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Readings:

As our week together draws to a close, we will begin our work Thursday by considering the audacious private-law innovation that now dominates takeover contests in the United States: the poison pill. We will learn how the pill functions, what its purpose is, and carefully examine a case study involving the pill’s use. To prepare for this session, please review:

- **WILLIAM T. ALLEN, REINIER KRAAKMAN AND GUHAN SUBRAMANIAN, COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION** (4th ed. 2012) (“AKS”) (please read only pages 522-533 (stop at “Choosing a Merger or Buyout Partner”).

I very much look forward to discussing these materials with you during our discussions on Thursday morning.
Commentaries and Cases on the Law of Business Organization

Third Edition

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must not substitute its judgment for the board's." The court found that neither the poison pill nor the repurchase program was coercive or preclusive, because AmGen could run a proxy contest to replace the Unitrin board. The court then remanded the case to the Chancery Court for a determination as to whether the pill and the repurchase program were within the range of reasonable defenses (with the burden on the Unitrin directors). If the defendant directors did establish that the board action was proportionate and within a range of reasonableness, the burden would then shift back to the plaintiffs to prove that the defensive action was nevertheless a breach of the duty, for instance, by being primarily motivated to maintain the board in office.

Unitrin reflects the almost Byzantine complexity of the Delaware corporate law of hostile takeovers. One might think that, if a court concludes that directors have taken an action that was proportionate to a threat and within a range of reasonable responses, the challenge to the action should be at an end. But under Unitrin, such a finding does not justify a dismissal of the complaint—it simply shifts the burden back to the plaintiff. Analogous consequences follow if the defendant directors do not establish that a defensive action is proportionate (i.e., if the action is deemed either coercive/preclusive or outside the range of reasonableness). Here, too, Delaware law does not simply say that such actions violate a board's fiduciary duty. Rather, according to the cases, it is open to defendants to prove the fairness of the action. See, e.g., Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989).

Unitrin also clarifies the Unocal test. In doing so, it makes clear how limited an "enhancement" to the business judgment rule Unocal really is. In this regard, Unitrin boils down to three things. First, under Unocal/Unitrin, the target's directors, not the plaintiff, bear the burden of going forward with evidence to show that the defensive action was proportionate to a threat. Second, substantively, action that is "preclusive" or "coercive" will fail to satisfy Unocal's test. Third, assuming that a defensive measure passes the preclusive/coercive test (in Unitrin's language, that it is not "draconian"), then it will satisfy Unocal so long as it is "within a range of reasonable action." Properly understood, this last aspect of the test is operationally similar to the business judgment rule: An action will be sustained if it is attributable to any reasonable judgment. It will not matter if the court would have regarded some other action as more reasonable. Taken together, these three aspects of "enhanced" business judgment in the end may be thought to provide more smoke than warmth. But see Omnicare v. NCS Healthcare, at Section 13.6.2.

13.3 PRIVATE LAW INNOVATION: THE POISON PILL

We turn now to a most remarkable innovation in corporate law, the shareholders' rights plan or "poison pill." This was an audacious invention that

17. A prominent New York City practitioner commented to one of us after Unitrin: "So it looks like we're back to business judgment review, aren't we?"
has proven to be remarkably effective, although it continues to be highly controversial. In this section, we describe these colloquially named "poison pills" and set forth yet another vital 1985 case of the Delaware Supreme Court, *Moran v. Household International, Inc.*, which validated the poison pill technique. Judicial acceptance of shareholders' rights plans was a major evolutionary step in U.S. corporate law. The invention of the pill was not quite like a technological innovation such as the cell phone because whether or not the pill "worked" depended largely on whether it could capture the sympathy of the Delaware courts. Nevertheless, the technical elegance of the pill, as it was perfected by New York's preeminent takeover law specialists, doubtless enhanced its attractiveness to the courts.

