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POISON AND DEAD HAND PILLS, MARKETS FOR CORPORATE CONTROL, AND IMPLICATIONS FOR AN EMERGING MARKET LIKE CHINA

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Introduction

The Delaware Supreme Court first upheld a poison pill share-rights plan created by the defendant corporation in Moran v. Household International.[1] Although the Delaware Supreme Court approved this defensive weapon in the pre-tender offer context, it warned that 'the ultimate response to an actual takeover bid must be judged by the Directors' action at that time. Their use of the Plan will be evaluated when and if the issue arises.'[2]

Because poison pills can make a takeover that the target corporation's directors oppose virtually impossible, many commentators argue that poison pills are merely an entrenchment device used by target directors to preserve their jobs.[3] However, supporters of the poison pill contend

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1 . 500 A.2d 1346, (del.), aff'g 490 A.2d 1059 (Del. Ch. 1985).

2 . 500 A.2d at 1357.

3 . Concept Release on Takeovers and Contests for Corporate Control, Exchange Act Release No. 23,486, Fed. Sec. L. Rep. (CCH) 84,018, 88,200, (July 31, 1986) [hereinafter Poison Pill Release]. This release requested public comment on the possibility of a federally promulgated shareholder approval rule for all poison pill plans. The responses are available to the public in File No. S7-18-86 at the Public Document Room of the Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.
'Poison pills are devices adopted by corporations--without shareholder consent--that erect insurmountable barriers to offers from outside bidders for a company's shares--except those favored by management.'

that the adoption of poison pills allows management to negotiate in the best interests of the shareholders, to protect shareholders from tender offers at inadequate prices and to forestall abusive takeover practices such as partial offers.[4] The central issue now, however, is whether and under what circumstances a board of directors has a duty to redeem a poison pill during a takeover attempt;[5] and whether we should limit the power of board of directors and how we should.

Clafman & Schlefer, The Fuss Over Poison Pills: Recipe for a Management Autocracy, N.Y. Times, Dec. 14, 1986, at F2, col. 3.

[4] . Poison Pill Release, supra note 5, at 84,018.
'The Pill gives targets more time, and thus a better opportunity to negotiate with a white knight or even with the raider. In these respects, the pill is beneficial to shareholders. It creates the opportunity to maximize shareholder values.' Lipton, The Fuss Over Poison Pills: A Sensible Deterrent to Takeover Mania, N.Y. Times, Dec. 14, 1986, at F2, col. 2.

[5] . Some changes in corporate control, such as a merger, are negotiated or 'friendly' acquisitions. The management of the two corporations bargain over the terms, conditions and future management. If the target corporation's board of directors approves of the merger, it is submitted to the corporation's shareholders for approval. When a 'friendly acquisition' cannot be arranged, the bidder may seek to gain control through a hostile takeover. The bidder makes a tender offer directly to the shareholders, thereby bypassing the board of directors. See L. Solomon, D. Schwartz & J. Bauman, Corporations, Law and Policy: Materials and Problems 1033-34 (2d ed. 1988); see also E. Aranow & H. Einhorn, Tender Offers for Corporate Control 70 (1973) (a tender offer is '[a] public offer or solicitation by a company, an individual or a group of persons to purchase during a fixed period of time all or a portion of ... securities of a publicly held corporation at a specified price or upon specified terms for cash and/or securities'). Congress regulates tender offers through the Williams Act. Corporate Equity Ownership-Disclosure (Williams) Act, Pub. L. No. 90-439, 82 Stat. 454 (codified as amended at 15 U.S.C. sec. 781-78n (1982 & Supp. IV 1986). Other less frequently used methods of gaining control include proxy contests, see L. Solomon, D. Schwartz & J. Bauman, supra, at 1040-43, and market sweeps, see Note, Proposed SEC Regulation of Market Sweeps: Should Market Sweeps Be Governed By The Williams Act?, 56 Fordham L. Rev. 797 (1988).

This thesis reviews diverse interpretations of the function of poison pills in light of recent judicial decisions and underlying empirical evidence; as well as reviews recent judicial decisions regarding the new version of poison pill--dead hand pill. This article also discusses the recent trend of by-law restrictions in an attempt to limit the abusive use of poison pills. The conclusion drawn is that poison pill plans must be designed to encourage bargaining between target management and hostile acquirers.

I. Poison Pill: Defensive Tactics that Impact Corporate Takeovers

A. Basic Design of Poison Pill

Originally known as "poison pill preferred stock,"[6] the term "poison pill" now refers to a share purchase rights plan - a corporate defensive measure designed to deter hostile bidders from purchasing control of a company. A target company's board of directors usually creates a rights plan without a shareholder vote. The board authorizes the creation and distribution to its common stockholders of a dividend of one right for each share of common stock they own. The right entitles the shareholder to purchase common or preferred stock of the target company or any potential acquirer. Initially the rights are transferable only with the stock and are not exercisable. However, once a "triggering event" occurs, such as the acquisition of more than a specified percentage of the

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[6] . The original poison pill plans were devised in 1983 by Martin Lipton, a senior partner in the New York law firm of Wachtell, Lipton, Rosen & Katz, on behalf of Lenox, Inc. See Allen & Swartz, Lenox Rebuffs Brown-Forman, Adopts Defense, Wall. St. J., June 16, 1983, at, col. 2 (widw. ed.). A memorandum written by Mr. Lipton describing early poison pill plans appears in R. GILSON, THE LAW & FINANCE OF CORPORATE ACQUISITION 637-39 (1986).

target company's stock,[7] new rights certificates are distributed to the target company's stockholders and these certificates become exercisable.[8] However, any unexercised rights may be redeemed by the target company's board of directors at a nominal price.[9]

1. Convertible Preferred Stock Provision

A convertible preferred stock dividend plan formed the cornerstone of the first poison pill introduced by Lenox, Inc. in June 1983. This plan was used by target companies to protect shareholders from partial and front-end loaded, two-tier offers.[10] Pursuant to this plan common

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[7] . The definition of a triggering event can vary between Rights Plans. One common definition is "the earlier of ten days after an entity acquires a certain percentage of the issuer's stock (typically 20%) or commences a tender offer that would result in the acquiring person (the bidder) owning a certain percentage of the issuer's stock (typically 30%)." Anthony Augliera, Shareholder Rights Plans: Saying No to Inadequate Tender Offers, 57 Fordham L. Rev. 803, 808 n.33 (1989).

[8] . The following Rights Plan terms are taken from 1 Moody's Bank and Finance Manual 1602 (1990), 1602 (cited in note 24):
Initially, the rights will not be exercisable and will transfer with and only with the shares of common stock. The rights will be exercisable and separately transferable twenty business days after a person or group of persons acquires generally 15% or more of Bancorp' common stock, or twenty business days, or such later date as may be determined by the Board of Directors' after a person or group announces a tender offer the consummation of which would result in ownership by a person or group of persons of generally 15% or more of the common stock. Id.

[9] . Pitt & Buthusiem, Tender Offers: Offensive and Defensive Tactics and the Business Judgment Rule, 1 BLOCK & PITT, HOSTILE BATTLS FOR CORPORATE CONTROL 1986 323, 324 (1986).

[10] . American Law Institute-American Bar Association Comm. on Continuing Professional Educ., Takeover Defenses and Director's Liabilities 95 (M.

stockholders of the issuer are issued a pro rata dividend consisting of convertible preferred stock.[11] At a specified period (e.g., thirty days) following a bidder's acquisition of control of the target company, the preferred holders are entitled to redeem their shares for a "fair price" set by the plan.[12] This price is determined through a formula provided in the plan, which may reflect the average price for the issuer's common stock over a specified period of time. However, exercise of this redemption right may be subject to suspension for a period of time (e.g., 120 days) in the event of a publicly announced intention to consummate certain business combinations. In this event, if the business combination is consummated within the allotted time, the right of redemption is extinguished. After a significant period of time has elapsed, the issuer may be able to redeem the poison pill stock at a price stipulated in the plan and typically set in excess of the current market price of the common stock. This price may reflect the long-term value of the issuer. An Acquiring Person,

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Lipton ed. 1986).

