Id.* The amount of its dividend was the same as the common stock dividend. *Id.* at 13. On dissolution, it received only that amount received by the common stock. *Id.* The only difference was that the preferred stock was to be paid first. *Id.* Furthermore, as to dissolution rights, the funds to pay the preferred had to be available by virtue of the fact that the amount per share is determined by dividing remaining net assets by the total number of preferred shares plus common shares. *Id.* Thus, the court concluded that "any supposed preference as to dividends or liquidation rights seem[ed] illusory at best." *Id.*

101. *Id.* at 14. The court held that where the holders of the common stock are given the right to approve certain transactions only by the majority vote required by the various applicable statutes, that right cannot be changed short of an amendment to the certificate of incorporation approved by the stockholders. *Id.*

102. *Id.* at 15. "Generally, a dividend must always be pro rata, equal, and without discrimination or preference." *Id.*

103. Section 151(g) now provides:

(g) When any corporation desires to issue any shares of stock of any class or of any series of any class of which the powers, designations, preferences and relative, participating, optional or other rights, if any, or the qualifications, limitations or restrictions thereof, if any, shall not have been set forth in the certificate of incorporation or in any amendment thereto but shall be provided for in a resolution or resolutions adopted by the board of directors pursuant to authority expressly vested in it by the certificate of incorporation or any amendment thereto, a certificate of designations setting forth a copy of such resolution or resolutions adopted by the board of directors pursuant to authority expressly vested in it by the certificate of incorporation or any amendment thereto, a certificate of designations setting forth a copy of such resolution or resolutions and number of shares of stock of such class or series as to which the resolution or resolutions apply shall be executed, acknowledged, filed recorded and shall become effective, in accordance with § 103 of this. Unless otherwise provided in any such resolution or resolutions, the number of shares of stock of any such class or series to which such resolution or resolutions apply may be increased (but not above the number of shares of the class authorized by the certificate of incorporation with respect to which the powers, designations, preferences and rights have not been set forth) or decreased (but not

rizes the target's directors to amend the charter simply by adopting and filing a resolution fixing the terms of the newly issued preferred stock.¹⁰⁴ Under Section 151(g), the directors have "the power to amend the charter by issuing blank check stock, even if such stock effectively alters the rights attached to preexisting classes of stock."¹⁰⁵ Due to this statutory refinement, *Telvest* now appears to stand only for the proposition that a target's directors cannot employ their blank check powers to create a "sham security," in the form of preferred stock with supermajority voting rights, which is designed solely to alter the voting rights of an existing substantial stockholder.¹⁰⁶ Consequently, the *Telvest* holding does not invalidate legitimate preferred dividend plans which possess superior dividend and liquidation rights, which can be traded separately from the common stock, and are issued on a pro rata basis.

Issuing a poison pill dividend necessarily deprives the raider of certain privileges or rights from which all other common shareholders will eventually benefit. Under any poison pill plan, both the voting rights and the equity of the raider are diluted upon the requisite triggering event.¹⁰⁷ This result has caused raiders to argue that poison pill plans discriminate among shareholders of the same class or series of stock.¹⁰⁸

below the number of shares thereof then outstanding) by a certificate likewise executed, acknowledged, filed and recorded setting forth a statement that a specified increase or decrease therein had been authorized and directed by a resolution or resolutions likewise adopted by the board of directors. In case the number of such shares shall be decreased the number of shares so specified in the certificate shall resume the status which they had prior to the adoption of the first resolution or resolutions. When no shares of any such class or series are outstanding, either because none were issued or because no issued shares of any such class or series remain outstanding, a certificate setting forth a resolution or resolutions adopted by the board of directors that none of the authorized shares of such class or series are outstanding, and that none will be issued subject to the certificate of designations previously filed with respect to such class or series, may be executed, acknowledged, filed and recorded in accordance with § 103 of this title and, when such certificate becomes effective, it shall have the effect of eliminating from the certificate of incorporation all matters set forth in the certificate of designations with respect to such class or series of stock. When any certificate filed under this subsection becomes effective, it shall have the effect of amending the certificate of incorporation.

