The Enduring Illegitimacy of the Poison Pill

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Late last year, in *Leonard Loventhal Account v. Hilton Hotels Corp.*, the Delaware Supreme Court relied on the doctrine of stare decisis to reaffirm the central holding of *Moran v. Household International, Inc.*, a 1985 decision that upheld the validity of the poison pill. While the court had reaffirmed and even extended the *Moran* holding on a few previous occasions, its specific and aggressive invocation of stare decisis in *Leonard Loventhal Account* can only be seen as a signal that the Delaware Supreme Court considers the legitimacy of the poison pill to be a settled matter.

The poison pill is the ultimate defense against a hostile takeover. It can be
implemented quickly and easily.\textsuperscript{5} It has no immediate negative effect on the company.\textsuperscript{6} And, while in place, it is an absolute barrier to the consummation of a hostile takeover.\textsuperscript{7}

The only way to counter a poison pill is to have it removed, which is easier said than done. From management's perspective, the poison pill is almost too good to be true.

The poison pill operates in a fairly simple manner.\textsuperscript{8} A company's board of directors adopts a "Shareholder Rights Plan" pursuant to which a dividend of one "Right" is declared on each share of common stock. Each Right is attached to, and not tradable separately from, its corresponding share. Initially, the Rights are essentially meaningless. However, if certain specified events occur, such as the acquisition by a hostile bidder of more than a specified percentage of the company's shares, the poison pill is triggered. Once triggered, the Rights would detach from the shares and entitle all of the target company's shareholders, other than the hostile bidder, to acquire securities at a discount.

The type of securities that may be acquired depends upon the type of Rights. "Flip-over" Rights allow the holders to purchase shares in the acquiring company under certain circumstances,\textsuperscript{9} "flip-in" Rights allow the holders to purchase shares of the target company,\textsuperscript{10} and "back-end" Rights entitle the holders to acquire debt securities or other assets.\textsuperscript{11} These discriminatory rights would severely dilute the hostile bidder's interest in abusive takeover tactics and inadequate bids is the share purchase rights plan, popularly known as the 'poison pill.'\textsuperscript{12}

\textsuperscript{5} See I\textsuperscript{1} ARTHUR FLEISCHER, JR. & ALEXANDER R. SUSSMAN, TAKEOVER DEFENSE § 5.01[B][2], at 5-9 (6th ed. 2002) [hereinafter TAKEOVER DEFENSE] ("[O]ne of the fundamental attributes of the [poison] pill is that it can be adopted by a board of directors without a stockholder vote . . . ."); John C. Coates IV, Takeover Defenses in the Shadow of the Poison Pill: A Critique of the Scientific Evidence, 79 TEX. L. REV. 271, 287 (2000) ("For large, sophisticated targets, [poison] pill adoption can occur in a single business day: the only legal action necessary is a board meeting and appropriate lawyers can keep necessary documents at the ready, and directors can meet by conference call on a few hours notice.").

\textsuperscript{6} See I TAKEOVER DEFENSE, supra note 5, § 5.01[C][1], at 5-12.

\textsuperscript{7} Another fundamental attribute of the [poison] pill is that its adoption does not impair the company's "value structure." Adoption of a poison pill rights plan involves no significant outlay of corporate funds, no earnings dilution, no change in the company's capital structure, and no adverse tax consequences to the company or its stockholders. Moreover, the prevalent investment banking view is that a [poison] pill's adoption has no adverse effect on the company's market price . . . .

Id.

\textsuperscript{8} See infra notes 246-251 and accompanying text.

\textsuperscript{9} See generally I TAKEOVERS & FREEZEOUTS, supra note 4, § 6.03[4][b], at 6-60 to -70.1; 1 TAKEOVER DEFENSE, supra note 5, § 5.01[B][1], at 5-7 to -9, and § 5.05, at 5-65 to -109. For prototype Shareholder Rights Plans, see 5 TAKEOVERS & FREEZEOUTS, supra note 4, app. H; 2 TAKEOVER DEFENSE, supra note 5, ex. 15.

9. "The flip-over feature would give shareholders the right to purchase shares of the acquiring company at a discount in the event of a freeze-out merger or similar transaction (thereby diluting the acquiring company)." 1 TAKEOVERS & FREEZEOUTS, supra note 4, § 6.03[4][b], at 6-60. The poison pill involved in Moran v. Household Int'l., Inc., 500 A.2d 1346 (Del. 1985), discussed infra Part II.A.2, was of the flip-over variety.

10. "[T]he flip-in feature would give shareholders, other than the holder triggering the flip-in, the right to purchase shares of the company at a discount from market price (thereby diluting the triggering shareholder)." 1 TAKEOVERS & FREEZEOUTS, supra note 4, § 6.03[4][b], at 6-60. The poison pill involved in Amalgamated Sugar Co. v. NL Indus., 644 F.Supp. 1229 (S.D.N.Y. 1986), discussed infra Part II.B.1, was of the flip-in variety, albeit in early form.

11. "The 'put' or 'back-end' [poison] pill . . . [gives] the target's shareholders the right to exchange their shares for cash and/or a package of debt securities with a value equal to the specified [amount]." 1 TAKEOVER DEFENSE, supra note 5, § 5.04[C][1], at 5-45. The poison pill involved in Revlon, Inc. v. MacAndrews & Forbes
the target company. To avoid this dilution, the bidder must refrain from exceeding the threshold ownership level that would trigger the poison pill. The poison pill derives its effectiveness from this deterrence value—the incumbent management can remain in power because the hostile bidder cannot afford to trigger the poison pill.\footnote{Id.}

There are only three known ways around the poison pill. The first is to negotiate a friendly transaction with the target company. This is possible because the Rights are redeemable by the target company’s board of directors until the poison pill is triggered.\footnote{See 1 TAKEOVER DEFENSE, supra note 5, § 5.02[A], at 5-18 to -19.} If a friendly arrangement can be reached, the poison pill Rights can be redeemed and the takeover can continue. However, this is little more than a phantom option; if a friendly transaction were feasible, a hostile bid would not have been necessary.\footnote{There is no known instance of a raider buying through the trigger level of a flip-in [poison] pill that is operative and has neither been judicially invalidated nor been redeemed or waived by the target’s board . . . . This exemplifies the point that one of the [poison] pill’s fundamental attributes is its deterrent effect. As the SEC has noted: “In fact such plans are adopted with the intent that they will never be implemented.” Id.}

A second way around the poison pill is to persuade the courts that the target company’s board of directors is breaching its fiduciary duties by refusing to redeem the poison pill Rights. If this can be done, the court may order the company to redeem the Rights and allow the takeover to continue. However, courts are not easily persuaded. The target company can often develop a plausible rationale for resisting the hostile takeover in the interests of its shareholders. Despite the obvious benefits to shareholders, who would prefer to sell their shares at an often substantial premium to market price, courts are hesitant to second-guess the business judgment of directors.\footnote{Friendly transactions are generally less expensive to the bidder than hostile transactions. See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1169 (1981). Thus, bidders tend to proceed with hostile takeovers only if their advances have been, or are expected to be, rejected by target companies.} Thus, the courts tend to permit the target company’s directors to resist hostile takeovers, by means of the poison pill or otherwise.

The third way around the poison pill is to launch a proxy contest to remove the target company’s board of directors and replace them with a more sympathetic group.

\textit{Holdings, Inc.}, 506 A.2d 173 (Del. 1986), discussed \textit{infra} Part II.A.2, was of the back-end variety.\footnote{12. See 1 TAKEOVER DEFENSE, supra note 5, § 5.02[A], at 5-18 to -19.}

There is no known instance of a raider buying through the trigger level of a flip-in [poison] pill that is operative and has neither been judicially invalidated nor been redeemed or waived by the target’s board . . . . This exemplifies the point that one of the [poison] pill’s fundamental attributes is its deterrent effect. As the SEC has noted: “In fact such plans are adopted with the intent that they will never be implemented.” \textit{Id.}

\textit{Id.} 13. See 1 TAKEOVERS & FREEZOUTS, supra note 4, § 6.03[4][b], at 6-63; 1 TAKEOVER DEFENSE, supra note 5, § 5.05[F][1], at 5-93.

14. Friendly transactions are generally less expensive to the bidder than hostile transactions. See Frank H. Easterbrook & Daniel R. Fischel, The Proper Role of a Target’s Management in Responding to a Tender Offer, 94 HARV. L. REV. 1161, 1169 (1981). Thus, bidders tend to proceed with hostile takeovers only if their advances have been, or are expected to be, rejected by target companies.

15. This general reluctance to second-guess the business judgment of directors is the foundation of the most basic principle of corporate law, the business judgment rule:

The business judgment rule is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” Aronson v. Lewis, Del Supr., 473 A.2d 805, 812 (1984) (citations omitted). A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter’s decision can be “attributed to any rational business purpose.” Sinclair Oil Corp. v. Levien, Del. Supr., 280 A.2d 717, 720 (1971).

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). The business judgment rule is applicable in the context of a hostile takeover, see id. (quoting Pogostin v. Rice, 480 A.2d 619 (Del. 1984)), and has worked its way into the threshold inquiry that is supposed to precede its application, see \textit{infra} notes 218-219, 238-40 and accompanying text.
This new board of directors can then redeem the poison pill Rights and allow the hostile takeover to proceed. A proxy contest, however, is expensive and time-consuming. Thus, only the most determined bidders can proceed with this option, and yet, this is the only real option available to most hostile bidders.\textsuperscript{16}

The \textit{Moran} decision to uphold the poison pill was not incomprehensible, given the circumstances of the day. It was an era of open corporate warfare, with hostile bidders often resorting to more or less reprehensible tactics to wrest control away from incumbent managements.\textsuperscript{17} Originally, the poison pill was seen as a way to guard against the worst of these tactics. It has been successful; the poison pill has virtually eliminated these tactics from the repertoires of hostile bidders.\textsuperscript{18}

However, the poison pill is extremely potent, capable of preventing all hostile takeovers, regardless of their underlying merit.\textsuperscript{19} If such a device is to be permitted, caution would not be simply appropriate, but necessary. Indeed, the courts were cautious when they first approved the poison pill.\textsuperscript{20} But over time this caution would subside, leaving management with nearly unbridled discretion to employ the ultimate defensive weapon as they see fit.\textsuperscript{21} Thus, the poison pill eventually became the means to employ a "just say no" defense of resisting hostile takeovers, regardless of the interests of shareholders.\textsuperscript{22}

The consequences of the poison pill to corporate governance have been tremendous. The threat of a hostile takeover operates as a disciplinary check on a company's management.\textsuperscript{23} If management fails to maximize shareholder wealth, share values suffer. This creates an opportunity for a third party to step in, buy the company at a low price, and replace the inefficient management. To avoid such a fate, management must continuously seek to maximize shareholder wealth. By severely restricting the market for corporate control, the poison pill has rendered management significantly less accountable.
to shareholders. Management need not be as concerned with the shareholders' interests if it is capable of resisting even the most lucrative hostile takeover offers.

This Article argues that the courts should view the poison pill defense with far greater skepticism than they have thus far. At the time the poison pill was first considered, corporate law did not authorize corporations to employ poison pills. Even now, Delaware corporate law, fairly interpreted, does not authorize the use of the poison pill against typical contemporary hostile offers. In short, the poison pill was originally, and remains to this day, an illegitimate defense mechanism. Part I reviews the legal history of the poison pill, and demonstrates that while the validity of the poison pill was initially in question, there is no longer any doubt as to the legal acceptance of the standard poison pill. Part II reassesses the validity of the poison pill, and argues that the poison pill should have been held invalid when the courts initially addressed the matter. Because the legal landscape has changed dramatically, however, the argument is unlikely to be considered persuasive by courts today. Thus, Part III analyzes the current situation, and argues that the poison pill, as it is currently employed, is illegitimate even under the lenient standards of review developed by sympathetic courts.

Ultimately, the goal of this Article is to demonstrate that the poison pill is an illegitimate defense tactic that allows management to entrench itself at the expense of shareholders. While it is probably too late to expect the courts to strike down the poison pill, either on ultra vires grounds or otherwise, it is never too late for the courts to re-examine their deferential treatment of poison pills. If courts were to apply fairly the standards of review that they themselves have developed, the mischief currently caused by the poison pill would be greatly diminished.

I. LEGAL HISTORY OF THE POISON PILL

The history of the poison pill has been a rather glorious one. Although the legality of the poison pill was initially in doubt, it has secured essentially universal acceptance. Moreover, in Delaware, the state that dominates the field of corporate law, the validity of the poison pill was never seriously in question.