[11] . Veasey, Flinklestein & Abrams, Selected Tactics in Control Contests, supra note 14, at 78 (1086).

however, is never permitted to participate in any issuer redemption of the poison pill stock.[13]

Alternatively, in the event of a substantial stock acquisition followed by a second-step merger, the preferred stock of the target can be exchanged for an equivalent amount, as determined by the plan, of voting stock of the acquiror or surviving corporation with all of the rights, powers, privileges, and preferences with respect to the Acquiring Person or survivor to which such convertible preferred stock had been entitled from the issuer.[14]

Consequently, these two provisions deter acquisition by either depleting the target's assets or diluting the value of acquiror's stock.[15] If a business combination is consummated, the provision of the Acquiring Person's existing stockholders would be diluted through the conversion of the preferred stock of the issuer into voting stock of the Acquiring Person. If the bidder acquires a stock position but no business combination is consummated, the issuer's assets could be depleted by the payment to stockholders of the issuer's 'fair value' through

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[12] . Id. at 429.

[13] . Id. at 430.

[14] . Takeover Defenses and Director's Liabilities, supra note 15, at 96.

[15] . The Poison Pill Preferred, 97 Harv. L.Rev. 1967 (1984).

redemption of the preferred stock upon demand by the holders thereof. [16]

2. Flip-Over Provisions[17]

Under the flip-over plan, common stockholders of the target corporation typically receive a pro rata dividend consisting of a right or warrant to purchase common or preferred stock, or both, of the issuer. The rights or warrants generally have a fixed-term existence (e.g., ten years[18]). Prior to the occurrence of a triggering event, such as the acquisition of a stipulated amount of stock[19] (e.g., fifteen percent or more[20]), or the

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[16] . Id.

[17] . In this kind of plan, the dilution effect of the poison pill flips over to the acquiror's corporate, not the target corporate. So it is named as "flip-over provision". See 1 TAKEOVER DEFENSES, supra note 15, at 96-101; Dawson, Pence & Stone, supra note 14, at 426-28; Selected Tactics in Control Contests, supra note 14, at 83-85. In Moran the Delaware Supreme Court upheld the validity of a flip-over pill. See also 1 Arthur Fleischer, Jr. & Alexander R. Sussman, Takeover Defenses s 5.04[A], at 64-69; OFFICE OF THE CHIEF ECONOMIST, SECURITIES AND EXCHANGE COMM'N, THE ECONOMICS OF POISON PILLS (March 5, 1986), at 4-5.

[18] . A few corporations (notably Pennzoil and National Intergroup) have adopted rights plans that expire automatically after a specified period of years (in the examples above, three or five, respectively) unless the stockholders expressly authorize their continuation. The theory behind these plans is that they can be used to respond to particular threats or applied during unique periods of the corporation's history without entrenching the Board for a long period of time. National Intergroup's plan was devised with the input of one of its large institutional investors.

[19] . Dawson, Pense & Stone, supra note 14, at 426 (including the threshold under the Federated right plan as 20% of the company's stock).

announcement or commencement of a tender offer for a specified percentage of the issuer's stock (e.g., thirty percent or more),[21] the rights are subject to redemption by the board of directors and can neither be exercised nor transferred separately.[22]

At or shortly after the occurrence of a triggering event, certificates evidencing the rights are distributed to common stockholders and the rights become exercisable, tradable, and, when so provided in the plan, non redeemable.[23] If the acquiror triggers the plan and then proceeds with a merger or similar business combination transaction, the flip-over provision entitles each rights holder to purchase the acquiror's common stock at a substantial discount. Because the flip-over provision does not operate unless the bidder attempts to acquire all the target company's stock by a merger or by some other type of business combination, flip-over pills do not prevent all

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[20] . The general trends is that the triggering percent is becoming lower and lower. Some courts even recognize 10% as a triggering percentage.

[21] . Under the Federated plan, the commencement of a tender offer for 30% is a triggering event, CRTF Corp., [1987-1988 Transfer Binder] Fed.Sec.L.Rep. (CCH), at 98,118.

[22] . Id. Initially, the rights are transferable only when the common stock are not exercisable.

[23] . Dawson, Pence & Stone, supra note 14, at 427; Veasey, Finklestein & Abrams, supra note 14, at 81.

cash tender offers for all of the target's shares, or open-market purchases of a controlling interest in the target.[24]

The exercise price for acquisition of the issuer's stock pursuant to the rights may reflect an attempt to establish the long-term value of the issuer over the life of the plan or may be set at a level that bears no relation to the issuer's value. Exercise of the rights generally becomes economic only in the event of a business combination involving the issuer that triggers the flip-over provision and entitles the holders of the rights to purchase, at a discount, common or preferred stock, or both, in the Acquiring Person or surviving corporation. For example, assuming an exercise price of $150, the standard flip-over poison pill plan would require that, in order for the issuer to consummate a merger into an Acquiring Person, the merger agreement must provide that the rights holders can purchase $300 worth of the Acquiring Person's common stock for $150. This has the effect of substantially diluting the equity of the Acquiring Person's existing stockholdings, thereby giving flip-over provisions their significant deterrent effect.

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[24] . 1 A Fleischer, supra note 16, at 69; Poison Pill Effects, supra note 16, at 122 (Mar. 5, 1986).

3 Flip-In Provisions[25]

Poison pill plans with flip-in provisions consist of a standard flip-over rights plan with additional flip-in features. Flip-in provisions enable common stockholders other than the acquiror,[26] to purchase shares of stock of the target company at a bargain price following certain self-dealing[27] or triggering events.

Flip-in provisions have the effect of diluting the investment and voting power of an Acquiring Person in the

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[25] . In this kind of plan, the dilution effect flips into the target corporate, not the acquiror corporate. So it is named as "flip-in provision". See 1 A. FLEISCHER, supra note 16, at 71-92; Dawson, Pence & Stone, supra note 14, at 28; Herzel & Shepro, The Changing Fortunes of Takeover Defenses, 15 SEC. REG. L.J. 116 (1987). Flip-in plans have met some opposition in the courts. See Amalgamated Sugar Co. v. NL Indus., 644 F.Supp. 1229 (S.D.N.Y. 1986), aff'd, 825 F.2d 634 (2d Cir. 1987); R.D. Smith & Co. v. Preway, Inc., 644 F. Supp. 868 (W.D. Wis. 1986); Dynamics Corp. of American v. CTS Corp., 637 F. Supp. 406 (N.D. Ill. 1986), aff'd, 794 F.2d 250 (7th Cir. 1986). But See CRTF Corp., [1987-1988 Transfer Binder} Fed. Sec. L. Rep. (CCH), at 98,122-23; Gelco Corp. v. Coniston Partners, 652 F. Supp. 829 (D. Minn. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).

[26] . This treatment among shareholders is discriminatory and has prompted several courts to consider flip-in provisions unlawfully discriminatory. See, e.g., Amalgamates Sugar Co. v. UL Indus., 644 F.Supp. 1299 (S.D.N.Y. 1986); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del.1985); CRTF Corp., [1987-1988 Transfer Binder} Fed.Sec.L.Rep. (CCH), at 98,122-23.

[27] . Identified selfdealing transactions created in flip-in rights to include:

(1) mergers of the acquiror or an affiliate into the target where the other stockholders are not squeezed out;

(2) transfers of assets to the target for target stock;

(3) sales, purchases, or pledges to, from, or with the target of any assets;

(4) receipt of employment compensation from the target;

(5) receipt of loans from the target; and

(6) reclassifications, such as reverse stock splits, that

issuer. This effectively prevents an Acquiring Person from purchasing a substantial block of the issuer's stock through open market purchases, negotiated sales, or partial tender offers, and encourages acquirors to negotiate with the target company's board of directors during a takeover contest to avoid dilution in the value of the target's shares.

4. Back-End Provisions[28]

Poison pill plans with back-end provisions generally involve the issuance, as a dividend to common stockholders of the issuer, of a right to tender their common stock to the issuer for a package of securities upon the occurrence of specified triggering events. Prior thereto, the rights are not exercisable, are redeemable by the issuer's board of directors for a nominal price, and trade with common stock. Following the occurrence of certain triggering events (e.g., acquisition of a specified amount of the issuer's capital stock), the rights become

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increase the acquiror's percentage holdings.

[28] . Under this kind of plan, the stocks come back to the target corporate upon the occurrence of specified triggering events. So it is named as "back-end provision." See POISON PILL ECONOMICS, supra note 16, AT 6; 1 TAKEOVER DEFENSES, supra note 15, at 101-02; 1 A. FLEISCHER, supra note 16, at 70-71; Dawson, Pence & Stone, supra note 14, at 428-29; Selected tactics in Control Contests, supra note 6, at 87-98. Courts have enjoined the use of note purchase plans in at least three cases. See Edelman, 798 F.2d at 882; Minstar Acquiring Corp. v.

nonredeemable and exercisable to all common stockholders, except acquiring persons, through tender of their common stock to the issuer.

