

Delaware Serves Shareholders the "Poison Pill": *Moran v. Household International, Inc.*¹ — In recent years, hostile acquisitions of publicly traded private corporations have posed a perpetual threat to the positions of board members and senior management of potential target companies. As the market has demonstrated, almost any public corporation can become a takeover target.² Commentators have debated heatedly over the effects of takeover battles on the economy and the propriety of state imposed regulation.³ Courts manifest the legal perspective of these battles by their scrutiny of the actions of the parties involved.

The level of judicial review in the corporate takeover context often reflects the court's interpretation of the appropriate role of corporate directors. On the one hand, if directors' sole responsibility, as overseers of the corporation and agents of the shareholders, is to maximize the short-term value of the corporation, then courts should not permit directors to interfere with tender offers.⁴ The shareholders themselves should decide at what price they are willing to sell their investments. On the other hand, if directors' responsibilities span a broader context of economic development, then courts should defer to directors' judgments regarding the impact of a takeover on long-term corporate planning and policies for growth and development.⁵ When a board of directors makes a good faith determination that a takeover is not in the best long-term interests of the corporation, courts should recognize the board's duty to oppose it.⁶

Directors have responded to takeover attempts with a variety of strategies. Some of these strategies, commonly known as "scorched earth" tactics, redeploy sought-after corporate assets, making the target less attractive.⁷ Other measures, such as "lock-up"

¹ 500 A.2d 1346 (Del. 1985).

² See, e.g., *Some Strategies to Avoid Unfriendly Acquisitions*, N.Y.L.J., May 28, 1985, at 25, col. 2 ("Given the availability of funds for purposes of hostile acquisitions — financing of ventures up to several billion dollars — even size does not guarantee security. Companies as large as Gulf Oil, Phillips Petroleum and Continental Group have found themselves in play, threatened by unsolicited, yet credible, takeover bids.").

³ Compare Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) [hereinafter cited as Easterbrook & Fischel, *Proper Role*] (arguing that tender offers are a check on management's efficiency and tendency to "shirk" the corporation's interests) with Lipton, *Takeover Bids in the Target Boardroom*, 35 BUS. LAW. 101 (1979) [hereinafter cited as Lipton] (condemning takeovers as disruptive of long-term planning and development of modern corporations).

⁴ See Easterbrook & Fischel, *Proper Role*, *supra* note 3, at 1164. (Tender offers are public offerings to buy stock directed at current shareholders to sell their shares to the bidder at the price offered.) But see *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, Nos. 353, 354, slip op. at 7 (Del. Mar. 13, 1986), where the court noted its approval of a board's adoption of a defensive poison pill notes purchase rights plan which ultimately helped to increase the return to shareholders by forcing the bidder to increase his bid price. The court's approval came, however, only after the plan had been revoked. *Id.*

⁵ See Lipton, *supra* note 3, at 103-04.

⁶ See *Panther v. Marshall Field & Co.*, 486 F. Supp. 1168, 1195 (N.D. Ill. 1980) *aff'd*, 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) ("Having so decided in good faith, with rational business purposes attributable to their decision, directors have not only the right, but the duty to resist by all lawful means persons whose attempts to win control of the corporation, if successful, would harm the corporate enterprise.") (quoting *Heit v. Baird*, 567 F.2d 1157, 1161 (1st Cir. 1977)).

⁷ One form of defensive asset redeployment is a board's sale of its "crown jewel," its most attractive asset or subsidiary which has caused the corporation to be the focus of a takeover attempt. See, e.g., *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982) (Brunswick Corporation, in

options, achieve the same result by tying up assets via agreements with "white knights" — friendly acquirers with whom directors negotiate terms to preclude a hostile acquirer from obtaining rights in the asset.⁸ Directors also have negotiated to redistribute common stock voting power into friendly hands, thereby preventing a hostile buyer from acquiring voting control of the corporation.⁹

By preventing hostile takeovers, directors deny shareholders takeover premiums which would have been available but for the board's actions. Disgruntled shareholders may resort to the courts to determine whether they may recover for the premiums denied by proving the directors acted improperly. Where directors have adopted any of the various antitakeover strategies, a danger exists that the directors may be acting for personal interests, such as to entrench themselves in their positions of control of the corporation. Therefore, courts have scrutinized the directors' antitakeover actions to determine whether the directors have acted in bad faith — for personal interests rather than in the corporation's best interests.¹⁰

Courts disagree on whether directors who will lose their positions in a hostile takeover necessarily present a sufficient conflict of personal and corporate interests to require close scrutiny of their actions.¹¹ When directors adopt a reasonable defense

the face of a takeover threat, sold its highly successful Sherwood Medical Division, a wholly owned subsidiary, and thereby dissolved the threat).

⁸ In a "lock-up arrangement," a target corporation grants a "white knight," a third party with whom management has negotiated favorable terms, an option to purchase a "crown jewel" in the event of an outsider's hostile acquisition of the target corporation. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, Nos. 353, 354, slip op. (Del. Mar. 13, 1986). In an attempt to thwart the efforts of Pantry Pride, Inc. to buy out Revlon, Inc., the Revlon board granted a third party, Forstmann Little & Co., a lock-up option to purchase a Revlon subsidiary at a price significantly below market value. This option would become exercisable, however, only if another acquirer obtained 40% of Revlon's outstanding shares of common stock. The Revlon board also adopted other defensive measures, including a "no-shop provision" — a promise to deal exclusively with the chosen white knight — and a note purchase rights plan. *Id.* at 5. *See also Mobil Oil Co. v. Marathon Oil Co.*, 669 F.2d 366 (6th Cir. 1981) (Marathon, fighting off an unfriendly takeover attempt by Mobil, granted United States Steel an option to purchase its "crown jewel" — a valuable oil field).

⁹ The issuance of stock to "friendly hands" to redistribute or retain a voting majority, as in *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981), or the reacquisition of shares by a target company at an inflated price, may hinder an insurgent's ability to acquire a majority position in the company stock. *See, e.g., Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 362, 230 A.2d 769, 773 (1967). A board may choose to reacquire shares held by a hostile party, generally being forced to pay an exaggerated premium, to relieve the corporation of the threat the hostile party represented. Some investors acquire large blocks of a company in hopes of obtaining this "greenmail" premium. *See, e.g., Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (noting that Boone Pickens has a national reputation as a "greenmailer").

Other strategic defenses employed have involved corporate acquisitions of assets or subsidiaries to create antitrust and other regulatory problems for a seeking acquirer. In *Panter*, for example, the target company negotiated agreements for store locations in malls where the acquirer was already present. 646 F.2d at 278. As a result, a successful takeover would have had monopolistic implications and legal consequences. *Id.*

¹⁰ *See, e.g., Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,136 (C.D. Cal. Nov. 29, 1976) (finding target board's "sole, primary, compelling and controlling purpose . . . to thwart the . . . tender offer"); *Condec Corp. v. Lunkenheimer Co.*, 43 Del. Ch. 353, 362, 230 A.2d 769, 773 (1967) (finding primary purpose of stock issuance to prevent takeover).

¹¹ Compare *Panter*, 646 F.2d at 295 (refusing to shift burden to directors where transaction would have the effect of their retaining control) with *Cheff v. Mathes*, 41 Del. Ch. 494, 504, 199

measure to protect their corporation from what they believe to be a threat to corporate policy or effectiveness, most courts will presume the decision was made in good faith after reasonable investigation and in the best interests of the corporation.¹² These presumptions constitute the business judgment rule, which courts invoke in deferring to the business judgment of a corporation's directors. When a board of directors, confronted with an immediate hostile takeover attempt, that is, a tender offer of which the board does not approve, takes some action to disenchant the would-be acquirer or to divert voting control into friendly hands, the business judgment rule presumptions may limit the scope of judicial review.

Traditionally, courts have been cautious in comparing their hindsight business judgment with the board's on-the-spot expertise,¹³ but in recent years the Delaware courts have intensified their scrutiny of directorial actions.¹⁴ In *Unocal Corp. v. Mesa Petroleum Co.*,¹⁵ for example, the Delaware Supreme Court established a two-part judicial inquiry first to determine whether the directors confronted with the hostile takeover attempt had reasonable grounds for believing that corporate policy and effectiveness were threatened, and second to determine if the directors' action was reasonable in relation to the threat recognized.¹⁶ Only upon satisfying these inquiries, the *Unocal* court held, would the business judgment rule assumptions of propriety be afforded the directors' actions.¹⁷ The Delaware Supreme Court designed this threshold test to ensure that the directors had satisfied the prerequisites for the business judgment rule — due care, loyalty to the corporation, and independence from the transaction.¹⁸

When a board adopts a defensive measure prospectively, as a general defense against the possibility of future takeover attempts, and that measure forces acquirers to negotiate with the board prior to extending a tender offer to shareholders, it becomes especially difficult for a court to determine whether the board has acted in the best interests of the corporation. If there is no immediate hostile offer, there is no threat for courts to evaluate and the basis for the directors' action is unclear. It is crucial, therefore, that courts carefully scrutinize the purpose and effect of the adoption of a prospective defensive measure in order to ensure that the directors are not acting for personal interests, such as entrenchment in their positions of control over the corporation.

When a board of directors adopts a poison pill rights plan as a prospective defensive measure deterring hostile takeover attempts, as did the board of Household in *Moran v. Household International, Inc.*,¹⁹ the issues of whether the board acted within its scope of authority and whether it acted for a proper purpose become particularly critical. A rights

A.2d 546, 554 (Del. 1964) (shifting burden to directors to prove good faith in authorizing corporation's purchase of its own stock, to deter a takeover attempt).

¹² See *Warshaw v. Calhoun*, 43 Del. Ch. 148, 157, 221 A.2d 487, 492-93 (Del. 1966).

¹³ Block & Prussin, *The Business Judgment Rule and Shareholder Derivative Actions: Viva Zapata?*, 37 BUS. LAW. 27, 31-32 (1981).

¹⁴ See *infra* notes 151-74 and accompanying text, discussing three recent cases in which the Delaware Supreme Court has conducted searching reviews of board actions.

¹⁵ 493 A.2d 946 (Del. 1985).

¹⁶ *Id.* at 955.

¹⁷ *Id.* at 954.

¹⁸ *Aronson v. Lewis*, 473 A.2d 805 (Del. 1985). See also *Unocal*, 493 A.2d at 954. The *Unocal* court found that "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.*

¹⁹ 500 A.2d 1346 (Del. 1985).

plan is enacted by a board of directors creating and issuing stock rights for the purchase of shares of a new class of preferred stock. The issuance of these rights does not require shareholder approval.²⁰ These rights are issued to stockholders as a dividend on common stock. Besides the right to purchase preferred stock, the rights also have a "poison pill" aspect designed to deter would-be acquirers. The deterrent may assume many forms, but always the holder, upon the occurrence of a triggering event, becomes entitled to some highly favorable exchange, the burden of which is borne by the hostile acquirer. Triggering events are typically the announcement of a tender offer for a controlling share of the outstanding common voting stock or the accumulation of a controlling share of common stock for the commencement of a proxy contest.²¹

The deterrent provision of a rights plan may be tailored to ensure that all shareholders will be treated fairly in the event of a hostile acquisition. This objective may be achieved by a redemption clause, which permits shareholders to redeem their shares for some predetermined fair price, or a conversion clause, which permits shareholders to exchange their stock in an acquired corporation for an equal value of the acquirer's stock.²² Flip-over provisions may also protect shareholders by taking a stock right which previously entitled holders to purchase shares of the corporation owned, and flipping it over, upon acquisition of the corporation by a hostile acquirer, to entitle the holders to buy shares of the acquirer. Any of these means can ensure that stockholders are treated fairly by guaranteeing a fair exchange for their investments.

These rights plan deterrent devices can also be abused. Boards of directors, for example, can prevent hostile acquisitions by artificially inflating the return guaranteed to the stockholders. Where, instead of a fair price, the right entitles the holder to receive from an acquirer some multiple of the value of the holder's investment, the issue of abuse arises. In these situations, the penalty imposed on an acquirer is evidence that directors are seeking some objective other than merely protecting shareholders.

Present controversy over rights plans focuses on the directors' reserved right to redeem the rights at a nominal price if the directors approve of a tender offer. As a result of this power to redeem, offerors must negotiate with the board and obtain their approval of any offer the bidder seeks to extend to the shareholders.²³ Where the directors deny approval, the offeror is subjected to the "poison" of the rights plan and acquisition becomes infeasible.²⁴ Thus, the employment of a rights plan may preclude

²⁰ The board's authority to create and issue stock rights plans is derived from DEL. CODE ANN. tit. 8, § 157 (1983) (authorizing a board to create, adopt, and issue new classes of securities by board resolution).

²¹ A proxy contest is the solicitation of shareholder votes to challenge the incumbent board of directors.

²² See Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 94 HARV. L. REV. 1964, 1964-65 (1984).

²³ *Moran v. Household Int'l*, 490 A.2d 1059, 1066 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

²⁴ The *Moran* court found that there were "many methods around the Plan" adopted by the Household board. *Moran*, 500 A.2d at 1354. The Securities and Exchange Commission (filing a brief *amicus curiae* for *Moran*) found that the Rights Plan deterred "virtually all hostile tender offers." Brief for the Securities Exchange Commission (*amicus curiae*), at 12, *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985).

In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, Nos. 353, 354, slip op. (Del. Mar. 13, 1986), the Revlon Board adopted a poison pill plan, but also passed a resolution redeeming the rights in connection with any cash proposal exceeding a stated minimum bid. *Id.* at 7. The offerer's

potential acquirers from considering the corporation as a potential target because they face the added risk of rejection of their offer by the board's ability to defeat their purchase attempt.²⁵

*Moran v. Household International, Inc.*²⁶ is the first case in which the Delaware Supreme Court ruled on the validity of a board's adoption of a "poison pill" rights plan as a prospective defensive measure. Household International is a holding company consisting of several independently operating subsidiaries engaged in diverse industries.²⁷ Early in 1984, the board of directors, concerned with Household's vulnerability to hostile takeovers,²⁸ obtained the services of a proxy solicitation consultant to evaluate the prospect of shareholder approval of a fair-price amendment to the corporation's charter.²⁹ After learning that the prospects were dim, Household's chairman sought legal and financial advice to formulate an alternative defensive proposal.³⁰ Following written and oral presentations and extended discussion, the Household board adopted a highly complex preferred stock purchase rights plan (the Rights Plan) prepared for them by the law firm of Wachtell, Lipton, Rosen & Katz, the originators of "poison pills."³¹

Under the Rights Plan, one right to purchase preferred stock would be issued as a dividend to stockholders for each share of common stock held. The rights could be exercised only upon the occurrence of a triggering event — a person or group's acquisition of 20% of Household's common stock, or the announcement of a tender offer for 30% of Household's stock.³² Once triggered, the rights would entitle the holder to purchase shares of a newly issued preferred stock at a price which far exceeded their market value.³³ If the holder did not purchase the preferred stock, a flip-over provision

bid exceeded the minimum, thus gaining the implicit approval of the board for the purpose of redeeming the rights. *Id.*

²⁵ *But see id.* at 4. In *Revlon*, the acquirer, Pantry Pride, announced a tender offer conditioned upon its receiving at least 90% of the outstanding common stock or otherwise conditioned on the board's removal of the impending note rights. *Id.* The risk remains that the conditions will not be met, but otherwise, such conditional offers may avoid the harm of poison pills.

²⁶ 500 A.2d 1346 (Del. 1985).

²⁷ *Id.* at 1349.

²⁸ *Moran v. Household Int'l*, 490 A.2d 1059, 1064 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985). The Household board's concern with coercive two-tier takeovers was founded on several factors. First, as a diversified holding company, Household would be vulnerable to a "bust-up" takeover, whereby highly leveraged acquirers could sell off pieces of the corporation to pay off their debt. *Id.* at 1064. Second, recent market activity showed special interest in the financial services industry (Household Finance Co. is one of Household's wholly owned subsidiaries). Third, the plaintiff, John A. Moran, a board member, also declared the interest of his company, D-K-M, in buying out Household. A study performed by D-K-M indicated that Household was undervalued in relation to its break-up value. *Id.*

²⁹ *Id.* As a charter amendment, the fair price provision may only be adopted by a shareholder majority vote. 8 DEL. CODE ANN. tit. 8, § 242(b)(1). The provision considered by Household required supermajority voting approval of acquisitions and mergers and set a minimum acceptable price. *Moran*, 490 A.2d at 1064 n.1.

