DIRECTORS' AND OFFICERS' LIABILITY

POISON PILL UPDATE

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APRIL 8, 2004

In the evolving field of corporate control transactions, no defensive mechanism has evolved more rapidly or provoked greater debate than the shareholder rights plan, or "poison pill." In appropriate circumstances, Delaware law permits the board of a corporation that is the target of a takeover bid to employ a rights plan and other defensive measures to resist a tender offer that is structured in a coercive manner (*e.g.*, a front-end loaded, two-tiered tender offer offering a disadvantageous back-end merger). The Delaware Court of Chancery's recent 130-page decision in *Hollinger Int'l, Inc. v. Black*,[1] addressing the complex dispute between Hollinger International and British media magnate Lord Black and his affiliates who hold majority voting control in Hollinger, upheld a shareholder rights plan adopted by a special committee of Hollinger International that is triggered by the sale of an upstream holding company that owns a controlling voting interest in the underlying corporation adopting the rights plan. The court's analysis of the rights plan is instructive on the circumstances giving rise to a legitimate purpose and factual basis for a poison pill.

Overview of Modern Rights Plans

In the nearly two decades since the Delaware Supreme Court's *Moran*[2] decision held that the adoption and deployment of a poison pill may be a legitimate exercise of business judgment by the board of directors, such rights plans are now commonplace in Delaware and authorized in every other state. Designed to devastatingly dilute the holdings of an unwanted potential acquirer, poison pills grant shareholders the right to purchase, at a deep discount, additional stock in the target prior to the acquisition or merger, or in the merged company after a successful hostile takeover. A standard poison pill provides that upon the occurrence of a triggering event, usually the acquisition of a threshold percentage of company stock (commonly 15-20 percent) by any person or affiliated group without board approval, each shareholder receives rights or warrants to purchase shares of the target's common or preferred stock at either a designated exercise price or a price set by formula. The initial exercise price for a right ordinarily is fixed at the anticipated value of the stock five to ten years in the future (typically three-to-five times the company's current market price), and changes only when the rights "flip-in" or "flip-over." Most current rights plans contain both "flip-in" and "flip-over" provisions, and it is these provisions that bring unacceptable levels of dilution to a hostile bidder's economic position in the target. Thus, unless the target board redeems the rights plan, a hostile

acquisition becomes prohibitively expensive because the plan grants all shareholders of the target other than the bidder the right to purchase shares of the target ("flip in") or of the bidder ("flip over") at a deep discount. As Vice Chancellor Strine wrote in *Hollinger*, a rights plan "has no other purpose than to give the board issuing the rights the leverage to prevent transactions it does not favor by diluting the buying proponent's interests (even in its own corporation if the rights 'flip-over')."

The company's shareholders do not need to be a party to the rights plan or formally vote to accept the plan to make it enforceable because the rights are considered a dividend of one stock purchase right for each outstanding common share. The rights generally expire after ten years, are not separately tradable and may not be exercised unless and until a triggering event occurs and rights certificates are then distributed. Rather than remaining static, post-*Moran* poison pills have evolved numerous provisions, such as the flip-in feature, the grandfathering provision, and the exchange option. Other innovations, such as "no hand" and "dead hand" rights plans, which permit no directors or only the directors in office at the time the rights plan was adopted or their designated successors to redeem the rights, have been rejected at least in Delaware as inconsistent with the board's the statutory authority to manage the corporation.[3]

Where a board of a Delaware corporation takes action to resist a hostile bid for corporate control, the target company board's defensive actions are subjected to enhanced judicial scrutiny to ensure that the board acts in the interests of the corporation or its unaffiliated stockholders, rather than its own interests. The well-settled *Unocal* standard thus applies the business judgment rule to a board's adoption of defensive measures such as a rights plan only if the board establishes (a) reasonable grounds for believing that a danger to corporate policy and effectiveness exists and (b) that the defensive measures adopted are reasonable in relation to the threat posed.[4] In addition, defensive measures may not unduly coerce a shareholder vote or preclude an offer to acquire the company.

Hollinger

Hollinger arose out of a complex dispute between the board of Hollinger International and Lord Black who, together with affiliates, owns a majority interest in Hollinger Inc., a holding company whose principal asset is its majority voting control in International. Briefly, in an effort to resolve an investigation by a special committee of the International board into, *inter alia,* certain multi-million dollar non-competition payments made by International to then-Chairman of the Board Black and his management team at International, Black entered into an extensive restructuring agreement with the independent directors of International. The central features of the restructuring agreement were changes in the composition of International's management and board, and the retention of Lazard LLC to review and evaluate International's strategic alternatives, including a possible sale of the company, and Black's agreement to "refrain from consummating transactions at the level of the intermediate holding company he dominated, except under strict conditions."

After an expedited trial, Vice Chancellor Leo E. Strine, Jr. concluded that rather than work with International to pursue a strategic transaction, Black covertly sought to negotiate "a transaction involving the sale of the holding company through which Black wields voting control of International [Hollinger Inc.] to the Barclays," English brothers who own newspapers and other businesses. The court observed "[e]ffectively, the Barclays Transaction would end the Strategic Process before the bidding even began." While Black negotiated with the Barclays, his relationship with International deteriorated further when a special committee of the board investigating Black concluded that International should sue him for self-dealing. International's Executive Committee then voted to remove Black as Chairman for breaches of fiduciary duty and Black's refusal to cooperate with an SEC investigation. Black promptly announced his intention to enter into an agreement with an affiliate of the Barclays that would provide for the Barclays' purchase of the outstanding shares of Hollinger Inc. (International's parent holding company). Thus, while the Barclays' offer was not an offer for the shares of International, but an offer for Hollinger Inc. -- a Canadian corporation with its own public stockholders – the sale of control of Hollinger Inc. as a practical matter involved the sale of control of International.