DEL. CODE ANN. tit. 8, § 151(g) (Supp. 1986).

104. See *supra* note 103.

105. See *supra* note 103.

106. *But cf.* *Asarco Inc. v. Court*, 611 F. Supp. 468, 479 (D.N.J. 1985) (holding that the reasoning in *Telvest* is sound and persuasive and relying on that decision to invalidate *Asarco's* poison pill plan).

107. See *supra* notes 32-73 and accompanying text.

108. See, e.g., *Dynamics Corp. II*, 805 F.2d 705 (7th Cir. 1986); *R.D. Smith & Co., Inc. v. Preway Inc.*, No. 86-C-641-C, slip op. (W.D. Wis. Sept. 26, 1986) (LEXIS, Genfed library, Courts file); *Amalgamated Sugar Co. v. NL Indus., Inc.*, 644 F. Supp. 1229 (S.D.N.Y. 1986); *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252 (S.D.N.Y. 1985); *Asarco Inc. v. Court*, 611 F. Supp. 468 (D.N.Y. 1985).

In opposition to such discrimination, Section 151(a) of the Delaware statute provides that the terms relating to each share in each class of stock must be uniform.¹⁰⁹ Although that section plainly forbids discrimination,¹¹⁰ the Delaware courts construe it to mean discrimination between shares, not discrimination between shareholders.¹¹¹ Consequently, because poison pill plans do not single out one specific shareholder but instead strip rights or privileges from any acquirer who obtains a certain percentage of the target's stock, they do not violate Section 151 of the Delaware statute.

B. *The Illinois Business Corporation Act*

The Illinois legislature, like the Delaware legislature, intended to confer upon a corporation's directors a broad power to issue blank check stock. Section 6.10 of the Illinois Business Corporation Act¹¹²

109. Section 151(a) provides:

(a) Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation. Any of the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of any such class or series of stock may be made dependent upon facts ascertainable outside the certificate of incorporation or of any amendment thereto, or outside the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by its certificate of incorporation, provided that the manner in which such facts shall operate upon the voting powers, designations, preferences, rights and qualifications, limitations or restrictions of such class or series of stock is clearly and expressly set forth in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors. The power to increase or decrease or otherwise adjust the capital stock as provided in this chapter shall apply to all or any such classes or stock.

DEL. CODE ANN. tit. 8, § 151(a) (1983).

110. *Contra Providence & Worcester v. Baker*, 378 A.2d 121, 122 (Del. 1977) (holding that the language of § 151(a), standing alone, neither permits nor prohibits discrimination).

111. *See Providence*, 378 A.2d at 124.

112. Section 6.10 provides in relevant part:

(a) If the articles of incorporation so provide, the shares of any preferred or special class may be divided into an issued in series. If the shares of any such class are to be issued in series, then each series shall be so designated as to distinguish the shares thereof from the shares of all other series and classes. Any or all of the series of any such class and the variations in the relative rights and preferences as between different series may be fixed and determined by the articles of incorporation or by resolution of the board of directors pursuant to authority contained in the articles of incorporation, subject to the provisions of Section 7.40, provided that all shares of the same class shall be identical except as to the following relative rights and preferences, in respect of

(the "Illinois Act") allows a target's directors to issue stock on such terms as they shall fix by resolution at the time of issuance, provided the power to do so is reserved in the corporate charter.¹¹³ Clearly, this section of the Illinois Act mirrors the Delaware blank check stock provisions¹¹⁴ and, therefore, Illinois courts which are forced to interpret it should look to Delaware for guidance.¹¹⁵ In so doing, the Illinois courts must hold that under Section 6.10 of the Illinois Act, a target corporation's directors possess the requisite authority to issue poison pill preferred stock as a pro rata dividend to all holders of the target's common stock.¹¹⁶