In one version of the back-end plan, the exercisability of the rights will be delayed for a specified period of time, e.g., 120 days, if the acquiring person publicly proposes to consummate a cash transaction to acquire any and all outstanding shares of the issuer's stock for a price at or above the stipulated value of the issuer's securities package. Another form of back-end plan removes the requirement for common stockholders to actually tender their common stock to the issuer by granting to stockholders the right, following a business combination or tender offer, to receive the difference between the stipulated back-end price less the average price paid by the bidder for the issuer's securities (as determined according to a formula specified in the plan).[29]

5. Voting Provisions

While not viewed as a garden variety poison pill, defensive measures with voting provisions typically involve the issuance, by way of a dividend to common stockholders,

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AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985); Revlon, 506 A.2d at 173.

[29] . See, e.g., Rights Agreement between Michigan Nat'l Corp. and

of securities having special voting powers. In one version, preferred stock is issued to common stockholders of the issuer with certain supervoting privileges under specified circumstances for the purported purpose of severely diluting the voting power of a bidder seeking control. Under another plan, common stockholders are issued securities with voting rights that increase with the length of time the securities are held. These plans are relatively easy to implement where the issuing corporation has authorized preferred stock with flexible voting feature available.

B. the New Frontier: Dead Hand Pill

In recent years, many companies have adopted shareholder rights plans which include continuing director ("dead hand") provisions. Continuing director provisions, such as the one adopted by Healthdyne,[30] generally permit the redemption or amendment of the company's rights plan only by one or more continuing directors - a term typically defined to include directors who were in office when the plan was adopted or who were subsequently elected to the board with the recommendation and approval of the directors

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Michigan Nat'l Bank, dated as of July 10, 1986.

[30] . See Invacare Corp. v. Healthdyne Technologies Inc., 968 F.Supp.

in office, or directors who joined the board after a change of control but with the approval of continuing directors.[31]

There are a number of different varieties of continuing director provisions. One type acts as an absolute prohibition against a newly elected board redeeming rights without the consent of the requisite number or percentage of the continuing directors.[32] A second type of continuing director provision -- similar to the one added in the Bank of New York decision -- does not provide an absolute prohibition against redemption of rights by a newly elected board, but instead typically allows a newly elected board to redeem the rights if (1) the noncontinuing directors "were elected by an affirmative vote of the holders of at least two-thirds of the issued and outstanding shares" of the company or (2) for some period of time before and after the election of such noncontinuing directors, no merger, consolidation, or other business combination involving the company is proposed.[33] A third variation is a "deferred redemption" dead-hand provision, which provides an absolute prohibition on the newly

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1578 (N.D. Ga. 1997).

[31]. See Lese, "Preventing Control From the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills," 96 Colum. L. Rev. 2175, 2191 (1996).

[32]. Id.

elected, noncontinuing, directors redeeming the target's right plan, but only for a fixed period of time (e.g., 180 days) after their election.

Continuing director provisions are designed to prevent a suitor from engaging in a proxy contest (which is part of the usual strategy for a hostile acquisition) to remove an incumbent board of directors and then have the new board amend or redeem the shareholder rights plan as a precursor to an unfriendly acquisition. These provisions are known as "dead hand" provisions because they prevent the redemption or amendment of rights plans if there are no continuing directors and thus provide a powerful tool for a company in fending off a coercive or unwanted takeover proposal.[34]

Poison pills containing continuing directors provisions thus have vast potential to hinder proxy contests, as well as to block hostile tender offers. The interests of the board may, as a result, conflict with those of shareholders when the former, responding to a control threat, adopts such a pill. Numerous commentators

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[33] . 139 Misc. 2d at 667, 528 N.Y.S. 2d at 483.

[34] . Lipin, "Big B's Unusual Poison Pill sparks Lawsuit by Hostile Suitor Revco," Wall St. J., Oct. 1, 1996, at B4; see Block, Hoff & Cochran, "Defensive Measures in Anticipation of and in Response to Unsolicited Takeover Proposals, 51 U. Miami L. Rev. 623, 644 (Apr. 1997).

have sought the invalidation of pills like this that encroach on shareholder voting rights. Companies that have adopted continuing director provisions argue that they are a reasonable response to the possibility that a hostile bidder may attempt to circumvent a target's rights plan by conducting a proxy contest aimed at replacing the target's board with directors who will then redeem the rights in order to facilitate a self-dealing or unfair transaction.

C. The Impact of the Poison Pill in Corporate Takeover

Proponents of poison pill plans argue that shareholder right plans give a target corporation's board of directors the power to protect shareholders from the potentially coercive tactics of a hostile bidder.[35] Although every shareholder might consider the bidder's offering price inadequate, a two-tiered offer will coerce all shareholders to tender at a lower price.[36]

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[35] . Moran, 500 A.2d at 1349 (Lipton discussing the frequency of "bust-up" takeovers as a justification for the adoption of a pill). See also Dynamics Corp. of Am. v. CTS Corp., 635 F.Supp. 1174, 1178 (N.D.Ill.1986) (discussing the "threat" or "evil" poised by squeeze-out mergers).

[36] . Prentice describes this coercion as follows:
The effect of front-end loaded, two-tiered tender offers is to "stampede" target shareholders into a decision to tender. The "whipsaw" effect is created by the "prisoner's dilemma." Although every shareholder may believe that the bid is too low and the wiser course would be to hold out for a higher bid, an inability to act cooperatively forces each shareholder to tender out of fear that if he does not tender, his fellow shareholders will, leaving his stuck with

To combat this perceived coercion, poison pills were developed, a move which courts and commentators have supported despite the risk that the pill will entrench management.[37] Courts have sanctioned poison pills as a legitimate defensive device to mitigate the coercive force of two-tiered tender offer;[38] and commentators have contended that the unfairness of two-tiered tender offers is the only justification for a target company's use of a poison pill.[39]

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the lower back-end merger price.
Prentice, supra note 61, at 442 (footnotes omitted).

37 . See Prentice, supra note 61, at 412 ("one of the main purpose of poison pills Ö is to deter front-end loaded, two-tiered tender offer."); Affidavit of John C. Coffee, Jr. at P 11, Big B, Inc. v. Revco D.S., Inc. (N.D. Ala. Filed 1996) ("The actual intent [of a poison pill] was probably Ö to employ it to deter two tier offers Ö."). Poison pills were developed with the intention of assuring equality among shareholders. Rather than serving as a tool to block takeovers, the pill was intended to allow back-end shareholders the same deal presented to front-end shareholders. Another arguably plausible justification for the "flip-in" variety of poison pill is that it prevents "creeping" acquisitions, and thereby the possibility that the aquiror will steal the shareholder's "control premium" by purchasing shares secretly and silently in the open market. See id. At P 14. In such a situation, the pill forces the acquiror to negotiate with the target board of directors. See id.

38 . See, e.g., Desert Partners v. USG Corp., 686 F. Supp. 1289, 1295-300 (N.D. Ill. 1988) (validating use of rights plan against unsolicited front-end loaded, two-tiered bid); CRTF Corp. v. Federated Dep't Stores, [1987-1988 Transfer Binder] Fed. Sec. L. Rep. (CCH) P 93,680, at 98,118-21 (S.D.N.Y. Mar. 18, 1988) (same); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (identifying as threat posed for purposes of Unocal test, "the threat in the market place of coercive two-tier tender offers").

39 . See Note, Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred, 97 Harv. L. Rev. 1964, 1971-72 (1984); see also Prentice, supra note 61, at 412 ("Commentators have argued that [poison pills] can only be justified if they are used to

In addition to discouraging front-end loaded and partial tender offers, the pills deter large shareholders from engaging in self-dealing transactions.[40] Supporters of the shareholder rights plans also contend that the plans force an acquiror to negotiate the terms of a business combination with the target board. Moreover, some scholars argued that the pills furnish target directors and management with the bargaining power necessary to force raiders to pay substantially higher premiums for the target's stock.[41]The empirical studies conducted by New York proxy solicitor Georgeson & Co. confirmed the belief that poison pills enacted by directors help maximize shareholder wealth in hostile bidding contest.

A study released by the Investor Responsibility Research Center criticized the defensive tactics in general and poison pill plans in particular because: (1) it transfers power from stockholders to directors and interfere with voting contests, (2) entrenches management,

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defeat front-end loaded, two tiered bids.").