Although academic commentators and institutional investors generally believe that hostile tender offers are a useful device for disciplining corporate management, managers themselves believe that vulnerability to hostile bids is a profound weakness in the corporate governance structure because it exposes disaggregated and disorganized shareholders to abusive tender-offer tactics. They argue that they cannot protect shareholders without the tools to defeat inadequate tender offers. Moreover, in the late 1970s and early 1980s, the practices of certain takeover entrepreneurs made management's arguments plausible. "Front-end loaded, two-tier" tender offers could unquestionably lead shareholders to sell, even if they were offered a price less than what they believed their shares were worth. This much was confirmed by the most rigorous academic research. And although the academics did not make the point, to managers the implication was clear: Only a loyal bargaining agent—namely, the board—could remedy the bargaining infirmities of dispersed shareholders.

Imagine that you are a corporate lawyer representing one of the corporations whose management and board were worried about abusive tender offers in the early 1980s. You search for a way to empower the board to act as a bargaining agent for shareholders in tender offers. The answer to your prayers is the shareholders' rights plan or "poison pill." Shareholders' rights plans take the form of capital instruments: rights to buy a capital asset, such as a bond, common share, or preferred share. Yet their only real function is to alter the allocation of power between shareholders and boards. The most common form of rights plans today functions rather like the Mesa exclusion in *Unocal*. Rights to buy the company's stock at a discounted price are "distributed" to all shareholders. (Shareholders do not literally receive a new piece of paper; the rights trade with the stock.) These rights are triggered—that is, become exercisable to actually buy discounted stock—only if someone acquires more than a certain percentage of the company's outstanding stock—say, 10 percent or 15 percent—without first receiving the target board's blessing. Moreover (and this is the key), the person whose stock acquisition triggers the exercise of the rights is herself (or in the case of a corporation, itself) excluded from buying

18. 500 A.2d 1546 (Del. 1985).
discounted stock. Thus, her holdings are severely diluted; she will end up losing the greatest part, perhaps most, of her investment in the company stock. The result is that buying a substantial block of stock without the prior consent of the target’s board will be ruinously expensive. This effect gives the board the practical power to veto a tender offer, just as it is able to veto a merger or asset sale under the corporation law.

Here is a simple example: T Corp. distributes as a dividend to shareholders Rights. Each Right purports to be a right to buy 1/100 of a share of the company’s common stock in the future for an extravagant, “out of the money” price: say, $50 (or $5,000 per share) when the common stock is selling for $75 a share. Given its terms, no one really expects this Right ever to be exercised (although the company’s lawyers might argue that the Right’s high exercise price represents the hidden long-term value of the company’s stock). The Rights do not trade separately at this point but are embedded in the common stock on which the dividend is paid. However, should a “triggering event” occur, the Rights detach and are tradable separately. Today, a triggering event might be the acquisition of 10 percent of the company’s stock by any single entity or an affiliated group of persons, or the announcement of a tender offer for 10 percent or more of the company’s stock.20

If a person or group did acquire a 10 percent block, then under a “flip-in” pill, each outstanding Right would “flip-into” a right to acquire some number of shares of the target’s common stock at one half of the market price for that stock. In other words, the Right’s holder would be able to buy stock from the company at half price. Now, if every Right holder bought stock at half price, the aggregate effect is to increase the proportionate holdings of all shareholders except the “triggering person,” whose Right would be canceled upon the occurrence of the triggering event and who, as a result, would only own a much smaller interest in the company than that for which she initially paid.

The original rights plans were not “flip-in” plans, but “flip-over” plans. They purported when triggered to create a right to buy some number of shares of stock in the corporation whose acquisition of target stock had triggered the right. In this plan, a triggering event (when followed by a merger or sale of more than 50 percent of the target’s assets to the triggering shareholder or an affiliate) results in the rights being exercisable. How can that be done? How can the target’s board create a right that requires a third party to sell its stock at half price to the target’s shareholders? Well, we are not certain that it can be done, since the question whether a triggering shareholder must respect an obligation created by a flip-over plan has yet to be litigated. The reason these plans are difficult to work, however, is that they purport to compel the target’s board to put terms in any merger

20. When rights plans were first introduced in the 1960s, triggering events typically involved 30 percent of the company’s stock. The size of the triggering threshold has steadily receded, however, and since 1990, triggers have been typically 10 percent. Once the rights are triggered, they are no longer redeemable by the company, and ten days later they are exercisable. For a commentary that examines pill design choices with respect to redeemability, see Guhan Subramanian, Bargaining in the Shadow of PeopleSoft’s (Defective) Poison Pill, 12 Harv. Nat’l L. Rev. 41 (2007).
agreement (or asset sale agreement, etc.) with the acquirer that will force the acquirer to recognize flip-over rights. 21

Flip-over plans may be thought to be less effective than flip-in rights because a hostile party may acquire a large block of target stock but propose no self-dealing transaction which would trigger the rights. It may wait to elect a new board. Indeed, this weakness was demonstrated in one instance and flip-in pills, which did not require the hostile acquirer to take any second step in order to execute the punishing dilution, were designed in response.