This section will describe the legal history of the poison pill. Because of Delaware’s importance in the field of corporate law, it will begin with a history of the poison pill in Delaware. Thereafter, a brief description of the response of other jurisdictions will follow.

A. The Poison Pill in Delaware

The poison pill is one of many defensive tactics employed by the boards of directors of target companies to defend against hostile takeovers. In order to understand the courts’ reaction to poison pills, one must first understand their reaction to defensive tactics generally. This Part, therefore, first surveys Delaware’s framework for reviewing hostile takeover defenses generally and then turns to Delaware’s treatment of the poison pill in particular.

1. General Framework

Delaware’s general policy towards defensive tactics employed by boards of directors
to resist hostile takeovers was established in *Unocal Corp. v. Mesa Petroleum Co.*, and subsequently restated in *Unitrin, Inc. v. American General Corp.* That policy can be summarized as follows: a company’s board of directors is permitted to resist hostile takeovers if it reasonably perceives a threat to corporate policy and effectiveness, provided that the board’s response is reasonable in relation to the threat posed.

The *Unocal* case involved a two-tier, front-loaded tender offer. *Mesa Petroleum Company* held approximately thirteen percent of Unocal Corp.’s stock. It was offering to acquire an additional thirty-seven percent of the shares for $54 per share in cash. After securing majority ownership, it planned to squeeze out the remaining shareholders in exchange for subordinated securities. Although such securities had a face value of $54, their fair market value was considerably less. Such an offer is generally considered coercive: a shareholder who may wish to reject the tender offer may nevertheless feel compelled to accept it because, if the tender offer is successful, the shareholder will be squeezed out on inferior terms.

The Unocal board of directors rejected Mesa Petroleum’s offer as inadequate and decided to take defensive action. The board embarked on an exchange offer pursuant to which it would exchange forty-nine percent of its own shares for new, senior debt securities worth $72 per share. Such securities would have been expected to have a fair market value at or near face value. Mesa Petroleum, however, would not be permitted to participate in the offer. The court noted that “[i]n adopting the selective exchange offer, the board stated that its objective was either to defeat the inadequate Mesa offer or, should the offer still succeed, provide the forty-nine percent of its stockholders, who

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25. 651 A.2d 1361 (Del. 1995).
26. See infra notes 36-39 and accompanying text. This is, of course, an over-simplification. The *Unocal* test itself has certain nuances, which are discussed throughout the remainder of this Part. In addition, the Delaware courts have announced related doctrines, including the *Revlon* and *Blasius* doctrines. Under the *Revlon* doctrine, if the break-up of a company becomes inevitable, the directors take on the roles of auctioneers and must seek the best value reasonably available to shareholders. See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986); see also Parament Communications, Inc. v. QVC Network Inc., 637 A.2d 34, 42-46 (Del. 1994). Under the *Blasius* doctrine, defensive actions taken for the purpose of interfering with shareholder franchise cannot be sustained without a compelling justification. See Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 659-63 (Del. Ch. 1988); see also Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992). As important as the *Revlon* and *Blasius* doctrines may be, they are not material to a discussion of poison pills and are therefore not considered in this Article.
27. As illustrated in the following text, a two-tier, front-loaded tender offer is a tender offer for a majority of a company’s shares with the explicit or implicit promise of a subsequent merger in which the minority shareholders will be eliminated for inferior consideration.
28. *Unocal*, 493 A.2d at 956 (“it is now well recognized that such offers are a classic coercive measure designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back end of the transaction.”). See supra text accompanying note 202.
29. In addition, the offer was conditioned on the success of Mesa Petroleum’s offer. This made Unocal’s offer coercive and preclusive: coercive in that shareholders are pressured not to tender to Mesa Petroleum in order to secure the benefit of the company’s self-tender, and preclusive in that if there is no Mesa Petroleum transaction there would be no Unocal transaction. Thus, it was, in effect, much like a poison pill. See infra notes 244-251 and accompanying text. However, it was intended to combat a coercive offer, and as such may be reasonable under the circumstances. See infra note 245 and accompanying text. In any event, Mesa Petroleum was advised to effect a partial waiver of the Mesa Purchase Condition for practical reasons. See *Unocal*, 493 A.2d at 951.
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would otherwise be forced to accept 'junk bonds,' with $72 worth of senior debt."\(^{30}\)

The Delaware Supreme Court's analysis was methodical. It began with the basic principal that the management of a corporation is entrusted to its board of directors.\(^{31}\) It then noted that the business judgment rule presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company,"\(^{32}\) and that "a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'"\(^{33}\)

The Unocal court did recognize that, in the context of a hostile takeover, there is an "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."\(^{34}\) However, the court did not rely on such conflicts of interests to invoke the duty of loyalty and the intrinsic fairness test, as one might expect. Rather, the court recognized only "an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."\(^{35}\) The court set forth a two-part threshold inquiry. First, the "directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed."\(^{36}\) This burden is satisfied by a showing of good faith and reasonable investigation; the proof is "materially enhanced . . . by the approval of a board comprised of a majority of outside independent directors."\(^{37}\) Second, the directors must demonstrate that the defensive measures in question are "reasonable in relation to the threat posed."\(^{38}\) This two-part inquiry, known as the Unocal test, has become the standard by which corporate defensive action is analyzed.\(^{39}\)

The court held that Unocal's defensive action survived this scrutiny. First, the court concluded that there were reasonable grounds for the directors to believe that a threat existed: "the threat posed was viewed by the Unocal board as a grossly inadequate two-tier coercive tender offer."\(^{40}\) Second, the court noted that Unocal's response was intended either to defeat the offer or to provide adequate compensation to the shareholders. The court held that these were valid purposes under the circumstances.\(^{41}\) The court further held that the decision to exclude Mesa Petroleum from Unocal's self-

\(^{30}\) Unocal, 493 A.2d at 956. The plan was to defeat the tender offer with an alternative transaction offering greater consideration. Id. As originally proposed, however, there would be no exchange offer if the tender offer were defeated. If the tender offer were not defeated, the exclusion of Mesa Petroleum from the exchange offer would leave it as the sole remaining shareholder, effectively draining the extra consideration from its equity interest.

\(^{31}\) DEL. CODE ANN. tit. 8, § 141(a) (2001).

\(^{32}\) Unocal, 493 A.2d at 954 (citing Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

\(^{33}\) Id. (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

\(^{34}\) Id.

\(^{35}\) Id.

\(^{36}\) Id. at 955.

\(^{37}\) Unocal, 493 A.2d at 955.

\(^{38}\) Id.


\(^{40}\) Unocal, 493 A.2d at 956. The court also noted "the threat of greenmail" as a ground for defensive action. "The term 'greenmail' refers to the practice of buying out a takeover bidder's stock at a premium that is not available to other shareholders in order to prevent the takeover." Id. at 956 n.13.

\(^{41}\) Id. at 956.
tender was reasonable because it was a necessary component of the directors' response. Thus, by developing a moderate test for judicial review and applying it in a reasonable manner, Unocal offered the promise of an "enhanced scrutiny" of corporate resistance to hostile takeovers.

Nearly ten years later, in Unitrin, Inc. v. American General Corp., the Delaware Supreme Court authored a significant restatement of the Unocal test. Unitrin involved an all-cash, all-shares offer. American General offered to purchase all of Unitrin's stock for $50 per share in cash. Such an offer is generally considered non-coercive: a shareholder could vote for or against the transaction with the knowledge that, if the transaction were approved, all shareholders—whether or not they voted for the transaction—would receive the same consideration in cash.

The Unitrin board of directors rejected American General's offer as inadequate. Its defensive responses included the initiation of a repurchase program, pursuant to which the company would purchase up to ten million shares (nearly twenty percent) of its own stock. The company's charter "already included a 'shark-repellant' provision barring any business combination with a more-than-15% shareholder unless approved by a majority of continuing directors or by a seventy-five percent stockholder vote." Because the Unitrin directors collectively held approximately twenty-three percent of the company's outstanding shares, the repurchase program would not only make a general proxy solicitation more difficult, it could also prevent American General from ever obtaining the approvals required by the shark-repellant provision. The company succeeded in purchasing nearly five million shares before being enjoined by the Delaware Court of Chancery.

On appeal, the Delaware Supreme Court affirmed the applicability of the Unocal

42. Id.

[Unocal's] efforts would have been thwarted by Mesa's participation in the exchange offer. First, if Mesa could tender its shares, Unocal would effectively be subsidizing the former's continuing effort to buy Unocal stock at $54 per share. Second, Mesa could not, by definition, fit within the class of shareholders being protected from its own coercive and inadequate tender offer.

43. 651 A.2d 1361 (Del. 1995).

44. The term "all-cash, all shares offer" generally refers to a tender offer for any and all shares of the target company's stock, with the consideration to be paid in cash. There is often a promise to cash out remaining shareholders at the same price. The offer in Unitrin was an offer to merge the target and acquiror, which would have had the same effect.

45. See Ronald J. Gilson & Reinier Kraakman, Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?, 44 BUS. LAW. 247, 254 & n.29 (1989) ("[A]ny bid, apart from an any-or-all cash bid with a commitment to freezeout non-tendering shareholders at the bid price, may have some coercive effect on target shareholders."); see also Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289 (Del. Ch. 1989) ("It is difficult to understand how, as a general matter, an ... all cash, all shares tender offer, with a back end commitment at the same price in cash, can be considered a ... threat ...."). But see Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140, 1152-53 (Del. 1989) (recognizing potential threats beyond structural coercion in all-cash, all-shares offers).

46. The company also offered antitrust complications as a ground for rejecting the offer, but the Delaware Court of Chancery characterized this as a "makeweight excuse." Unitrin, 651 A.2d at 1375.

47. Other defensive measures adopted by Unitrin included an advance notice bylaw provision and a poison pill. See id. at 1369-70. However, these provisions were not directly at issue on appeal. See id. at 1376.

48. Id. at 1377 (footnote omitted).
test. After noting the Delaware Court of Chancery's holding that the board of directors had satisfied the first prong of the *Unocal* test, the "reasonableness test," the Delaware Supreme Court turned its attention to the second prong, the "proportionality test." The court recharacterized the proportionality test as follows: "If a defensive measure is not draconian... because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to 'the range of reasonableness.'" As the court explained,

a court applying enhanced judicial scrutiny should be deciding whether the directors made a *reasonable* decision, not a *perfect* decision. If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination. Thus, courts will not substitute their business judgment for that of directors, but will determine if the directors' decision was, on balance, within a range of reasonableness.

In the case at hand, the Delaware Supreme Court held that the Delaware Court of Chancery had applied an incorrect legal standard. Rather than decide whether it was "within a range of reasonableness," the Delaware Court of Chancery enjoined the repurchase program because it was "unnecessary." The Delaware Supreme Court remanded the case, but only after pointing out a factual error made by the lower court. It noted that the repurchase program probably did not make the approvals required by the shark-repellant provision any less likely, and, in any event, could not prevent American General from circumventing such provision with a proxy contest. These facts all but precluded a finding by the Delaware Court of Chancery that Unitrin’s repurchase program was a draconian response: it was clearly not coercive and apparently not preclusive, either. Thus, the Delaware Court of Chancery was left to determine only whether the repurchase program was within the range of reasonableness. The Delaware Supreme Court suggested an answer on that point as well, noting that "[t]he Court of Chancery’s holding in [Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278 (Del. Ch. 1989)], cited with approval by this Court in [Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1155 n.19 (Del. 1989)], appears to be persuasive support for

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49. *Id.* at 1375.
50. *Unitrin*, 651 A.2d at 1373 ("First, a *reasonableness test*, which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed...").
51. *Id.* ("Second, a *proportionality test*, which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed.").
52. *Id.* at 1387-88 (citations omitted).
53. *Id.* at 1385-86 (quoting Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)) (emphasis in original).
54. *Id.* at 1381 ("[W]ithout the Repurchase Program, the director shareholders' absolute voting power of 23% would already constitute actual voting power greater than 25% in a proxy contest with normal shareholder participation.").
55. *See Unitrin*, 651 A.2d at 1381-83 ("If American General were to initiate a proxy contest before acquiring 15% of Unitrin's stock, it would need to amass only 45.1% of the votes assuming a 90% voter turnout.").
56. *Id.* at 1388 ("A limited nondiscriminatory self-tender... may thwart a current hostile bid, but is not inherently coercive... Here, there is no showing... that the Repurchase Program was coercive.").
the proportionality of the multiple defenses Unitrin’s board adopted.  