In addition, Illinois has a strong public policy against hostile takeovers. Even though the United States Supreme Court invalidated the Illinois Business Takeover Act¹¹⁷ in *Edgar v. Mite*

any or all of which there may be variations between different series:

- (1) The rate of dividend.
- (2) The price at and the terms and conditions on which shares may be redeemed.
- (3) The amount payable upon shares in event of involuntary liquidation.
- (4) The amount payable upon shares in event of voluntary liquidation.
- (5) Sinking fund provisions for the redemption or purchase of shares.
- (6) The terms and conditions on which shares may be converted, if the shares of any series are issued with the privilege of conversion.
- (7) The limitation or denial or voting rights, or the grant of special voting rights.

ILL. REV. STAT. ch. 32, § 6.10 (1985).

113. See *supra* note 112.

114. See *supra* notes 80-81.

115. Other courts forced to determine the validity of poison pill plans have also looked to Delaware statutory and case law. See, e.g., *Dynamics Corp. II*, 805 F.2d 705 (7th Cir. 1986) (relying on Delaware law to determine that Indiana directors have the requisite authority, under Indiana law, to implement a poison pill plan).

116. The Illinois statute, like the Delaware statute, prohibits discrimination within the same class or series of shares. See *supra* note 112. However, the Illinois courts, relying on Delaware case law, should hold that the statute prohibits discrimination among shareholders, not among shares. See *supra* note 111 and accompanying text. Consequently, because poison pill plans do not single out one specific shareholder but instead strip rights or privileges away from any acquiror who obtains a certain percentage of the target's stock, they do not violate Section 6.10 of the Illinois Business Corporation Act.

117. ILL. REV. STAT. ch. 121 ½, § 137.521 (1981). The Illinois Business Takeover Act possessed the following features: a precommencement notification requirement which required a tender offeror to notify the Illinois Secretary of State and the target company of its intent to make a tender offer and the terms of the offer 20 days before the offer became effective, *id.* § 137.54(A); hearing provisions which enabled the Secretary of State to call a hearing at any time during the twenty-day waiting period to adjudicate the substantive fairness of the offer if he believed it was necessary to protect the stockholders of the target company and a hearing was required to be held if requested by a majority of the target company's outside directors or by Illinois stockholders who owned 10% of the class of securities subject to the offer, *id.* § 137.54(a); and disclosure and fairness tests which provided that if the Secretary of State held a hearing, he was directed by the statute to deny registration of the tender offer if he found that it failed to provide full and fair disclosure to the offerees of all material information concerning the takeover offer, or that the takeover offer was inequitable, *id.* § 137.57(E).

Corp.,¹¹⁸ the fact that it was enacted is evidence of the Illinois legislature's strong interest in prohibiting hostile takeovers. Consistent with this policy, the Illinois legislature recently added Section 7.85¹¹⁹ to the Illinois Act. This new amendment protects a target's minority shareholders by regulating the second step of a hostile two-tiered takeover attempt.¹²⁰ The amendment requires a supermajority vote of eighty percent of all outstanding voting shares and a majority of the voting shares of disinterested shareholders in order to accomplish certain business combinations or transactions.¹²¹ Further, the amendment provides that if at least two-thirds of the target's disinterested directors approve a merger, the supermajority vote is unnecessary.¹²²

Section 7.85 of the Illinois Act, which clearly resembles a poison pill, reflects the Illinois legislature's effort to discourage hostile takeover activity in Illinois.¹²³ In adopting the new amendment to deter

118. 457 U.S. 624 (1982). The United States Supreme Court held the Illinois Business Takeover Act unconstitutional under the Commerce Clause because the indirect burdens on interstate commerce were excessive in relation to the putative local benefits. *Id.* at 646. Three justices also believed that the Illinois Business Takeover Act violated the Supremacy Clause because it conflicted with the goals and purposes of the Williams Act by "upset[ing] the careful balance struck by Congress" between incumbent management and tender offerors. *Id.* at 634.