Rights plans were, and to some extent remain, controversial. One can easily see how they could be beneficial to shareholders, but it is just as easy to see ways in which they might be misused to protect the status quo. Institutional investors generally dislike them, mainly because boards do not need shareholder approval to adopt rights plans and generally do not seek it. (Of course, the corporation's charter must authorize enough shares to cover the exercise of the rights in the wholly unimaginable event that they were ever exercised in their untriggered state.) When rights plans were first introduced, it was fairly clear that the charters of most corporations—and the corporation law—authorized boards to issue rights resembling those created by rights plans. It was less clear, however, that these rights could be issued solely as a defense against takeovers rather than to raise capital. This issue surfaced in the 1985 case involving Household International, Inc.

**MORAN v. HOUSEHOLD INTERNATIONAL, INC.**

500 A.2d 1346 (Del. 1985)

McNeilly, J.:

This case presents to this Court for review the most recent defensive mechanism in the arsenal of corporate takeover weaponry—the Preferred Share Purchase Rights Plan ("Rights Plan" or "Plan"). The validity of this mechanism has attracted national attention. . . .

In a detailed opinion, the Court of Chancery upheld the Rights Plan as a legitimate exercise of business judgment by Household. Moran v. Household International, Inc., Del. Ch., 490 A.2d 1059 (1985). We agree, and therefore, affirm the judgment below. . . .

On August 14, 1984, the Board of Directors of Household International, Inc. adopted the Rights Plan by a fourteen to two vote. 2 The intricacies of the Rights Plan are contained in a 48-page document entitled

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21. If the second-step transaction were a sale of assets, the theory would likely be the same. The target's board cannot agree to the sale unless the triggering shareholder agrees to respect the flip-over rights. How good is this theory?

2. Household's Board has ten outside directors and six who are members of management. Messrs. Moran (appellant) and Whitehead voted against the Plan. The record reflects that Whitehead voted against the Plan not on its substance but because he thought it was novel and would bring unwanted publicity to Household.
"Rights Agreement." Basically, the Plan provides that Household common stockholders are entitled to the issuance of one Right per common share under certain triggering conditions. There are two triggering events that can activate the Rights. The first is the announcement of a tender offer for 30 percent of Household's shares ("30% trigger") and the second is the acquisition of 20 percent of Household's shares by any single entity or group ("20% trigger").

If an announcement of a tender offer for 30 percent of Household's shares is made, the Rights are issued and are immediately exercisable to purchase 1/100 share of new preferred stock for $100 and are redeemable by the Board for $.50 per Right. If 20 percent of Household's shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase 1/100 of a share of preferred. If a Right is not exercised for preferred, and thereafter, a merger or consolidation occurs, the Rights holder can exercise each Right to purchase $200 of the common stock of the tender offeror for $100. This "flip-over" provision of the Rights Plan is at the heart of this controversy.

Household is a diversified holding company with its principal subsidiaries engaged in financial services, transportation and merchandising. HFC, National Car Rental and Vons Grocery are three of its wholly-owned entities.

Household did not adopt its Rights Plan during a battle with a corporate raider, but as a preventative mechanism to ward off future advances. The Vice-Chancellor found that as early as February 1984, Household's management became concerned about the company's vulnerability as a takeover target. . . .

In the meantime, appellant Moran, one of Household's own Directors and also Chairman of the Dyson-Kissner-Moran Corporation ("D-K-M") which is the largest single stockholder of Household, began discussions concerning a possible leveraged buy-out of Household by D-K-M. D-K-M's financial studies showed that Household's stock was significantly undervalued in relation to the company's break-up value. It is uncontradicted that Moran's suggestion of a leveraged buy-out never progressed beyond the discussion stage.