Thus, the standards by which a board of directors’ defensive responses to a hostile takeover bid will be judged can be ascertained by combining the holdings of *Unocal* and *Unitrin*. They could be summarized as follows: Before the board of directors will be given the benefit of the business judgment rule, it must survive a two-part inquiry. First, the board must establish that there are reasonable grounds for believing that the hostile offer poses a threat to corporate policy and effectiveness. This burden is met by a showing of good faith and reasonable investigation, and is materially enhanced by approval of a board consisting of a majority of outside independent directors. Second, the board must establish that the defensive response was reasonable in relation to the threat posed. This burden is met by establishing that the response was neither coercive nor preclusive, but within a range of reasonableness. At no point will the reviewing court substitute its own business judgment for that of the directors.

2. Poison Pills Specifically

The leading case in the legal history of the poison pill is *Moran v. Household International, Inc.*. In that case, the Delaware Supreme Court upheld the validity of the poison pill for the first time. At issue in *Moran* was only a flip-over pill, but it proved to be the decisive case. The back-end pill was approved, without much discussion, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, while the flip-in has only been tacitly approved by the Delaware Supreme Court in cases such as *Unitrin, Inc. v. American General Corp.*. In *Leonard Loventhal Account v. Hilton Hotels Corp.*, the Delaware Supreme Court apparently reaffirmed its commitment to the *Moran* holding and to the poison pill. Although there was a point at which it appeared that the Delaware courts would be willing to mandate the redemption of the poison pill in the face of a non-coercive tender offer, *Paramount Communications, Inc. v. Time Inc.* appears to have eliminated any such hopes. However, even if the company would not in fact be forced to redeem the poison pill, the courts have insisted that it retain the ability to do so. Thus, in *Quickturn Design Systems, Inc. v. Shapiro*, the Delaware Supreme Court invalidated a delayed redemption provision that restricted the board of director’s ability to redeem the

57. Id. at 1389.

58. The irony of the Delaware Supreme Court’s development of the *Unocal* test should not escape mention. The *Unocal* test was intended to be a “threshold” inquiry, applied “before the protections of the business judgment rule may be conferred.” *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985). Yet the Delaware Supreme Court later determined that, in the application of the component tests, courts will not substitute their business judgment for that of the directors.” *Unitrin*, 651 A.2d at 1386 (quoting *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 45-56 (Del. 1994)). Directors thus are afforded substantially the benefits of the business judgment rule before it can be determined that they are entitled to its protection, despite the court-acknowledged “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders . . . .” *Unocal*, 493 A.2d at 954.

59. 500 A.2d 1346 (Del. 1985).

60. 506 A.2d 173 (Del. 1986).

61. 651 A.2d 1361 (Del. 1995).

62. 780 A.2d 245 (Del. 2001).

63. 571 A.2d 1140 (Del. 1990).

64. 721 A.2d 1281 (Del. 1998).
As mentioned above, the Moran case was the case in which the Delaware Supreme Court first validated the poison pill. In that case, Moran, a director and shareholder of Household International, Inc., was contemplating an acquisition of the company. Household adopted a Preferred Share Purchase Rights Plan, which was essentially a non-discriminatory flip-over pill. Moran sued to challenge the validity of the plan. The court upheld the company's adoption of the poison pill over a litany of arguments raised by Moran.

The court first held that the company had the power to issue such Rights under section 157 of the Delaware General Corporation Law. Moran argued that section 157 was intended as a corporate financing provision and not as a takeover defense mechanism. While the court agreed that the provision was not specifically intended for takeover defense purposes, the court found determinative the fact that such purposes were not specifically precluded either. Moran also argued that the poison pill Right was a sham because it was designed so as never to be exercised. The court rejected this argument, noting that Sir James Goldsmith had triggered similar rights in his attempt to acquire Crown Zellerbach.

65. The Moran court described the poison pill involved in the case as follows:

   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% 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.

66. Moran v. Household Int'l, Inc., 500 A.2d 1346, 1348-49 (Del. 1985). It should be noted that the Right to purchase preferred stock was not particularly meaningful. Although each 1/100 of a share of preferred was essentially the economic equivalent of one share of common stock, the exercise price of $100 was "well in excess of the then-current market price of the common." TAKEOVER DEFENSE, supra note 5, § 5.04[D][2], at 5-56 to -57. Thus, the poison in the Rights Plan came solely from its flip-over provision.

67. Moran, 500 A.2d at 1351. Section 157 provided in relevant part as follows:

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

Id. at 1351 n.7. One of the arguments raised by Moran, and rejected by the court, is that this language is inconsistent with a flip-over pill because "the statute does not authorize Household to issue rights to purchase another's capital stock upon a merger or consolidation." Id. at 1352. This argument is considered infra Part II.B.

68. See id. at 1352. For a description of the circumstances surrounding Sir James Goldsmith's tender offer
The court also upheld the poison pill against the argument that it would "usurp stockholders' rights to receive tender offers by changing Household's fundamental structure." As proof, the court again pointed to the successful tender offer for shares of Crown Zellerbach by Sir James Goldsmith despite the existence of a similar poison pill. More importantly, however, the court noted that the board of directors may be required, in the exercise of their fiduciary duties, to pull the poison pill and redeem the Rights:

"[T]he 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."

In other words, the subsequent refusal to redeem the Rights might not survive scrutiny under the Unocal test.

Finally, the court upheld the poison pill on the ground that it would not impede anyone's ability to wage a proxy contest. By waging a proxy contest, a hostile bidder could replace the board of directors and redeem the poison pill before acquiring a controlling interest in the company. This would prove to be the most enduring aspect of the case, as the proxy contest remains the only viable method for overcoming the poison pill.

In applying the Unocal standard to the board's actions in Moran, the court concluded that "the Directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself." Unfortunately, the facts in Moran did not include an outstanding tender offer, so how the court would rule on a board's refusal to redeem the Rights in the midst of a takeover

for Crown Zellerbach, see 1 TAKEOVER DEFENSE, supra note 5, at 5-58 to -59; Peter V. Letsou, Are Dead Hand (and No Hand) Poison Pills Really Dead?, 68 U. CIN. L. REV. 1101, 1109-11 (2000).

69. Moran, 500 A.2d at 1353-54.

70. See supra note 68. The court also pointed to a number of possible strategies to circumvent the flip-over provision:

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 [the company] to self-tender for the Rights. One could also form a group of up to 19.9% and solicit proxies for consents to remove the Board and redeem the Rights.

Moran, 500 A.2d at 1354.

71. Id.

72. Id. at 1355.

73. The court itself noted this option: "One could also form a group of up to 19.9% and solicit proxies for consents to remove the Board and redeem the Rights." Id. at 1354.

74. In Unitrin, the Delaware Supreme Court itself noted that "the emergence of the 'poison pill' as an effective takeover device has resulted in such a remarkable transformation in the market for corporate control that hostile bidders who proceed when such defenses are in place will usually 'have to couple proxy contests with tender offers.'" Unitrin Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1379 (Del. 1995) (citing Joseph A. Grundfest, Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates, 45 STAN. L. REV. 857, 858 (1993)).

75. Moran, 500 A.2d at 1357.
The Enduring Illegitimacy of the Poison Pill

battle would be left for another day. The court said only that "[t]he ultimate response to an actual takeover bid must be judged by the Directors' actions at the time, and nothing we say here relieves them of their basic fundamental duties to the corporation and its stockholders."  

The poison pill considered in Moran was of the flip-over variety. The result for a back-end pill or a flip-in pill might well have been different. In fact, much of the Moran court's logic would not be applicable to those pills. For example, in discussing the advantages of a flip-over pill as compared to other defensive mechanisms, the court noted that "[t]he 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 . . . ."  

By contrast, the back-end pill does result in an outflow of money and impairs financial flexibility, while the flip-in pill dilutes the earnings per share considerably. Moreover, while the flip-over version of the poison pill need not discriminate against the hostile bidder, the flip-in and back-end versions necessarily do discriminate. Nevertheless, the Delaware Supreme Court relied on Moran to validate, without much consideration, other forms of the poison pill.

In Revlon, the court approved the adoption of a back-end poison pill. In Revlon, Pantry Pride made a hostile bid for Revlon. Revlon considered the offer to be "grossly inadequate," and therefore took a number of defensive measures, including the adoption of a poison pill. Revlon also turned to Forstmann Little & Co. to prepare an alternative offer for shareholders, and a bidding war ensued. As the offering price escalated, Revlon's directors granted increasingly preferential treatment to Forstmann Little. Therefore, Revlon sought an injunction.

By the time of the injunction proceeding, the poison pill was no longer at issue because the Revlon board had agreed to redeem the Rights for any offer exceeding the final Forstmann Little offer. Nevertheless, the court briefly addressed the issue of the back-end poison pill, upholding its validity by reference to the Moran decision.

76. Id.
77. Id. at 1354.
78. See infra notes 172-173 and accompanying text.
80. The court described Revlon's poison pill as follows:

Under this plan, each Revlon shareholder would receive as a dividend one Note Purchase Right (the Rights) for each share of common stock, with the Rights entitling the holder to exchange one common share for a $65 principal Revlon note at 12% interest with a one-year maturity. The Rights would become effective whenever anyone acquired beneficial ownership of 20% or more of Revlon's shares, unless the purchaser acquired all the company's stock for cash at $65 or more per share. In addition, the Rights would not be available to the acquiror, and prior to the 20% triggering event the Revlon board could redeem the Rights for 10 cents each.

Revlon, 506 A.2d at 177. Revlon also adopted a share repurchase program, id., as well as other defensive measures, see infra note 81 and accompanying text.

81. In addition to granting Forstmann Little access to confidential information, Revlon, 506 A.2d at 178, Revlon granted Forstmann Little many favorable contractual terms. At issue in the court's opinion were the provisions granting Forstmann Little a "lock-up option" to purchase certain Revlon assets at a discount, the "no-shop provision" requiring Revlon to deal exclusively with Forstmann Little, and the "termination fee" pursuant to which Revlon would be required to make a large payment to Forstmann Little if its transaction were aborted. Id. at 178-79.
82. Id. at 180-81.
Applying the *Unocal* test, the court upheld the board’s adoption in the case at hand as a reasonable response to a grossly inadequate offer. Despite the potentially preclusive effect of a back-end pill, the court noted that “[f]ar from being a ‘show-stopper,’ . . . the measure spurred the bidding to new heights, a proper result of its implementation.” Whether the board of directors could have used the poison pill to block a hostile bid was not at issue in *Revlon*.

The Delaware Supreme Court has never specifically determined the validity of the flip-in pill. Nevertheless, few doubt what the court’s position would be. In *Unitrin*, the court implicitly upheld a flip-in poison pill. When addressing the issue, the Delaware Supreme Court simply cited *Moran*, stating that it “has upheld the propriety of adopting poison pills in given defensive circumstances. Keeping a poison pill in place may be inappropriate, however, when those circumstances change dramatically.” In addition, the Delaware Court of Chancery has on many occasions upheld poison pills with flip-in provisions without addressing the issue directly. Apparently, the Delaware courts see no material differences among the various forms of the poison pill.

Recently, in *Leonard Loventhal Account*, the Delaware Supreme Court took the opportunity to reaffirm, in an emphatic way, its holding in *Moran* that the adoption of a poison pill defense is a valid exercise of a board of directors’ authority under state law. The case involved a rather unique challenge to the poison pill by a shareholder. Rather than challenging the company’s authority to adopt the poison pill by a shareholder. Rather than challenging the company’s authority to adopt the poison pill by a shareholder, the shareholder asserted a right to refuse the benefits thereof. For example, it was argued that since the Shareholder Rights Plan provided that “[e]very holder of a Right by accepting the same consents and agrees [to the terms of the Rights Plan],” the Rights Plan was unenforceable as to any shareholder who did not accept its terms. Since the legal arguments raised in the case do not directly challenge the board of directors’ authority to adopt the poison pill, the court’s rejection of such arguments was not terribly significant.