119. Section 7.85 states in relevant part:

This Section shall apply to any domestic corporation which (i) has a class of equity securities registered under the Securities Exchange Act of 1934 (or any subsequent provisions replacing such Act), or (ii) any domestic corporation other than described in (i) which either specifically adopt this Section 7.85 in its original Articles of Incorporation or amends its Article of Incorporation to specifically adopts this Section 7.85. Notwithstanding any other provisions of the Articles of Incorporation or the By-Laws of corporation (and notwithstanding the fact that a lesser percentage may be specified by law, the Articles of Incorporation or the By-Laws of the corporation), the affirmative vote of (i) the holders of 80 percent or more of the combined voting power of the then outstanding Voting Shares voting together as a single class, and (ii) a majority of the combined voting power of the then outstanding Voting Shares held by Disinterested Shareholders (as hereinafter defined), voting together as a single class, shall be required to amend, or repeal, or to adopt any provision inconsistent with, any provision in the Articles of Incorporation of the corporation specifically adopting this Section 7.85.

ILL. REV. STAT. ch. 32, ¶ 7.85 (1985).

120. *See supra* note 119.

121. *Id.*

122. *Id.*

123. *See also* ILL. REV. STAT. ch. 32, ¶ 8.85 which states as follows:

In discharging the duties of their respective positions, the board of directors, committees of the board, individual directors and individual officers may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers and customers of the corporation, communities in which offices or other establishments of the corporation are located and all other pertinent factors.

Id. This section allows directors to take other variables, besides the company's shareholders, into consideration when determining whether to accept or reject a tender offer. Consequently, directors will have an easier time justifying the implementation of defensive mechanisms.

takeovers, the Illinois legislature would not unwittingly facilitate takeovers by outlawing the poison pill. In fact, the Delaware cases and statutes to which Illinois looks for guidance in corporate matters suggest just the opposite. Consequently, poison pill plans are legitimate defensive tactics under Illinois corporate law.

III. STATE FIDUCIARY LAW AND THE BUSINESS JUDGMENT RULE

Although poison pill plans, regardless of their form, will pass muster under both the Delaware Statute and the Illinois Act, courts still must determine whether the adoption of a particular plan constitutes a breach of the directors' fiduciary duties to the corporation and its shareholders. The ultimate responsibility for managing corporate affairs rests on the board of directors.¹²⁴ In discharging this function, the directors owe a fiduciary duty to the shareholders to act in their best interests.¹²⁵ The directors' fiduciary obligations consist of, *inter alia*, the duty of care and the duty of loyalty.¹²⁶ The duty of care requires the directors to exercise the care that a reasonably prudent person in a similar position would use under similar circumstances, whereas the duty of loyalty requires only that the directors act in subjective good faith.¹²⁷

When the directors are accused of breaching their fiduciary duty, the courts review the directors' actions under the business judgment rule. Traditionally, courts have applied the business judgment rule as a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in an honest belief that the action taken was in the best interests of the company.¹²⁸ This rule expresses a sensible policy of judi-

124. See ILL. REV. STAT. ch. 32, § 8.05(a) (1985); *accord* *Asarco Inc. v. Court*, 611 F. Supp. 468, 473 (D.N.J. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. Super. Ct. 1986).

125. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293-95 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Horwitz v. Southwest Forest Indus., Inc.*, 604 F. Supp. 1130, 1134 (D. Nev. 1985); *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. Super. Ct. 1986); *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. Super. Ct. 1985); *Shlensky v. So. Parkway Bldg. Corp.*, 19 Ill. 2d 268, 278 (1960); *Fields v. Sax*, 123 Ill. App. 3d 460, 463 (1984); *Kreider, Corporate Takeovers And The Business Judgment Rule: An Update*, 11 J. CORP. L. 633 (1986); *Lipton & Brownstein, supra* note 7, at 1404; Note, *Protecting Shareholders, supra* note 5, at 1968 (1984); Note, *Potent Takeover Defense, supra* note 7, at 905 (1986).