Concerned about Household's vulnerability to a raider in light of the current takeover climate, Household secured the services of Wachtell, Lipton, Rosen and Katz ("Wachtell, Lipton") and Goldman, Sachs & Co. ("Goldman, Sachs") to formulate a takeover policy for recommendation to the Household Board at its August 14 meeting. . . .

Representatives of Wachtell, Lipton and Goldman, Sachs attended the August 14 meeting. The minutes reflect that Mr. Lipton explained to the Board that his recommendation of the Plan was based on his understanding that the Board was concerned about the increasing frequency of "bust-up" takeovers, the increasing takeover activity in the financial service industry . . . and the possible adverse effect this type of activity could have on employees and others concerned with and vital to the continuing

4. "Bust-up" takeover generally refers to a situation in which one seeks to finance an acquisition by selling off pieces of the acquired company.
successful operation of Household even in the absence of any actual bust-up takeover attempt. Against this factual background, the Plan was approved.

Thereafter, Moran and the company of which he is Chairman, D.K.M., filed this suit. . . . The primary issue here is the applicability of the business judgment rule as the standard by which the adoption of the Rights Plan should be reviewed. . . .

[But] the business judgment rule can only sustain corporate decision making or transactions that are within the power or authority of the Board. Therefore, before the business judgment rule can be applied it must be determined whether the Directors were authorized to adopt the Rights Plan.

While appellants contend that no provision of the Delaware General Corporation Law authorizes the Rights Plan, Household contends that the Rights Plan was issued pursuant to 8 Del. C. §§ 151(g) and 157. It explains that the Rights are authorized by § 157 and the issue of preferred stock underlying the Rights is authorized by § 151. . . .

[First, appellants contend that § 157 is a corporate financing statute, and that nothing in its legislative history suggests a purpose that has anything to do with corporate control or a takeover defense. Appellants are unable to demonstrate that the legislature, in its adoption of § 157, meant to limit the applicability of § 157 to only the issuance of Rights for the purposes of corporate financing. Without such affirmative evidence, we decline to impose such a limitation upon the section that the legislature has not. . . .

Secondly, appellants contend that § 157 does not authorize the issuance of sham rights such as the Rights Plan. They contend that the Rights were designed never to be exercised, and that the Plan has no economic value. . . .

Appellants' sham contention fails in both regards. As to the Rights, they can and will be exercised upon the happening of a triggering mechanism, as we have observed during the current struggle of Sir James Goldsmith to take control of Crown Zellerbach. See Wall Street Journal,
July 26, 1985, at 3, 12. As to the preferred shares, we agree with the Court of Chancery that they are distinguishable from sham securities. . . . The Household preferred, issuable upon the happening of a triggering event, have superior dividend and liquidation rights.

Third, appellants contend that §157 authorizes the issuance of Rights "entitling holders thereof to purchase from the corporation any shares of its capital stock of any class . . ." (emphasis added). Therefore, their contention continues, the plain language of the statute does not authorize Household to issue rights to purchase another's capital stock upon a merger or consolidation.

. . . We find no merit to such a distinction. We have already rejected appellants' similar contention that §157 could only be used for financing purposes. We also reject that distinction here.

"Anti-destruction" clauses generally ensure holders of certain securities of the protection of their right of conversion in the event of a merger by giving them the right to convert their securities into whatever securities are to replace the stock of their company . . . . The fact that the rights here have as their purpose the prevention of coercive two-tier tender offers does not invalidate them . . .

Fourth, [a]ppellants contend that the lack of [a strong Delaware antitakeover statute] indicates a legislative intent to reject anything which would impose an impediment to the tender offer process. Such a contention is a non sequitur. The desire to have little state regulation of tender offers cannot be said to also indicate a desire to also have little private regulation. Furthermore, as we explain infra, we do not view the Rights Plan as much of an impediment on the tender offer process . . . .

Having concluded that sufficient authority for the Rights Plan exists in 8 Del. C. §157, we note the inherent powers of the Board conferred by 8 Del. C. §141(a), concerning the management of the corporation's "business and affaire" (emphasis added), also provides the Board additional authority upon which to enact the Rights Plan . . . .