³⁰ *Moran*, 490 A.2d at 1064. The consultant estimated the shareholder approval rate at 50.8% to 58.3% *Id.*

³¹ *Id.* at 1067.

³² *Id.* at 1066.

³³ *Id.* Shareholders were unlikely to purchase the preferred stock due to the exercise price and terms of the stock. A \$100 exercise price entitles the holder to purchase 1/100 share of preferred

provided that, in the event of a merger or consolidation, the holder could purchase \$200 worth of the acquirer's stock for \$100 (the "two-for-one flip-over" provision).³⁴

The Household board could redeem the rights for \$.50 per right at any time prior to the 20% triggering event — the acquisition by a person or group of 20% of Household's outstanding stock.³⁵ Once the 20% trigger occurred, however, the rights became a permanent part of Household's capital structure for their ten-year life.³⁶ If a tender offer were made for 30% of Household's stock, the board would have to consider redeeming the rights. The board viewed this right of redemption as a strong negotiating device which they could employ to protect the interests of all constituencies of the corporate family.³⁷ All but two of Household's directors, a majority of which were independent (not members of Household's management), approved the Rights Plan.³⁸

Following the board's adoption of the Rights Plan, John A. Moran, a director of Household, and his company, Dyson-Kisner-Moran Corporation (D-K-M) filed suit in the Court of Chancery of Delaware against Household and thirteen of its directors who voted to adopt the Rights Plan.³⁹ Moran's action sought to invalidate Household's Rights Plan on the grounds that it abridged fundamental rights of stock ownership by restricting the alienability and marketability of Household shares, and it severely limited the ability of shareholders to engage in proxy contests.⁴⁰ Household responded that the Rights Plan was designed for the protection of both the shareholders and the corporation.⁴¹

with dividends 100 times that received on common stock (then trading between \$30 and \$33 per share). *Id.*

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.* at 1067. The Household Board consisted of sixteen directors: nine independent, one a retired chief executive officer and chairman, and six members of senior management. *Id.* at 1064.

³⁹ *Id.* at 1063. Suit was filed in Delaware because Household was incorporated in that state. Gretl Golter, a shareholder, was permitted to intervene as an additional plaintiff. *Id.* Golter reiterated Moran's claims and challenged a board resolution amending Household's employee stock option plan. *Id.* at 1081.

⁴⁰ *Id.* at 1064. Moran brought suit both individually, as a corporate director, to protect the rights of the shareholders, and derivatively, as a shareholder. *Id.* at 1063. The court found that Moran had no standing as a director, but rather that the claims were derivative in nature. *Id.* at 1071.

⁴¹ *Id.* at 1068. Household counterclaimed that Moran had violated his directorial fiduciary duty by abusing his position to gain access to confidential information which he used for personal gain at the expense of the shareholders. *Id.* at 1082. The court held for Moran on this counterclaim because no evidence indicated that the information was confidential or that it was used against the corporation. *Id.* The issue was not appealed.

Household moved to dismiss the claim on three grounds: failure to comply with procedural requirements of a derivative suit, lack of ripeness, and failure to join necessary parties. *Id.* at 1069. The court denied the motion for dismissal. *Id.* at 1074. The asserted procedural failure to make a demand on the board to remedy the dispute prior to litigation, the court held, was excused for futility. *Id.* at 1071 (citing *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (excuse of demand where a derivative plaintiff alleges facts creating a reasonable doubt that directors were disinterested and independent and validly exercising their business judgment)). The court then held that Moran's claim was ripe because Moran alleged that the Rights Plan deterred tender offers and, if this were so, injury would result in the absence of specific tender offers. *Moran*, 490 A.2d at 1072. Finally, the court found that other shareholders need not be joined because their interests were adequately

Moran argued that the Household directors were not entitled to protection from judicial scrutiny under the business judgment rule because their actions were beyond their authority and were intended to accomplish the improper purpose of entrenchment.⁴² Even if the court were to apply the business judgment rule, Moran further argued, the rule would require that the Household directors bear the burden of proving that the Rights Plan was reasonable and fair to the shareholders.⁴³

Finding that the directors had not acted for an improper purpose, the trial court deferred to the board's judgment by invoking the business judgment rule presumptions of good faith, reasonable investigation, and acting in the corporation's best interests.⁴⁴ The court held that the burden of proving good faith did not shift to the board where Moran had not shown that the directors acted for the sole or primary purpose of entrenchment.⁴⁵ Evidence that entrenchment was only one of the board's motives, the court stated, was insufficient to shift the burden.⁴⁶

Having held the business judgment rule applicable to the Household board's adoption of the Rights Plan, the trial court next found that Delaware General Corporation Law authorized the Household board to adopt the Rights Plan.⁴⁷ The board derived this authority, the court reasoned, from section 151 of the Delaware General Corporation Law,⁴⁸ which empowers the board to issue new classes of securities, and *National Education Corp. v. Bell & Howell*, which interpreted section 151 to include securities issued for non-financial purposes.⁴⁹ The *Moran* trial court found that the board's authority to adopt a defensive measure derived from its responsibility to govern the corporation, and, therefore, that the board was entitled to formulate takeover policy.⁵⁰ The adopted Rights Plan was within the board's discretion, the court held, because it did not unduly restrict alienation of the stock,⁵¹ or subvert corporate democracy,⁵² and because entrenchment was not the board's primary purpose for adopting the Rights Plan.⁵³ The court determined that the infringements upon shareholders' rights were acceptable as incidental to the board's valid exercise of its business judgment.⁵⁴

represented by the parties already involved in the litigation. *Id.* at 1074. Delaware Chancery Rule 19(a) mandates joinder of parties whose presence is required to afford complete justice to the parties present and where the absent parties claim an interest in the subject matter of the litigation and their absence would impair their ability to protect that interest. *Id.* at 1072-74.

⁴² *Id.* at 1075.

⁴³ *Id.* at 1074-75.

⁴⁴ *Id.* at 1076.

⁴⁵ *Id.*

⁴⁶ *Id.*

⁴⁷ *Id.* at 1076-77. The court found the Rights Plan authorized under DEL. CODE ANN. tit. 8, § 157 (1983) (authorizing the issuance of stock rights) and DEL. CODE ANN. tit. 8, § 151 (1983) (permitting the issuance of preferred shares with non-financially related terms). *Id.* The court found that the Rights Plan did not violate DEL. CODE ANN. tit. 8, § 202(b) (1983) (prohibiting restrictions on the transferability of stock). *Id.* at 1079.

⁴⁸ *Id.* (citing DEL. CODE ANN. tit. 8, § 151 (1974)).

⁴⁹ No. 7278, slip op. at 1, 10 (Del. Ch. Aug. 25, 1983).

⁵⁰ *Moran*, 490 A.2d at 1079.

⁵¹ *Id.*

⁵² *Id.* at 1080.

⁵³ *Id.* at 1082.

⁵⁴ *Id.* at 1082-83. The court found that all aspects of plaintiff intervenor's claim merged with

In affirming the trial court's decision,⁵⁵ the Delaware Supreme Court held that the business judgment rule was the appropriate standard for reviewing the board of directors' decision to adopt a poison pill rights plan.⁵⁶ Recognizing the inherent conflict facing directors confronting hostile takeover attempts, however, the *Moran* court followed *Unocal Corporation v. Mesa Petroleum Co.*⁵⁷ in conducting a threshold inquiry into the appropriateness of the directors' action.⁵⁸ Pursuant to *Unocal*, the court placed an initial burden on the directors to come forward with evidence showing reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and showing that the rights plan was reasonable in relation to the demonstrated danger.⁵⁹ A perceived threat in the marketplace of coercive two-tier tender offers,⁶⁰ the court held, was a sufficient threat to justify the Household board's adoption of a poison pill rights plan with a two-for-one flip-over entitling shareholders to purchase \$200 worth of an acquirer's stock for \$100.⁶¹ Ruling that the Rights Plan was a reasonable measure adopted for a valid purpose and was authorized under the Delaware General Corporation Law, the court deferred to the board's decision by invoking the business judgment rule presumptions to protect the decision.⁶² Because *Moran* did not adequately rebut the presumptions by proving the directors had acted in bad faith to retain their control, the court upheld the Rights Plan without further scrutiny.⁶³

The Delaware Supreme Court's decision in *Moran* effectively permits a board of directors to appoint itself negotiating agent for the shareholders. This power exceeds the directors' scope of authority and infringes on fundamental shareholder rights. In *Moran*, the Delaware Supreme Court correctly extended the application of the *Unocal* test to prospective defensive measures, that is, defense mechanisms adopted in anticipation of hostile takeovers where no specific threat of takeover exists.⁶⁴ The *Moran* court, however, applied the *Unocal* threshold burden so liberally that the purpose of the test — to ensure that directors do not unduly infringe on shareholder rights — was defeated. The Household board adopted a rights plan that infringed on shareholders' rights more than was necessary to achieve the objective sought by the board. Although the *Unocal* test should prevent such an invasion of shareholder rights, the *Moran* court's application of *Unocal* did not protect shareholder rights.

The *Moran* court's lenient application of *Unocal*'s threshold test permits a corporate board to perpetuate its control of a corporation, to usurp shareholders' rights to receive

Moran's and that so long as the directors were validly exercising their business judgment, the incidental harms complained of were without remedy. *Id.* at 1082.

⁵⁵ 500 A.2d 1346, 1348 (Del. 1985).

⁵⁶ *Id.* at 1350.

⁵⁷ 493 A.2d 946 (Del. 1985).

⁵⁸ *Moran*, 500 A.2d at 1356.

⁵⁹ *Id.* at 1357.

⁶⁰ Coercive two-tier tender offers are a means by which an acquirer may purchase 100% of a public corporation's outstanding stock. Using this strategy, the offeror makes an attractive cash bid for a bare majority of shares (for example, 51%) in the first tier of purchases, and once the stock is no longer actively trading on the stock market, the offeror forces out the remaining shareholders at a lower bail-out price in the second tier. Shareholders are coerced into selling in the first tier for fear they will be forced out in the second tier. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

⁶¹ *Moran*, 500 A.2d at 1352.

⁶² *Id.* at 1355-56.

⁶³ *Id.* at 1356.

⁶⁴ *Id.* at 1350.

and accept tender offers, and to deny shareholders their vote on fundamental decisions regarding the corporate structure and existence. This reallocation of decisionmaking power upsets corporate democracy and inverts the corporate structure. Under *Moran*, directors can escape judicial review of their breaches of the fiduciary duty owed to shareholders, including the breach arising from directors' actions taken to retain their control of the corporation. A board is able, under the standard of review applied in *Moran*, unilaterally and indirectly to effect changes and make decisions which should require authorization by a shareholder majority.

This casenote begins with a background discussion of judicial approaches to the actions of a board of directors confronted with hostile takeover attempts. The section examines the various adaptations of the business judgment rule that courts have applied to directors' defensive decisions, focusing on the directors' level of interest and the corresponding burden of proof which courts impose on the directors. The background section then discusses the unique judicial concerns associated with poison pill rights plans. Section two presents the Delaware Supreme Court's opinion in *Moran v. Household International, Inc.*⁶⁵ Section three analyzes the *Moran* opinion in light of the *Unocal* precedent, which the court attempted to follow. This section suggests that the *Moran* court applied *Unocal* leniently, and discusses the harms that arise under a lenient application of the *Unocal* standard — the infringements on shareholder rights.

I. BASES FOR SCRUTINIZING TAKEOVER DEFENSES

Under the business judgment rule, courts will not hold the directors of a corporation liable for mistakes of judgment in the absence of fraud, bad faith, or gross overreaching,⁶⁶ if the directors can show reasonable grounds for believing their action was in the best interests of the corporation.⁶⁷ Through this rule, courts have created a presumption that the directors' action was undertaken in good faith, after reasonable investigation, and in the company's best interests.⁶⁸ A party challenging a board's decision must prove the directors acted in bad faith to overcome the presumption.⁶⁹

Courts generally refuse to review a board's valid exercise of business judgment in day-to-day transactions when shareholders are dissatisfied with the results of those judgments.⁷⁰ This policy, the embodiment of the business judgment rule, is appropriate because directors are agents whom shareholders elect to manage the daily business and affairs of the corporation.⁷¹ When directors become involved in making ownership decisions for shareholders, however, they no longer share common interests with the shareholders. Shareholders generally seek profits, while directors may seek to retain their positions. Therefore, in making ownership decisions, the directors may be acting beyond their authority⁷² and be interfering with shareholder democracy and property rights.⁷³

⁶⁵ 500 A.2d 1346 (Del. 1985).

⁶⁶ *Warshaw v. Calhoun*, 43 Del. Ch. 148, 157, 221 A.2d 487, 492-93 (1966).

⁶⁷ *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

⁶⁸ *Id.*

⁶⁹ *Johnson v. Trueblood*, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981).

⁷⁰ *See, e.g., Auerbach v. Bennett*, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979).

⁷¹ DEL. CODE ANN. tit. 8, § 141 (1983).

⁷² *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984).

⁷³ *See id.* The *Norlin* court noted that "[w]hile the day-to-day affairs of a company are to be

Given this potential conflict of interests between shareholders and directors in the context of hostile takeovers, commentators have debated over whether courts should invoke the business judgment rule and defer to directors' decisions relating to takeover contests where the board acts to avert hostile acquisition attempts.⁷⁴ Two divergent views of this issue would support different levels of judicial review. If courts view directors whose positions are at stake in a control contest as having a vital personal interest in making the corporation takeover-proof, then instead of deferring to the directors' judgments, the court will apply an "intrinsic fairness test" to ensure that the directors have dealt fairly with all parties involved in the transaction.⁷⁵ If, however, courts view directors as facing only a minor conflict of interest not much greater than that which usual transactions might invite, then the courts will regard the directors' action with a lower level of scrutiny, such as that represented by the business judgment rule.⁷⁶

Initially, when confronting a shareholder challenge to a board's defensive action, courts scrutinize directors' defensive actions to ensure that the directors acted to further business and not personal interests.⁷⁷ In conducting this test, courts first examine whether a proper business purpose exists to justify the board action.⁷⁸ For example, the adoption of a defensive mechanism to avert a clear danger to corporate policy and effectiveness has a valid business purpose.⁷⁹ Conversely, action for the sole or primary purpose of entrenchment of management has no proper purpose. If directors can show no other purpose for their action, a court will strictly scrutinize the effects of that decision, possibly finding that directors breached their fiduciary duty owed to shareholders.⁸⁰

Those courts holding that directors have no conflict of interest in control contests may presume good faith when any rational purpose can be attributed to a board's action.⁸¹ This standard, whereby a court will impute any rational purpose to the board's action, places a heavy burden on the plaintiff challenging the board. In recent years, several states, including Delaware, have asserted that this lenient standard is insufficient

managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures." *Id.* See *infra* notes 215-20 and accompanying text for a discussion of shareholder democracy.

⁷⁴ See Block & Miller, *The Responsibilities and Obligations of Corporate Directors in Takeover Contests*, 11 SEC. REG. L.J. 44, 72 (1983) ("[w]hile the business judgment rule may in some circumstances serve to insulate certain of recalcitrant management's actions from judicial review, if interpreted properly, it well may advance the best interests of both the shareholders and management's other constituencies"); Easterbrook & Fischel, *Proper Role*, *supra* note 3, at 1162 ("corporate directors should not be entitled to interfere with the relationship between offerors and the shareholders to whom their offers are directed"); Herzel, Schmidt & Davis, *Why Corporate Directors Have a Right to Resist Tender Offers*, 3 CORP. L. REV. 107, 116 (1980) ("[P]rohibiting the directors from interfering with tender offers would wholly eliminate the director's negotiating posture as an element in the involuntary acquisition process and severely weaken the competitive position of target companies and their shareholders . . . [Such prohibition] could also severely damage other participants in the corporation such as employees, customers, and creditors").