126. See *Norline Corp. v. Rooney, Pace, Inc.* 744 F.2d 255, 264 (2d Cir. 1984); *Horwitz*, 604 F. Supp. at 1134; *Revlon*, 506 A.2d at 279; *Armson v. Lewis*, 473 A.2d 805, 811 (Del. Super. Ct. 1984); *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. Super. Ct. 1939).

127. See *Norline Corp.*, 744 F.2d at 264; *Horwitz*, 604 F. Supp. at 1134.

128. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Super. Ct. 1984); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. Super. Ct. 1971); *Veasey, The New Incarnation Of The Business Judgment Rule In Takeover Defenses*, 11 DEL. J. CORP. L. 503, 505 (1986).

cial noninterference with business decisions made in circumstances free from self-dealing, bad faith or fraud.¹²⁹ Courts are willing to defer to directors because managing the affairs of the corporation is the board's duty and the courts often consider themselves ill-equipped to second-guess business decisions.¹³⁰ Consequently, under the business judgment rule, the burden of proof rests on the party attacking the directors' actions to demonstrate that the directors breached their fiduciary duty.¹³¹

Although directors have a duty to adopt defensive measures in order to defeat a takeover attempt which they perceive as contrary to the best interests of the corporation and its shareholders,¹³² courts have determined that such decisions warrant a more searching judicial review than decisions concerning "ordinary" business judgment.¹³³ Courts have held that when directors implement anti-takeover measures, such as the poison pill, there is a greater likelihood that the directors are acting in their own self-interest¹³⁴ rather than in the interests of the corporation and its shareholders.¹³⁵ This

129. See *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293 (7th Cir. 1981), cert. denied, 454 U.S. 1092 (1981); *Minstar Acquiring Corp. v. AMF Inc.*, 621 F. Supp. 1252, 1259 (S.D.N.Y. 1985); *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 409 (S.D.N.Y. 1985); *Asarco Inc. v. Court*, 611 F. Supp. 468, 473 (D.N.J. 1985).

130. See *Joy v. North*, 692 F.2d 880, 886 (2d Cir. 1982), cert. denied, 460 U.S. 1051 (1983); *Gibson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN L. REV. 819, 822-23 (1981); *Today's Business Judgment Rule*, supra note 12, at 30; Note, *Protecting Shareholders*, supra note 125, at 1969.

131. *Norline Corp. v. Rooney Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984); *Treadway Co., Inc. v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980); *Horwitz v. Southwest Forest Indus., Inc.* 604 F. Supp. 1130, 1134 (D. Nev. 1985).

132. *MacAndrews & Forbes v. Revlon, Inc.*, 501 A.2d 1239, 1247 (Del. Super. Ct. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. Super. Ct. 1985).

133. See, e.g., *Moran v. Household Int'l, Inc.*, 490 A.2d 1059, 1076 (Del. Ch.), aff'd, 500 A.2d 1346 (Del. Super. Ct. 1985) (holding that where the takeover device is itself calculated to alter the structure of the corporation and results in a fundamental transfer of power from one constituency (shareholders) to another (the directors), the business judgment rule will not foreclose inquiry into the directors' action). See also *Unilever Acquisition Corp. v. Richardson-Vicks, Inc.*, 618 F. Supp. 407, 409 (S.D.N.Y. 1985).

134. Courts have held that a conflict of interest exists when managers are busy erecting obstacles to the taking over of the corporation by an investor who is likely to fire them if the takeover attempt succeeds. *Dynamics Corp. I*, 794 F.2d 250, 256 (7th Cir. 1986).