The International Board immediately met and formed a Corporate Review Committee ("CRC) composed of all directors other than Black and two close affiliates. The CRC was delegated broad authority to act for International and to adopt defensive measures, including a shareholder rights plan. Black and certain affiliates in response used their majority voting interest in International to deliver a written consent to International, which, among other things, adopted bylaws under section 109(a) of the Delaware General Corporation Law purporting to disband the CRC. Undeterred, the CRC forged ahead and adopted a shareholder rights plan that included "flip-in" and "flip- over" provisions, and which had "the effect of making it economically impractical for the Barclays Transaction to proceed unless the Barclays reach an accommodation with the International board." The rights plan adopted after the announcement of the Barclays' offer was unusual in that the board adopting the plan – International's – was not addressing a bid for the shares of the corporation that it had the authority and responsibility to manage.

The court invalidated the new bylaws, stating that "it is no small thing to strike down bylaw amendments adopted by a controlling stockholder," but holding that invalidation was appropriate because the bylaws were adopted for an "inequitable purpose" and had an "inequitable effect," *i.e.*, "disabling the International board from taking effective action at the board level that is within" its authority.

What of the rights plan? Defendants argued first that the rights plan adopted by the CRC after the announcement of the tender offer by the Barclays' affiliate was invalid because neither International's Board nor the CRC had any authority with respect to the management of International's parent company, protection of the parent's stockholders or determination of what constitutes a threat to the parent's corporate policy and effectiveness. The court disagreed, invoking the landmark *Moran* decision's emphasis on "the elastic nature" of Delaware's law of corporate control. The fact that International's rights plan was triggered by bids for shares of its

parent company was not problematic, the court concluded, because if a rights plan could not cover upstream transactions, its efficacy could be too easily circumvented.[5] Addressing Black's argument that the rights plan was intended to frustrate the exercise of voting control by an existing controlling shareholder, the court stated that "[a]lthough there are good reasons why fiduciary principles ought to take into account the legitimate expectations of controlling stockholders in evaluating directors' use of a rights plan, the mere fact that a rights plan inhibits the ability of an intermediate holding company to sell itself does not make that rights plan statutorily impermissible, or even inequitable in all circumstances."

Turning to Black's argument that the rights plan was not reasonable and proportional to any threat to International – *i.e.*, not justified under *Unocal* – the court held that the rights plan was a reasonable response to what the CRC "in good faith and on responsible information given the time constraints it faced, reasonably perceived to be serious threats to International." The court emphasized that Black had contractually committed to actively support a strategic process to maximize International shareholder value, and then "undermined International's ability to get the best deal by end-running the Strategic Process and pre-empting a rational search for the highest price." If the Barclays transaction were consummated, it would "prevent International from conducting the full market and transactional exploration contemplated by" International's business strategy. The court deemed the proposed Barclays transaction a threat to the strategic process and "a potent one justifying a strong response." Vice Chancellor Strine did reject an alternate proposed justification for the rights plan – the Special Committee's concern that Black might transfer the proceeds from the sale of his Hollinger stock to jurisdictions from which recovery might be difficult or impossible -- holding that "the fear that a party who might be found liable to the corporation will hide his newly liquid funds is [not] the type of threat that satisfies the *Unocal* requirement of a threat to corporate policy and effectiveness."[6]

The court then held that the rights plan was a proportional response to the perceived threat of the Barclays' transaction. The court acknowledged that ordinarily a parent company has the right to sell itself as long as it breaches no duty to its subsidiary, and that typically "the replacement of a subsidiary's controlling corporate stockholder with another through a transaction at the parent level should pose no cognizable threat to the subsidiary." The general rule admits exceptions, however, as when the parent intends to sell to looters or money launderers. The court noted that Delaware law also has admitted the possibility of a subsidiary taking action to dilute a stockholder's control position when the stockholder threatens to breach its fiduciary duties to the subsidiary. "By parity of reasoning, if actual action to dilute the majority might be justified, the less extreme act of interposing a rights plan should not be ruled out entirely as a permissible response to a controlling stockholder's serious acts of wrongdoing," because the rights plan in the first instance only inhibits additional purchases and does not cause immediate dilution.

The court underscored that the rights plan was a proportional response to the threat of the Barclays' transaction for a limited period of time. The proper function of the rights plan is

to give “the board breathing room to identify value maximizing transactions,” so that upon completion of the strategic process, further use of the plan “would be suspect, absent further misconduct justifying its continued use.”[7]

[1] 2004 WL 360877 (Del. Ch. Feb. 26, 2004).

[2] *Moran v. Household Int’l, Inc.*, 500 A.2d 1346 (1985).

[3] *Quickturn Design Sys. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

[4] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).

[5] *Hollinger*, 2004 WL 360877, at *50-51.

[6] *Id.* at *53.

[7] *Id.* at *55.