⁷⁵ See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).

⁷⁶ *Cheff v. Mathes*, 41 Del. Ch. 494, 199 A.2d 548 (1964).

⁷⁷ *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971).

⁷⁸ See *Joy v. North*, 629 F.2d 880, 889 (2d Cir. 1982), *cert. denied*, 460 U.S. 1051 (1983).

⁷⁹ *Cheff*, 41 Del. Ch. at 496, 199 A.2d at 554-55; see also *Kaplan v. Goldsamt*, 380 A.2d 556, 569 (Del. Ch. 1977) (business judgment rule protects directors' actions taken in response to "a clear threat to the future business or the existing, successful business policy").

⁸⁰ *Petty v. Penntech Papers, Inc.*, 347 A.2d 140, 143 (Del. Ch. 1975).

⁸¹ See, e.g., *Sinclair*, 280 A.2d at 720.

to protect shareholders.⁸² Thus, those courts have begun to tighten restrictions on directors' actions and promote shareholder interests in the context of takeover contests.⁸³

The following sections discuss the various considerations a court confronts in reviewing a board's decision to adopt a rights plan as a defense against hostile takeovers. When reviewing directorial actions intended to avert hostile takeovers, a court must first determine whether the directors have a personal interest in their decision such that their action must be strictly scrutinized.⁸⁴ Next, the court must ensure that the board acted for a proper business purpose and within the scope of its authority.⁸⁵ Finally, the court must review the rights plan's reasonableness — in light of its impact upon the corporation, the shareholders, and potential tender offerors — in relation to its alleged purpose.⁸⁶

A. Directors' "Interest" in Control Contests

Courts have imposed a fiduciary duty on corporate directors to act with undivided loyalty for the benefit of the corporation.⁸⁷ Directors breach this duty when they intentionally or otherwise manipulate the corporation to serve their own interests to the exclusion or detriment of the shareholders.⁸⁸ Hostile acquisitions present a threat to the positions of the directors and senior management of a target corporation. Therefore, when directors act to avert these takeover attempts, they may be motivated by either personal or corporate objectives.⁸⁹

When directors have a personal and pecuniary interest in a transaction, they are held to an extraordinary standard of proving the intrinsic fairness of their actions to all parties who have an interest.⁹⁰ This situation exists, for example, when a director sells property to a corporation. In these circumstances, the burden of proof shifts from the plaintiff challenging a directors' action, to the defendant director.⁹¹

By preventing a hostile takeover, directors also protect their board positions. Even where a defense adopted is clearly in the best interests of the corporation, the directors' actions are tainted by a conflict of interest because they enjoy a benefit, the retention of

⁸² See *Cheff*, 41 Del. Ch. at 504, 199 A.2d at 554 (quoting *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962)); *Easterbrook & Fischel, Proper Role*, *supra* note 3, at 1164; see also *Panther v. Marshall Field & Co.*, 646 F.2d 271, 299 (7th Cir. 1981) (Cudahy, J., dissenting), *cert. denied*, 454 U.S. 1092 (1981); *Johnson v. Trueblood*, 629 F.2d 287 (3d Cir. 1980) (Rosenn, J., dissenting), *cert. denied*, 450 U.S. 999 (1981).

⁸³ See, e.g., *Norlin*, 744 F.2d at 258 (applying New York law); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

⁸⁴ See *Aronson*, 473 A.2d at 814.

⁸⁵ *Cheff*, 41 Del. Ch. at 504, 199 A.2d at 554.

⁸⁶ *Unocal*, 493 A.2d at 955.

⁸⁷ H. HENN & J. ALEXANDER, *LAWS OF CORPORATIONS* § 235, at 626 (3d ed. 1983) (citing *Litwin v. Allen*, 25 N.Y.S.2d 667, 677-78 (Sup. Ct. 1940)).

⁸⁸ *Royal Indus. v. Monogram Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,137 (C.D. Cal. Nov. 29, 1976).

⁸⁹ See *Bennett v. Propp*, 41 Del. Ch. 14, 22, 187 A.2d 405, 409 (1962). Directors often have ties to the corporation beyond their directorship. Many directors are members of management or of directly related companies or firms with which the target company does business. See E. HERMAN, *CORPORATE CONTROL, CORPORATE POWER* 36-39 (1981).

⁹⁰ *Sinclair*, 280 A.2d at 719-20.

⁹¹ *Puma v. Marriott*, 283 A.2d 693, 695 (Del. Ch. 1971).

their offices, which is not generally enjoyed by the corporation and its shareholders.⁹² Therefore, by rejecting the takeover, the directors further their personal interests.⁹³ Since bidders seeking to acquire control of a company generally must make an offer that exceeds the current market value of a target's stock, shareholders' desire to receive takeover premiums may conflict with directors' desire to retain their offices. Despite the possible conflict of interests, courts generally hold that the directors' interest in retaining their positions is not a self-dealing interest of the same magnitude as a director's sale of personally owned property to the corporation.⁹⁴ Therefore, most courts do not apply the intrinsic standard in the takeover context, but rather resort to a modified business judgment rule standard, such as that established in *Unocal*, where directors were required to satisfy a threshold test.⁹⁵

Irrespective of the fact that directors will further their personal interests, in some situations directors have a duty to oppose takeover attempts which would be detrimental to the well-being of the corporation.⁹⁶ This may be required even at the expense of the short-term interests of the shareholders.⁹⁷ Directors are, therefore, subject to conflicting duties: they must not act in their self-interest, yet they must oppose acquisitions not in the best interests of the corporation. In certain instances, the directors' self-interest in retaining control may coincide with their duty to oppose acquisitions not in the corporation's best interest. Because these interests may coincide, courts have held that directors breach their fiduciary duty only when retention of control was the sole or primary purpose of their action.⁹⁸ Therefore, evidence that the retention of control was one of the results of, or even one of the motivating factors of, the board's decision does not by itself constitute a showing of bad faith.⁹⁹

Judicial review of directors' defensive actions can thus be classified into three categories. The strictest review, the intrinsic fairness test, is applied when directors engage in a transaction in which they have a personal and pecuniary interest. Generally this scrutiny is reserved for situations where a director actually buys or sells assets from or to the corporation and requires directors to prove the intrinsic fairness of the transaction to all interested parties.¹⁰⁰ At the other extreme is the business judgment rule. According to this rule, which courts apply to transactions where the court has no reason to suspect the directors have acted for personal or improper reasons, courts will defer to the directors' business judgment and presume any directorial action was taken in good faith,

⁹² *Royal Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,137.

⁹³ See *Bennett*, 41 Del. Ch. at 22, 187 A.2d at 409.

⁹⁴ See *Unocal*, 493 A.2d at 954-55; *Cheff*, 41 Del. Ch. at 505, 199 A.2d at 554.

⁹⁵ See *Unocal*, 493 A.2d at 954. The *Unocal* court found that "a board's duty [in addressing a pending takeover bid] is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment." The court increased judicial examination at the threshold in recognition of the conflict of interests. *Id.*

⁹⁶ See *supra* note 6 for a description of the board's duty to oppose harmful tender offers. See also *Revlon*, slip op. at 6-7 (where the Revlon board adopted a poison pill rights plan in the face of a hostile bid which it "reasonably concluded was grossly inadequate," the court found the adoption to be valid).

⁹⁷ *Panter*, 486 F. Supp. at 1195.

⁹⁸ *Cheff*, 41 Del. Ch. at 505, 199 A.2d at 554. *Trueblood*, 629 F.2d at 293.

⁹⁹ *Trueblood*, 629 F.2d at 293.

¹⁰⁰ See *Sinclair*, 280 A.2d at 719-20.

after reasonable investigation, and in the best interests of the corporation.¹⁰¹ Once afforded these presumptions of propriety, the directors bear no burden of proof. A compromise standard, which falls somewhere between the strict scrutiny of the intrinsic fairness test and the deferential treatment of the business judgment rule, is applied when a plaintiff introduces evidence that the directors had a personal interest in the transaction challenged, or that the directors were manipulating the corporation to achieve personal gains not shared by the corporation generally.¹⁰² Courts are not uniform in their allocation of burdens of proof in these circumstances.¹⁰³

B. Directors' Burden of Proof in Control Contests

A trio of circuit courts of appeals cases — *Panter v. Marshall Field & Co.*,¹⁰⁴ *Treadway Companies v. Care Corp.*,¹⁰⁵ and *Johnson v. Trueblood*,¹⁰⁶ have considered the question of how to allocate properly burdens of proof in actions where shareholders contest directors' adoption of defenses to prevent takeovers. In these cases, the parties challenging the directors' actions bore the burden of proving fraud, bad faith,¹⁰⁷ or the predominance

¹⁰¹ See *Cheff*, 41 Del. Ch. at 505, 199 A.2d at 554.

¹⁰² See *Royal Indus.*, [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,863, at 91,137.

¹⁰³ Block & Miller, *supra* note 74, at 49.

¹⁰⁴ 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981). In *Panter* (decided under Delaware law), Marshall Field & Co., a target for acquisition by Carter Hawley Hale (CHH), negotiated leases for properties that would cause antitrust problems for CHH if CHH succeeded in its acquisition attempt. *Id.* at 278. Marshall Field shareholders brought suit against the directors and the corporation for violation of S.E.C. laws and state law fiduciary duties in connection with the withdrawn CHH offer. *Id.* at 299. The court directed a verdict for the defendants because plaintiffs presented no evidence of bad faith, overreaching, self-dealing, or any other fraud necessary to shift the burden of justification of the transactions to the defendants. *Id.* The court found that the uncontroverted evidence showed that the acquisitions were in line with the target's plans for long-term development and that the directors did not profit from their own wrongdoing. *Id.* at 297.

¹⁰⁵ 638 F.2d 357 (2d Cir. 1980). The *Treadway* court (interpreting New Jersey law) reviewed Treadway Companies' sale of 230,000 shares of stock to a white knight, preparatory to a merger which occurred immediately after a third party, Care Corp., acquired a large block of Treadway common stock. *Id.* at 360. The trial court found a breach of fiduciary duty in the directors' haste in negotiating the friendly merger and in their failure to make a good-faith consideration of the tender offer by Care. *Id.* at 373. The Second Circuit reversed, holding that the plaintiffs failed in their initial burden of proving the directors' interest or bad faith. *Id.* at 383. The court of appeals stated:

[T]he Treadway board was simply not acting to maintain its own control over the corporation. Rather, in approving the stock sale, they were moving Treadway toward a business combination with Fair Lanes . . . Moreover, Care made no showing that the directors other than Lieblich had any personal interest in having the merger consummated.

Id.

¹⁰⁶ 629 F.2d 287 (2d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981). In *Johnson v. Trueblood* (construing Delaware law), the minority shareholders brought suit against the majority shareholders, who comprised a majority of the board of directors, for acting against the corporate interest for the personal motive of entrenching their power. *Id.* at 292. The court required the plaintiff to show, by a preponderance of the evidence, that the directors acted for the sole or primary purpose of retaining control. The court declared that it would uphold the action so long as it could be attributed to any rational purpose. *Id.*

¹⁰⁷ *Panter*, 646 F.2d at 294; *Treadway*, 638 F.2d at 383 (placing the initial burden upon plaintiff to prove the directors' interest, bad faith or improper purpose).

of impermissible motives.¹⁰⁸ Irrespective of the takeover context, these courts would not interfere with the exercise of business judgment by corporate directors in the absence of fraud, bad faith, gross overreaching or abuse of discretion.¹⁰⁹

In the 1986 federal case of *Hanson Trust v. ML SCM Acquisitions, Inc.*,¹¹⁰ the Second Circuit, construing New York law, explicitly stated that the initial burden of proving directors' breach of fiduciary duty in averting a hostile takeover rests with the plaintiff.¹¹¹ The court shifted the burden, however, once the plaintiff had demonstrated that the directors' action was not fair to the corporation, and had shown that the directors breached their duty of care.¹¹² The court then required the board to prove the fairness of the action.¹¹³

Although these majority opinions from the federal courts placed the initial burden of going forward with evidence upon the plaintiff challenging directorial actions, two of these opinions, were accompanied by extensive dissents condemning the deference with which the courts treated the interested directors.¹¹⁴ In *Panter*, Judge Cudahy "emphatically disagree[d] that the business judgment rule should clothe directors, battling blindly to fend off a threat to their control, with an almost irrebuttable presumption of sound business judgment, prevailing over everything but the elusive hobgoblins of fraud, bad faith or abuse of discretion."¹¹⁵ Judge Rosenn, in *Johnson v. Trueblood*, sought to shift to the defendant directors the burden of going forward with the evidence to justify the transaction as primarily in the corporation's best interest, once a plaintiff had shown that the desire to retain control was one of the directors' motivating factors.¹¹⁶

Delaware state courts historically have diverged from the federal court majority view, and their decisions more closely resemble the dissents of Judges Cudahy and Rosenn. In the 1962 case of *Bennett v. Propp*,¹¹⁷ for example, the Delaware Supreme Court, deeming the board of directors to be inherently interested in retaining control, required the board to demonstrate a proper business purpose for their purchase of a large block of their own common stock.¹¹⁸ By requiring the board to go forward with

¹⁰⁸ *Trueblood*, 629 F.2d at 292.

¹⁰⁹ *Panter*, 646 F.2d at 293.

¹¹⁰ 781 F.2d 264 (2d Cir. 1986).

¹¹¹ *Id.* at 273.

¹¹² *Id.* at 272. In *Hanson*, the directors granted the white knight an option at less than fair market value. The option precluded the hostile offeror from acquiring the corporation, even though his bid price was higher than that of the white knight. *Id.*

¹¹³ *Id.* at 278.

¹¹⁴ In the *Hanson* case, the court ultimately shifted the burden to the directors, but only after the plaintiff made a substantial showing that the directors had breached their fiduciary duties. The opinion was accompanied by a dissent which, unlike the aforementioned federal cases, favored the directors. While the majority ruled for the plaintiffs and found that the directors did not satisfy their burden, the dissent found that the burden which the majority imposed was too severe. *Id.* at 289 (Oakes, J., dissenting). The dissent proposed that the directors' action should have been deferred to once it was proven free of any self-interest, fraud, and bad faith because it was reasonable for the directors to rely on the recommendations of financial advisors. *Id.* The majority found that the directors breached their duty of care because they unreasonably relied on reports of advisors. *Id.* at 273.

¹¹⁵ 646 F.2d at 299 (Cudahy, J., dissenting).

¹¹⁶ 629 F.2d at 301 (Rosenn, J., dissenting).

¹¹⁷ 41 Del. Ch. 14, 187 A.2d 405 (1962).

¹¹⁸ *Id.* at 22, 187 A.2d at 409. In the suit against the corporation and the directors, the chairman of the board alone was held liable because he covertly and without authority made the stock purchases and "practically admitted" that the purchases were made to preserve control. *Id.* at 20, 187 A.2d at 408.

evidence of a proper purpose, the *Bennett* court, in 1962, shifted the burden of proof to the board, a step that Judge Cudahy in *Panter* and Judge Rosenn in *Johnson* unsuccessfully attempted to have their courts take years later.