Nevertheless, the tone of the court’s opinion should not be disregarded in assessing the impact of the decision. The court repeatedly invoked the doctrine of stare decisis to

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83. *Id.* at 181.
84. 651 A.2d 1361 (Del. 1995).
85. *Id.* at 1378.
86. *See* 1 TAKEOVERS & FREEZEOUTS, *supra* note 4, § 6.03[4][d], at 6-75 to -76, n.72 (listing cases).
87. 780 A.2d 245 (Del. 2001).
88. At first blush, this appears to be a rather strange issue to litigate. If a shareholder does not appreciate the benefits of poison pill rights, she could always refuse to exercise them should the opportunity ever arise. However, once the rights become exercisable, it becomes irrational to refuse to exercise them, since a shareholder would be subjecting herself to the same economic poison facing the hostile acquiror. Thus, it would seem that the challenge was aimed at eviscerating the poison pill defense itself. For example, if the Rights could not be issued without shareholder consent, this could limit the effectiveness of the poison pill defense since shareholders may well decide that, ex ante, the benefits of the poison pill are outweighed by the drawbacks. However, plaintiff’s argument merely asserted the right to reject poison pill rights. The rejection of such rights by one or a few shareholders would do little to limit the effectiveness of the poison pill, thus making rejection by many shareholders extremely unlikely. There might be a slightly greater chance of success if there are a significant number of shareholders with large holdings, such as may be the case with institutional investors—but not a much better chance. Why a shareholder would pursue such a case is therefore puzzling unless it is seen as part of a larger strategy to challenge the legitimacy or effectiveness of the poison pill defense itself. It seems clear that the court was attempting to forestall any such effort.
The court recognized that many of the claims were not “precisely controlled by stare decisis,” but reasoned that “[t]o recognize [the] validity of . . . [such] claim[s] would emasculate the basic holding of Moran, both as to this case and in futuro, that directors of a Delaware corporation may adopt a rights plan unilaterally.” Moreover, the issues raised were not terribly significant and could easily have been decided on their merits. Thus, the court’s emphatic invocation of stare decisis can only be seen as a deliberate action; one which would seem to lay the foundation for the invocation of the doctrine in the face of future, more substantial challenges to the poison pill. Certainly after Leonard Loventhal Account, if not before, it becomes difficult to imagine the Delaware Supreme Court reversing itself and invalidating the poison pill on any ground.

For a short while, it appeared as if the Delaware courts might be willing to give some real bite to their review of directors’ refusal to redeem poison pills in the face of a hostile tender offer. In a string of decisions from the Delaware Court of Chancery, a rule seemed to be developing that “an all-cash, all-shares [tender] offer, falling within a range of values that a shareholder might reasonably prefer, cannot constitute a legally recognized ‘threat’ to shareholder interests sufficient to withstand a Unocal analysis.” This argument has intuitive appeal. If an offer is non-coercive, shareholders are free to decide whether or not to sell their shares—a decision they face every day as investors. Ultimately, however, it was not to be. In Time, the Delaware Supreme Court explicitly “disapprove[d] of such a narrow and rigid construction of Unocal.”

In Time, Time had negotiated a strategic “merger of equals” with Warner Communications, Inc. when Paramount initiated an all-cash, all-shares tender offer for Time. In order to protect the initial transaction, Time restructured the merger with Warner into an acquisition of Warner. Paramount responded in turn with an increase in

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90. Id. at 250.
91. Id. at 249. In fact, it does not seem at all clear that Moran would be emasculated. If directors may adopt the plan, the fact that some shareholders may reject the benefits thereof is a rather minor limitation to the directors’ power—one that shareholders in any event enjoy in substance by being able not to exercise any Rights that they may hold.
92. Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 278, 289 (Del. Ch. 1989) (“It is difficult to understand how, as a general matter, an inadequate all cash, all shares tender offer, with a back end commitment at the same price in cash, can be considered a continuing threat under Unocal.”); Grand Metropolitan, PLC v. Pillsbury Co., 558 A.2d 1049, 1058-60 (Del. Ch. 1988) (“I emphasize, that the only ‘threat posed’ here is to shareholder value—nothing whatever affects the corporate entity or any other constituency . . . . I conclude that the Board’s decision to keep the Pill in place was not reasonable in relationship to any threat posed . . . .”); City Capital Assoc. v. Interco, Inc., 551 A.2d 787, 799 (Del. Ch. 1988) (“I conclude that reasonable minds not affected by an inherent, entrenched interest in the matter, could not reasonably differ with respect to the conclusion that the CCA $74 cash offer did not represent a threat to shareholder interests sufficient in the circumstances to justify, in effect, foreclosing shareholders from electing to accept that offer.”); Paramount Communications v. Time Inc., 571 A.2d 1140, 1152 (Del. 1990); see also AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 112-13 (Del. Ch. 1986) (“There is no evidence that the BS/G offer—which is non-coercive and at a concededly fair price—threatens injury to shareholders or to the enterprise.”); Id. at 113 (“[Assuming it poses a minimal threat], it is not reasonable in relation to such a ‘threat’ . . . to preclude as a practical matter shareholders from accepting the BS/G offer.”).
93. Time, 571 A.2d at 1152.
94. Id. at 1153.
its tender offer price and a lawsuit. Paramount argued in court that “an all-cash, all-shares offer with values reasonably in the range of acceptable price cannot pose any objective threat to a corporation or its shareholders.” The Delaware Supreme Court disagreed. Among the threats posed by the Paramount tender offer that the court was willing to recognize were “inadequate value” and “substantive coercion” — i.e., the “concern... that Time shareholders might elect to tender into Paramount’s cash offer in ignorance or a mistaken belief of the strategic benefic which a business combination with Warner might produce.”

The significance of *Time* should not be underestimated, and is considered at length later in this Article. For present purposes, it is sufficient to recognize that *Time* allows directors significant additional flexibility in determining whether a hostile bid poses a threat to the company. This makes the poison pill that much more effective as a defense against a hostile bid.

The first and only real setback to the poison pill in Delaware came in late 1998, in the case of *Quickturn Design Systems, Inc. v. Shapiro.* In that case, Mentor Graphics Corp. made an all-cash, all-shares tender offer for Quickturn Design Systems, Inc. Quickturn responded by amending its poison pill to include a “delayed redemption” provision, also known as a “no hand” provision. Under the delayed redemption provision, the current board of directors would be permitted to redeem the Rights, but any newly appointed board of directors would be unable to do so for six months. The court noted that “the justification or rationale for adopting the Delayed Redemption Provision was to force any newly elected board to take sufficient time to become familiar with Quickturn and its value, and to provide shareholders the opportunity to consider alternatives, before selling Quickturn to any acquiror.” In fact, the provision was designed to deter hostile bidders by extending the amount of time required for a takeover.

95. *Id.* at 1152.
96. The Delaware Supreme Court would not use the term “substantive coercion” until *Unitrin Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1384 (Del. 1995), but it first accepted the concept in *Time*.
97. *Time*, 571 A.2d at 1153. Other concerns noted by the court included the conditionality of Paramount’s offer, which depended inter alia upon the termination of the merger agreement, *id.* at 1147, and the timing of the offer, “viewed as arguably designed to upset, if not confuse, the Time shareholders,” *id.* at 1153.
98. *See infra* Part III.B.2.
100. In addition to adopting a delayed redemption provision for its poison pill, Quickturn also amended its bylaws, delaying the date for any special meeting at which its directors could be replaced. *Id.* at 1287.
101. The court described the effect of the provision as follows: “[I]f a majority of the directors are replaced by stockholder action, the newly elected board cannot redeem the rights for six months if the purpose or effect of the redemption would be to facilitate a transaction with an ‘Interested Person.’” *Id.* at 1289.
102. *Id.* at 1290 (quotations and citation omitted).
103. *See Letsou, supra* note 68, at 1114 (“all dead-hand and no-hand provisions ... have the same purpose: making it more difficult, or even impossible, for the bidder to use a proxy contest for control of the corporation’s board to secure the power necessary to redeem the corporation’s poison pill”). Because of the poison pill, a hostile bidder must first wage a successful proxy contest in order to replace the board of directors and redeem the Rights. Without a delayed redemption provision, the hostile bidder could redeem the Rights immediately after replacing the board of directors and then proceed with the acquisition. With the introduction of a delayed redemption provision, the hostile bidder would have to wait six months before redeeming the Rights and proceeding with the acquisition.
The Delaware Court of Chancery had struck down the delayed redemption provision under the *Unocal* test as an unreasonable response to a perceived threat. The Delaware Supreme Court, however, struck down the provision as contrary to fundamental corporate law. It noted that section 141 of the Delaware General Corporation Law requires that any exception to the rule that the board of directors shall manage the corporation must be set out in the certificate of incorporation, not in a mere contract such as the Shareholder Rights Plan. The fact that the delayed redemption provision would prevent a newly elected board from fulfilling its fiduciary duties in such an important matter as a hostile tender offer required that the provision be declared unenforceable.

While decided under the rubric of directors’ powers, the significance of the *Quickturn* decision lies in its sustenance of the proxy contest as a way around the poison pill. As mentioned earlier, the significance of the proxy contest was apparent to the court even in the original *Moran* decision. Since then, the court had repeated “its concern about defensive actions designed to thwart the essence of corporate democracy by disenfranchising shareholders.” In *Quickturn*, the court demonstrated its willingness to uphold shareholder voting rights against excessive interference by an overzealous management.}

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One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. Section 141(a) requires that any limitation on the board’s authority be set out in the certificate of incorporation. The *Quickturn* certificate of incorporation contains no provision purporting to limit the authority of the board in any way. The Delayed Redemption Provision, however, would prevent a newly elected board of directors from completely discharging its fundamental management duties to the corporation and its stockholders for six months. While the Delayed Redemption Provision limits the board of directors’ authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board’s power in an area of fundamental importance to the shareholders—negotiating a possible sale of the corporation. Therefore, we hold that the Delayed Redemption Provision is invalid under Section 141(a)....

105. *Id.* at 1292.

This Court has held “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.” The Delayed Redemption Provision “tends to limit in a substantial way the freedom of [newly elected] directors’ decisions on matters of management policy.” Therefore, “it violates the duty of each [newly elected] director to exercise his own best judgment on matters coming before the board.”

... In *Revlon*, this Court held that no defensive measure can be sustained when it represents a breach of the directors’ fiduciary duty. *A fortiori*, no defensive measure can be sustained which would require a new board of directors to breach its fiduciary duty.

106. *See supra* notes 72-74 and accompanying text.


108. The *Blasius* doctrine requires a compelling justification for defensive action with the primary purpose of interfering with the exercise of the shareholder franchise. *Stroud*, 606 A.2d at 92 & n.3; *Blasius Indus.*, 564 A.2d at 659-63.

It should be noted, however, that the Delaware courts have by no means adopted a “zero tolerance” rule. The Delaware Supreme Court has noted that “boards of directors often interfere with the exercise of shareholder voting when an acquirer launches both a proxy fight and a tender offer.” *Unitrin*, 651 A.2d at 1379.
B. The Poison Pill Elsewhere

The legal history of the poison pill outside of Delaware has been more eventful than in Delaware, but it has also been more glorious. Early on, there was disagreement among the courts, with a number of cases finding the poison pill to be ultra vires and others upholding its validity. Ultimately, those cases upholding the validity of the pill won out, and even in states where the pill was declared ultra vires, the legislatures responded by giving corporations the authority to adopt such devices.

1. Invalidating the Poison Pill

The leading case among those invalidating the poison pill was *Amalgamated Sugar Co. v. NL Industries, Inc.* The case was among the first to involve a flip-in pill. Its determination centered on the discriminatory features of the flip-in provision.

*NL Industries* was a federal district court case applying New Jersey state law. In that case, NL Industries, Inc. had been suffering in the stock market and had recently survived a hostile takeover attempt by a third party. As a response, in anticipation of other hostile bids, the board of directors adopted a poison pill with a flip-in provision. Under the *NL Industries* variant, the first trigger was “an announcement that a shareholder held 20 percent or more of [NL Industries] common [stock] or that a tender offer was to be commenced for 30 percent or more of [NL Industries common] stock.” The consequences of the first trigger were that the Rights would detach and become non-redeemable. While the Rights were now exercisable for an interest in newly issued junior preferred stock, the exercise price was high and so the Right was “out of the money.”

It was only the occurrence of the second trigger, which included mergers and similar transactions, as well as increases in the acquiror’s ownership interest, that gave the Rights economic value under the flip-in provision.

Amalgamated Sugar sought to acquire NL Industries. When NL Industries rejected the advances and refused to redeem the Rights, Amalgamated Sugar sued for an injunction. A few days later, Amalgamated Sugar announced that its holdings in NL Industries had exceeded 20 percent, thereby pulling the first trigger of the poison pill. At this point, the Rights became non-redeemable. This fact figured prominently in the court’s decision.