135. See, e.g., *Dynamics Corp. II*, 805 F.2d 705, 708 (7th Cir. 1986). In *Dynamics Corp. II*, the court noted that while the board of directors of a corporation that is a target or potential target of a hostile tender offer has the power to adopt a poison pill, the particular poison pill it adopts must be reasonably related to the goal of shareholder wealth maximization. *Id.* Moreover, the court determined that because there is a potential conflict of interest between the managers and shareholders of the target, courts are not to simply rubber stamp the board's judgment, but must review it carefully to make sure that in adopting the poison pill, the board was really acting in the best interests of the corporation. *Id.* The court then concluded that in making this determination, a court must consider the procedures leading up to the adoption

concern has led courts to apply the business judgment rule to the adoption of a poison pill plan in a manner which places the initial burden of proof not on the party challenging the directors' actions, but rather on the directors themselves.¹³⁶ To satisfy this initial burden, the directors must demonstrate that they exercised good faith and reasonable investigation in determining whether a danger to corporate policy existed¹³⁷ and that the poison pill plan was reasonable in relation to the threat posed.¹³⁸ Only when the directors satisfy this burden are their actions entitled to the traditional presumptions of the business judgment rule.¹³⁹ The shareholder challenging the directors' action must then show that the sole primary motive of the directors was entrenchment.¹⁴⁰

Despite the concern of the courts, directors should not lose the benefit of the business judgment rule simply because the adoption of a poison pill plan implies a conflict of interest. The courts must recognize that directors are necessarily confronted with a conflict of interest not only in implementing a poison pill plan, but also in almost every action they take.¹⁴¹ Moreover, heightened judicial review of ac-

of the poison pill and the terms of the poison pill. *Id.* See *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 180 (Del. Super. Ct. 1986) (holding that when a board implements anti-takeover measures there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

136. See *Moran v. Household Int'l, Inc.*, 550 A.2d 1346, 1356 (Del. Super. Ct. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. Super. Ct. 1985).

137. In *Dynamics Corp. II*, 635 F. Supp. 1174 (N.D. Ill.), *modified*, 638 F. Supp. 802 (N.D. Ill.), *rev'd in part, vacated in part, and remanded with directions*, 805 F.2d 705 (7th Cir. 1986), the district court found that the second rights plan adopted by CTS satisfied the standard of good faith and reasonable investigation. *Id.* at 1182. The district court found particularly important certain of the steps CTS took after the initial order enjoining the first rights plan. The directors appointed a special committee of outside directors to analyze the situation in order to minimize the conflict of interest inherent in a board of directors' adoption of defensive measures. *Id.* at 1176. This committee obtained separate counsel. *Id.* at 1176-77. The directors studied the district court's earlier decision carefully in an attempt to avoid constructing a plan that would interfere with an ongoing proxy contest and partial tender offer. *Id.* at 1178. The special committee concluded that shareholders, other than Dynamics Corp., would be likely to maximize the value of their shares if the company was sold and if the minority shareholders were protected by a carefully tailored rights plan. *Id.* Finally, the rights plan did not insulate management from all hostile offers, since the rights issued under the plan expressly expired upon tender of a sufficiently high offer. *Id.* at 1180. Based on these facts, the district court denied the motion to enjoin CTS's second rights plan. *Id.* at 1182.

138. A rights plan cannot be so restrictive as to preclude any possibility of a hostile takeover. See *Dynamics Corp. I*, 794 F.2d 250, 259 (7th Cir. 1986); *R.D. Smith & Co. v. Preway*, No. 86-C-641-C, slip op. (W.D. Wis. Sept. 26, 1986) (LEXIS, Genfed library, Courts file).

139. See *R.D. Smith & Co.*, No. 86-C-641-C, slip op.

140. *Id.*

141. The appellate court in *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981), noted:

It is frequently said that directors are fiduciaries. Although this statement is true in some senses, it is also obvious that if directors were held to the same

tions taken in adopting a poison pill plan leaves directors overcautious and forces them to adopt ponderous court-like procedures at a time when a takeover threat mandates a quick response. Heightened judicial review also encourages judicial "second-guessing" of business decisions, which the courts themselves have determined they are ill-equipped to do.¹⁴²

Additionally, the business judgment rule affords directors the personal freedom necessary to act effectively on behalf of the corporation and its shareholders. Without this freedom, directors would be potentially liable for damages resulting from every wrong decision and, thus, would be frozen into immobility. Moreover, if directors have a duty to prohibit hostile takeover attempts which are not in the best interests of the corporation and are not permitted the freedom necessary to counteract the raider's coercive tactics, they are forced to walk a "legal razor's edge." Consequently, in determining the validity of a poison pill plan, the courts must recognize the directors' dilemma and cease shifting the initial burden of proof upon them to justify their actions.