Appellants contend that the Board is unauthorized to usurp stockholders' rights to receive tender offers by changing Household's fundamental structure. We conclude that the Rights Plan does not prevent stockholders from receiving tender offers, and that the change of Household's structure was less than that which results from the implementation of other defensive mechanisms upheld by various courts.

Appellants' contention that stockholders will lose their right to receive and accept tender offers seems to be premised upon [a mis]understanding of the Rights Plan . . . .

[L]ook at the recent takeover of Crown Zellerbach, which has a similar Rights Plan, by Sir James Goldsmith. Wall Street Journal, July 26, 1985, at 3, 12. The evidence at trial also evidenced many methods around the Plan ranging from tendering with a condition that the Board redeem the Rights, tendering with a high minimum condition of shares and Rights, tendering and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing Household to self-tender for the Rights. One could also form a group of up to 19.9% and solicit proxies for consent to remove the Board and redeem the Rights. These are but a few of the methods by which Household can still be acquired by a hostile tender offer.
In addition, the Rights Plan is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem the Rights, they will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards any other board of directors would be held to in deciding to adopt a defensive mechanism, the same standard as they were held to in originally approving the Rights Plan. See Unocal, 493 A.2d at 954-55, 958 . . .

The Rights Plan does not destroy the assets of the corporation. The implementation of the Plan neither results in any outflow of money from the corporation nor impairs its financial flexibility. It does not dilute earnings per share and does not have any adverse tax consequences for the corporation or its stockholders. The Plan has not adversely affected the market price of Household’s stock.

Comparing the Rights Plan with other defensive mechanisms, it does less harm to the value structure of the corporation than do the other mechanisms . . .

. . . Appellants contend that the “20% trigger” effectively prevents any stockholder from first acquiring 20% or more shares before conducting a proxy contest and further, it prevents stockholders from banding together into a group to solicit proxies if, collectively, they own 20% or more of the stock.

. . . In essence, the Rights Agreement provides that the Rights are triggered when someone becomes the “beneficial owner” of 20% or more of Household stock. Although a literal reading of the Rights Agreement definition of “beneficial owner” would seem to include those shares which one has the right to vote, it has long been recognized that the relationship between grantor and recipient of a proxy is one of agency, and the agency is revocable by the grantor at any time . . . Therefore, the holder of a proxy is not the “beneficial owner” of the stock. As a result, the mere acquisition of the right to vote 20% of the shares does not trigger the Rights.

The issue, then, is whether the restriction upon individuals or groups from first acquiring 20% of shares before waging a proxy contest fundamentally restricts stockholders’ right to conduct a proxy contest.

. . . Evidence at trial established that many proxy contests are won with an insurgent ownership of less than 20%, and that very large holdings are no guarantee of success. There was also testimony that the key variable in proxy contest success is the merit of an insurgent’s issues, not the size of his holdings . . .

[1] In Unocal we held that when the business judgment rule applies to adoption of a defensive mechanism, the initial burden will lie with the directors. The “directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . . [T]hey satisfy that burden ‘by showing good faith and reasonable investigation . . .” Unocal, 493 A.2d at 955 . . .

There are no allegations here of any bad faith on the part of the Directors’ action in the adoption of the Rights Plan. There is no allegation that the Directors’ action was taken for entrenchment purposes.
Household has adequately demonstrated...that the adoption of the Rights Plan was in reaction to what it perceived to be the threat in the market place of coercive two-tier tender offers...

In addition, to meet their burden, the Directors must show that the defensive mechanism was "reasonable in relation to the threat posed". The record reflects a concern on the part of the Directors over the increasing frequency in the financial services industry of "boot-strap" and "bust-up" takeovers. The Directors were also concerned that such takeovers may take the form of two-tier offers. In addition, on August 14, the Household Board was aware of Moran's overture on behalf of D-K-M. In sum, the Directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself.

In conclusion, the Household Directors receive the benefit of the business judgment rule in their adoption of the Rights Plan...

The Directors adopted the Plan in the good faith belief that it was necessary to protect Household from coercive acquisition techniques. The Board was informed as to the details of the Plan. In addition, Household has demonstrated that the Plan is reasonable in relation to the threat posed...