The district court held that

the rights plan, and in particular the flip-in provision of that plan, . . . is *ultra vires* as a matter of New Jersey Business Corporation Law. The flip-in effects a discrimination among shareholders of the same class or series. . . .

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(citing *Stroud*, 606 A.2d at 92 n.3). Nevertheless, the court has held that the *Blasius* doctrine “is quite onerous, and is therefore applied rarely.” *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996).

110. See infra Part I.B.2.
112. Id. at 1232.
113. Id.
114. “[U]nder the second trigger, all right’s [sic] holders, except the acquiring person, are entitled to purchase $100 worth of [NL Industries] common stock for $50, and the acquiring person’s rights become void.” Id.
New Jersey law clearly does not allow discrimination among shareholders of the same class and series.115

The district court found discrimination in a couple of ways. First, with respect to voting rights: “Given a trigger, there suddenly exists votes that did not exist before which have the effect of upsetting normal corporate structure.”116 With respect to dividend rights, the court said that “[t]he 20 percent shareholder, and all other shareholders, received a dividend [i.e., the Rights]. Once there is a second trigger what they received changes in value according to whom the shareholder is.”117

The district court went on to distinguish Moran.118 First, the district court noted that the poison pill in Moran was not discriminatory: all shareholders received flip-over rights.119 The district court then noted that the “sham” argument—“that the right was designed never to be exercised”120—fared better in this case. Although the first trigger had, in fact, been pulled, the dilutive effect of the flip-in provision is so great that “no one in his right mind will ever tender in the face of this plan.”121

Because of the way the poison pill was structured in NL Industries, all parties, not just Amalgamated Sugar, would be precluded from acquiring NL Industries. The district court considered this a “key distinction.”122 It opined that “[i]f this board of directors instead of adopting this rights plan had adopted a rule that no tender offers will be permitted, it would clearly be beyond their power, and yet that is the situation that exists today, that there is no tender offer possible by anyone within the next ten years.”123 The district court concluded that, in contrast to Moran, there was no longer any way around the poison pill in this case. Even the option of waging a proxy contest to replace the directors was unavailable because the Rights were no longer redeemable.124

Finally, the district court also noted that the advantages of the flip-over poison pill cited by the Moran court125 were inapplicable, stating that “[w]ith respect to this plan, the flexibility of the board is certainly impaired and . . . the plan certainly dilutes earnings per share so far as the acquiror is concerned.”126 Thus, the district court struck down the flip-in pill. In doing so, it found the logic of the Moran case, validating the flip-over pill, to be inapplicable to the flip-in provisions of newer poison pills.

NL Industries was not an isolated case and would prove persuasive in a number of subsequent cases. Over the next few years, a number of other courts would follow its lead.

115. Id. at 1234.
116. NL Indus., 644 F. Supp. at 1236.
117. Id.
119. NL Indus., 644 F. Supp. at 1237 (“[T]he rights plan challenged in Moran v. Household did not contain a provision for voiding certain rights and increasing others.”). Nevertheless, a non-discriminatory flip-over pill has essentially the same effect as a discriminatory one. See infra note 173 and accompanying text.
120. NL Indus., 644 F. Supp. at 1237.
121. Id. at 1238.
122. Id. (“The court in Moran—and I regard this as a key distinction between what was before that court and what is before this court—stated ‘we do not view the rights plan as much of an impediment on the tender offer process.’”).
123. Id. at 1238-39.
124. Id. at 1238.
125. See supra note 77 and accompanying text.
126. NL Indus., 644 F. Supp. at 1239.
and invalidate flip-in provisions of poison pills.\(^{127}\) However, the weight of authority would remain in favor of the poison pill, and legislative developments would make NL Industries' impact ephemeral.

2. Upholding the Poison Pill

The case law upholding the poison pill outside of Delaware is not a particularly interesting body of law. As is often the case in corporate law matters, courts often turned to Delaware in assessing the validity of the poison pill. Therefore, the themes found in those decisions often echo those found in the Moran decision. For example, courts often distinguish between the validity of adopting a poison pill and refusing to redeem it in the face of a particular tender offer.\(^{128}\) Some courts found the poison pill to be a reasonable response to the threat posed.\(^{129}\) Some courts note that the poison pill is acceptable because it will not block all hostile offers.\(^{130}\) The impact of Moran in such cases is undeniable.

However, the Moran decision is not the only influence evident in these cases. For example, many cases relied on standard corporate law doctrines such as the business judgment rule.\(^{131}\) Along entirely different lines, some courts focused explicitly on the need for the laws of the given state to remain competitively flexible with those of other states.\(^{132}\) Moreover, in certain respects, other courts have actually taken steps ahead of

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128. See, e.g., Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 850 (D. Minn. 1986) (“Given these concerns, keeping the Rights Plan in place was a reasonable course of action.”); Copeland Enter., Inc. v. Guste, 706 F. Supp. 1283, 1291 (W.D. Tex. 1989) (“The validity of the poison pill . . . can be viewed in two contexts: its validity at the time of adoption and its continued validity in light of events subsequent to adoption.”).

129. See, e.g., Harvard Indus., Inc. v. Tyson, 1986 WL 36295, at *2 (E.D. Mich. Nov. 25, 1986) (“The rights plan is a reasonable response to the threat posed.”); Gelco, 652 F. Supp. at 849 (“The Board's refusal to redeem the Rights Plan was clearly a reasonable response to the hostile bid, which the Board . . . concluded was inadequate from a financial point of view.”).

130. Harvard Indus., 1986 WL 36295, at *2 (“It is not a total blockade to those who seek to acquire the corporation.”); Gelco, 652 F. Supp. at 849 (“At least some of [Moran's] options appear possible under Gelco's plan.”).


132. Georgia-Pacific Corp. v. Great N. Nekoosa Corp., 728 F. Supp. 807, 811 (D. Me. 1990) (“Denying Maine corporations access to one of the most common defensive measures used in corporate takeover battles is the antithesis of affording corporations ‘the greatest possible flexibility with [their] structures and procedures.’”). Cf. Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986) (“[W]e hesitate to
Delaware.

As mentioned earlier, Delaware had not specifically embarked on an evaluation of the discriminatory aspects of the flip-in pill and the back-end pill.\textsuperscript{133} It is virtually axiomatic that shares of the same class and series must be treated equally, and many state corporation statutes make this an express requirement.\textsuperscript{134} Thus, it was not at all clear that a discriminatory poison pill should be permitted, and Delaware had not spoken on the matter. Yet a number of courts turned to other Delaware case law to uphold discriminatory poison pills.

The Delaware case relied on by other courts was \textit{Providence & Worcester Co. v. Baker}.\textsuperscript{135} In that case, the Providence & Worcester Co. charter provided for unequal voting rights among shareholders: share ownership beyond a certain level would carry reduced voting power.\textsuperscript{136} The Supreme Court of Delaware upheld the provision, assessing it as follows:

In the final analysis, these restrictions are limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock \textit{per se}. The voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding.\textsuperscript{137}

The ruling in \textit{Providence & Worcester}, however, was based on statutory language, which specifically permitted this type of arrangement.\textsuperscript{138} The court went on to describe the history of corporate voting rights under Delaware law, demonstrating that charter provisions of this type were well-established.\textsuperscript{139}

A number of courts have read this case to stand for the broad proposition that discrimination among shareholders is not the same thing as discrimination among shares.\textsuperscript{140} No effort was made by such courts to read \textit{Providence & Worcester} in its

\textsuperscript{133} See supra text accompanying notes 82-86.
\textsuperscript{134} See, e.g., \textsc{model bus. corp. act $\S\$ 6.01-.02} (1999).
\textsuperscript{135} 378 A.2d 121 (Del. 1977).
\textsuperscript{136} The relevant portion of the company’s charter is set forth at infra text accompanying note 159.
\textsuperscript{137} \textit{Providence & Worcester}, 378 A.2d at 123.
\textsuperscript{138} “Under \S 121(a), voting rights of stockholders may be varied from the ‘one share–one vote’ standard by the certificate of incorporation . . .” \textit{Id.}
\textsuperscript{139} \textit{Id.} at 123-24.
\textsuperscript{140} See, e.g., Georgia-Pacific Corp. v. Great N. Nekoosa Corp., 728 F. Supp. 807, 810 (D. Me. 1990) (“Delaware courts have long distinguished between discrimination among shareholders and discrimination among shares, finding the former permissible . . .”); Harvard Indus., Inc v. Tyson, 1986 WL 36295, at *1 (E.D. Mich. Nov. 25, 1986) (“[T]he position of the better-reasoned cases is that such a rights plan does not discriminate among shares but, rather, among shareholders, which is not forbidden.”); Gelco Corp. v. Coniston Partners, 652 F. Supp. 829, 848 (D. Minn. 1986) (“Delaware corporate law . . . permits discrimination in rights within a single class of stock.”); Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986) (“The Delaware Code forbids discrimination, and the Delaware courts have construed this to mean discrimination between shares, not shareholders.”).

One court has gone even further, holding that there is no discrimination at all:

The rights involved do not discriminate between shareholders. Anyone who owns a share . . . possesses the right which is attached. Every shareholder who does not undertake a triggering event may exercise those rights to purchase shares at half price. Every shareholder who undertakes a
This broad interpretation has provided such courts with an avenue for upholding discriminatory poison pills:

[S]ince a pill discriminates against a particular class of stockholder—namely, one who has acquired a specified level of stock ownership without board approval—rather than that stockholder's shares—which, in the hands of any unaffiliated transferee, confer full entitlement to exercise the associated rights—it does not violate the equal treatment rule.  

More interesting than the case law is the legislative support that developed in support of the poison pill outside of Delaware. In each of the cases where the corporate law had been interpreted to invalidate the poison pill, the state legislatures passed laws authorizing their use. Moreover, in many other states the legislatures also passed laws specifically authorizing the use of poison pills. Clearly the legislatures of various states have made it clear that poison pills are to be permitted.

As a result, such states have proven significantly more tolerant of poison pill variations than has Delaware. While Delaware courts have invalidated "dead hand" and "no hand" provisions in cases such as Quickturn, those provisions have been upheld in other jurisdictions. Thus, companies in certain states have been considered "takeover proof."  

As the law currently stands, then, the validity of the poison pill is not in question. This is true not only of the flip-over pill, but also of the more deadly flip-in pill and the back-end pills. Thus, the real legal issue with respect to poison pills is not their validity, but rather the circumstances, if any, under which a court will order the target company to triggering event is precluded from exercising the rights. The rights plan gives all ... shareholders equal protection from takeovers.


141. The failure to read Providence & Worcester in context is a fatal error. See infra Part II.A.

142. 1 TAKEOVER DEFENSE, supra note 5, § 5.06[B][1], at 5-114 to -115.

143. "In states where pre-existing corporate law had been held to preclude discriminatory pills (e.g., Colorado, Georgia, New Jersey, New York, Virginia, and Wisconsin), these statutes directly overturned those court rulings." 1 TAKEOVER DEFENSE, supra note 5, § 5.06[B][2], at 5-117. See, e.g., COLO. REV. STAT. § 7-106-205 (1999); GA. CODE ANN. § 14-2-624(c) (1994); N.J. REV. STAT. § 14A:7-7 (2001); N.Y. BUS. CORP. LAW § 505(a)(2) (McKinney 2001); VA. CODE ANN. § 13.1-646 (Michie 1999); WIS. STAT. § 180.0624 (1999).

144. 1 TAKEOVER DEFENSE, supra note 5, § 5.06[B][2], at 5-116 to -117 (citing statutes).


147. See, e.g., Chesapeake Corp. v. Shore, 771 A.2d 293, 303 (Del. Ch. 2000). While a "no hand" or delayed redemption provision simply delays a bidder's ability to replace the board and redeem the poison pill, see supra notes 100-101 and accompanying text, a "dead hand" provision eliminates the bidder's ability to do so—only the incumbent board may redeem the Rights, see 1 TAKEOVER DEFENSE, supra note 5, § 5.05[G], at 5-101 to -102.