[40] . Examples of self-dealing include: reducing dividends, selling assets to affiliates on terms less favorable than the target could have obtained in arm's-length negotiations, increasing compensation levels for the acquiror, and recapitalizing or reclassifying the target's stock to increase the proportionate interest of the acquiror. Dawson, Pence & Stone, supra note 14, at 428 (1987).

[41] . Lee, Poison Pills Benefit Shareholders by Forcing Raiders to Pay more for Targets, Wall St.J., Mar. 31, 1988, at 55, Cols. 2, 3 (quoting Martin Lipton stating that the poison pill is the most effective way to

(3) precludes all takeovers, and (4) decreases shareholders wealth.[42]

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equalize the negotiating strength of management with the overwhelming advantage that the corporate raider has).

[42] . Institutional Investors Oppose Poison Pill Plans, IRRC Survey Shows, 19 Sec. Reg. & L.Rep. (BNA) No. 46 at 1751-52 (Nov. 20, 1987).

II. Judicial Review of Incumbents' Use of Poison Pill

A. The Traditional Business Judgment Rule

Under Delaware law, the business judgment rule flows from the fundamental principle that the business and affairs of a Delaware corporation are managed by or under its board of directors.[43] The rule has often been characterized in its application as a rebuttable presumption of management good faith.

Generally, the protection of the business judgment rule applied only to disinterested directors. In addition, to invoke the rule's protection, directors have a duty to inform themselves, prior to making a business decision, of any reasonably available information that is material to the transaction, and by acting with requisite care in the discharge of their duties. Normally, where the business judgment rule applies, liability of directors for breach of the duty of care will only exist if the directors are found to have been grossly negligent.[44]

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[43] . Polk v. Good, 507 A.2d 531, 536 (Del. 1986); Smith v. Van Gorkom, 488 A.2d 858, 872 (Del.1985); Pogostin v. Rice, 480 A.2d 619 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984).

The courts have modified the presumption of the basic business judgment rule in tender offer situations, since tender offern threates the directors' control of management positions in the corporation. In Unocal Corp. v. Mesa Petroleum Co.[45], the Delaware Supreme Court first articulated the duties of a corporate baord faced with a hostile tender offer. Mesa, which owned thirteen percent of Unocal's stock, made a two-tired "front-loaded" cash tender offer for thirty-seven percent of Unocal's outstanding stock.[46] After gaining control of the corporation, Mesa intended to buy out the remaining shareholders using highly subordinated securities, commonly called "junk bonds."[47] Unocal's board, which had a majority of disinterested directors, determined that Mesa's tender offer was inadequate and adopted a self tender plan in order to give Unocal shareholders what they believed to be an adequate alternative to Mesa's offer.[48] The self tender plan provided that if Mesa were successful in its tender offer, Unocal would buy the remaining outstanding shares for an exchange

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[44] . Van Gorkom at 873; Aronson at 812.

[45] . 493 A.2d 946 (Del. 1985).

[46] . Id. At 949. Mesa offered $54.00 per shares tendered in the first tier of its offer. Id.

[47] . Id. At 949-50. The junk bonds had an estimated value of $54.00 per share. Id.

of debt securities. The exchange was designed to ensure that shareholders who did not tender to Mesa at the front end of the tender offer would be adequately compensated at the back end of the offer.[49] The resolution specifically excluded Mesa from participating in the exchange.[50] Evaluating the board's decision to adopt the exchange plan, the Delaware court noted that "because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty ... before the protections of the business judgment rule may be conferred."[51] The Delaware Supreme Court adopted a two-prong test which must be satisfied before the board's decisions in the takeover context are protected by the business judgment rule. First, the board must show that it had 'reasonable grounds for believing that a danger to corporate policy and effectiveness existed.'[52] This burden

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[48] . Id. At 950-51.

[49] . Id.

[50] . Id. Including Mesa in the exchange plan would have defeated the plan's purpose, because under the pro rata provision of the plan, some Mesa shares tendered would have to be accepted, thereby excluding other shareholders. Id. Thus, including Mesa would have in effect forced Unocal to partially finance Mesa's tender offer. Mesa argued that the exclusion violated the board's fiduciary duty to it as a shareholder. Id. At 953, 957.

[51] . Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 946 Del. 1985).

[52] . Id. at 955. The first prong of the Unocal test ensures that a

is satisfied by a showing of "good faith and reasonable investigation.'[53] Second, the board's defensive measure must be 'reasonable in relation to the threat posed.'[54] Although Unocal did not involve a poison pill situation, the case is important, however, because it imposed on the Unocal board the initial burden of proving the reasonableness of its decision to oppose a takeover bid.[55] The Unocal court modified the basic or traditional judgment rule by shifting the initial burden to the board. By allowing a court to examine the reasonableness of a board's adoption of a defensive tactic, Unocal cleared the way for judicial intervention in takeover cases.

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defensive measure designed to prevent a takeover is motivated by a good faith concern for the welfare of the corporation and its shareholders. See id. The court listed examples of concerns which a board might have in analyzing the nature of a bid including: (a) inadequacy of the price offered; (b) nature and timing of the offer; (c) questions of illegality; (d) the impact on constituencies other than shareholders; (e) the risk of nonconsummation; and (f) the quality of the securities being offered in an exchange. See id. Unocal also states that a finding that the first prong is satisfied will be materially enhanced if the defensive measure was approved by a majority of the outside independent directors. See id. The importance of a vote of independent directors was taken from an earlier Delaware case. See Puma v. Marriott, 283 A.2d 693, 695 (Del. Ch. 1971).

[53] . See Unocal, 493 A.2d at 955.

[54] . Id. at 955. The second prong adds an element of balance by requiring that the board analyze the nature of the takeover bid and its effect on the corporation. Because of the balancing requirement, the test is sometimes referred to as the proportionality test. See TW Services, Inc. v. SWT Acquisition Corp., [Current Binder] Fed. Sel. L. Rep. (CCH) 94,334, at 92,174 (Del. Ch. Mar. 2, 1989).

[55] . Id. at 955.

Judicial standards for implementing the Unocal test in the directorial defensive action context have oscillated dramatically in recent years. In Paramount Communications, Inc. v. Time, Inc.,[56] the court considered, among other things, a number of subjective and intangible elements in determining whether the Time board satisfied Unocal's requirements in responding to a hostile tender offer by Paramount Communications. This case involved an attempt by Paramount to acquire Time in a cash tender offer, interfering with a proposed friendly merger between Time and Warner Communications. In response to the Paramount bid, the Time board recast the proposed Warner merger into an acquisition of Time by Warner, and refused to redeem its shareholder rights plan. The Delaware Supreme Court expanded in two directions the powers of a target company's board to reject a hostile tender. First, it greatly expanded the list of potential threats that a board could consider under the first prong of Unocal.[57] In addition to considering the financial inadequacy of Paramount's unsolicited offer, the court allowed Time, the target, to argue that Paramount's offer was inconsistent with Time's long-term business strategy, involved a

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[56] . 571 A.2d 1140 (Del. 11989).

significant degree of uncertainty that skewed a comparative analysis, was designed to confuse or upset the shareholders' vote on a proposed merger with a competing bidder (Warner), and did not provide the best strategic fit with Time's policy and culture. Second, it shifted the standard for judicial review of the directors' determination that a threat exists away from the independent judicial determination emphasized by prior chancery court decisions and toward a more lenient business judgment type standard. In short, Time seems to mark the collapse of heightened judicial scrutiny for takeover defensive tactics against hostile tender offers and a retreat to their deferential review under the business judgment rule.[58]

Despite this apparent momentum in favor of target board of directors, Paramount Communications Inc. v. QVC Network Inc.[59] reverted back to what could be viewed as a "more shareholder-friendly standard."[60] In this case, the

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[57] . Id. at 1942.

[58] . Id. at 1945-47. In other words, the Delaware Supreme Court "seems to have abandoned the effort to subject defensive tactics in hostile takeovers to serious scrutiny, backing away from several recent precedents and undermining a sophisticated developing jurisprudence in the Chancery Court." Id. at 1947.

[59] . 637 A.2d 34 (Del. 1993).