While we conclude for present purposes that the Household Directors are protected by the business judgment rule, that does not end the matter. The ultimate response to an actual takeover bid must be judged by the Directors' actions at that time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders... Their use of the Plan will be evaluated when and if the issue arises.

**QUESTIONS AND NOTES ON MORAN**

1. What effect should poison pills have on shareholder value? Most commentators agree that, in the hands of absolutely loyal managers, the pill benefits shareholders by providing the managers with the power to bargain on their behalf and so overcome their chronic collective action problem. Thus, the pill might have the effect of increasing corporate value, or at least the size of takeover premia. But in the hands of disloyal managers, the pill might be used to entrench managers or to increase their private benefits. In this case, the pill undoubtedly lowers corporate value. Will it also lower takeover premia— or just decrease the likelihood of takeovers?

   Testing the effects of pills on corporate value is not easy, in part because every Delaware company might be said to have a pill. Companies that do not presently have a pill can adopt one in a matter of days (if not hours) if they are threatened by an impending takeover bid. All that is required to adopt a pill is a board meeting, after all, not a shareholder vote. See John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex. L. Rev. 271 (2000).
2. The Delaware Supreme Court was careful in *Moran* to state that corporate directors continue to exercise power subject to their fiduciary duty after adoption of a stock rights plan. In particular, the court noted that, under *Unocal*, a board might have a duty to redeem rights issued under its rights plan if their effect no longer appears reasonable in relation to the threat posed by an invited tender offer. But exactly when must a pill be redeemed? Is the board entitled to keep rights outstanding only long enough to complete an important company transaction, such as a recapitalization, that serves as an alternative to the bidder’s offer? Or is the board entitled to “just say no” to a hostile bidder indefinitely, even without proposing an alternative to its shareholders?

Should the distinction between doing nothing and offering a management alternative to a hostile offer matter? The courts have sometimes acted as if it did. The cases in which the Delaware Court of Chancery forced boards to redeem their pills were ones in which the pills were used to protect company-sponsored alternatives to all-cash tender offers. In *City Capital Associates Ltd. Partnership v. Interco, Inc.*, 551 A.2d 787 (Del. Ch. 1988), the court ordered Interco, Inc., to redeem a stock rights plan that the company used to protect its recapitalization alternative to a hostile all-cash, all-shares tender offer. Similarly, in *Grand Metropolitan Public Ltd. Co. v. Pillsbury Co.*, 558 A.2d 1049 (Del. Ch. 1988), the court required Pillsbury to redeem its rights plan after concluding that Pillsbury’s own restructuring proposal compared unfavorably in value to a hostile all-cash, all-shares offer from Grand Met. To be sure, these cases were expressly disapproved by the Delaware Supreme Court in dicta in the *Time-Warner* case excerpted below. Despite such disapproval, however, the Supreme Court continues to assert that boards have an ongoing fiduciary obligation to redeem the pill if it is no longer reasonable in relationship to the threat of an acquisition offer.

3. The poison pill at issue in *Household* was a so-called flip over pill, which gives target shareholders the right to buy shares of the bidder at a discounted price in the event of a trigger event. Since then poison pills have evolved so that the primary mechanism of defense is a so-called flip over feature, which gives target shareholders the right to buy shares of the target at a substantially discounted price. With shareholder activists generally disfavoring poison pills today, so-called chewable pills have also become more common. These pills disappear if certain fair price criteria are met, for example, a fully financed, 100 percent offer for a 50 percent or more premium over the current market price.

4. The *Household* court states that there are “many methods around the Plan,” including “tendering with a high minimum condition of shares and Rights.” To illustrate the proposition, the court noted that Sir James Goldsmith, a British corporate raider, had busted through (to use pill-speak)