148. There are many variations on the poison pill. It is possible that a court will find certain variations to be invalid, as the Delaware courts have with delayed redemption provisions. See supra notes 99-108 and accompanying text. However, standard flip-in, flip-over, and back-end provisions are not in question, and many variations are unlikely to raise serious concerns.
pull the pill in the face of a hostile takeover.149

II. THE INVALIDITY OF THE POISON PILL

The legality of the poison pill is well-established.150 However, while the courts in Delaware and many other states have clearly upheld the poison pill, this Part considers the question of whether they should have done so. It concludes that they should not have, and that the poison pill should have been declared ultra vires. The discriminatory feature of the flip-in pill and the back-end pill should have been held unauthorized under the laws of most states. In addition, the non-discriminatory flip-over pill suffers serious legal infirmities of its own. In fact, every poison pill at some point becomes non-redeemable and thus raises serious problems, at least under Delaware law. Thus, the courts should not have upheld the poison pill in virtually any form. After defending these positions, this Part nevertheless concludes that such arguments are doomed to failure in light of judicial and legislative acceptance of such devices. It will take significantly more than ultra vires arguments to persuade the states.

A. Discrimination Among Shareholders

The flip-in pill and back-end pill are most susceptible to the criticism that they impermissibly discriminate among shares of the same class151 by granting meaningful Rights to some shareholders and meaningless Rights to others.152 This is problematic because, while most state corporation laws permit shares of different classes to have different rights, they forbid, either explicitly or implicitly, discrimination among shares of the same class.153 Most courts that have struck down the poison pill have done so on this

149. See I TAKEOVERS & FREEZEOUTS, supra note 4, § 6.03[4], at 6-59 ("[A]lmost all litigation concerning rights plans now focuses on whether or not a board of directors should be required to redeem the rights in response to a particular bid.").

150. "There is now no doubt as to the legality of the poison-pill rights plans. The "flip-in" feature of the plan was held, in some early cases, to violate state corporate law. These rulings, however, have now been overruled, either judicially or by legislation explicitly authorizing the flip-in." Id. § 6.03[4], at 6-59.

151. Most states authorize shares of the same class to be issued in different series, with different rights being afforded to shares of each series. See DEL. CODE ANN. tit. 8, § 151(a) (2001); MODEL BUS. CORP. ACT § 6.02 (1999). Thus, the technically accurate claim would be that discrimination among shares of the same class and series is impermissible. However, for the sake of convenience, the text will refer only to shares of the same class, assuming that the given class has not been issued in series—as is generally the case with common stock. The logic of the argument would not be affected by the existence of multiple series of a class of stock.

152. See, e.g., supra notes 115-117 and accompanying text.

153. See MODEL BUS. CORP. ACT §§ 6.01-.02 (1999) ("All shares of a class [and series] must have preferences, limitations, and relative rights identical with those of other shares of the same class [and series]."). The Delaware General Corporation Law contains no such provision. However, Delaware courts have generally accepted the principal as a matter of common law. See, e.g., In re Sea-Land Corp. S'holder Litig., 642 A.2d 792, 799 n.10 (Del. Ch. 1993) ("It has long been acknowledged that absent an express agreement or statute to the contrary, all shares of stock are equal.") (citing cases); see also 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS & BUSINESS ORGANIZATIONS § 5.4, at 5-7 (3d ed. 1999) ("At common law, and in the absence of any statute or agreement to the contrary, all stocks enjoy equal rights and privileges.") (quoting Sullivan Money Mgmt., Inc. v. FLS Holdings, Inc., C.A. No. 12731, slip op. at 5 n.6 (Del. Ch. Nov. 20, 1992); 1 RODMAN WARD, JR., EDWARD P. WELCH & ANDREW J. TUREZYN, FOLK ON THE DELAWARE GENERAL CORPORATION LAW § 151.5.1, at GCL-V-21 (4th ed. 1999) (citing cases).
Delaware courts have never directly dealt with this issue. However, other courts that have dealt with the issue have argued that poison pills do not discriminate among shares (which is forbidden), but only among shareholders (which is not forbidden). Interestingly enough, this distinction was premised on Delaware law. In particular, courts have cited the case of *Providence & Worcester Co. v. Baker* for the proposition that, while discrimination among shares of the same class may be forbidden, discrimination among shareholders of the same class is permissible. However, the case does not support the distinction.

In *Providence & Worcester*, plaintiffs challenged a provision in the company’s charter that limited the voting power of larger shareholders. In particular, each stockholder [was] entitled to one vote for every share of the common stock of said company owned by him not exceeding fifty shares, and one vote for every twenty shares more than fifty, owned by him; provided that no stockholder [was] entitled to vote upon more than one fourth part of the whole number of shares issued and outstanding of the common stock of said company. The court did uphold these provisions as “limitations upon the voting rights of the stockholder, not variations in the voting powers of the stock per se.” However, it did so on very narrow grounds. There are at least three reasons why the holding in *Providence & Worcester* cannot be applied to the poison pill.

First, *Providence & Worcester* dealt with voting rights, not dividend rights. The distinction is significant because the discrimination was justified specifically with respect to voting rights. The court noted that such discrimination among voting rights was historically common and specifically authorized by state statutes. The case offers no

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154. *See supra* note 127 and accompanying text.
155. *See supra* text accompanying notes 82-86, 133.
156. *See supra* notes 135-142 and accompanying text.
158. *See supra* note 140.
159. Providence & Worcester, 378 A.2d at 121 n.2.
160. *Id.* at 123.
161. *Id.*
suggestion that its holding would apply to any matter other than voting rights. It certainly could not apply to dividend rights.

Where the history of voting rights clearly supports the concept of discrimination among shareholders, the history of dividend rights does not. A corporation does not generally have the power to discriminate among shareholders of the same class in terms of dividends,\$162 and never has.\$163 Thus, Providence & Worcester simply cannot support

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162. See In re Sea-Land Corp. S'holders Litig., 642 A.2d 792, 799 n.10 (Del. Ch. 1993) ("It has long been acknowledged that absent an express agreement or statute to the contrary, all shares of stock are equal. . . . Flowing from that premise is the rule that all shares of the same class or series are equally entitled to share in the profits of the corporation and in the distribution of its assets on liquidation."); see also 11 WILLIAM MEADE FLETCHER, FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5352, at 733-34 (perm. ed., rev. vol. 1995) [hereinafter FLETCHER, CYCLOPEDIA CORPORATIONS] ("Dividends among shareholders of the same class generally must be distributed on a pro rata basis without discrimination or preference. In other words, the board of directors cannot pay dividends only to certain shareholders to the exclusion of others of the same class, give certain shareholders more than others of the same class, or pay certain shareholders cash and others of the same class by another method."); 18 C.J.S. Corporations § 298.c (1990) ("Unless the charter provides otherwise, no discrimination can be made between stockholders of the same class as to the amount of the dividend, the time of its payment, or the form in which it is made payable.") (citations omitted); 18B AM. JUR. 2D Corporations § 1220 (1985) ("Discrimination between stockholders of the same class in declaring and paying dividends is not within the legal discretion of the officers of a corporation, and the directors have no legal right to discriminate between them.") (citations omitted). But see 11 FLETCHER, CYCLOPEDIA CORPORATIONS, supra, § 5352, at 734 ("Shareholders of closely-held corporations may unanimously agree upon a scheme other than pro rata distribution. Courts also have upheld bylaws that authorize unequal dividend payments to shareholders.").

163. See HENRY WINTHROP BALLENTINE, BALLENTINE ON CORPORATIONS § 159, at 518 (1927) ("A corporation has no right in paying dividends, to exclude any stockholder, or to discriminate between stockholders."); 6 WILLIAM MEADE FLETCHER, Cyclopedia of the Law of Private Corporations § 3674, at 6111-12 (1919) ("Dividends among stockholders of the same class must always be pro rata, equal, and without discrimination or preference. . . . So the directors cannot discriminate by voting a dividend to certain shareholders only, to the exclusion of others of the same class, or by giving certain stockholders more than others of the same class, or by providing for the payment of some of the stockholders in money and others in bonds."); CHARLES B. ELLIOTT, LAW OF PRIVATE CORPORATIONS § 407, at 430-31 (1900) ("When not restricted by charter the manner of paying a dividend is under the control of the directors and may be in cash, property or in dividend stock. . . . But there can be no discrimination between stockholders, and this applies to stock which has not been paid in full."); W.L. CLARK, JR., PRIVATE CORPORATIONS § 137(e), at 348 (1897) ("The profits of a corporation are to be distributed pro rata among those who are its stockholders at the time when the dividend is declared, no matter when the profits may have been earned, and without regard to the length of time particular members may have been stockholders. . . . [I]t is . . . well settled that the directors in declaring dividends have no right to discriminate between stockholders, unless the contract under which particular shares were issued gives them the right."); B. VAUGHAN ABBOTT & AUSTIN ABBOTT, DIGEST OF THE LAW OF CORPORATIONS 302 (1869) ("The officers of a corporation, when they undertake to declare a dividend, are bound to make it equal and just among all those interested. If they attempt to make an unjust discrimination, giving one class of stockholders an unfair advantage over another, a court of equity has power to interfere to correct the wrong.").
the proposition that discrimination among shareholders is generally permissible. The dividend rights involved in the poison pill are fundamentally different than the voting rights involved in *Providence & Worcester*.

Second, *Providence & Worcester* dealt with rights that truly only discriminated among shareholders rather than shares. As the court observed, "[t]he voting power of the stock in the hands of a large stockholder is not differentiated from all others in its class; it is the personal right of the stockholder to exercise that power that is altered by the size of his holding." 164 In other words, if the large shareholder sold his shares, the new shareholder would have the right to one vote per share. 165 This is because the actual shares are not affected. The same cannot be said of poison pill Rights.

Poison pill Rights become permanently altered when a triggering event occurs. 166 The Rights of the acquiror become void, not merely non-exercisable in its hands. The acquiror cannot even sell his Rights to others who could exercise them because the Rights become non-transferable. Thus, it is difficult to see how the poison pill can be characterized as discrimination merely among shareholders and not among shares. The discrimination involved with the poison pill is fundamentally different than that involved in *Providence & Worcester*.

Finally, *Providence & Worcester* dealt with a charter provision, whereas the poison pill involves only a board resolution. The charter establishes the rights of shareholders, 167 so a holding that charter provisions may affect the rights of shareholders is unremarkable. Shareholders are protected by the fact that they must consent to charter amendments. 168 Thus, a poison pill might be acceptable if it were included in, or permitted by, a company’s charter. As a mere board resolution, however, it is unacceptable.

Poison pill Rights, if exercised, clearly effect a drastic change in the corporate control structure. 169 They redistribute the equity interest and voting power among shareholders of the same class. 170 Such a significant change cannot be permitted without a charter amendment. Thus, the poison pill exceeds the authority of the board of directors. The dynamic involved in the poison pill is fundamentally different than that involved in *Providence & Worcester*.

The notion that discrimination among shareholders should be acceptable when discrimination against shares of the same class is prohibited is deeply problematic. The point of a prohibition against discrimination among shares of the same class is to prevent discrimination against any shareholder. It is never the share against which management would like to discriminate; it is the shareholder. The prohibition was intended to prevent such discrimination. Only sophistry will support a distinction between shares and shareholders, and the distinction renders the non-discrimination rule meaningless.

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165. The new shareholder would have normal voting rights assuming he held fifty or fewer shares. Any larger holdings would subject the new shareholder to the same voting restrictions.
166. See *Takeovers & Freezeouts*, supra note 4, § 6.03[4][b], at 6-61 to -62.
167. DEL. CODE ANN. tit. 8, § 151(a) (2001).
168. See id. § 242(b) (2001); see also id. §§ 251-253 (mergers require shareholder approval).
169. Amalgamated Sugar Co. v. NL Indus., 644 F. Supp. 1229, 1236 (S.D.N.Y. 1986) ("Given a trigger, there suddenly exist votes that did not exist before which have the effect of upsetting normal corporate structure.").
170. Id. at 1233 ("[T]he flip-in provision . . . subjects an acquiring person’s interests, voting rights and equity, to discriminatory dilution.").
As the preceding analysis reveals, the Providence & Worcester holding is not as potent as some courts have maintained. Instead of supporting the broad notion that a corporation may freely discriminate among its shareholders, it stands only for the limited proposition that shareholder voting rights may be limited in the corporate charter. This narrower holding cannot be used to sustain discriminatory poison pills.

Reliance on Providence & Worcester to uphold discriminatory poison pills is particularly disconcerting when it occurs outside of Delaware. This is because, while the Delaware General Corporation Law does not have a provision expressly prohibiting discrimination among shares of the same class, many states' corporation laws do. Thus, while perhaps Delaware courts could expand Providence & Worcester to adopt the broad reading proposed by other courts, many other state courts have far less liberty to do so. Yet many such states have taken Providence & Worcester and expanded its holding in the face of an express statutory prohibition against discrimination. In the case of the poison pill at least, this is wholly inappropriate.