[60] . Lawrence A. Cunningham & Charles M. Yahlon, Delaware Fiduciary Duty Law After QVC and Technicolor: A Unified Standard (and the End of

lock-up option at issue gave Viacom, a third corporation, the right to purchase almost 20 percent of Paramount stock for approximately $1.6 billion, which Viacom could opt to pay with a subordinated note instead of cash. Additionally, the lock-up option contained a put provision that permitted Viacom to require Paramount's stock at the time the option was triggered, with no cap limiting the maximum dollar value of the put. The court enjoined the lock-up on the grounds that the note and put provisions were potentially draconian to Paramount and unusually and highly beneficial to Viacom. The court reasoned that the Paramount board's primary obligation was to use its informed judgment for the "realization of the best value reasonably available to the stockholders."[61] To ensure that boards satisfy this requirement, courts must subject the boards' actions to "enhanced judicial scrutiny"[62] whenever an extraordinary corporate transaction occurs. Conversely, Unitrin, Inc. v. American General Corp.,[63] restrained the reach of QVC's enhanced judicial scrutiny standard. In this case, the

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Revlon Duties?), 49 Bus. Law. 1593 (1994); see also Cede & Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (subjecting board action in takeover scenario to judicial scrutiny under "entire fairness" standard of review).

[61] . Id. at 51.

[62] . Id. at 45.

[63] . 651 A.2d 1361 (Del. 1995).

Delaware Chancery Court upheld a shareholder right plan, but preliminarily enjoined a repurchase program implemented by Unitrin, the target of a hostile takeover offer by American General Corporation. The Delaware Supreme Court overruled the Chancery Court's determination that the target board's actions in defending against a hostile tender offer[64] were "unnecessary" and therefore "disproportionate" under the second prong of the Unocal test.[65] The Unitrin Court stated that "a court applying enhanced judicial scrutiny should be deciding whether the directors made a reasonable decision, not a perfect decision."[66] The court indicated that any defensive maneuvers fall outside the range of reasonableness if it can be characterized as "draconian," by which the court meant to signify "preclusive or coercive."[67] Thus, after

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[64] . In response to American General's (the bidder) tender offer for the stock of Unitrin (the target), the Unitrin board adopted a poison pill and commenced a stock repurchase program. See id. at 1370-71.

[65] . Id. at 1385 ("The Court of Chancery applied an incorrect legal standard when it ruled that the Unitrin decision to authorize the Repurchase Program was disproportionate because it was unnecessary.").

[66] . Id.

[67] . Id. at 1387. The court stated that "defensive measures which are either preclusive or coercive are included within the common law definition of draconian." According to the court, a defensive action is "preclusive" if it deprives "the stockholders of their rights to receive tender offers [or] fundamentally restricts proxy contests." Id. A defensive act is "coercive" if it is "aimed at 'cramming down' on ... shareholders a management-sponsored alternative." Id. The court's rationale for this standard is as follows: The ratio decidendi for the "range of reasonableness" standard is a need of the board of directors

Unitrin, a defensive action that can be characterized as preclusive or coercive will fail the second prong of the Unocal test.

The Delaware Chancery Court in Blasius Industries v. Atlas Corp.[68] stated what some scholars consider to be the "most important contemporary articulation of the judicial franchise."[69] In that case, Blasius was a new stockholder of Atlas who had accumulated over nine percent of Atlas' common stock within four months; Blasius then subsequently recommended that Atlas restructure the company, amend its bylaws to increase the size of its board and fill the new directorships with Blasius' nominees.[70] The board viewed Blasius' action as an attempt to takeover the company.[71] The board then amended the corporation's bylaws to change the date of the shareholders' meeting, increased the size of its board from seven to nine and filled the two new positions with nominees friendly to the inccumbent

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for latitude in discharging its fiduciary duties to the corporation and its shareholders when defending against perceived threats. The concomitant requirement is for judicial restraint. Consequently, if the board of directors' defensive response is not draconian (preclusive or coercive) and is within a "range of reasonableness," a court must not substitute its judgment for the board's. Id. at 1388.

[68] . 564 A.2d 651 (Del. Ch. 1988).

[69] . Irwin H. Warren & Kevin G. Abrams, Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests, 47 Bus. Law. 647, 654 (1992).

[70] . See Blasius, 564 A.2d at 653-54.

board.[72] In reviewing these board actions, the court recognized that the directors acted to protect the company and its stockholders from what they, in good faith, believed was an unwise and potentially harmful consent solicitation proposed by a shareholder.[73] The court determined that it must provide "closer scrutiny" of the board's action than would be provided under the Unocal test because the board's action was designed primarily to interfere with shareholder franchise.[74] Although the Blasius distinguished its own test from that of Unocal, later cases treated the Blasius standard as a "specific expression" of the Unocal test.[75]

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71 . Id.

72. Id. (discussing board's emergency decision to expand number of directors by amending bylaws). Although there was a scheduled meeting within a week, the board called an emergency meeting in order to add additional directors. See id. Evidence suggested, and the court concluded, that the board was motivated to preclude the holders of a majority of the company's shares from placing a majority of new directors on the board through Blasius' consent solicitation. See id. at 656 (concluding that board immediately endorsed persons for board in order to preclude majority of shareholders from electing new board members selected by Blasius).

73 . See id. at 663 (noting that board entitled to take steps to evade perceived risk).

74 . Id. at 659.

75 . Shamrock Holdings v. Polaroid Corp., 559 A.2d 278, 285-86 (Del. Ch. 1989); See e.g., Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992) ("We note that the two 'tests' are not mutually exclusive because both recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise."); Apple Bancorp, Inc., [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) at 97,036 (concluding that Blasius and Unocal standards are "structurally similar and may ... be functionally similar as well"). Although "many of the litigants and the courts ... have treated the Blasius standard

Although the decisions demonstrate the unsettled state of the law governing boards' defensive actions, one thing is clear: the trend is toward relaxing the applicable level of scrutiny used to ensure that target company boards properly exercise their fiduciary duties with respect to tender offers.

B. Judicial Review of Poison Pill

In Moran v. Household International, Inc.[76], a substantial shareholder of the company who was not actively engaged in an effort to acquire the company challenged the validity of Household International's Rights Plan, one of the first Rights Plan put into place. Plaintiffs contended that the Rights Plan, which resulted in the issuance of what they call a "poison pill preferred," abridged fundamental rights of stock ownership by restricting the alienability and marketability of Household shares and severely limited the ability of shareholders to engage in

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as requiring a more searching and critical judicial inquiry than the Unocal framework," commentators, as well as Delaware courts, have recognized the "Blasius may be viewed as a reformulation and not necessarily an extension of Unicol in the context of stockholder voting rights." Warren & Abrams, supra note , at 669. Such commentators reason the "by inquiring into both the incumbent directors' motives and the practical effect of their tactics on the insurgents' proxy or consent solicitation, Blasius parallels the two-prong Unocal inquiry into the target directors' reasonable perception of a threat to a valid corporate interest, and the proportionality of their response to the threat." Id.

proxy contests. Household maintained that the Rights Plan provided a drastic but highly effective deterrent device designed to prevent hostile, bust-up takeovers, for the protection of both the corporation and its shareholders. In this case, the Delaware Court extended for the first time the application of the business judgment rule to the adoption of a flip-over poison pill in the absence of a specific threat of takeover.[77] Relying extensively on its decision in Unocal, the Delaware Supreme Court concluded that the reasonableness of a defensive mechanism is materially enhanced where a majority of the board approving it consists of outside independent directors who have developed a good-faith belief through reasonable investigation that a danger to the corporation exists.[78] The court conclusively declared that the adoption of poison pill rights plan was within a board of director's power,[79] and held that the business judgment rule was the applicable standard to review the board's adoption of the poison pill.[80]

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[76] . 490 A.2d 1059 (Del. Ch. 1985).

[77] . Moran at 1346.

[78] . Moran at 1356.

[79] . Moran at 1351. In other jurisdictions, poison pill rights plans continuing flip-over provision have been declared invalid. See e.g. Amalgamated Sugar Co. v. UL Inds., 644 F.Supp. 1299 (S.D.N.Y. 1986).

When the modified business judgment standards were applied to the Moran facts, the court found that Household's Board of Directors was entitled to the protection of the business judgment rule. The board met their initial burden of a good faith in the plan adopted to protect the company from coercive takeover tactics and that the plan was reasonable in relation to the threat posed due to the board's awareness of several merger overtures by other companies, and the increased frequency of bust-up and two-tier tender offers.[81]

The Delaware court then opened the door of the current redemption litigation by shifting the emphasis from the adoption of the plan to its implementation. The court stated that the ultimate response to an actual takeover bid will be judged by the board at the time and the actual use of the rights plan when and if the issue arose.