The shifting of the burden established in *Bennett* was followed two years later in *Cheff v. Mathes*.¹¹⁹ The *Cheff* court granted the directors business judgment rule protection only after they had satisfied an initial burden of demonstrating a threat to corporate policy and effectiveness from which they sought to defend the corporation.¹²⁰ The court distinguished the burden placed on these directors from that which would be placed on directors selling property to their corporation, because these directors did not have the same self-dealing interest. Whereas a director selling property would have to prove the intrinsic fairness of his dealings, the court stated, these directors needed only to satisfy a lesser standard of proof.¹²¹ The court also distinguished between directors related to the corporation only through their directorship (disregarding the ownership of common stock in the corporation), from those with a clear pecuniary interest, such as an executive of the corporation or the corporation's attorney.¹²² The court stated that it would not hold the former to the same standard of proof required of directors having a personal and pecuniary interest in the transaction.¹²³

The *Cheff* court declared that perpetuation of control is an improper motive for director action, but action motivated by a sincere belief that a defense is necessary to maintain what the board believed to be proper business practices would be protected by the business judgment rule.¹²⁴ To satisfy the *Cheff* burden of showing reasonable grounds to believe a danger to corporate policy and effectiveness existed, the directors needed only to show good faith and reasonable investigation.¹²⁵ The directors in *Cheff* presented sufficient evidence, based upon long-standing business policies of the corporation and the reputation of the acquirer, for the court to conclude that they reasonably believed in the presence of a threat to the future of the company in its present form.¹²⁶ Therefore, the *Cheff* court afforded the directors' judgment a presumption of good faith under the business judgment rule.¹²⁷

The 1971 decision of *Sinclair Oil Corp. v. Lewis*¹²⁸ weakened the burden *Cheff* had placed on interested directors. In the absence of directors' self-dealing, the *Sinclair* court

¹¹⁹ *Cheff*, 41 Del. Ch. at 504-05, 199 A.2d at 554.

¹²⁰ *Id.* at 506, 199 A.2d at 555.

¹²¹ *Id.* at 505, 199 A.2d at 554-55.

¹²² *Id.*

¹²³ *Id.*

¹²⁴ *Id.* at 504, 199 A.2d at 554 (citing *Kors v. Carey*, 39 Del. Ch. 47, 158 A.2d 136 (1960)).

¹²⁵ *Cheff*, 41 Del. Ch. at 506, 199 A.2d at 555.

¹²⁶ *Id.* at 508, 199 A.2d at 556.

¹²⁷ *Id.*

¹²⁸ 280 A.2d 717 (Del. 1971). Although *Sinclair* did not involve a hostile takeover, it did implicate a potential breach of fiduciary duty by "interested" directors who were in an analogous position to that of directors in a takeover defense. The action in *Sinclair* was brought by minority shareholders of a subsidiary against the parent corporation for damages sustained by the subsidiary due to the parent's decision to have the subsidiary pay excessive dividends, thereby denying it any opportunity for expansion. *Id.* at 719. The court found that the parent so decided due to its need for money, but found no breach of fiduciary duty because the minority holders were treated fairly. *Id.* at 721.

The *Sinclair* court defined self-dealing, in the context of a parent-subsidary transaction, as a situation where "the parent, by virtue of its domination of the subsidiary, causes the subsidiary to act in such a way that the parent receives something from the subsidiary to the exclusion of, and detriment to, the minority shareholders of the subsidiary." *Id.* at 720.

held that it would not review business decisions by informed directors unless plaintiffs showed improper motives, fraud or gross overreaching on the part of the directors.¹²⁹ Under this standard, courts would defer to the directors' judgment if a board decision could be attributed to any rational business purpose, thereby freeing the board from having to defend or even go forward with evidence to justify their actions.¹³⁰ The *Sinclair* "any attributable purpose" test proved too lenient, however, where directors sought to protect their companies from takeovers, because of the inherent danger that the directors could be acting for selfish purposes.¹³¹ Where the *Cheff* court's application of the business judgment rule required directors to show good faith once a plaintiff introduced evidence that the directors had personal interests in a transaction, the *Sinclair* court was willing to impute a good faith purpose if any such purpose could be construed.

Responding to the problems inherent in the lenient *Sinclair* standard, the Delaware Supreme Court, in *Unocal Corp. v. Mesa Petroleum Co.*,¹³² increased the burden placed on directors. Under *Unocal*, directors were, at the threshold, required to show a valid purpose for adopting a takeover defense before business judgment rule protection would be conferred.¹³³ Furthermore, the court required the directors to show that the measure adopted was reasonable in relation to their stated purpose.¹³⁴

In *Unocal*, the board of the target company sought to protect the corporation from what it determined was a grossly inadequate and coercive two-tier takeover.¹³⁵ The *Unocal* board adopted a discriminatory self-tender plan to subsidize the shareholders who would otherwise be forced to accept "junk bonds" — bonds of dubious value representing subordinated debt with poor ratings.¹³⁶ The self-tender plan was discriminatory because the board would purchase the corporation's shares from any holder except Mesa, the party extending the coercive offer.¹³⁷ In reviewing the board's action, the *Unocal* court placed a two-part burden upon the *Unocal* board, which it was required to satisfy in order to qualify for the business judgment rule presumptions of good faith, reasonable investigation, and acting in the best interests of the corporation. First, the board was required to show reasonable grounds for believing that a threat to corporate policy or effectiveness existed.¹³⁸ The board presented, and the court discussed in detail, the board's grounds for believing that the tender offer presented was grossly inadequate and coercive, such that shareholders might be forced to accept an unfavorable ex-

¹²⁹ *Id.* at 722.

¹³⁰ *Id.* at 720.

¹³¹ See *Unocal*, 493 A.2d at 954 ("Because of the omnipresent spectre that a board may be acting primarily in its own interests . . . there is an enhanced duty" requiring the board to justify its action.).

¹³² 493 A.2d 946 (Del. 1985).

¹³³ *Id.* at 954-55.

¹³⁴ *Id.* at 955.

¹³⁵ *Id.* at 956. Coercive two-tier takeovers generally comprise an offer of a cash premium to a bare majority of shareholders followed by an exchange forced upon the remaining minority shareholders at a low price. *Id.* In *Unocal*, the offeror, Mesa Petroleum, offered \$54 per share for 37% of *Unocal*'s outstanding stock and intended in the second tier to eliminate the remaining publicly held shares by exchanging securities "purportedly worth \$54 per share." *Id.* at 949. The securities offered were highly subordinated and "rather aptly termed . . . 'junk bonds.'" *Id.* at 949-50.

¹³⁶ *Id.* at 956.

¹³⁷ *Id.* at 951.

¹³⁸ *Id.* at 955.

change.¹³⁹ The *Unocal* court noted the inequity of the exchange to which shareholders would be subjected if the takeover attempt were successful.¹⁴⁰ The court found that the board's purpose, to defeat the inadequate offer or to provide shareholders with an equitable exchange, was a sufficient purpose to justify a defensive action.¹⁴¹

The second part of the directors' burden was a required showing that the adopted measure was reasonable in relation to the stated threat.¹⁴² After establishing the board's authority under Delaware law to make a discriminatory self-tender offer,¹⁴³ the court analyzed the effect of the measure on shareholders and on Mesa, the acquirer.¹⁴⁴ The court noted that the board's defensive measure would provide shareholders, who might suffer from the inadequacy of the second tier of Mesa's tender offer, the substantial equivalent of what they held before the tender offer.¹⁴⁵ The court further noted that the plan needed to be discriminatory in order to avoid benefiting Mesa, who would mistreat the shareholders.¹⁴⁶ The board's duty, the court declared, was to ensure that the minority shareholders receive equal value for their shares.¹⁴⁷ Thus, the board's action was reasonable, the court stated, because it offered a fair value to those shareholders who would otherwise have suffered from Mesa's offer.¹⁴⁸ Finding that the board had satisfied the two-part test, the court invoked the business judgment rule presumptions that the board had properly exercised its business judgment, and upheld the board's action without further scrutiny.¹⁴⁹

Unocal represents the final product of Delaware's gradual development of a test appropriate for reviewing the actions of directors' adopting defenses against hostile takeovers. The *Unocal* test is a compromise standard between the strict scrutiny of an intrinsic fairness test and the lack of scrutiny under the traditional business judgment rule. The test allows a court to make a threshold review of crucial aspects of a defensive measure and thereby ensure its overall reasonableness to the parties affected. The *Unocal* court, however, went further than just seeking reasonableness. The court looked to the fairness of the transaction, specifically noting that the directors' defensive action was consistent with the directorial role of ensuring that minority shareholders receive the substantial equivalent in value that they would have received but for the directors' action and the coercive tender offer.¹⁵⁰ This review of actual value equivalence represents a substantive review, in contrast with procedural reviews which would test only whether the directors acted in good faith for a proper purpose. This search for fairness demonstrates the Delaware courts' increasing willingness to delve deeper into the substance of business transactions.

¹³⁹ *Id.* at 956.

¹⁴⁰ *Id.*

¹⁴¹ *Id.* at 956-57.

¹⁴² *Id.* at 955.

¹⁴³ DEL. CODE ANN. tit. 8, § 160(a)(1) (1983). Section 160(a)(1) provides in relevant part: "Every corporation may purchase . . . use and otherwise deal in and with its own shares." *Id.*

¹⁴⁴ *Unocal*, 493 A.2d at 956.

¹⁴⁵ *Id.* (quoting *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 306, 93 A.2d 107, 114 (1952)).

¹⁴⁶ *Unocal*, 493 A.2d at 956.

¹⁴⁷ *Id.* at 957.

¹⁴⁸ *Id.* at 956-57.

¹⁴⁹ *Id.* at 958.

¹⁵⁰ *Id.* at 956.

C. Substantive Judicial Review of Directors' Actions

When a court invokes the business judgment rule it affords directors a presumption of propriety, thereby glossing over the substance of the board's judgment.¹⁵¹ An intrinsic fairness test, at the other extreme, is a complete substantive review which ensures that all interested parties are treated fairly.¹⁵² The *Unocal* court's concern with substantive fairness demonstrates the trend in Delaware case law of increasing scrutiny of directors' decisions that infringe on shareholders' rights.¹⁵³ In *Aronson v. Lewis*,¹⁵⁴ for example, the Delaware Supreme Court looked into the substance of the directors' actions rather than relying on the presumption of the business judgment rule in considering plaintiff's failure to make a demand of the board to address an alleged wrong prior to filing a derivative suit against the corporation.¹⁵⁵ The court held that if, under the facts alleged, there is reasonable doubt that the directors are disinterested and independent and that the challenged transaction was the product of a valid exercise of business judgment, then demand of the board would be excused.¹⁵⁶ In determining the propriety of the board's action, the *Aronson* court analyzed the substantive nature of the challenged transaction.¹⁵⁷ Thus, the *Aronson* decision reflects the court's willingness and obligation to look beyond the illusive motivational test and to conduct searching reviews of procedures and outcomes.

This substantive scrutiny has carried into the law of freeze-out mergers.¹⁵⁸ In a freeze-out merger, a majority shareholder eliminates all remaining publicly held shares of the corporation's common stock. Since, at the time of the elimination, the stock is generally no longer traded on the market, the acquirer is free to set his forced buy-out price. In *Weinberger v. UOP, Inc.*, for example, the Delaware Supreme Court proposed a fairness test for parent-subsidiary mergers where directors sit on both boards, and required the board to demonstrate its good faith and the "entire fairness" of the bargain.¹⁵⁹ The court defined "entire fairness" as a two-part test of fair dealing and fair price.¹⁶⁰ The *Weinberger* decision specifically eliminated the business purpose test for freeze-out mergers,¹⁶¹ and provided for scrutiny of the board's actions. Applying this strict test, the court found the board had not dealt fairly with the stockholders¹⁶² and

¹⁵¹ See *id.*

¹⁵² See *Sinclair*, 280 A.2d at 720.

¹⁵³ Compare *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (making two inquiries, one into the independence and disinterestedness of the directors and the other into the substantive nature of the alleged transaction) with *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784, 784 n.10 (Del. 1981) (applying the business judgment rule presumptions of propriety to the board's refusal to act pursuant to a stockholder's demand on the board). Compare *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983) (throwing out the business purpose test applied by *Singer* to a freeze-out merger and adopting a fairness test) with *Singer v. Magnavox*, 380 A.2d 969, 979 (Del. 1977) (focusing its review of a freeze-out merger on the propriety of the board's alleged purpose).

¹⁵⁴ 473 A.2d 805 (Del. 1984).

¹⁵⁵ *Id.* at 814.

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ See *Weinberger*, 457 A.2d at 710-11.

¹⁵⁹ 467 A.2d 701, 710-11 (Del. 1983) (citing *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (1952)).

¹⁶⁰ *Weinberger*, 457 A.2d at 711.

¹⁶¹ *Id.* at 715.

¹⁶² *Id.* at 712.

remanded the case for a determination of damages based upon entire fairness standards.¹⁶³

In addition to enhancing shareholder protection from interested directors through rigorous new tests, as in *Aronson v. Lewis*¹⁶⁴ and *Weinberger v. UOP, Inc.*,¹⁶⁵ the Delaware courts have also strictly enforced traditional tests, such as the duty of care requiring directors to make informed decisions. In the 1985 case of *Smith v. Van Gorkom*,¹⁶⁶ for example, directors were held personally liable for their gross negligence in failing to act with informed and reasonable deliberation.¹⁶⁷ Although the duty of care was not revised, strict enforcement of traditional duties of care and the finding of personal liability demonstrate the court's careful scrutiny of directors' actions.

In *Van Gorkom*, the board approved a cash-out merger, an outsider's offer to purchase all outstanding shares of the corporation for cash and merge the target company with the acquirer.¹⁶⁸ The board's decision to approve the merger was made after two hours of consideration, and the board relied primarily on a twenty minute presentation by one of the directors who had negotiated the deal with the offeror.¹⁶⁹ The other directors viewed no written summary or documentation to support the price offered, and approved an unseen agreement which was explained by the director who was personally involved in the transaction.¹⁷⁰ The *Van Gorkom* court refused to defer to the directors' uninformed judgment.¹⁷¹ The directors' failure to be informed, the court held, was a breach of the fiduciary duty directors owe shareholders.¹⁷² According to the court, this duty required more than the absence of bad faith;¹⁷³ the directors were bound to an affirmative duty to protect the interests of the shareholders and assess all information critically.¹⁷⁴

These cases demonstrate the increased scrutiny with which Delaware courts are reviewing directors' actions. They represent a trend of increased protection of shareholder interests, and a willingness by the courts to restrict directors' autonomy. Under these standards, courts require directors to respect and advance shareholder rights.

D. Interaction of Federal Law with State Corporation Law

While the standard of review which a court applies to directors' defensive reactions to hostile takeovers is a reflection of the state's corporation statute and its common law, courts may also consider a standard of shareholder protection which Congress has codified in federal securities law.¹⁷⁵ State corporation laws are generally regarded as enabling acts protecting management decisions and providing flexibility to facilitate

¹⁶³ *Id.* at 714.

¹⁶⁴ 473 A.2d 805 (Del. 1984).

¹⁶⁵ 457 A.2d 701 (Del. 1983).

¹⁶⁶ 488 A.2d 858 (Del. 1985).

¹⁶⁷ *Id.* at 872.

¹⁶⁸ *Id.* at 874.

¹⁶⁹ *Id.* at 874-78, 878 n.19.

¹⁷⁰ *Id.* at 874.

¹⁷¹ *Id.*

¹⁷² *Id.* at 893.

¹⁷³ *Id.*

¹⁷⁴ *Id.*

¹⁷⁵ See Securities Exchange Act of 1934, § 14(d), 15 U.S.C. § 78n(d) (1982).

business transactions.¹⁷⁶ Many commentators criticize the inadequacy of state law as an instrument of corporate control.¹⁷⁷ While proposals have arisen for federalizing corporation law,¹⁷⁸ no such preemption has yet occurred.