B. Rights in Another Company

Unlike the flip-in pill and the back-end pill, the flip-over pill does not (or at least need not) discriminate among shareholders. This is because the flip-over Right—the right to purchase shares of the acquiror's stock—is, by definition, meaningless in the hands of the acquiror and can therefore be granted indiscriminately without detriment to the target. Thus, the flip-over pill cannot be considered ultra vires on the same grounds as its discriminatory siblings can be. Nevertheless, the flip-over pill suffers from a serious defect of its own that likewise renders it ultra vires. The problem is that the flip-over pill grants rights to acquire shares of another corporation when it has no authority to do so.

The laws of many states, including Delaware, only authorize corporations to issue rights to purchase shares of the company's own stock. Under the principle of expressio unius est exclusio alterius—and simple common sense—corporations do not have authority to issue rights to purchase shares of another company's stock. Yet that is exactly what the flip-over pill does: it grants shareholders the right to buy shares in the

171. See supra note 153.
172. Because most modern poison pills contain both flip-in and flip-over provisions, see 1 TAKEOVER DEFENSE, supra note 5, § 5.01[B][1], at 5-7 to -8 ("Today, the prevalent version of the pill . . . is the standard 'flip-in/flip-over' stockholder rights plan."). flip-over poison pills generally are discriminatory. However, there is nothing inherent to the flip-over poison pill that requires such discrimination. See, e.g., Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (non-discriminatory flip-over pill).
173. Under the laws of many states, shares acquired by the issuing company are considered "authorized but unissued shares." MODEL BUS. CORP. ACT § 6.31(a) (1999). While Delaware does not treat treasury shares in the same way, the inevitable fact is that shares owned by a corporation redound to the benefit of all other shareholders equally. Thus, an exercise by an acquiror of its flip-over Rights cannot mitigate the effect of the exercise of the same Rights by others.
174. See DEL. CODE ANN. tit. 8, § 157 (2001) (" . . . every corporation may create and issue . . . rights or options entitling the holders thereof to purchase from the corporation any shares of its capital stock of any class or classes . . . "); see also MODEL BUS. CORP. ACT § 6.24 (1999) ("A corporation may issue rights, options, or warrants for the purchase of shares of the corporation.").
175. "A canon of construction holding that to express or include one thing implies the exclusion of the other, or of the alternative. For example, the rule that 'each citizen is entitled to vote' implies that noncitizens are not entitled to vote." BLACK'S LAW DICTIONARY 602 (7th ed. 1999).
acquiring company. Since this violates the express terms of the enabling statute, it is plainly ultra vires.

The Moran court addressed this argument and rejected it.\textsuperscript{176} The court concluded that since “anti-destruction” provisions\textsuperscript{177} in preferred stock have been upheld, the flip-over pill is equally valid.\textsuperscript{178} However, the Moran court did not provide much support for its conclusion. A more thoughtful assessment would have been appropriate.

Anti-destruction provisions grant rights to the stock of another company solely as a means to ensure the survival of the right-holders’ other legitimate rights in the face of a merger or similar transaction.\textsuperscript{179} The flip-over pill, by comparison, grants rights to the stock of another company as an independent right. There is a fundamental difference between the two that makes the latter a defensive mechanism rather than a legitimate business transaction. The Delaware court did not care for the distinction, stating that “[t]he fact that [flip-over pill rights] have as their purpose the prevention of coercive two-tier tender offers does not invalidate them.”\textsuperscript{180}

The court’s reasoning seems to be that, if the power exists, it can be used regardless of the company’s motivation. However appropriate this type of reasoning may be in other corporate law circumstances,\textsuperscript{181} it has no application here because, under the clear statutory language, the power does not exist. The statute only permits a company to issue rights for its own shares, not for the shares of other companies. Anti-destruction provisions are a judicially permitted exception to that rule.\textsuperscript{182} The exception itself may be of questionable legitimacy, given the clear statutory language, but it is only a minor exception for a right that is incidental to, and necessary in order to preserve, other valid rights. The flip-over pill, by contrast, is nothing more than a separate right to purchase shares in another corporation.\textsuperscript{183} Thus, it cannot be justified by reference to the anti-

\textsuperscript{176} Moran, 500 A.2d at 1352.

\textsuperscript{177} “A provision in a security protecting a shareholder’s conversion rights, in the event of a merger, by granting the shareholder a right to convert the securities into the securities that will replace the company’s stock when the merger is complete.” BLACK’S LAW DICTIONARY 91 (7th ed. 1999).

\textsuperscript{178} See Moran, 500 A.2d at 1352.

\textsuperscript{179} Id. at 1352 (“‘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.”); see also Noddings Inv. Group, Inc. v. Capstar Communications, Inc., 1999 WL 182568, at *4 (Del. Ch. Mar. 24, 1999) (“The purpose of such a paragraph is to prevent Warrant holders from losing the value of their Warrants through the sale of the company or similar actions.”); Mariner LDC v. Stone Container Corp., 729 A.2d 267, 275 (Del. Ch. 1998) (“[T]he purpose of an anti-destruction provision . . . is to protect the value of the conversion feature of the security.”).

\textsuperscript{180} Moran, 500 A.2d at 1352.

\textsuperscript{181} Form tends to prevail over substance more readily in corporate law than in most other areas of law largely because of the doctrine of independent legal significance, also known as the “equal dignities rule.” See Hariton v. Arco Elecs., Inc., 188 A.2d 123, 125 (Del. 1963).


\textsuperscript{183} Unlike an anti-destruction provision, a flip-over poison pill does not really protect a valid conversion
destruction provision exception. It was wholly inappropriate for the Moran court to use a limited exception as the basis for permitting conduct that blatantly violates the statutory language. The flip-over provision should have been declared ultra vires.

C. Redeemability Issues

An essential element of the poison pill structure is that the Rights be redeemable until a certain triggering event occurs and thereafter become non-redeemable.\(^{184}\) In the standard modern version of the poison pill, the Rights are redeemable until an acquiror passes a threshold ownership level, usually set between ten percent and twenty percent.\(^{185}\) Redeemability prior to the triggering event is necessary in order to permit the company to negotiate with the hostile bidder. If a favorable agreement can be reached, then the poison pill can be eliminated and the Rights can be redeemed. Non-redeemability after the triggering event is necessary in order to prevent the hostile bidder from avoiding negotiations, obtaining control of the company, and redeeming the Rights on its own.\(^{186}\)

In *Quickturn Design Systems, Inc. v. Shapiro*,\(^{187}\) a case discussed earlier in this Article,\(^{188}\) the Delaware Supreme Court addressed the fundamental importance of the redeemability of the Rights. In that case, Quickturn adopted a delayed redemption provision that would have prevented newly elected directors from redeeming the poison pill Rights for 180 days. Despite the plausible justification offered by the company,\(^{189}\) the court invalidated the provision because it would “impermissibly deprive any newly elected board of both its statutory authority to manage the corporation... and its concomitant fiduciary duty pursuant [thereof].”\(^{190}\)

If the holding of *Quickturn* is to be taken seriously, then the very foundation of the poison pill is in jeopardy. Professor Letsou made this concern clear in a recent article:

Read literally, this language from *Quickturn* bodes ill for all poison pills, not just poison pills with the no-hand feature invalidated in *Quickturn*. This is because *all* poison pills (including traditional poison pills that lack no-hand and dead-hand features) operate as limitations on future boards of directors’ powers to sell the company ... .\(^{191}\)

Once any poison pill becomes non-redeemable, as they all theoretically do at some point, the board of directors no longer has the power to effectively negotiate a transaction with the hostile bidder or any other purchaser.\(^{192}\) This raises the same concern for standard

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\(^{184}\) See 1 *TAKEOVER DEFENSE*, supra note 5, § 5.05[F], at 5-93 (“[T]he redemption feature proved critical to the pill’s resilience in the courts ... .”)

\(^{185}\) See 1 *TAKEOVERS & FREEZEOUTS*, supra note 4, § 6.03[4][b], at 6-60; 1 *TAKEOVER DEFENSE*, supra note 5, § 5.01[B][1], at 5-7.

\(^{186}\) See generally 1 *TAKEOVERS & FREEZEOUTS*, supra note 4, § 6.03[4][b], at 6-60 to -61.

\(^{187}\) 721 A.2d 1281 (Del. 1998).

\(^{188}\) See *supra* notes 99-108 and accompanying text.

\(^{189}\) See *supra* text accompanying note 102.

\(^{190}\) Quickturn, 721 A.2d at 1291.

\(^{191}\) Letsou, *supra* note 68, at 1124 (emphasis in original).

\(^{192}\) See id.
poison pills as the dead-hand and no-hand provisions raise, thus making all poison pills
equally suspect. While the Quickturn court clearly did not intend to invalidate all
poison pills, that is the natural result of its holding. This has lead Professor Letsou to
urge a very narrow interpretation of Quickturn. The inconsistency is largely negligible because it is avoidable. A court would not have to confront the issue until it became ripe. With respect to standard poison pills, this issue would not arise until after the poison pills were triggered. In other words, to raise the issue, a hostile bidder would have to be willing to gamble by triggering the poison pill and hoping that the courts provide a cure. It is unlikely that anyone would be willing to do so.

Nevertheless, such a risky endeavor has been undertaken once before. This occurrence is documented in Amalgamated Sugar Co. v. NL Industries, Inc. By pulling the first trigger, Amalgamated Sugar caused the Rights to detach, become exercisable (albeit "out of the money") and, more importantly, non-redeemable. As a result, all acquisitions—with Amalgamated Sugar or anyone else—became practically impossible. The court noted that:

[j]f this board of directors instead of adopting this rights plan had adopted a rule that no tender offers will be permitted, it would clearly be beyond their power, and yet that is the situation that exists today, that there is no tender offer
possible by anyone within the next ten years.\footnote{NL Indus., 644 F. Supp. at 1238-39.}

In that case, the court struck down the poison pill, assigning blame to the directors for providing that the Rights could become non-redeemable.\footnote{In their defense, the directors “argued that this whole problem was created by the plaintiffs in triggering the rights plan by buying up to and through the 20 percent limit, and they argue since the plaintiffs created this situation that is now before the court, they cannot be heard to complain.” Id. at 1239. The court rejected this argument, noting that “[t]here was a prior decision that was made that made that trigger an irreversible trigger and that was the board’s decision not to reserve the right to redeem with respect to a 20 percent shareholder.” Id.} \textit{NL Industries} thus addressed, twelve years earlier, the issue raised by the \textit{Quickturn} holding.

Because the poison pill has evolved in response to events such as those in \textit{NL Industries}, it is unlikely that the Delaware courts will face the same situation in the future. Most modern poison pills provide that Rights only become non-redeemable at the same time they become exercisable (and “in the money”).\footnote{See \textsc{1 Takeovers \\ & Freezeouts}, supra note 4, § 6.03[4][b], at 6-62 to -63.} Thus, one would have to risk the economic poison in order to raise the issue today. Nevertheless, the holdings of \textit{Quickturn} and \textit{NL Industries} reveal a fundamental flaw in the poison pill that ought to cause its invalidation as ultra vires.

\textbf{D. Ultra Vires Arguments Doomed to Failure}

Despite the force of the foregoing arguments, it must ultimately be conceded that attempts to invalidate the poison pill with ultra vires arguments are doomed to failure. It is clear that the courts, including the Delaware courts, are simply not receptive to such arguments. Moreover, the legislatures have proven even more protective of the poison pill, taking affirmative steps whenever the poison pill was jeopardized. If one were to persuade the courts of the invalidity of the poison pill, state legislatures would no doubt act quickly to resolve any problems. Few, if any, would argue that authorizing the poison pill is beyond the power of state legislatures. Thus, any attempt to deal with the problem of the poison pill must go far beyond ultra vires arguments.