After Moran, the Delaware Chancery Court in City Capital Associates v. Interco Inc.[82] clarified the duty to auction first announced in Revlon.[83] Interco involved two

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[80] . Moran at 1350.

[81] . Moran at 1356-57 (citing Van Gorkom at 873) (concluding the Household Board had made an informed decision after reasonable investigation).

[82] . C.A. No. 10105 (Del. Ch. Nov. 1, 1988).

[83] . MacAndres & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239 (Del. Ch. 1985) (Walsh, J.) aff'd, 506 A.2d 173 (Del. 1986). Revlon had

questions: (1) whether Interco's board of directors in refusing to redeem a poison pill was breaching their fiduciary duties to stockholders under Unocal and Moran;[84] and (2) whether the implementation of a restructuring plan constituted a violation of the board's fiduciary duty under Unocal and Revlon.[85] The Interco court concluded that the poison pill plan was not a reasonable response to the threat to Interco from City Capital Associates' (CCA) noncoercive offer.[86] The court upheld the restructuring plan, however, on the theory that it constituted a reasonable response to an offering price perceived by Interco's board to be 'inadequate.'[87]

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given a lockup option on its health divisions to Fortmann Litte & Co. in the face of a hostile takeover attempt by Pantry Pride. The Court stated that once the sale was inevitable, 'the duty of the board ... had changed from the preservation of Revon as a corporate entity to the maximization of the company's calue at a sale for the stockholders' benefit.' Id. at 182.

[84] . Interco, C.A. No. 10105, slip op. at 1-2.

[85] . Id.

[86] . Id. at 4. The fact that CCA's offer was a cash offer for all shares, and thus noncoercive, seemed to weigh heavily in the court's decision to enjoin Interco's pill. The Interco court ruled that Unocal and Moran supply the appropriate legal framework for evaluating the adoption of a defensive tactic in the hostile takeover context. In addition, the court distinguished Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987), which placed on the board of directors the burden of proving the entire fairness of keeping a pill in place while implementing a recapitalization, as only applying to situations where a board has engaged in self-dealing. Interco, C.A. No. 10105, slip op. at 3.

[87] . Id. at 4.

The board of the target of a hostile takeover attempt may refuse to redeem an intact rights plan without offering its shareholders an economic alternative to tendering (the "just say no" defense). The most recent judicial pronouncement on the issue of a board's obligation to redeem a shareholder rights plan is Moore Corp. Limited v. Wallance Computer Services, Inc.,[88] where the court affirmed the ability of a target to "just say no" to a hostile takeover attempt in some circumstances.

Wallace affirmed the availability of the "Just Say No" defense by holding the target board's refusal to redeem a shareholder rights plan when the board failed to offer an economic alternative to the hostile tender offer. The court found that the board's refusal to redeem the shareholder rights plan satisfied the Unocal test. First, the court found that Moore's offer was inadequate, noncoercive tender offer can constitute a threat under Unocal not only when the target needs additional time to organize a suitable alternative to the tender offer, but, significantly, also when shareholders might tender their shares without a complete understanding of the economic value of the target's business strategy.

The court went on to find that the board's refusal to redeem the shareholder rights plan was "reasonable in relation to the threat posed" because it was neither preclusive nor coercive. Wallace further indicates that if a target demonstrates present financial success, courts will be more likely to presume that the board's long term business strategy is to the shareholders' best interests and uphold a refusal to redeem a shareholder rights plan, not withstanding shareholders' positive response to an unsolicited bid.

A recent chancery court case, In re Gaylord Container Corp. Shareholders Litigation[89] supports the view that proportionality review should take into account the cumulative effects of target defense measures and the distribution of share ownership. In light of shark repellent bylaw and charter amendments compounded by 20% stock ownership by corporate insiders, a poison pill could well have an illegitimate preclusive effect, the court said. "[T]he board's unilateral adoption of the shareholder rights plan is subject to enhanced scrutiny, and that

[88] . 907 F. Supp. 1545 (D. Del. 1995).

[89] . C.A. No. 14616, 1996 WL 752356 (Del. Ch. Dec. 19, 1996).

scrutiny must consider the effect of the rights plan in combination with the amendments."[90]

The case law regarding the board's obligation to redeem rights plans essentially follows the logic of the Delaware courts' sale of control/non-control transaction case law, as well as the basic Unocal standard. Thus, a board engaged in the sale of control of the company may not apply a rights plan, including to favor a preferred strategic merger, as part of a business strategy to remain independent.

C. Judicial Review of Dead Hand Provisions In Poison Pill

1. Bank of New York and Invacare Decisions

The first court to address the validity of a dead-hand provisions was the New York Supreme Court, in Bank of New York.[91] Construing New York law, the court enjoined enforcement of a such a provision.

The case arose from a tender offer by the Bank of New York, or BNY, for all of the outstanding shares of Irving Bank Corp., or IBC. In response to the tender offer,

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[90] . Id. at *3.

IBC's board of directors adopted a shareholder rights plan which provided that those rights could be redeemed by the board before the time the acquiring person or entity obtained ownership or control of 10 percent or more of IBC's stock.

BNY responded to IBC's rights plan by commencing a proxy contest seeking to replace the IBC board with directors who, if elected, would redeem the shareholder rights, paving the way for the consummation of BNY's tender offer.[92] To counter that response, IBC adopted an amendment to its shareholder rights plan containing a dead-hand provision.[93]

The court addressed the validity of the dead-hand provision under the New York Business Corporation Law, Sec. 620 (b), which provides that any restriction on the powers of the board of directors to manage the corporation must be set forth in the company's certificate of incorporation.[94] IBC's board of directors had neither sought nor obtained shareholder approval for its continuing director provision and the court held that in the absence of such approval,

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[91] . 139 Misc. 2d, at 665, 528 N.Y.S. 2d 482.

[92] . Id. at 665, 528 N.Y.S. 2d at 483.

[93] . Id. at 667, 528 N.Y.S. 2d at 483.

[94] . Id. at 670-71, 528 N.Y.S. 2d at 485 (citing N.Y. Bus. Corp. Law secs. 620, 701, 708).

IBC's board of directors was without statutory authority to adopt a continuing director provision since it had selectively restricted future board members from managing the affairs of the company.[95]

The court also recognized that the existence of the dead-hand provision was likely to cause BNY "irreparable harm" insofar as the mere existence of the provision would likely taint the outcome of the proxy contest.[96] The court reasoned that shareholders might not vote for the insurgent slate knowing that if elected, it would not (if it did not receive more than 66 percent of the shareholder vote)[97] have the power to redeem the rights (and that perhaps their election might make it impossible to accept any offer to sell the company).[98]

However, in 1997, the U.S. District Court for the Northern District of Georgia, in Invacare Corp. v.

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[95] . Id. at 671, 528 N.Y.S. 2d at 486.

[96] . Id. at 669, 528 N.Y.S. 2d at 484.

[97] . Pursuant to the dead-hand provision adopted by IBC, the company's board can redeem the rights only if the board (1) consists of a majority of continuing directors; (2) does not consist of a majority of continuing directors, but the new directors were elected by affirmative vote of the holders of at least two-thirds of the outstanding shares of the company; or (3) does not consist of a majority of continuing directors, but in connection with the election of the directors who are not continuing directors no merger consolidation or similar transaction was proposed with respect to IBC. Id. at 667, 528 N.Y.S. 2d at 483.

[98] . Id. at 668-69, 528 N.Y.S. 2d at 484.

Healthdyne Technologies Inc.,[99] refused to enjoin a "continuing directors" provision contained in a shareholder rights plan adopted by Healthdyne Technologies Inc., a Georgia corporation.