Under the traditional business judgment rule, a corporate raider would rarely satisfy his burden of proof because the courts will defer to the directors' business decisions. Absent evidence of fraud, bad faith, or self-dealing, the directors' decision to implement a poison pill plan will be upheld. Moreover, when the directors properly implement a particular poison pill plan, they have a legitimate, unselfish business purpose for their action: protecting target shareholders from the raider's coercive and underpriced takeover bid. Consequently, because the poison pill will be upheld under the traditional business judgment rule, the target corporation will have more time

standard as ordinary fiduciaries the corporation could not conduct business. For example, an ordinary fiduciary may not have the slightest conflict of interest in any transaction he undertakes on behalf of the trust. Yet by the very nature of corporate life a director has a certain amount of self-interest in everything he does. The very fact that the director wants to enhance corporate profits is in part attributable to his desire to keep shareholders satisfied so that they will not oust him.

The business judgment rule seeks to alleviate this problem by validating certain situations that otherwise would involve a conflict of interest for the ordinary fiduciary. The rule achieves this purpose by postulating that if actions are arguably taken for the benefit of the corporation, then the directors are presumed to have been exercising their sound business judgment rather than responding to any personal motivations.

Faced with the presumption raised by the rule, the question is what sort of showing the plaintiff must make to survive a motion for directed verdict. Because the rule presumes that business judgment was exercised, the plaintiff must make a showing from which a factfinder might infer that impermissible motives predominated in the making of the decision in question.

Id. at 292. See generally Block & Prussin, *The Business Judgment Rule and Shareholders' Derivative Actions: Viva Zapata*, 37 Bus. Law. 27, 32 (1981).

142. See *supra* note 130.

and a better opportunity to maximize shareholder values in the face of a hostile corporate takeover.

IV. THE EFFECTIVENESS OF A POISON PILL PLAN

*Revlon, Inc. v. Mac Andrews & Forbes Holdings*¹⁴³ aptly demonstrates that a properly implemented poison pill plan will not only deter coercive underpriced tender offers, but will also enable shareholders to realize increased profits on the tender of their stock. In *Revlon*, Pantry Pride made a hostile tender offer for forty-five dollars per share of Revlon stock.¹⁴⁴ Revlon's investment banker advised the Revlon directors that forty-five dollars per share was a "grossly inadequate" price, and that Pantry Pride intended to finance the acquisition through "junk bonds" followed by a break-up of Revlon which would produce a return to Pantry Pride of sixty to seventy dollars per share.¹⁴⁵ To prevent Pantry Pride from acquiring this benefit for itself, the Board adopted a "Note Purchase Rights Plan."¹⁴⁶ Under the plan, each Revlon stockholder, other than a hostile acquirer, received as a dividend one Note Purchase Right for each share of common stock.¹⁴⁷ The right entitled the holder to exchange one common share of Revlon stock for a sixty-five dollar principal Revlon note valued at par.¹⁴⁸ The rights would become effective whenever anyone acquired beneficial ownership of twenty percent or more of Revlon's shares, unless the purchaser acquired all of the company's stock for cash at sixty-five dollars or more per share.¹⁴⁹

After the Revlon Board implemented the plan, Pantry Pride increased its cash bid for the company to forty-seven dollars and fifty cents per share but the Revlon directors still considered the offer inadequate.¹⁵⁰ Pantry Pride remained determined in its efforts and continued to make bids for Revlon, offering fifty dollars per share,

143. 506 A.2d 173 (1986).

144. *Id.* at 176.

145. *Id.* at 176-77.

146. *Id.* at 177.