Federal law has, in some areas, entered the field of corporate law to provide specific shareholder protections. The Williams Act, amending the Securities Exchange Act of 1934,¹⁷⁹ for example, speaks in clear terms of shareholder protection. The Williams Act provides that no party involved in making a tender offer shall engage in acts that are fraudulent, deceptive, or manipulative.¹⁸⁰ Courts have interpreted the Securities and Exchange Act of 1934 as merely a standard of disclosure,¹⁸¹ but in the legislative history to the Williams Act, Congress made clear its desire to protect shareholders' ability to receive and consider tender offers by promoting a policy of evenhandedness.¹⁸² Congress sought a balance between the powers of directors and tender offerors such that neither could unduly influence the shareholder, the proper party for deciding the success of a tender offer.¹⁸³

In the 1982 case of *Edgar v. MITE Corp.*,¹⁸⁴ the United States Supreme Court, alluding to the congressional intent to protect shareholders, found a state statute regulating takeovers to be invalid.¹⁸⁵ According to the Court, Congress intended, by the passage of the Williams Act, to protect shareholders by keeping them fully informed and by preventing either management or a bidder from obtaining an unfair advantage over the other such that they could frustrate the shareholder's exercise of free choice.¹⁸⁶ Therefore, the *MITE* Court struck down an Illinois precommencement notification statute which, in the Court's view, gave management an unfair advantage in takeover battles.¹⁸⁷ The *MITE* decision thus provides the states with a model for following the congressional mandate manifested in the Williams Act. Moreover, state courts are in a position to provide, through the enforcement of common law duties of loyalty and care owed by directors to shareholders, the shareholder protection sought by Congress.

This high level of protection, implicitly proposed in the Williams Act, has been provided under state law, for example, in the 1984 case of *Norlin Corp. v. Rooney, Pace Inc.*¹⁸⁸ In *Norlin*, the Second Circuit, interpreting New York law, emphasized the impor-

¹⁷⁶ Jennings, *Federalization of Corporate Law: Part Way or All the Way*, 31 BUS. LAW. 991, 991 (1976).

¹⁷⁷ *Id.* (citations omitted) ("[T]he inadequacy of these statutes as instruments of corporate control is common knowledge . . .").

¹⁷⁸ Two congressional proposals concerning federalizing corporate law include S. 2567, 86th Cong., 2d Sess. (1980) (the proposed Federal Protection of Shareholders' Rights Act) and H.R. 7010, 96th Cong., 2d Sess. (1980) (the proposed Federal Corporate Democracy Act). Both proposals attempted to define the directors' duty of loyalty and duty of care, as well as to set requirements for a majority of independent directors.

¹⁷⁹ 15 U.S.C. § 78n(d)-(f) (1982).

¹⁸⁰ *Id.* at § 78n(e).

¹⁸¹ See *Santa Fe Indus. v. Green*, 430 U.S. 462, 477 (1977).

¹⁸² S. REP. NO. 550, 90th Cong., 1st Sess. 3 (1967).

¹⁸³ See generally *id.*; H.R. REP. NO. 1711, 90th Cong., 2d Sess.; reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811.

¹⁸⁴ 457 U.S. 624 (1982).

¹⁸⁵ *Id.* at 633.

¹⁸⁶ *Id.* at 635.

¹⁸⁷ *Id.* at 645.

¹⁸⁸ 744 F.2d 255 (2d Cir. 1984) (applying New York law).

tance of protecting the fundamental structure of corporate governance and traditional shareholder democracy.¹⁸⁹ The court held that decisions regarding a corporation's ultimate destiny are properly made by the shareholders.¹⁹⁰ Where the board action was intended to shift control of the corporation in favor of the board, the *Norlin* court required the board to demonstrate that the transaction was fair and served the best interests of the corporation and its shareholders.¹⁹¹ The *Norlin* court's powerful advocacy for shareholder interests represents a stronger form of shareholder protection than generally provided by state law. The *Norlin* decision complements and enforces congressional intent as found in the Williams Act by strictly enforcing directorial duties.

Congressional intent is not the sole basis available to Delaware courts for justifying an increase in shareholder protection. A more concrete source of guidance may be found in the Delaware General Corporation Law. For example, section 159 of the Delaware General Corporation Law¹⁹² deems stock to be personal property and guarantees shareholders the right to transfer their interests, unless under section 202, the shareholder agrees to a restriction.¹⁹³ Shareholders also have the right to protect their investment by voting on certain corporate actions pursuant to section 212.¹⁹⁴ Thus, strict judicial scrutiny of corporate directors is neither novel nor extreme; indeed, strict scrutiny, as suggested by the congressional intent underlying the Williams Act, is merely adherence to the language of state corporate law.

E. The Nature of "Poison Pills"

The "poison pill" — the preferred share purchase rights plan — distinguishes *Moran v. Household International, Inc.*¹⁹⁵ from earlier judicial tests of director's good faith. Rights plans, although new and controversial, offer a board of directors many advantages over other defensive measures. One obvious advantage is the low cost of enacting a rights plan. The only expenses associated with its adoption are the legal and financial services costs required to formulate it and explain it to the board.¹⁹⁶ A second advantage is the ease of adoption — the measure may be adopted by board resolution without shareholder approval.¹⁹⁷ A third benefit is the flexibility which a rights plan gives the board in determining how lethal the poison should be. The terms may be designed to protect shareholders against inadequate offers by guaranteeing a fair price through a redemp-

¹⁸⁹ *Id.* at 258.

¹⁹⁰ *Id.*

¹⁹¹ *Id.* at 265.

¹⁹² DEL. CODE ANN. tit. 8, § 159 (1983). Section 159 provides in part: "The shares of stock in every corporation shall be deemed personal property and transferable . . ." *Id.*

¹⁹³ *Id.* at § 202. Section 202 provides in part: "No restriction, so imposed shall be binding . . . unless the holders of the securities are party to an agreement or voted in favor of the restriction." *Id.*

¹⁹⁴ *Id.* § 212. Section 212 provides in part: "[U]nless otherwise provided in the certificate of incorporation . . . each stockholder shall be entitled to one vote for each share of capital stock held by such stockholder." *Id.*

¹⁹⁵ 500 A.2d 1346 (Del. 1985).

¹⁹⁶ The duty of reasonable investigation, clearly illustrated in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), would implicate directors adopting a defense plan without being reasonably familiar with its workings.

¹⁹⁷ See DEL. CODE ANN. tit. 8, § 157 (1983) (authorizing a board to create, adopt and issue new classes of securities by board resolution).

tion, conversion, or flip-over provision. Alternatively, a rights plan may be formulated to prevent all offers by demanding an unreasonable reward for shareholders, such as a two-for-one exchange provision.

The most vital benefit accruing to directors from rights plans is the directors' ability to redeem the rights. The directors are able to negotiate tender offers for shareholders, rejecting any or all, while shareholders remain powerless to reap the benefits of tender-offer premiums. Should the directors decide not to redeem the rights upon request by an offeror, the board can prevent a takeover by their inaction. This decision not to redeem the rights is difficult for courts to review, because there may be no evidence of the board's basis for deciding not to redeem rights upon request of a tender offeror. The question of redeeming the rights need not even arise in a board meeting, where the decision would be recorded in the corporate minutes, as opposed to the adoption of a rights plan, which courts can review by analyzing the terms of the written product, the rights plan itself, and by reviewing the board's discussion surrounding the adoption as recorded in the corporate minutes.

In the 1979 case of *Telvest, Inc. v. Olson*, the first legal challenge to a poison pill preferred stock defensive plan, the Court of Chancery of Delaware held that the securities issued by the target corporation's board did not qualify as preferred stock, and that the board was not authorized to issue them.¹⁹⁸ Because the target had sought to alter the voting rights of the shareholders, the court granted an injunction against the plan.¹⁹⁹ The securities were labeled preferred shares and were to be issued as a stock dividend. The court found that the stated dividend and liquidation preferences were illusory, and that therefore the stock was not a preferred stock.²⁰⁰ The only true preference the stock granted was a vote in those situations which required a supermajority vote of 80% to approve any business combination or transaction with any party owning 20% or more of the outstanding voting stock of the company.²⁰¹ The voting rights were ineffective if the board approved the transaction.

The *Telvest* controversy focused on the preferred plan's alteration in the voting power of common stock, and on whether this same manipulation which could be effected by an amendment to the certificate of incorporation, could also be accomplished by board resolution without shareholder approval.²⁰² The court noted that the corporation's certificate of incorporation²⁰³ and section 151 of the Delaware Code, which enabled directors to create and issue securities with such terms as the board should adopt by resolution,²⁰⁴ permitted the board to modify common stock voting rights by issuing

¹⁹⁸ *Telvest, Inc. v. Olson*, No. 5798, slip op. at 12 (Del. Ch. Mar. 8, 1979).

¹⁹⁹ *Id.* at 16.

²⁰⁰ *Id.* at 13. The terms of the preferred stock guaranteed that preferred dividends or liquidation payments would be paid prior to those payments on common stock, but the amounts received in all cases would be the same. *Id.*

²⁰¹ *Id.* at 7.

²⁰² *Id.* at 9.

²⁰³ Paragraph 45 of the target corporation's certificate of incorporation stated:

The Board of Directors of the corporation is hereby expressly granted authority to fix, by resolution duly adopted prior to the issuance of any shares of a particular series of *preferred stock* so designated by the Board of Directors, the voting powers of such stock of such series, if any, and the designations, preferences and relative, participating, optional and other special rights.

Id. (emphasis added).

²⁰⁴ DEL. CODE ANN. tit. 8, § 157(a), (g) (1983).

preferred stock with superior rights.²⁰⁵ Nevertheless, the court held the securities issued invalid because of their sham nature and illusory terms.²⁰⁶ The *Telvest* decision thus raised the issue of whether Delaware law permitted the issuance of securities for nonfinancial purposes such as antitakeover schemes.

In 1983, however, in *National Education Corp. v. Bell & Howell Co.*, the Delaware Court of Chancery approved the issuance of securities for nonfinancial purposes.²⁰⁷ Distinguishing the *Telvest* decision, the *National Education* court explained that the *Telvest* court's "sham" terminology implicated only the failure of the stated preferences of the stock described.²⁰⁸ The *National Education* court held that the preferred stock plan before them did have real preferences beyond those relating to voting power and refused to grant a preliminary injunction against the plan.²⁰⁹ Although the court noted that a degree of manipulation was inevitable when a board adopted a preferred plan, the court refused to grant a preliminary injunction against implementation of the plan because the plaintiff had not shown any improper manipulation of the corporation by the directors for the purpose of entrenching incumbent management.²¹⁰

The *National Education* court, citing the Delaware legislature's amendment of section 151²¹¹ as support for its action, concluded that the effect of the *Telvest* decision was terminated.²¹² *National Education* foreclosed further inquiry into whether securities could be issued to existing shareholders for nonfinancial purposes as an antitakeover measure, and thus laid the foundation for the expansion of defensive rights plans.²¹³ The amended section 151 together with the *National Education* decision establish that poison pill preferred stocks are valid securities under Delaware law.²¹⁴

Attacks on boards adopting rights plans have also focused on the directors' authority to enact such a measure.²¹⁵ Section 141(a) of the Delaware General Corporation Law, the statutory source for directors' authority, provides that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the

²⁰⁵ *Telvest*, No. 5798, slip op. at 16.

²⁰⁶ *Id.* at 13.

²⁰⁷ No. 7278, slip op. at 1, 11 (Del. Ch. Aug. 25, 1983).

²⁰⁸ *Id.* at 9-10.

²⁰⁹ *Id.* at 10.

²¹⁰ *Id.*

²¹¹ See 64 Del. Laws 112 (1983).

²¹² *National Education*, No. 7278, slip op. at 5.

²¹³ *Id.* The *National Education* court did require that a preferred stock have real valid preferences beyond mere voting rights, *id.* at 10, but this requirement is one of form, not substance. Because the preferred rights granted will never be exercised according to their terms, a board may adopt any terms which will satisfy the court's inquiry. Any terms adopted are meaningless because the board can, by making the purchase of the preferred shares totally infeasible, insure that the rights will never be exercised. *Id.*

²¹⁴ The *National Education* court, holding that a security may be authorized under Delaware law even though its primary purpose is noneconomic, authorized the challenged preferred stock plan under section 151. *Id.* at 11. Section 151 of the Delaware General Corporation Law grants a board "blank check" powers (the power to create unilaterally any desired terms) for any type of security. DEL. CODE ANN. tit. 8, § 151 (1983). Section 157 parallels the language of section 151 and empowers the board to issue stock rights and options with the same blank check powers as are available for other securities under section 151. *Id.* § 157. Pursuant to § 157, a board is authorized to create a poison pill stock plan from preferred share purchase rights. *Id.*

²¹⁵ See, e.g., *Newell Co. v. Wm. E. Wright Co.*, No. 8161, slip op. at 1-2 (Del. Ch. Oct. 15, 1985).

direction of a board of directors."²¹⁶ While this is a broad mandate, the powers granted are not unlimited, as demonstrated by other statutory provisions granting shareholders democratic voting power on questions concerning the ultimate destiny of the corporation.²¹⁷ The "business and affairs" language of the statute defines a limit to the directors' discretion.²¹⁸ That limit does not include extraordinary transactions, those causing fundamental changes in the corporate structure. Extraordinary transactions are beyond ordinary business, whose management is delegated to the board, and therefore require shareholder approval.²¹⁹ The demarcation of the extent of management discretion distinguishes ordinary course of business decisions from those that fundamentally affect the existence and purpose of the corporation.²²⁰

Courts defer to directors' judgment by invoking the business judgment rule presumptions of propriety when the board acts within its scope of authority.²²¹ Courts, however, scrutinize directors' decisions regarding ownership questions where the shareholders' and directors' common goal of profit maximization is subordinate and the individual interests of directors and shareholders weigh heavily.²²² In regard to ownership questions, section 141 does not authorize unilateral board action because shareholder authorization is required.²²³ Section 141, along with sections 151 and 157, enable a board to issue securities for financial purposes, and, as *National Education* held, for nonfinancial purposes.²²⁴ Section 141 also empowers a board to adopt takeover defenses to protect the corporate enterprise.²²⁵ The rationale of *National Education* indicates that rights plans are not per se invalid, that is, their nonfinancial focus and corporate control orientation do not preclude poison pill rights and preferred stock from being authorized under the Delaware corporation statutes. Therefore, a shareholder seeking to enjoin a board-adopted rights plan is forced to attack its reasonableness in relation to the circumstances facing the board, instead of attacking the rights themselves.

II. THE MORAN DECISION

In *Moran v. Household International, Inc.*,²²⁶ the Delaware Supreme Court upheld a board of directors' decision to adopt a poison pill rights plan. The court decided that a rights plan would receive the business judgment rule presumptions that the decision was made in good faith, after reasonable investigation, and in the best interests of the

²¹⁶ DEL. CODE ANN. tit. 8, § 141(a) (1983).

²¹⁷ See, e.g., *id.* § 212 (shareholders' general right to vote); *id.* § 251 (shareholders' right to vote on mergers and consolidations); *id.* § 271 (shareholders' right to vote on the sale, lease, or exchange of all or substantially all of the corporation's assets); *id.* § 275 (shareholders' right to vote on any proposed dissolution of the corporation).

²¹⁸ *Aronson*, 473 A.2d at 813 (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782-86 (Del. 1981)).

²¹⁹ H. HENN & J. ALEXANDER, *supra* note 87, § 340, at 952.

²²⁰ See *Gimbel v. Signal Cos.*, 316 A.2d 599, 606 (Del. Ch. 1974), *aff'd*, 316 A.2d 619 (Del. 1974).

²²¹ *Unocal*, 493 A.2d at 953-54.

²²² *Id.* at 954-55.

²²³ See *supra* notes 215-20 and accompanying text for a discussion of the scope of shareholders' right to decide issues concerning the corporate existence.

²²⁴ See *supra* notes 207-14 and accompanying text for a discussion of *National Education*.

²²⁵ See *Panter*, 646 F.2d at 299.