2. Toll Brother and Quickturn Decisions

The Delaware courts addressed dead hand rights plan provisions for the first time during the summer of 1998 in Carmody v. Toll Brothers, Inc.[100] Vice Chancellor Jack B. Jacobs denied a motion to dismiss claims alleging that the adoption of a dead hand provision by Toll Brothers, Inc. violated Delaware statutory law and constituted a breach of fiduciary duty. He said the dead hand poison pill is intended to thwart hostile bids by vesting shareholders with preclusive rights that cannot be redeemed excepted by the Continuing Directors. Thus, even replacing the entire board, which is practically possible to redeem the pill, is legally impossible to achieve that goal. Based on these grounds, the court held, "the complaint states claims under Delaware law upon which relief can be granted." However, the court also noted that condemning the dead hand provision that remains effective

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[99] . 968 F.Supp. 1578 (N.D. Ga. 1997).

for the life of the pill did not involve the validity of a provision of limited variation, and cautioned that "nothing in this opinion should be read as expressing a view or pronouncement" concerning "'dead hand' provisions of limited duration (e.g., six months)."[101]

A short time later, Vice Chancellor Jacobs was faced with the issue he had left open in Toll Brothers[102]: a rights plan precluding redemption only for a six-month period. The plan in this case was adopted by Quickturn Design Systems, Inc., the target of an unwanted bid by Mentor Graphics Corporation, less than one month after Toll Brothers was decided.

At the time Mentor commenced its bid, Quickturn had in place a dead hand rights plan. After determining that Mentor's offer was inadequate, Quickturn's board replaced the plan's dead hand feature with a no hand delayed redemption provision. The new plan provided that if a majority of Quickturn's directors were replaced by shareholder action, then for six months no directors could redeem the rights "if such redemption is reasonably likely

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[100] . 1998 Del. Ch. LEXIS 131 (Del. Ch. July 24, 1998).

[101] . Id. at [FN29] -50 & 50 n. 52.

[102] . Quickturn Design Systems, Inc. v. Mentor Graphics Corporation, 721

to have the purpose or effect of facilitating a Transaction with an Interested Person."[103]

According to the Unocal test, the Court of Chancery first found that Quickturn's board reasonably perceived a cognizable threat presented by Mentor's offer. The Board believed Quickturn shareholders might mistakenly ignore Quickturn's true value, accept Mentor's inadequate offer, and elect a new board that would prematurely sell the company before the new board could adequately inform itself of Quickturn's fair value and before the shareholders could consider other options."[104]

After the Chancery Court found the Board satisfied the first prong of the Unocal test, the Court went to the second prong of the Unocal test. The Court of Chancery found that Quickturn's no hand provision was a disproportionate response to the threat the board perceived.

The Supreme Court affirmed on an alternative ground: Sec. 141 (a) of the Delaware General Corporation Law -- one of the sources, according to the Delaware Supreme Court's decision in Moran v. Household

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A.2d 1281 (1998).

[103] . Id., at 1287

[104] . Id. at 25.

International, Inc.,[105] of a board's authority to enact rights plans.[106]

The Supreme Court in Quickturn stated that the concept that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation is one of the most basic tenats of Delaware corporate law. The business and affairs of every corporation shall be managed by or under the direction of a board of directors, except as may be otherwise provided in its certificate of incorporation.[107] Quickturn's certificate of incorporation, the court stated, "contains no provision purporting to limit the authority of the board in any way."[108]

The court accordingly held that Quickturn's rights plan was invalid under Section 141(a), because the plan prevented a newly elected board of directors from completely discharging its fiduciary duties to the corporation and its stockholders for six months. The court acknowledged that this suspension of the rights plan "limits the board of directors' authority in only one

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105 . 500 A.2d 1346 (Del. 1985).

106 . Quickturn, slip op. at 27; Household, 500 A.2d at 1353.

107 . Id.

108 . Quickturn, slip op. at 28-29 & n. 37.

respect" but stated that it "restricts the board's power in an area of fundamental importance to the shareholders--negotiating a possible sale of the corporation."[109]

The court concluded, the delayed redemption provision "would prevent a new Quickturn board of directors from managing the corporation by redeeming the Rights Plan to facilitate a transaction that would serve the stockholders' best interests, even under circumstances where the board would be required to do so because of its fiduciary duty to the Quickturn stockholders."[110] The provision thus "impermissibly circumscribes the board's statutory power under Section 141 (a) and the directors' ability to fulfill their concomitant fiduciary duties."

The Supreme Court's decision in Quickturn directly involved a no hand delayed redemption rights plan, but the court's reasoning makes clear that all types of dead hand and no hand poison pill rights plans now are prohibited in Delaware. The extent to which other states follow the lead of Delaware in Quickturn and New York in Bank of New York -- or the lead of Georgia in Healthdyne and Pennsylvania in AMP -- remains to be seen.

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[109] . Id. at 29.

III. Abuses of the Poison Pill, Shareholder Choice, and By-Law Restrictions

A. Abuses of the Poison Pill

The market for corporate control works to identify weak managers and inhibits at least some agency-cost problems in the firm. Poison pills can prevent a change in management when extended long enough to keep the costs of a takeover prohibitively high until potential bidders lose interest altogether. Thus, by refusing to redeem a pill, a board can eliminate the firm as a profitable commodity in the takeover market, thereby retaining the status quo in which they maintain control. As a result, not only will the pill possibly prevent shareholders from gaining from a higher price for shares offered by the bidder, inefficient management may not be replaced. Furthermore, the monitoring function served by the market for corporate control is dealt a serious blow because potential acquirers are deterred from tendering an initial offer in the first place because the pill makes the cost of acquisition artificially (and prohibitively) high. Thus, less information is

[110] . Id.

gathered and transmitted in the market about poorly functioning managers and less replacement also results.

The poison pill is open to abuse because it is an effective entrenchment tool, especially when coupled with the low probability of judicial invalidation of the pill.[111] Nonetheless, as previously discussed, the poison pill is an important tool for raising shareholder value. Thus, finding ways to keep the pill but curb the abuse should be of critical importance to the development of efficient corporate governance mechanisms.

B. By-Law Restrictions on Poison Pills

Initially, attempts to defeat poison pills entrenchment effects unsuccessfully challenged the validity of the pill.[112] Subsequently efforts to overcome the pill centered around proxy contests.[113] The problem with this tactic, of course, is that many companies have staggered

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[111] . See Irwin H. Warren & Kevin G. Abrams, Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests, 47 Bus. Law. 647, 647 (1991) (outlining the various legal factors that have strengthened the authority of boards to defend against hostile takeovers).

[112] . See Moran, 500 A.2d at 1356 (validating the board of directors' use of a poison pill, even where no hostile takeover was present or threaten at the time of adoption).

[113] . See Jeffrey N. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder Adopted Bylaws: An Essay For Warren Buffet, Cardozo L. Rev. 511, 522-23 (1997) (describing the board's power to use a poison pill to block hostile acquirers who combine a tender offer

elections for their boards of directors.[114] A staggered board can deter a tender offer coupled with a proxy contest because of the length of time required to take control of such a board.[115] Control of a staggered board usually cannot be obtained for two to three years.[116] The uncertainty and expense created by having to wait two to three years to obtain control of the board effectively deters many potential hostile bidders.[117] Thus, shareholders may be prevented from getting a premium for their shares.[118]

In response to this reality, shareholders and tender offerors alike began searching for a solution.[119] Their solution takes the form of mandatory by-laws prohibiting the adoption of poison pills or requiring the redemption of existing poison pills.[120]

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with a proxy contest); see also Thomas, supra note , at 509.

[114] . See id. at 529.

[115] . See id.

[116] . See id.

[117] . See id.

[118] . See id.

[119] . See Lawrence A Hamermesh, Corporate Democracy and Stockholder-Adopted By-laws: Taking Back the Street?, 73 Tul. L. Rev. 409, 414-16 (1998). This solution has again touched off the debate about the proper allocation of corporate power between shareholders and boards of directors. Id.

[120] . See id.

The structure of the shareholder rights bylaw is exemplified by the proposal of Guy P. Wyser-Pratte to the shareholders of Pennzoil.[121] The proposal resulted after Pennzoil received a tender offer from Union Pacific Resources Group Inc. The Pennzoil board used the poison pill to "just say no" to the offer, maintaining the pill for an extended period of time until the offer eventually terminated.[122] Wyser-Pratte's proposal applies when there is an offer to purchase one hundred percent of common stock at twenty-five percent premium over the market price.[123] It would cause the board of directors to cease using a poison pill to block an offer after ninety days unless the shareholders approve continued use of the pill to block the offer.[124]

Thus, by providing an automatic review by the shareholders of a poison pill, bidders will be more confident that management will be unable to entrench itself in conflict with shareholder interests. Fewer bidders will

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[121]. See Jonathan R. Macey, Manager's Journal: A Poison Pill That Shareholders Can Swallow, Wall St. J., May 4, 1998, at A22.

[122]. See id.

[123]. See id.