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22. After reviewing the company’s own restructuring plan, the court concluded that the hostile all-cash, all-shares offer did not constitute a sufficient threat to Interco or its shareholders to justify foreclosing the shareholders indefinitely from choosing to accept the offer.
Crown Zellerbach's flip-over poison pill just months earlier. However, in the first twenty-five years of experience with poison pills after Household, there were no deliberate triggers that we are aware of. To our knowledge, Selectica, a $20 million "microcap" software company incorporated in Delaware and traded on the NASDAQ, holds the dubious honor as the first company to implement a flip-in pill's dilutive effect. Selectica had a pill since 2003 with a 15 percent trigger threshold. In November 2008 it reduced its trigger threshold to 5 percent, with an exemption for Versata, a 6.1 percent shareholder, as long as Versata did not acquire more than an additional 0.5 percent. Versata then intentionally triggered Selectica's pill, and challenged its validity in Delaware Chancery Court. Selectica implemented the dilutive effect of its pill through an "exchange feature," which gave all shareholders other than Versata one additional share for each share that it previously held. The Selectica board also promptly put in a new pill with a 5 percent trigger threshold. As of February 2009 the Delaware Chancery Court action is pending.

NOTE ON THE JAPANESE GUIDELINES ON TAKEOVER DEFENSE

In September 2004, Japan's Ministry of Economy, Trade, and Industry convened a group of experts and business representatives, chaired by Professor Hideki Kanda of the University of Tokyo, to propose a governmental response to the hostile takeovers that were beginning to appear on the Japanese corporate landscape. After extensive study and consultation with takeover experts around the world, the Corporate Value Study Group published its report in March 2005. Two months later, METI and the Japanese Ministry of Justice jointly promulgated "guidelines" that adopted the general approach and many of the specific recommendations from the report. On one hand, the Guidelines follow Delaware by allowing Japanese boards to adopt poison pills without a shareholder vote, and, more generally, requiring that defenses be "necessary and reasonable in relation to the threat posed." (Sound familiar?) On the other hand, the Guidelines indicate that defenses can only be used to maximize shareholder value, not to protect other constituencies as suggested in Unocal. In addition, the Guidelines suggest a more stringent form of reasonableness review than the Delaware courts have historically applied. For example, in order to be reasonable a board-adopted poison pill must provide a mechanism for shareholders to eliminate it, such as through an annual election of all the directors, or a sunset provision.

Taken as a whole, Japan seems to have adopted a middle-ground approach somewhere between Delaware and the EU Takeover Directive. Of course, the Guidelines only provide general principles, and it will take at

least a few years of judicial interpretation to see how they play out in practice. For an insightful commentary on these developments, see Curtis J. Milhaupt, In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan, 105 Colum. L. Rev. 2171 (2005).

13.4 CHOOSING A MERGER OR BUYOUT PARTNER: REVLON, ITS SEQUELS, AND ITS PREQUELS

The board’s entrenchment interest can affect not only its takeover defenses but also its choice of a merger or buyout partner. Management can obtain a variety of benefits in “friendly” deals, ranging from a place on the surviving corporation’s board to a cascade of consulting contracts, termination payments, and other compensation-related benefits. Traditionally, corporate law treated decisions to initiate merger proposals as business judgments so long as management did not have a conflicting ownership interest. In its third revolutionary takeover opinion of the 1985–1986 season, the Delaware Supreme Court addressed the board’s fiduciary duty in arranging for the “sale” of a company. The case was Revlon, Inc. v. MacAndrews and Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). Even before Revlon, however, the Delaware Supreme Court signaled its concern about the possibility that incumbent managers might sell their company at a low price to a favored bidder in the remarkable case of Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985). At the time it was issued, the Van Gorkom opinion was believed to be an aggressive articulation of the board’s general duty of care. (Accordingly, we also discuss it in Chapter 8 above.) In hindsight, however, Van Gorkom has come to seem much more like a precursor of the great Delaware takeover cases of the mid-1980s, and especially of Revlon. We reproduce portions of this very lengthy opinion below.

SMITH v. VAN GORKOM
488 A.2d 858 (Del. 1985)

HORSEY, J.:

This appeal from the Court of Chancery involves a class action brought by shareholders of the defendant Trans Union Corporation (“Trans Union” or “the Company”), originally seeking rescission of a cash-out merger of Trans Union into ..., a wholly-owned subsidiary of the defendant, Mamon Group, Inc. (“Mamon”). Alternate relief in the form of damages is sought against the defendant members of the Board of Directors of Trans Union. ...

Speaking for the majority of the Court, we conclude that both rulings of the Court of Chancery are clearly erroneous. Therefore, we reverse and direct that judgment be entered in favor of the plaintiffs and against the