²²⁶ 500 A.2d 1346 (Del. 1985).

corporation, if, pursuant to the *Unocal* test, the rights plan was adopted in response to a perceived threat to the corporation's policy or effectiveness and was reasonable in relation to that threat.²²⁷ Applying the *Unocal* test in this instance, the court found that a perceived general marketplace threat of coercive two-tier takeovers was a valid reason for Household to adopt a poison pill rights plan with a two-for-one flip-over which permitted a holder to purchase \$200 worth of an acquirer's stock for \$100.²²⁸ Thus, finding that the rights plan adopted by the Household board was an authorized and reasonable defense mechanism,²²⁹ the court invoked the business judgment rule presumptions affording deference to the Household board's decision.²³⁰ The court further noted that the board's duties under section 141 of the Delaware General Corporation Law, which provides that directors shall manage the business and affairs of the corporation, include a duty to determine whether a tender offer is in the best interests of the corporation and its shareholders.²³¹ Finding this duty substantially equivalent to other directorial responsibilities, the court held that the business judgment rule should apply equally to takeover defenses as it would to other board duties.²³²

The court noted that decisions from many jurisdictions apply the business judgment rule to actions intended to forestall hostile takeovers.²³³ In this case, the court noted, the defensive measure was prospective, designed to meet potential future takeover attempts, not reactive to a particular threat.²³⁴ The court held that prospectiveness would not preclude application of the business judgment rule since prospective action eliminates the risks associated with rash decisions made in the face of an imminent threat.²³⁵ Thus, the court determined, prospective actions may appropriately receive deference, provided the action is within the board's authority.²³⁶

The court found authority for the adoption of the Rights Plan under sections 151 and 157 of the Delaware Code.²³⁷ Section 157 provides for the issuance of rights and options entitling holders to purchase capital stock,²³⁸ while section 151 provides for the issuance of the underlying preferred stock.²³⁹ The court rejected Moran's contention that section 157 does not authorize takeover defenses, refusing to infer a limitation of the potential functions of securities which appears neither in the language nor history

²²⁷ *Id.* at 1356.

²²⁸ *Id.* at 1357 (citing *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).

²²⁹ *Moran*, 500 A.2d at 1353.

²³⁰ *Id.* at 1357.

²³¹ *Id.* at 1353.

²³² *Id.* at 1350.

²³³ *Id.*

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ *Id.*

²³⁷ *Id.* at 1351 n.7.

²³⁸ *Id.* See DEL. CODE ANN. tit. 8, § 157 (1983). Section 157 provides, in pertinent part: 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.

Id.

²³⁹ DEL. CODE ANN. tit. 8, § 151(g) (1983) (preferred stock may be issued by resolution of the board).

of the statute.²⁴⁰ The court emphasized the need for corporate law to develop and anticipate evolving concepts and needs, and the corresponding duty of courts to avoid unduly strict construction of corporate statutes.²⁴¹

Moran's contentions that the securities had no economic value, were not intended to be exercised, and were a sham and therefore not authorized under section 157 because of their illusory nature, were also rejected by the court.²⁴² The court found that the rights would be exercised if triggered, and distinguished them from sham securities.²⁴³ The preferred shares represented by the rights, when issuable, the court stated, would possess real dividend and liquidation preferences.²⁴⁴

The court also rejected Moran's argument that section 157 permits a board to issue rights for the purchase of its own stock, but not that of another company, as provided for in the flip-over provision of Household's Rights Plan.²⁴⁵ The court analogized the flip-over provision to an antidestruction provision, commonly used to insure the continuity of stockholders' investments when one publicly held corporation is acquired by another, which is permitted under Delaware corporate law.²⁴⁶ The court did not accept Moran's distinction between the incidental nature of antidestruction clauses which provide for an equal exchange, and the intentionally defensive nature of the two-for-one flip-over.²⁴⁷ Reasoning that the flip-over is an antidestruction provision applied to an evolving need, the court upheld the provision.²⁴⁸

The court then turned to Moran's contention that Household's reliance on section 157, which permits a board to issue stock rights, to validate an antitakeover device is contradictory to the intent of section 203, a notice statute establishing procedural requirements for tender offers.²⁴⁹ Moran contended that since Delaware law has refrained from imposing restrictions upon takeover activities, courts must infer that the legislature intended that no party should impair shareholders' ability to receive tender offers.²⁵⁰ The court found that the legislators' intended scope of state law has no bearing on the ability of private parties to impose greater restrictions, and concluded that the legislature did not intend to impede private action. Furthermore, the court reasoned, the Rights Plan was not a major impediment to tender offers.²⁵¹ Similarly, the court held that authorizing the Rights Plan under section 157 did not violate the policies underlying the Williams Act, and was not, therefore, unconstitutional as a violation of the federal commerce clause.²⁵² The court noted Congress' intent to regulate only state action, and

²⁴⁰ *Moran*, 500 A.2d at 1351.

²⁴¹ *Id.* (quoting *Unocal*, 493 A.2d at 957).

²⁴² *Moran*, 500 A.2d at 1352.

²⁴³ *Id.* The court noted the attempt by Sir James Goldsmith to acquire Crown Zellerbach, which adopted a rights plan similar to Household's, and the resulting exercise of the rights issued pursuant to the plan. *Id.*

²⁴⁴ *Id.*

²⁴⁵ *Id.*

²⁴⁶ An antidestruction provision is a conversion right which protects a shareholder's investment when his corporation is acquired or merged with another by allowing him to exchange his shares for those of the surviving corporation. *Id.*

²⁴⁷ *Id.*

²⁴⁸ *Id.*

²⁴⁹ *Id.* at 1352-53.

²⁵⁰ *Id.* at 1353.

²⁵¹ *Id.*

²⁵² *Id.*

found no relevance to Household's private action.²⁵³ The court reasoned that where a state is involved in an action only to the extent that a private party acts in accordance with its statutes, there is not sufficient state action to constitute a violation of the commerce clause or the supremacy clause.²⁵⁴

After concluding that Delaware General Corporation Law section 157 authorized the issuance of securities such as those described by the Rights Plan, the court reviewed the authority of the board to adopt the Rights Plan as a defensive measure.²⁵⁵ The court noted that section 141 of the Delaware General Corporation Law confers upon the board the power to manage the business and affairs of the corporation.²⁵⁶ The court held that section 141 authorized the board to adopt the Rights Plan because, contrary to Moran's arguments, the Rights Plan did not prevent stockholders from receiving tender offers, and did not unduly alter the corporate structure.²⁵⁷ Furthermore, the court reasoned, the Rights Plan did not preclude future judicial review, since the board would still be subject to its fiduciary duties and could not arbitrarily refuse to honor an offeror's request to redeem the rights.²⁵⁸ Finally, the court noted, the Rights Plan was not unduly harmful to either the corporation's financial structure and assets or its governance structure.²⁵⁹ Finding that the Rights Plan neither broadened the board's discretion in blocking takeover attempts, nor made Household takeover-proof, nor altered the corporate structure more than other defensive measures,²⁶⁰ the court held that the Rights Plan did not constitute an unauthorized transfer of power from shareholders to directors.²⁶¹

The court then turned to Moran's contention that the Rights Plan restricted stockholder rights to conduct proxy contests.²⁶² The court identified the primary question as whether the restriction upon individuals or groups from first acquiring 20% or more of

²⁵³ *Id.* The court distinguished *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), which struck down a state takeover statute as an unconstitutional burden on interstate commerce, because, unlike *MITE*, there was no state action in the case at bar. *Moran*, 500 A.2d at 1353.

²⁵⁴ *Moran*, 500 A.2d at 1353.

²⁵⁵ *Id.*

²⁵⁶ *Id.* DEL. CODE ANN. tit. 8, § 141(a) (1983). Section 141 provides:

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

Id.

²⁵⁷ *Moran*, 500 A.2d at 1354. The court cited the takeover of Crown Zellerbach, which had adopted a similar rights plan, by Sir James Goldsmith, as well as several possible means of acquisition introduced into evidence by appellees, as proof that the Plan did not preclude all takeovers. *Id.*

²⁵⁸ *Id.*

²⁵⁹ *Id.*

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² *Id.* at 1355. The "20% trigger" term of the rights causes the rights to be exercisable when any party or group becomes beneficial owner of 20% or more of Household stock. *Id.* at 1348. Moran contended that the rights would be triggered by a successful proxy solicitation. *Id.* at 1355. The court determined, based upon treatise law, that the transfer of a proxy vote creates a revocable agency relationship and not beneficial ownership. *Id.* at 1355 (citing H. HENN & J. ALEXANDER, *supra* note 87, § 196, at 518). Thus, a proxy solicitation would not trigger the rights.

shares before waging a proxy contest fundamentally restricted the stockholders' right to conduct a proxy contest.²⁶³ The court concluded, based upon the trial court's findings,²⁶⁴ that the effect upon proxy contests would be minimal considering the evidence established at trial that many proxy contests are won with an insurgent ownership of less than 20%, and that very large holdings are no guarantee of success.²⁶⁵

Having found that the board's action was within its scope of authority, the *Moran* court then examined whether the directors had satisfied their burden of going forward with evidence in accordance with the *Unocal* test.²⁶⁶ Pursuant to this test, the court required the directors to show reasonable grounds for believing a danger to corporate policy and effectiveness existed, and to show that the defense adopted was reasonable in relation to the threat posed.²⁶⁷ The court also stressed that it gave a high degree of credibility to the board's evidence of a perceived threat and the reasonableness of a defense where the majority of directors voting to adopt a defensive plan are independent.²⁶⁸

Applying the first tier of the *Unocal* test, the court reviewed the threat that the board perceived was facing the corporation, the threat in the marketplace of coercive two-tier tender offers.²⁶⁹ The court held that the evidence Household presented adequately demonstrated that the board adopted the Rights Plan in reaction to what it perceived as a threat to the corporation. The court deemed this threat reasonable for the adoption of a defensive measure.²⁷⁰

The court also found that the Household directors satisfied the second tier of the *Unocal* analysis, the reasonableness of the defense in relation to the threat posed.²⁷¹ The court noted evidence of the board's concern with two-tier and "bust-up" takeovers, in which an acquirer sells off the independently operating subsidiaries which comprise the corporation acquired, and held that the board adopted a reasonable defense mechanism to protect itself.²⁷² Based on its determination that the Rights Plan had only limited effects on the corporate structure, the board's scope of authority, and the shareholders' rights, the court found the Rights Plan to be reasonable.²⁷³ Therefore, the court afforded the Household board the benefit of the business judgment rule presumptions.²⁷⁴ The court held that *Moran* had not rebutted the business judgment rule presumptions, and upheld the board's adoption of the Rights Plan.²⁷⁵

Moran further alleged that the Household board breached their fiduciary duty to shareholders by failing to act on an informed basis.²⁷⁶ The court noted that the Household board received a description and summary of the Rights Plan prior to adopting it,

²⁶³ *Moran*, 500 A.2d at 1355.

²⁶⁴ *Id.* The Vice Chancellor concluded that it would be "highly conjectural" to assume that this limitation would frustrate a shareholder seeking to assert his views. *Moran*, 490 A.2d at 1080.

²⁶⁵ *Moran*, 500 A.2d at 1355.

²⁶⁶ *Id.* at 1357.

²⁶⁷ *Id.* at 1356 (citing *Unocal*, 493 A.2d at 955).

²⁶⁸ *Moran*, 500 A.2d at 1356.

²⁶⁹ *Id.*

²⁷⁰ *Id.* at 1357.

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ *Id.* at 1354.

²⁷⁴ *Id.*

²⁷⁵ *Id.* at 1356.

²⁷⁶ *Id.*

and engaged in extended discussion with its legal and financial counsel.²⁷⁷ Applying the *Smith v. Van Gorkom* standard, the court found that the board was not grossly negligent in its failure to review available information and therefore held that the decision was made after reasonable investigation.²⁷⁸

In concluding its opinion, the court emphasized that deferring to the board's judgment under the business judgment rule in this case did not terminate the courts power to review the directors' actions relating to takeovers.²⁷⁹ The court found that the directors' fundamental duties to the corporation and its shareholders were still enforceable.²⁸⁰ The directors' ultimate response to an actual takeover attempt and their compliance with their fiduciary duty to shareholders, the court reasoned, would be subject to review if the directors were to refuse to redeem the rights upon request of an offeror.²⁸¹

III. MORAN: TAKING THE BITE OUT OF UNOCAL

The *Moran* decision represents an unduly lenient interpretation of precedent established by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*²⁸² The *Unocal* court developed a two-part threshold test to determine whether a board of directors should be granted business judgment rule presumptions. *Moran* minimized this test and protected the Household board's action after a limited threshold review. The *Moran* court granted business judgment rule presumptions to the Household board's decision to adopt a poison pill rights plan despite the absence of a specific threat to the corporation, as was present in *Unocal*, and without consideration of the reasonableness of the defensive measure in relation to the vague threat. The *Moran* court found the Rights Plan to be a reasonable defense, but never justified the need for the action.

The *Moran* decision expands the scope of directors' discretion, thereby permitting directors to undermine fundamental principles of corporate law. The remainder of this casenote will analyze the source of the *Moran* court's error, and the resulting evils the directors wrought upon the corporation — the entrenchment of the directors, the breach of their fiduciary duty owed to the shareholders, the denial of shareholder democracy, and the inversion of the corporate structure. This casenote will conclude with a discussion of Delaware corporate statutory law and federal law foundations which reinforce the argument for strict scrutiny of parties infringing on the shareholders' rights to receive and consider tender offers.

A. The Source of Error

Recognizing the inherent conflict directors face in deterring hostile takeovers, the *Moran* court held that directors adopting poison pill rights plans must satisfy the *Unocal*

²⁷⁷ *Id.*

²⁷⁸ *Id.* (citing *Van Gorkom*, 488 A.2d at 873). The court reviewed the record and found that the board had been supplied with information providing the essentials of the Plan as well as a summary of the Plan and articles on the takeover environment. The literature along with the presentations by advisors and ensuing discussions, the court held, constituted reasonable investigation. *Moran*, 500 A.2d at 1356.

²⁷⁹ *Id.* at 1357.

²⁸⁰ *Id.*

²⁸¹ *Id.*

²⁸² 493 A.2d 946 (Del. 1985).

threshold test.²⁸³ *Unocal* held that directors may receive the business judgment rule's presumptions of propriety only after the directors have demonstrated reasonable grounds for believing the corporation was threatened, and have shown that their adopted defense was reasonable in relation to the threat.²⁸⁴ By extending the application of the *Unocal* test to cases involving prospective measures, the *Moran* court helped ensure the protection of shareholders. The *Moran* court erred, however, by loosely applying the *Unocal* test in determining the validity of the Household Rights Plan. The *Unocal* threshold examinations were designed to prevent directors from defeating hostile tender offers which do not pose a harmful threat to the corporation.²⁸⁵ The *Moran* precedent defeats the *Unocal* test by permitting boards to adopt defense measures deterring takeover attempts which would not be harmful to the corporation.

The Household board adopted the Rights Plan "in reaction to what it perceived to be the threat in the marketplace of coercive two-tier tender offers."²⁸⁶ The *Moran* court held that this stated threat satisfied the *Unocal* requirement for believing a threat to the corporation existed.²⁸⁷ This general threat of takeover, however, is marketwide; every corporation is subjected to it. Thus, if a court accepts this general marketplace characteristic as satisfying the board's burden of identifying a threat to which it reacted, the court will render the first tier of the *Unocal* test nugatory. According to *Moran*, therefore, every corporation is justified in adopting prospective poison pill provisions.

Moreover, in applying the second tier of the *Unocal* test, the *Moran* court did not scrutinize the relationship between this general fear of takeovers and the adoption of the Rights Plan by the Household board. While courts should permit directors to adopt prospective defensive measures,²⁸⁸ courts must also ensure that shareholders' rights to tender their shares are not unnecessarily inhibited.²⁸⁹ Thus, to ensure that a defensive plan is designed to deter only harmful takeovers, courts must examine the terms and effects of the measure in light of the board's stated fear.²⁹⁰

An analysis of whether the board properly tailored its defensive mechanism to the demonstrated threat pervades the *Unocal* decision.²⁹¹ This analysis is absent in *Moran*. The *Moran* court extensively examined the board's authority to adopt the Rights Plan,²⁹²

²⁸³ *Moran*, 500 A.2d at 1356.