[124]. See id.; see also Seth Goodchild & Daniel J. Buzzetta, Shareholder Rights By-Law Amendment, N.Y. L.J., Oct. 30, 1997, at 5 (describing a similar proposal to the shareholders of Wallace Computer Services Inc.).

be deterred from tendering an offer. Therefore, the ninety day time limit allows the shareholders to reap the benefits of the poison pill -- by avoiding the "prisoner's dilemma" and by buying time to negotiate an even better bid -- while preventing the board from using the pill as an entrenchment technique. The ability to approve continued use of the pill enables the shareholders to either buy more time or to push away a bidder that they believe is truly adverse to their best interests.

IV. Implications for an Emerging Market like China

In the past twenty years, the Chinese government has been adopting open door and economic reform policies. Because of historical, economic, legal, and culture traditions, a modern corporation system is far form being established in China. There are lots of things that need to do to establish a perfect corporate system.

A. Clarify the State as a Shareholder's Role in Corporate Management

For many State owned enterprise, the big problem in the process of transition into a modern corporation is how to deal with the relationship between the state and the corporation itself. Under present Chinese Corporate Law, as a prerequisite to receiving corporate status, enterprises must adopt an internal governance structure comprised of shareholders, a board of directors (or a general manager for smaller concerns), and a supervisory committee.[125] The

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[125] . See the Corporate Law of the People's Republic of China, at art. 51. For an English version of the Corporate Law of the People's

corporation's investors, at a shareholders' meeting, appoint a board of directors for management purposes and, together with labor, designate a supervisory committee for internal corporate monitoring.[126] By permitting the state to exercise an ownership and shareholder position in a corporation with state-owned assets and the right to safeguard the socialist market economy, culture and ethics, the Corporate Law invites conflict between corporate (and their investors) and the state. This conflict is institutionalized into a system of corporate governance that grants board powers to shareholders (like the state), while concurrently legislating collaboration among shareholders, managers and labor, and subjecting corporations government and public supervision

In promoting strong, more autonomous enterprises, China's system of corporate governance purports to create boundaries between state ownership and enterprise management. Yet the state's position as a shareholder and owner in companies with state-owned assets, coupled with its supervision powers, undermines the notion of enterprise

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Republic of China (PRC) (passed at the 5th Session of the Standing Committee of the 8th National People's Congress (NPC); adopted Dec. 29, 1993 by the 8th NPC; effective as of July 1, 19994) [hereinafter "Corporate Law"]; see CHINA ECONOMIC NEWS, Mar. 7, 1994, at Supplement No. 2.

[126] . See Corporate Law, supra note 199, at art. 104 (requiring an annual meeting in addition to interim shareholder meetings).

autonomy. Consequently, it remains unclear how enterprises under corporate law will operate: whether like the businesses found in the private sector or like state enterprises under the government's direct control and ownership.

Clarification of the state's role in enterprise management is essential for potential private foreign and domestic investors, given their concern over the risks of state intervention and, especially, of the Party's influence over governmental economic, social and political policies. In order to increase the efficiency of state owned corporations, the state must stop governmental interference with corporation. The only way that state can dominate corporate is shareholder action. State can exercise majority voting control and dominate the corporation.

B. Establish a Market for Corporate Control

In economic terms, the judicial tradition of wide deference to the decisions of a board of directors can be justified by the existence of certain markets that constrain inefficient management performance without incurring the enormous transaction costs involved with litigation.[127] These markets include the products market, the employment market, the capital market, and the market for corporate control.[128] Together, they form the structure through which the board of directors of a corporation is constrained.[129]

Because of a board of directors' wide range of discretion, the market for corporate control remains essential to constrain self-dealing by management and the board. In order for the market for corporate control to operate efficiently, directors should not be allowed to have complete control over defensive tactics, especially

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[127] . See Ralph Winter, Government and the Corporation 5-46 (1978); Alison Greg Anderson, Conflicts of Interest: Efficiency, Fairness and Corporate Structure, 25 UCLA L. Rev. 738, 784-87 (1978); Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 845 (1981) (citing Richard Posner, Economic Analysis of Law 300-13 (2d ed. 1977)); Walter Werner, Management, Stock Market and Corporate Reform: Berle and Means Reconsidered, 77 Colum. L. Rev. 388, 389 (1977) (examining the allocation of power in the modern corporation); see also Lucian Arye Bebchuck, The Case for Facilitating Competing Tender Offers, 95 Harv. L. Rev. 1028, 1034-51 (1982) (arguing that the facilitation of corporate auctions is desirable for both target shareholders and society); Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target's Managemnet in Responding To a Tender Offer, 94 Harv. L. Rev. 1161, 1173-74 (1981) (arguing that the facilitation of corporate auctions is undesirable and that corporate directors and managers should therefore be passive in such situations -- in effect, corporate directors and managers should never use defensive tactics).

[128] . See Gilson, supra note 212, at 845.

[129] . See id.; see also Marcel Kahan & Michael Klausner, Lockups and the Market for Corporate Control, 48 Stan. L. Rev. 1539 (1996) (arguing that lockups can affect the outcome of bidding contests and that "judicial leniency toward lockups would both weaken the disciplinary influence of the takeover threat and reduce the number of value-enhancing acquisitions that occur").

effective defensive tactics like the poison pill.[130] Allowing directors to have such power would give them a degree of control over tender offers similar to that enjoyed in the context of mergers and sales of assets.[131] Such a degree of control would fundamentally alter the corporate structure in a way that would provide the board with an effective monopoly over corporate control.[132] In this situation, corporate control would only be transferred if the benefits to management from the transfer exceeded the value to management of its existing power.[133] Such a result is inefficient both for shareholders and the economy as a whole.[134]

In a big market like China, establishing a market for corporate control is extremely important for increasing economic efficiency. In the past years, government plays an important role in appointing or taking corporate directors. Under the market for corporate control model, shareholders

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130 . See Gilson, supra note 219, at 846.

131 . See id.

132 . See id.

133 . See id.

134 . See id. This is because shareholders would rarely receive premiums for their shares. In addtion, the failure of management to maximize the corporation's wealth (because of the monopoly power the board maximizes its own wealth) would frequently mean less profitable corporations. It is also unlikely that investors would be willing to sink much money into corporations that are being run for the benefit of management.

should have a decisive role in determining the tenure of corporate directors. Government can only function as a shareholder. Through shareholder meetings, or proxy contests, government can also elect directors, or move and replace directors.

A market for corporate control in China is also important for private corporation and foreign investment. It is clear that in the future the merger and acquisition activity between Chinese and foreign corporation will increase. A market for corporate control can relocate corporate assets to good management, increase productivity and efficiency. A perfect corporate takeover legal framework will increase foreign investors' confidence, and also let Chinese corporations have a chance to join world markets.

V. Conclusion

The poison pill is a complicated defense measure. Although its adoption does not necessarily breach a board of directors' fiduciary duty, but the subsequent board decisions, as to whether or not to redeem the pill in face of a bid, may.

When evaluating poison pill plans, courts should utilize the modified business judgment rule developed in Unocal and Moran. This approach will ensure that shareholder wealth maximization remains the primary goal of all defensive tactics. First, the board must prove the plan was adopted in good faith and pursuant to a reasonable investigation into the existing damages. Second, the board must show that its adoption of a poison pill plan was reasonable in relation to the actual threat posed.

When faced with an actual tender offer the board should have a duty to react in an informed manner to maximize shareholder wealth. In some cases, if adopted with the proper guidelines in mind, a rights plan may reinforce the underpinnings of our corporate laws, rather than distorting them, by providing directors with greater time, opportunity, and bargaining power to exercise their fiduciary responsibilities on behalf of shareholders.

The shareholder by-law amendment has developed as a response to the unjustified adoption of a poison pill or refusal to redeem a poison pill by boards of directors. Shareholder by-law amendments allow a corporation's shareholders to prohibit a board of directors from adopting a poison pill and to require redemption of an existing pill. It properly places ultimate power for corporate control transactions in the hands of the owners of the corporation: the shareholders.

Courts should follow the Fleming[135] court's lead and hold this type of action legal. The Delaware General Corporation Law (DGCL) provides a solid statutory authority for vesting this power in the hands of shareholders. While the DGCL gives the board of directors the power to run the business and affairs of the corporation, this power is subject to the shareholders' power to adopt and amend by-laws.

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135 . International Bhd. of Teamsters Gen. Fund v. Fleming Cos., Inc., No. 97-6035, 1997 U.S. Dist. LEXIS 2980 (W.D.Okla. Jan. 24, 1997).

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