147. *Id.*

148. *Id.*

149. *Id.* Revlon also took other defensive measures. *Id.* It commenced its own offer for up to 10 million shares, exchanging for each share of common stock tendered one senior subordinated note (the "notes") of \$47 and 50¢ principal at 11.75% interest, due 1995, and one-tenth of a share of \$9 cumulative convertible exchangeable preferred stock valued at \$100 per share. *Id.* Revlon stock holders tendered 87% of the outstanding shares and the company accepted the full 10 million shares of a pro rata basis. *Id.* The new notes contained covenants which limited Revlon's ability to incur additional debt, sell assets, or pay dividends unless otherwise approved by the "independent" members of the board. *Id.*

150. *Id.* This tender offer was conditioned upon Pantry Pride's obtaining financing for the purchase, and the rights being redeemed, rescinded or voided. *Id.*

raising its bid to fifty-three dollars and then to fifty-six dollars and twenty-five cents.¹⁵¹ Subsequently, however, Forstman Little & Co. offered the Revlon Board fifty-seven dollars and twenty-five cents per share.¹⁵² The directors accepted this offer and redeemed the rights.¹⁵³

The Delaware Supreme Court held that in adopting the Note Purchase Rights Plan, the board protected the shareholders from a hostile takeover at a price below the company's intrinsic value, while retaining sufficient flexibility to address any proposal deemed to be in the stockholders' best interests.¹⁵⁴ The court determined that the board acted in good faith and upon reasonable investigation.¹⁵⁵ The court also noted that under the circumstances, the Note Purchase Rights Plan was reasonable considering the threat posed.¹⁵⁶ Indeed, the court held that it was a factor in causing Pantry Pride to raise its bids from a low of forty-two dollars to an eventual high of fifty-eight dollars.¹⁵⁷ The court concluded that far from being a "show stopper," the Note Purchase Rights Plan spurred the bidding to new heights, the desired result of its implementation.¹⁵⁸

CONCLUSION

During the past several years, takeover activity has markedly increased as corporate raiders have developed new and powerful acquisition techniques. The various poison pill plans available to target corporations, however, are innovative and effective responses to these powerful techniques. Both the Delaware and Illinois corpora-

151. *Id.*

152. *Id.* at 178. Forstmann's tender offer was based on several conditions. The principal demand was a lock-up option to purchase Revlon's Vision Care and National Health Laboratories divisions for 525 million dollars, some 100-175 million dollars below the value ascribed to them by Revlon's investment banker, if another acquiror obtained 40% of Revlon's shares. *Id.* Revlon was also required to accept a no-shop provision. *Id.* The rights and notes covenants had to be removed. *Id.* There would be a 25 million dollar cancellation fee to be placed in escrow, and released to Forstmann if the new agreement terminated or if another acquiror obtained more than 19.9% of Revlon's stock. *Id.* There would be no participation by Revlon management in the merger. *Id.* Finally, Forstmann demanded immediate acceptance of its offer or it would be withdrawn. *Id.* at 179.

153. *Id.* The board unanimously approved Forstmann's proposal because it was for a higher price than the Pantry Pride bid; it protected the note holders; and Forstmann's financing was firmly in place. *Id.*

154. *Id.* at 181.

155. *Id.*

156. *Id.* The court noted that at the time of its adoption, the Rights Plan afforded a measure of protection consistent with the directors' fiduciary duty in facing a takeover threat perceived as detrimental to corporate interest. *Id.*

157. *Id.*

158. *Id.* Although the court considered the adoption of the poison pill plan to have been valid under the circumstances, its continued usefulness was rendered moot when the directors redeemed the rights. *Id.*

tion statutes grant a target corporation's directors the requisite authority to implement such plans, regardless of their form. In addition, under the traditional business judgment rule, the directors' adoption of a poison pill plan generally should not constitute a breach of their fiduciary duty. Finally, when a poison pill plan is implemented properly, it will not only deter those tender offers that management considers to be in direct opposition to the target's best interests, but will also enable the shareholders to realize increased profits on the tender of their stock. Thus, the poison pill is truly a panacea for the hostile corporate takeover.

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