²⁸⁴ *Unocal*, 493 A.2d at 958-59. The *Unocal* test first required the board to demonstrate a threat of potential harm to the corporation. *Id.* Next, the board was required to show that the defensive measure was reasonably tailored to meet that harm. *Id.* The reasonableness of the measure must, therefore, be judged not only by its ability to prevent the harm, but also by its potential effect on harmless takeovers and other shareholder interests. *Id.*

²⁸⁵ *Id.* at 955. The *Unocal* threshold test required the board to demonstrate reasonable grounds for believing the corporation was threatened. *Id.* If there was no present danger, the board would not satisfy the threshold requirement and any defense mechanism adopted would be invalid.

²⁸⁶ *Moran*, 500 A.2d at 1356.

²⁸⁷ *Id.*

²⁸⁸ The *Moran* court noted that a board which suddenly finds itself faced with a threatening takeover may act unreasonably or irrationally. *Moran*, 500 A.2d at 1350. Therefore, the court approved of prospective defensive measures which could be carefully planned in anticipation of a takeover threat. *Id.*

²⁸⁹ See *Treadway Companies v. Care Corp.*, 638 F.2d 357, 381 (2d Cir. 1980).

²⁹⁰ Note, *supra* note 22, at 1971.

²⁹¹ The *Unocal* court extensively reviewed the effects of the defensive action and went further to determine the fairness to all of the parties involved. *Unocal*, 493 A.2d at 956-57.

²⁹² *Moran*, 500 A.2d at 1353.

but it never alluded to the necessity of the poisonous two-for-one flip-over provision. By failing to seek board justification for the specific provisions of the Rights Plan, the court allowed the board to retain an overly broad defensive measure. As a result, the Rights Plan would deter takeover attempts that would be favorable to shareholders, as well as those that would be harmful. This is a result which should not be permitted under a proper application of the *Unocal* test.

B. The Impact of *Moran*

1. The Corporate Directors' Fiduciary Duty

In adopting the Rights Plan, the Household board sought to protect shareholders from coercive two-tier takeovers, but also sought to install themselves as negotiating agents for considering tender offers on behalf of the shareholders.²⁹³ This role violates the fiduciary duty directors owe the corporation's shareholders. By affording presumptions of propriety to the Household board's adoption of the Rights Plan, the court has condoned a corporate board's use of its discretion unilaterally to expand its own scope of authority. This power could vitiate any duty or accountability directors owe shareholders. Although shareholders retain the right to remove directors,²⁹⁴ shareholders generally lack the organization, means, and motivation required to effect a removal and replacement of directors.²⁹⁵ This weakness emphasizes the importance of courts' strictly enforcing the fiduciary duty directors owe shareholders.

The directors' fiduciary duty is derived from their capacity as trustees of the corporation for the benefit of the shareholders.²⁹⁶ If the directors' sole or primary purpose for defending the corporation is entrenchment, however, then they breach their fiduciary duty.²⁹⁷ When a court affords a board the benefit of the business judgment rule presumptions, there is no opportunity to review the board action in the absence of fraud, bad faith, or gross overreaching,²⁹⁸ and a breach of fiduciary duty may escape review. To prevent this unaccountability, the *Unocal* court established a threshold test of the directors' purpose and method before business judgment rule presumptions could be applied.²⁹⁹ Where the *Unocal* test is not strictly applied, directors' breaches of their fiduciary duties may continue to escape judicial review, and shareholders' rights may be infringed.

The *Moran* court's loose application of the *Unocal* test will thus expand the concept of directors' fiduciary duties at the expense of shareholders' rights. The Household board, in adopting the Rights Plan, claimed to be protecting shareholders against coercive takeovers and inequitable treatment. A defense designed to guarantee a fair exchange or to prevent inadequate tender offers would fulfill a fiduciary duty.³⁰⁰ Instead, the

²⁹³ *Moran*, 490 A.2d at 1066.

²⁹⁴ DEL. CODE ANN. tit. 8, § 141(k) (1983).

²⁹⁵ See W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS 209 (5th ed. 1982) ("shareholders who are extremely dissatisfied often prefer to sell rather than vote . . . incumbent management will normally be protected in its control by the heavy costs and poor prospects that proxy fights involve").

²⁹⁶ *Lofland v. Cahill*, 13 Del. Ch. 384, 389, 118 A. 1, 3 (1922).

²⁹⁷ *Cheff*, 41 Del. Ch. at 504, 199 A.2d at 554.

²⁹⁸ See *Moran*, 500 A.2d at 1356.

²⁹⁹ *Unocal*, 493 A.2d at 954.

³⁰⁰ *Id.* at 957.

Household board adopted a plan to deter all hostile tender offers and to require bidders to negotiate with the board. To the extent that a defense hinders nonharmful tender offers, the board is entrenching itself. Actions for the purpose of entrenchment conflict with the directors' fiduciary duty requiring that directors' actions be taken in good faith for valid business purposes.³⁰¹

The *Moran* court cited several cases illustrating that defending the corporation constituted a valid corporate purpose deserving of judicial deference.³⁰² In the cited cases, courts generally required directors to demonstrate substantial business reasons for any action which was designed primarily to prevent a threatened takeover.³⁰³ The Household board did not cite a substantial business reason when it enacted the Rights Plan. The Rights Plan adopted by Household was an obstacle to all takeovers, good or bad.

The rights plan adopted by Household installs the board as negotiating agent for considering all tender offers on behalf of shareholders. Thus, by their control of the decision whether to redeem the rights, the board has the increased power to determine the fate of any tender offer. Potentially, the board could refuse to redeem the rights without a valid business purpose. While such rejections would be indicative of ulterior motives and a breach of the directors' fiduciary duty,³⁰⁴ the courts would have difficulty in establishing a breach of duty. Although the directors may have defeated a tender offer, the only action which the court would have to review would be the directors' inaction. Once a rights plan is in place, a tender offer cannot succeed unless the directors redeem the rights. Therefore, for the directors to do nothing is fatal to the offer.

Judicial review of inaction is necessarily limited because there is no evidence from which a court can construe the directors' purpose. When a board adopts a rights plan, a court can review the terms to ensure that it is carefully tailored to a clear threat which

³⁰¹ *Id.* at 954.

³⁰² *Moran*, 500 A.2d at 1350.

³⁰³ The *Moran* opinion cited several cases supporting the application of the business judgment rule to antitakeover activities. *Id.* at 1350. In all of these cases, the courts carefully justified the directors' roles in the transactions. For example, in *Gearhart Indus. v. Smith Int'l*, where the plaintiff challenged the issuance of the board's sale of discounted subordinated debentures containing springing warrants, the court denied an injunction because the warrant represented a fairly priced financing tool and the springing provision provided for a stock conversion at a reasonable exercise price. 741 F.2d 707, 722-24 (5th Cir. 1984).

In *Treco, Inc. v. Land of Lincoln Savings and Loan*, the Lincoln board adopted supermajority voting requirements for the removal of directors and for shareholders to amend the bylaws. 749 F.2d 374, 375 (7th Cir. 1984). The court upheld the action upon the directors' demonstration of the insurgent's intent to remove all directors and liquidate the company. *Id.* at 376. The court found that the board reasonably believed that a liquidation would substantially decrease the value of stock held by the shareholders. *Id.* at 378.

In *Panter v. Marshall Field & Co.*, 646 F.2d 271 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981) and *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982), the challenged transactions, the purchase and the sale of assets, respectively, were in the regular course of business and the courts reviewed only the independence of the parties involved in finding that self-dealing was not involved. *Panter*, 646 F.2d at 297; *Whittaker*, 535 F. Supp. at 951.

In *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623 (D. Md. 1982), plaintiff sought to enjoin a counter tender offer by a target corporation. The court stated, "the public interest requires that a tender offer, probably legal, be permitted to proceed without intervention by the courts The stockholders are entitled to exercise their own judgment as to these matters The decision whether to buy, exchange, or do neither should rest with each individual stockholder." *Id.* at 635 (quoting *Conoco, Inc. v. Seagram Co.*, 517 F. Supp. 1299, 1303-04 (S.D.N.Y. 1981)).

³⁰⁴ See Note, *supra* note 22, at 1971-72 ("[I]t would be manifestly improper for the redemption or conversion price to be a multiple of the tender price.").

the board seeks to avert. The rights plan itself is a manifestation of the board's action which can be scrutinized to uncover ulterior motives. When a board refuses to act, the court has no product to look at and is bound to accept any rational reason for refusal which the directors allege, there being no evidence available to disprove their statement. Thus, by loosely applying the *Unocal* test, the *Moran* court increased the likelihood that directors' breaches of their fiduciary duties will escape judicial scrutiny, and as a result shareholders will be injured.

2. Shareholder Democracy

Beyond their role of governing the business and affairs of the corporation,³⁰⁵ the directors also have fiduciary duties to protect the interests of the shareholders.³⁰⁶ This duty includes determining whether a tender offer is in the best interests of the corporation and its shareholders.³⁰⁷ Even with this broad mandate, directors are not authorized to control every aspect of the corporate existence.³⁰⁸ For example, unless a board can show that a tender offer is not in the corporation's best interests, it is not the role of the board to determine whether shareholders will be allowed to accept it.³⁰⁹ If the offer is not harmful, the board's role is to analyze critically all available information and present it to the shareholders so that they may decide for themselves whether it is in their interest to accept.³¹⁰ Corporate laws also reserve for shareholders the rights to elect and remove directors;³¹¹ to amend the corporate bylaws;³¹² to vote on substantial dispositions of assets;³¹³ on mergers and consolidations;³¹⁴ on the dissolution of the corporation;³¹⁵ and

³⁰⁵ DEL. CODE ANN. tit. 8, § 141(a) (1983).

³⁰⁶ *Unocal*, 493 A.2d at 954.

³⁰⁷ *Id.*

³⁰⁸ See *supra* notes 215-20 and accompanying text for a discussion of shareholders' role in deciding questions of corporate existence.

³⁰⁹ See generally S. REP. NO. 550; H.R. REP. NO. 1711, 90th Cong., 2d Sess., reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811.

³¹⁰ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985).

³¹¹ DEL. CODE ANN. tit. 8, § 141(a) (1983).

³¹² *Id.* § 216(a). Section 216(a) provides in part:

After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote . . . provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend, or repeal bylaws.

Id.

³¹³ *Id.* § 271(a). Section 271(a) provides, in part: "[e]very corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets . . . when and as authorized by a resolution adopted by a majority of the outstanding stock of the corporation entitled to vote thereon"

Id.

³¹⁴ *Id.* § 251 (requiring the board to "adopt a resolution approving an agreement of merger or consolidation" stating the proposed terms and to submit it "to the stockholders of each constituent corporation at an annual or special meeting for the purpose of acting on the agreement").

³¹⁵ *Id.* § 275(a). Section 275(a) provides:

If it should be deemed advisable in the judgment of the board of directors of any corporation that it should be dissolved, the board, after the adoption of a resolution to that effect by a majority of the whole board at any meeting called for that purpose, shall cause notice to be mailed to each stockholder entitled to vote thereon of the

to sue the corporation derivatively when the action of corporate personnel constitutes a wrong to the corporation.³¹⁶ Directors must seek shareholder authorization to amend the certificate of incorporation, or to make unusual transactions.³¹⁷ These voting rights are part of the "corporate democracy" which allows shareholders to check the directors' unfettered discretion in corporate affairs.

Issuance of preferred stock rights or similar securities by the board alone for purposes other than financing may, if its impact on shareholder rights is drastic and unjustified, be analogous to transactions which require shareholder approval.³¹⁸ By failing to scrutinize properly such extraordinary actions of directors, courts fail to protect the corporate democracy. Courts must, therefore, reject the argument that it is within the directors' managerial capacity to grant themselves greater discretionary power — as the Household board was permitted to do. If future courts abide by the *Moran* standard, corporate boards will be able to circumvent limitations imposed upon the scope of their power by their fiduciary obligations, and matters traditionally requiring shareholder consent may be resolved through unilateral board action.³¹⁹

The *Moran* court found that the directors did not circumvent their fiduciary duty because the Rights Plan was not the board's last reviewable action.³²⁰ The court reasoned that the board would still be subject to their fiduciary duty when a tender offer was presented and directors were requested to redeem the rights.³²¹ This "second chance review" of the directors' refusal to redeem the rights, as noted,³²² is not as effective as scrutinizing the directors' purposes in the first instance, when they adopted the defensive measure. This second chance review also fails to account for the potential bidders who are discouraged from making any offer. Preparation of a tender offer requires extensive

adoption of the resolution and of a meeting of stockholders to take action upon the resolution.

Id.

³¹⁶ See *id.* § 327; FED. R. CIV. P. 23.1.

³¹⁷ See *Gimbel v. Signal Cos.*, 316 A.2d 599, 605-06 (Del. 1974).

³¹⁸ Where a Rights Plan entrenches management or impairs the proxy process, shareholders' right to elect and remove directors is infringed. Where a Rights Plan creates a fundamental change in the corporate structure, the adoption of the plan is analogous to an amendment to the corporate charter, an act that requires a shareholder vote. Adoption of a Rights Plan that cannot be justified as protection for shareholders' interests is an ultra vires act if unilaterally enacted by the board of directors.

³¹⁹ The Chancery Court's opinion in *Moran*, 490 A.2d 1059 (Del. Ch. 1984), discussed the doctrine of "independent legal significance," whereby "if an action can be accomplished under one section of General Delaware Corporation Law it need not satisfy the requirements of another section which permits the same result." *Id.* at 1077 (citations omitted). The Household board sought to inhibit partial tender offers and, after being convinced that a fair price amendment would not easily obtain shareholder majority approval, adopted a plan which would achieve the same result without requiring shareholder support (via a board resolution). Where a board of directors is permitted to circumvent the need for shareholder majority vote on an unusual transaction, the independent legal significance doctrine clashes with the rule of *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439 (Del. 1971), which provides that an inequitable action is not permissible merely because it is not in violation of the law.

³²⁰ *Moran*, 500 A.2d at 1354.

³²¹ *Id.*

³²² See *supra* note 304 and accompanying text for a discussion of the difficulties a court faces in reviewing the directors' refusal to redeem poison pill rights.

research and expenses. The added risk, that the directors as well as the shareholders may reject the offer, may curtail the bidders from even considering the target. The gain to the directors in their power to negotiate may well be borne by shareholders in their loss of premiums. The result is that directors realize an increase in their autonomy and decisionmaking power, while the shareholder is deprived of his traditional decisionmaking role in questions of ownership and stock transfers.

3. The Corporate Structure

The *Moran* court analyzed the effect of the Rights Plan on the corporate structure and determined that it caused less harm to the value structure of the corporation than other defenses and caused little change in the governance structure.³²³ The noneconomic impact is an advantage rights plans generally have over other defenses.³²⁴ Adopting and implementing a rights plan may have no tangible effects.³²⁵

The court concluded that the Rights Plan had little effect on the governance structure because the board would still be subject to review upon refusal to redeem the rights, and also because numerous methods to launch successfully a hostile tender offer still existed.³²⁶ The court's rationale that the Rights Plan was reasonable since certain types of takeover plans may be successful, does not, however, justify an attempt by a board to curtail any takeovers other than those demonstrated to be harmful to shareholders. Permitting a board to enlarge its scope of authority or broaden their discretion to any degree greater than that required to protect corporate interests is not in the shareholders' interests. The *Unocal* threshold test was designed to prevent directors from unduly infringing on shareholder rights by requiring a careful tailoring of the defensive measure adopted to the harm which the directors demonstrated threatened shareholders.³²⁷ By failing to apply *Unocal* properly, the *Moran* court permitted the board to alter the corporate structure unnecessarily.

³²³ *Moran*, 500 A.2d at 1354.

³²⁴ See *supra* notes 7-9 and accompanying text for a discussion of the qualities of poison pill rights plans. In contrast to the noneconomic effects of rights plans are the devastating effects of scorched earth tactics in which a most profitable subsidiary may be sold off. See, e.g., *Whittaker Corp. v. Edgar*, 535 F. Supp. 933 (N.D. Ill. 1982) (target corporation sold its most attractive subsidiary to avert a takeover).

³²⁵ *Moran*, 500 A.2d at 1354. The *Moran* court stated, "the implementation of the plan neither results in any outflow of money from the corporation nor impairs its financial flexibility. It does not dilute earnings per share and does not have any adverse tax consequences for the corporation or its shareholders." *Id.*

³²⁶ *Id.* The *Moran* court found that

[t]he evidence at trial also evidenced many methods around the Plan ranging from tendering with a condition that the board redeem the Rights, tendering with a high minimum condition of shares and Rights, tendering and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing Household to self-tender for the Rights.

Id. Contrary to the court's findings, both *Moran* and the Securities Exchange Commission *amicus* brief stated that the Rights Plan would deter virtually all hostile takeover attempts. *Id.*

³²⁷ *Unocal*, 493 A.2d at 955. The *Unocal* court developed a test of reasonable tailoring. The court found that *Unocal* passed this test because the defensive measure was fair to stockholders. *Id.* at 956. This implies that a defense which treats shareholders unfairly would not pass muster under *Unocal*.

4. Foundations in State Corporation Law

Courts need not rely solely on the common law for finding bases for imposing restrictions on directors' discretion. State corporation statutes also recognize limits to a board of directors' authority to infringe on shareholder rights. For example, in Delaware, as owners of the corporation, shareholders receive certain protected property rights. Section 212 of the Delaware General Corporation Law guarantees stockholders the right to vote to protect their interests and investments in the corporation.³²⁸ Section 159 deems stock to be personal property and transferable.³²⁹ Section 202 grants the right to transfer securities free from any restrictions which are unreasonable or nonexistent when the stock was purchased or those to which the holder did not specifically agree.³³⁰ These property rights are fundamental and strictly protected by the courts.³³¹

When directors place themselves between a bidder extending an offer and the shareholders intended to receive it, they effectively restrict the shareholders' ability to transfer their shares. This is a violation of section 202(b) if the shareholder has not consented specifically.³³² Delaware law generally disfavors restraints on alienation, refusing to enforce them where they are ambiguous, uncertain, or not adopted in relation to a valid business purpose.³³³ When a court reviews a rights plan which ultimately will restrict the shareholders' ability to sell their stock, the state corporation statutes must be

³²⁸ DEL. CODE ANN. tit. 8, § 212(a) (1983). Section 212(a) provides in part, "[u]nless otherwise provided in the certificate of incorporation and subject to § 213 of this title, each stockholder shall be entitled to 1 vote for each share of capital stock held by such stockholder." *Id.*

³²⁹ *Id.* § 159. Section 159 provides in part, "[t]he shares of stock in every corporation shall be deemed personal property and transferable as provided in Article 8 of subtitle 1 of Title 6." *Id.*

³³⁰ *Id.* § 202(b). Section 202(b) provides:

A restriction on the transfer or registration of transfer of securities of a corporation may be imposed either by the certificate of incorporation or by the bylaws or by an agreement among any number of security holders or among such holders and the corporation. No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

Id. The statute further regulates the types of restrictions that may be adopted to ensure their reasonableness. *See Id.* § 202(c)-(e).

³³¹ *See, e.g., Norlin*, 744 F.2d at 267 ("we have never given the slightest indication that we would sanction a board decision to lock up voting power by any means"); *Hill v. Warner, Berman & Spitz, P.A.*, 197 N.J. Super. 152, 166, 484 A.2d 344, 351 (N.J. Super. Ct. App. Div. 1984) ("restraint on the transfer of the corporate stock is against public policy and therefore unlawful and invalid").

³³² *See supra* note 330 for the text of section 202(b). The statute refers generally to direct restrictions such as that enjoined in *Joseph E. Seagram & Sons, v. Conoco, Inc.*, in which the corporation would not recognize any transfers of shares to "aliens," making the transfer ineffective. 519 F. Supp. 506, 508 (D. Del. 1981). Indirect restraints, however, may constitute a violation of the shareholder's right to transfer stock. *See, e.g., B & H Warehouse v. Atlas Van Lines*, 490 F.2d 818, 821 (5th Cir. 1974) (requirement that shareholder offer his shares to the corporation at a predetermined book value on a first refusal basis, prior to selling shares otherwise was enjoined due to lack of shareholder consent); *Greene v. E.H. Rollins & Sons, Inc.*, 22 Del. Ch. 394, 398-99, 2 A.2d 249, 251 (1938) (invalidating a provision in corporation's certificate of incorporation permitting the board to repurchase at book value any shares acquired through an unapproved sale). Through these measures, the boards of Atlas and Rollins reserved the power to determine whether a buyer could purchase shares at a reasonable price and protect his ownership. The *Atlas* and *Rollins* courts enjoined these restrictions since they represented transfers of power to the directors which could only be accomplished with shareholder consent.

³³³ *Atlas*, 490 F.2d at 826-27.

considered.³³⁴ A corporation must present valid business reasons for any restrictions placed on the shareholders' ability to sell their stock. Under a stricter review of corporate purpose, the *Moran* Rights Plan might not have satisfied these corporate statutes.

5. Foundations in Federal Law

The *Unocal* court established a higher standard of shareholder protection than was previously granted by Delaware courts. While this degree of protection may be novel to state corporate law,³³⁵ it has long been present in federal law.³³⁶ Although corporate law is generally considered a field of state law jurisdiction, Congress has resolved to increase shareholder protection. Federal law protection of shareholders is primarily found in the Williams Act, which provides procedural requirements for all parties engaged in tender offers to insure that shareholders are fully informed and have a reasonable amount of time to decide whether to tender their shares.³³⁷ The language of the Williams Act, amending the Securities and Exchange Act of 1934, demands that no party to a tender offer engage in acts that are fraudulent, deceptive, or manipulative.³³⁸ Despite this broad language, the Williams Act is interpreted as a disclosure requirement and not an enhanced fiduciary duty burdening directors.³³⁹ The legislative history of the Act indicates that Congress believed that the shareholders are the proper party for making tender offer acceptance decisions, and thus sought to insure that shareholders receive a fair opportunity to consider tender offers.³⁴⁰ In debates over the Williams Act, Congress has

³³⁴ See DEL. CODE ANN. tit. 8, § 202 (1983).

³³⁵ See, e.g., *Norlin*, 744 F.2d at 258 (holding that shareholders must make the decisions affecting a corporation's ultimate destiny).

³³⁶ See The Williams Act § 14(d)-(f), 15 U.S.C. § 78n(d)-(f) (1982) (amending The Securities Exchange Act of 1934, 15 U.S.C. § 78n (1964)).

³³⁷ The Williams Act amendments to the Securities and Exchange Act of 1934, § 14(d)-(f), set requirements for director and bidder disclosure in tender offers. 15 U.S.C. § 78n(d)-(f) (1982). Section 78n(e) of the Act provides:

It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. The commission shall, for the purposes of this subsection, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, and practices as are fraudulent, deceptive, or manipulative.

Id. The Act also requires proper notice of intent to commence a tender offer for large blocks of shares and a mandatory period for which offers must be extended. 15 U.S.C. § 78n(d) (1982).

³³⁸ See *supra* note 337.

³³⁹ See *Santa Fe Indus. v. Green*, 430 U.S. 462, 471 (1977).

³⁴⁰ S. REP. NO. 550, 90th Cong., 1st Sess. 3, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812; Brief of the Securities and Exchange Commission, *amicus curiae*, at 14-15, *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985).

In *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969), the court found that the legislative intent of the 1968 amendment to section 78n was to insure that public shareholders to whom tender offers are made should have the benefit of a full statement from the offeror with a chance for incumbent management to explain its position publicly. *Id.* at 945. Target management also is subject to disclosure requirements, so as to give investors the same opportunity to make informed decisions with respect to takeover attempts whether the vehicle employed in any such attempt is the obtaining of proxies or the acquisition of voting control through tender offers. *Id.* at 945-46.

indicated that takeover bids should not be discouraged because they provide a check on entrenched but inefficient management,³⁴¹ and sought to preserve for shareholders the economic opportunities which result from the competitive bidding for a block of stock of a target company.³⁴² Congress has repeatedly asserted its policy of evenhandedness in takeover struggles, maintaining a balance between management and the bidder such that neither party could influence unduly the tendering process.³⁴³

In *Edgar v. MITE Corp.*,³⁴⁴ the United States Supreme Court found that Congress sought to protect the investor not only by informing him, but also by withholding from management or the bidder any undue advantage that could frustrate the exercise of an informed choice.³⁴⁵ The *Edgar* Court struck down a state statute whose provisions required an acquirer to give precommencement notification of a pending tender offer because the statutory provisions were unfair to the acquirer.³⁴⁶ The Court found that the provisions "furnish incumbent management with a powerful tool to combat tender offers, perhaps to the detriment of the stockholders."³⁴⁷ The Court followed Congress' lead in protecting takeover attempts and in placing shareholders in the forefront of the decisionmaking arena.³⁴⁸ The United States Supreme Court thereby set an example of how state courts might follow the lead of Congress.

Although corporation law traditionally has been controlled by the states, Congress could intercede, enforcing its desired standard of shareholder protection, and achieving certain benefits through uniformity by preempting under the commerce clause.³⁴⁹ Although Congress has never adopted a proposal to this effect, it has expressed its desire to maintain evenhandedness between directors and bidders while protecting the investing shareholder.³⁵⁰ State law tends to inhibit tender offers for the benefit of management, and seeks to regulate the internal corporate structure.³⁵¹ The gap representing the differences between state and federal law, the disparity between levels of shareholder protection, is one which courts could narrow by scrutinizing directors' purposes in adopting defensive measures. The test provided by *Unocal*, if properly employed, would provide an adequate level of scrutiny.

Unocal is an example of a court applying state law to review a board's actions in a takeover situation where the court afforded an increased level of protection to shareholders. *Norlin Corp. v. Rooney, Pace Inc.*, a 1984 Second Circuit case, is another example where a court focused on protecting the stockholder when the board adopted unreason-

³⁴¹ S. REP. NO. 550, 90th Cong., 1st Sess. 3, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812.

³⁴² See 113 CONG. REC. S24,666 (daily ed. Aug. 29, 1967) (statement of Sen. Javits).

³⁴³ See 113 CONG. REC. S24,665 (daily ed. Aug. 29, 1967) (statement of Sen. Williams) ("We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bids.").

³⁴⁴ 457 U.S. 624 (1982).

³⁴⁵ *Id.* at 634.

³⁴⁶ *Id.*

³⁴⁷ *Id.* at 635.

³⁴⁸ *Id.* at 633.

³⁴⁹ See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 697 (1974).

³⁵⁰ See *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 30-31 (1977).

³⁵¹ See, e.g., *Great Western United Corp. v. Kidwell*, 577 F.2d 1256, 1278-80 (5th Cir. 1978) (Idaho law's promanagement provisions preempted by Williams Act), *rev'd on other grounds sub nom. Leroy v. Great Western United Corp.*, 443 U.S. 173 (1979).

able defense measures.³⁵² The *Norlin* court declared that its most important duty was to protect the fundamental structure of corporate governance.³⁵³ The court noted that directors manage the day-to-day affairs of a company, but shareholders, in accordance with democratic procedures, must make the decisions affecting a corporation's ultimate destiny.³⁵⁴ The court acknowledged the duty of the board to protect the corporation against takeover attempts that are not in the corporate interest, but condemned the board for its failure to demonstrate that the defense adopted was fair and reasonable.³⁵⁵ Voicing its primary concern, which coincided with the concerns expressed by Congress, the court insisted that it must not approve "a wholesale wresting of corporate power from the hands of the shareholders, to whom it is entrusted by statute, and into the hands of the officers and directors."³⁵⁶ *Norlin*, in harmony with congressional expressions of concern for shareholder protection, reinforces the importance of protecting the interests of shareholders in corporate transactions, and contradicts notions that shareholders must succumb to directors' plenary power in all corporate matters. Whereas the *Moran* court assumed that the board had authority to infringe on shareholder rights where the board could provide minimal justification, Congress and other courts have decided to promote shareholder interests with greater resolve.

IV. CONCLUSION

Poison pills are not an inherently evil creation. Properly constructed, rights plans are a highly practical means of eliminating a very real threat to shareholders, such as coercive two-tier takeovers of the sort proposed by T. Boone Pickens, which formed the basis for *Unocal Corp. v. Mesa Petroleum Co.*³⁵⁷ In the face of such a threat, a board is justified in adopting a rights plan under which any tender offeror willing to offer all shareholders a fair price can do so without board interference.³⁵⁸ Any rights plan,

³⁵² 744 F.2d 255, 258 (2d Cir. 1984). In *Norlin*, the board of a corporation targeted for a takeover took two defensive actions: transfer of a large block of common stock to a wholly owned subsidiary (in consideration of the cancellation of a promissory note), and creation of an employee stock option to which a large block of shares was transferred and three directors were appointed as voting trustees. *Id.* at 259. The court found both of these defensive actions to be improper. *Id.* at 264, 266.

³⁵³ *Id.* at 258.

³⁵⁴ *Id.*

³⁵⁵ *Id.* at 266-67. The court analyzed the board's creation of the stock option plan, noting that an ESOP:

may serve a number of legitimate corporate purposes . . . [W]hen an employee stock options plan is set up in the context of a contest for control, however, it devolves upon the board to show that the plan was in fact created to benefit the employees, and not simply to further the aim of managerial entrenchment.

Id. at 266. Commendably, the court refused to accept *Norlin's* contention that the plan served "important corporate and shareholder interests," because its arguments did not "establish the independent legitimacy of the actions taken by the board to counter a perceived threat." *Id.* at 267.

³⁵⁶ *Id.*

³⁵⁷ 493 A.2d 946 (Del. 1985). See *supra* notes 128-33 and accompanying text.

³⁵⁸ As demonstrated in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, rights plans may also be used effectively as a means of maximizing the return to shareholders where there is competitive bidding for control. Nos. 353, 354, slip op. at 7 (Mar. 13, 1986). The court noted its approval of the rights plan adopted, however, after the board removed the plan, so it was no longer a barrier to an acquirer's offer.

however, that is more intrusive on shareholder rights than is necessary to achieve the directors' legitimate objectives should require shareholder majority approval.

In *Moran v. Household International, Inc.*,³⁵⁹ the Delaware Supreme Court reviewed for the first time the legitimacy of a preferred share purchase rights plan adopted by a board as a prospective takeover defense. The *Moran* court held that the business judgment rule was the appropriate standard for reviewing the board's defensive action of adopting a poison pill rights plan.³⁶⁰ Recognizing the inherent conflict which directors face when deterring hostile takeovers, however, the *Moran* court held that directors should bear an initial burden.³⁶¹ Applying the *Unocal* threshold test, the court required directors to show reasonable grounds for believing a threat to the corporation existed, and to demonstrate that the action taken was reasonable in relation to that threat.³⁶² By extending the application of the *Unocal* test to prospective defensive measures as well as defenses against immediate threats, *Moran* improves the state of the business judgment rule and shareholder protection.

The problem with the *Moran* decision, however, is its lenient application of the *Unocal* test. When applying the first part of the test, the *Moran* court was satisfied with the board's "perceived threat in the marketplace of coercive two-tier tender offers."³⁶³ If courts accept general market-wide threats as valid purposes, then directors need not produce any greater justification to satisfy their "burden." When the court purported to apply the second part of the test, requiring the board to prove that the defense was reasonable in relation to the danger facing the corporation, it did not require the board to justify the need for the controversial flip-over provision to meet the stated purpose. By not scrutinizing the relationship between the Rights Plan and the stated danger, the *Moran* court permitted the Household board to adopt a defense which would deter all takeovers, even those which might be in the corporation's best interests. By upholding the Rights Plan, the court permitted the directors to increase their discretionary power at the expense of shareholders' fundamental rights.

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³⁵⁹ 500 A.2d 1346 (Del. 1985).

³⁶⁰ *Id.* at 1357.

³⁶¹ *Id.* at 1356.

³⁶² *Id.* These were the tests developed by the Delaware Supreme Court in *Unocal*, 493 A.2d at 955.

³⁶³ *Moran*, 500 A.2d at 1356.