\textbf{III. \textsc{The Enduring Illegitimacy of the Poison Pill}}

Although the courts should have declared the poison pill ultra vires, they did not. The chances of the courts doing so at this late date are slim. Thus, a persuasive argument must demonstrate that the current use of the poison pill is illegitimate, even assuming the poison pill is authorized. This Part attempts to do just that. It begins with a review of the historical justifications for the poison pill and argues that the most common justifications are entirely pretextual. It then turns to the \textit{Unocal} test, the judicial standard by which use of the poison pill is reviewed. After demonstrating that the \textit{Unocal} test has been watered down nearly to insignificance, it argues that the poison pill cannot withstand scrutiny even under its unexacting standards. In raising such arguments, it is hoped this Article will establish that the poison pill, as commonly employed today, is an illegitimate defensive mechanism.
A. Legitimate Uses of the Poison Pill

Two of the most common arguments made in favor of poison pills are first, that they permit the company to protect its shareholders from coercive offers, and second, that they permit the company to offer the shareholders an alternative that is superior to the hostile bidder's initial offer. While these goals may seem appropriate, closer examination reveals that they are mere pretenses.

The first argument in defense of poison pills is that they enable the company to protect its shareholders from coercive offers. The classic form of coercive offer is the two-tier, front-loaded tender offer:

In a two-tier, front-end loaded takeover bid, the bidder makes a first step cash tender offer for approximately fifty percent of the target's shares and then 'squeezes out' the remaining shareholders in a lower-priced 'back-end' merger. Two-tier bids can be highly coercive since the two-tier aspect of the bid stampedes shareholders into tendering (in the first step) out of the fear of receiving only the lower back-end consideration in the second-step merger.

Few would attempt to deny that such an offer is coercive. When a hostile bidder threatens shareholders with a coercive offer, it seems a reasonable response for the company to seek to protect its shareholders by implementing a poison pill.

However, the very existence of the poison pill has caused a radical transformation in the world of hostile takeovers. Two-tier, front-loaded tender offers have become virtually extinct precisely because they provide legitimate grounds for management to refuse to redeem the poison pill Rights.

By the late 1980s, coercive offers were already rare. In 1988, Professor Coffee addressed the concern over coercive offers as follows:

[A]n enormous body of academic writing has focused on the problem of coercion in takeovers. This literature has an undeniable theoretical elegance and is no doubt correct within its four corners, but the problem of coercion in takeovers nonetheless represents the hobgoblin of the law professors. In the real world, demonstrated examples of coercion remain as rare as confirmed sightings of the Loch Ness monster. Why? The answer is twofold: First, shareholders are more than able to protect themselves against bidder coercion through self-help remedies, such as "fair price" charter amendments or the more controversial "poison pill" shareholder rights plans. Market solutions have probably been even more effective, as competitive auction markets have largely
more common today is the all-cash, all-shares offer with a commitment to squeeze-out remaining shareholders at the same price. Such an offer is entirely non-coercive: shareholders can freely decide not to tender in the first stage, comfortable in knowing that even if the hostile bidder should gain control, they would be no worse off than if they had tendered.

If the poison pill were truly about coercion, directors would be consistently redeeming the poison pill Rights in the face of non-coercive offers. But directors do not. They continue to find reasons to resist fully non-coercive offers. Thus, whatever its original purpose may have been, the poison pill today is simply not about protecting shareholders from coercive offers.

The second argument in defense of the poison pill is that it allows the company to solved or mitigated the problem of two-tier or low premium bids. In short, the simplest remedy for an inadequate bid is for the target to seek a higher one within the active and liquid market for corporate control; as a last resort, management, itself, can always create an auction by making a self-tender. Given these alternatives, the view that shareholders are exposed to a high potential for coercion is probably the first and greatest myth in this field. The reality is that, if anything, shareholders tend to be overprotected by managers who have excessive incentives to fortify the battlements and deepen the moats around their corporate castles.


205. More common than “all-cash” offers are those involving the offeror’s securities. See Joseph H. Flom, *Mergers and Acquisitions: The Decade in Review*, 54 U. MIAMI L. REV. 753, 767 (2000), (“stock and equity-based instruments have become the principal acquisition currency . . .”). However, an offer involving marketable securities, such as the common stock of a large, publicly traded corporation, is very similar to cash in that the owner can sell such shares easily. The major difference is that the price of the stock may vary, perhaps even significantly, between the date the offer is approved and the date it is consummated.

206. See supra note 45 and accompanying text.

offer the shareholders an alternative that is superior to the hostile bidder's initial offer. This argument can take many different forms. For example, one form of the argument is that the poison pill may allow directors to conduct an auction for the company, in order to ensure that shareholders receive the highest price available. If companies were using the poison pill in this manner, it would be virtually beyond criticism. Management clearly would be seeking the shareholders' interests, which is their fundamental charge.

The problem is that target companies rarely use the poison pill in order to conduct an auction. Management does not want to put the company up for sale, but would rather retain its independence. So while the auction may be a legitimate defense in the appropriate case, it would be the rare case.

Another form of the argument is that poison pills can be used as a delaying mechanism in order to allow management to offer the shareholders a restructuring or other transaction that would be superior to the hostile bid. This is similar to the previous argument in that the management-sponsored alternative can simply be seen as a competing bid at an auction.

Allowing management to compete at the auction would seem to be an easy way to increase shareholder wealth, provided management is not the arbiter of the competing bids, since management may be tempted to favor its own transaction even when shareholders would consider it inferior. If the alternative transaction is offered to shareholders as an option, however, shareholders could decide which transaction offers the better value and management could be said to be pursuing shareholders' interests.

In any event, the alternative transaction form of the argument is also generally irrelevant. At least since Time, target companies have often been using the poison pill to block hostile tender offers without offering shareholders any real alternative. This posture has come to be known as the "just say no" defense: management does not offer a better option, it simply rejects the hostile bid as inadequate. Thus, however acceptable

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208. There are those who argue that management should remain passive in response to any takeover offer because resistance will increase the cost of takeovers, thereby reducing the number of takeover offers and reducing shareholder welfare generally. See, e.g., Easterbrook & Fischel, supra note 14, at 1174-80. While the extreme position enjoys little support, a more moderate form of the argument agrees that management should not be permitted to resist hostile takeovers, but should be permitted to seek out competitive bids before submitting to a takeover offer in order to secure the maximum price available to shareholders. See generally Ronald J. Gilson, Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense, 35 STAN. L. REV. 51 (1982); Lucian A. Bebchuk, The Case For Facilitating Competing Tender Offers, 95 HARV. L. REV. 1028 (1982). The former position demands that attention be paid to shareholder welfare generally, rather than the welfare of the shareholders of any particular company. Since corporate law requires directors to act in the interests of the particular company, and its shareholders, the latter position seems more tenable.

209. On a certain level, management-sponsored alternatives are inherently suspect. Management is always charged with maximizing shareholder wealth. However, the very existence of a hostile bid strongly suggests that management was unable to maximize shareholder wealth. The hostile bidder, who is offering a premium, appears better suited to managing the company; it is certainly ready to increase shareholder wealth. Shareholders have a right to be skeptical of the directors' newfound ability to improve the company's performance dramatically in the face of a hostile bid.

210. In fact, to offer an alternative is somewhat dangerous under Delaware law, since it might expose the company to Revlon duties and require it to conduct an auction. See Time, 571 A.2d at 1150 ("Revlon duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction . . ."). If management hopes to retain its independence, as is generally the case, it cannot risk incurring Revlon duties.

211. The company's long-term plan is said to offer shareholders superior long-term value. This is, of
it may be for a company to use the poison pill as a delaying mechanism in order to present its shareholders with alternatives, the argument is simply inapplicable in most situations.

A third form of the argument is that the poison pill can be used as a negotiating device, in order to extract a higher price from the hostile bidder. Such a tactic would seem, on its surface, to be in the interests of shareholders. In fact, history offers plenty of examples in which the poison pill has caused the hostile bidder to increase its offer considerably.\textsuperscript{212} However, such negotiating power is fundamentally problematic.

A target company can use its negotiating power effectively only if the hostile bidder knows that the target has the ability to block “inadequate” offers. Otherwise, the hostile bidder could simply ignore target management and appeal directly to shareholders. Yet the power to block offers is susceptible to abuse by a management intent on entrenchment.\textsuperscript{213} The “inadequate offer” defense can serve as a facade for what is essentially a “just say no” defense.\textsuperscript{214} In fact, it makes a refusal to deal easier to justify, since negotiation necessarily requires precisely the type of discretion that is generally protected by the business judgment rule. Yet the result would be exactly the same: no deal.

Clearly, then, the negotiating power is not nearly as innocuous as it may at first appear. It can easily serve as a cover for an entrenchment strategy. If there were no other options, it might have been necessary to suffer its existence, although with judicial supervision. However, since an auction is always a possibility (perhaps even with a management-sponsored competing bid), a robust negotiating power is ultimately more dangerous for shareholders than it is beneficial.

From the foregoing, it should be clear that the two most common defenses of the poison pill cannot provide much support for the poison pill as it is used today. While the poison pill does provide much-needed protection against coercive offers, its continued use in the face of non-coercive offers is indefensible. And while it may allow management to provide shareholders with superior alternatives, it is rarely used for such course, a claim that is easy to make but difficult to substantiate. However, since it is also difficult to disprove, deferential courts may be willing to accept management’s “business judgment” on the matter, despite the conflict of interests.

\textsuperscript{212} See, e.g., Revlon, 506 A.2d at 181 (“Far from being a ‘show stopper,’ . . . the [Rights Plan] spurred the bidding to new heights, a proper result of its implementation.”) (offer ultimately improved from $42 to $58). See generally 1 TAKEOVER DEFENSE, supra note 5, § 5.01[D], at 5-14 to -17 (discussing “evidence that, in general, companies with poison pills tend to receive higher takeover premiums that those without them”).

\textsuperscript{213} Perhaps the courts could allow management some time to negotiate, but ultimately require the pill to be pulled so that shareholders can decide for themselves. However, if the hostile bidder knows that this is the rule, it can simply refuse to negotiate, or negotiate only to some minor extent, and wait for the inevitable action by shareholders.

\textsuperscript{214} Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261 (Del. 1989), provides an amusing example of the lengths to which a company may be willing to go in order to resist a hostile takeover—and how far investment bankers will go along with them. A $64 all-cash, all-shares offer was rejected as “inadequate” because the company was valued by investment bankers at $72.57 per share, even though management’s restructuring, valued at $64.15 per share, was deemed “fair.” Id. at 1270. When the hostile bid was raised to $73, and later to $80, the same investment bankers delivered opinions declaring those offers to be “inadequate.” Id. at 1271. Although these developments were clearly frowned upon by the court, they illustrate how self-serving directors’ claims of inadequate value can be, and how meaningless an opinion from an investment banker can likewise be.
purpose. Thus, while the two defenses are perfectly valid so far as they go, they do not go very far at all. They certainly cannot justify the "just say no" posture prevalent in today's market.

B. The Problem with Unocal

As with any other defensive measure, the poison pill is subject to judicial review under the Unocal test. In brief, Unocal requires the board to establish, before it is entitled to the benefit of the business judgment rule, that there are reasonable grounds to believe that the hostile offer poses a threat to corporate policy and effectiveness, and that the defensive response was reasonable in relation to the threat posed. This bipartite test sounds reasonable, but its application—particularly with respect to the poison pill—has not been reasonable. The reasonableness test has been watered down to insignificance by allowing even the flimsiest of perceived threats to be considered reasonable, and the proportionality test has also been severely limited to be effective in only the narrowest of circumstances. This exceedingly deferential review has eviscerated the Unocal test and allowed the poison pill to become the preeminent management entrenchment mechanism. Even with such restrictions, however, the Unocal test ought to operate to invalidate the poison pill as it is currently employed.

1. Substantive Coercion is Unreasonable

In order for its defensive actions to withstand scrutiny under Unocal, a board must establish reasonable grounds to believe a threat to the corporate entity exists. This sounds reasonable: if there is a threat, the board should be permitted to take defensive action. But the Unocal test does not require the existence of a threat; rather, it requires only reasonable grounds to believe there is a threat. Moreover, the board satisfies this requirement merely by establishing good faith and reasonable investigation, and the existence of a majority of independent directors greatly enhances the board's credibility. In other words, it is the board's judgment as to whether there is a threat that matters; courts will not substitute their own judgment in such matters. The "judicial review" that occurs under the reasonableness test is therefore extremely limited.

The dilution of the reasonableness test is exposed as complete when one considers what passes as a "reasonable" threat. Early on, hostile offers posed many real threats. In Moran, for example, there was an inherently coercive front-loaded, two-tier tender offer. It was not long thereafter, however, that most bidders abandoned coercive

215. Because of the development of the Unocal test that occurred in Unitrin, see supra notes 51-53 and accompanying text, it has come to be known by many as the Unocal/Unitrin test. For the sake of convenience, the text will continue to refer to the current standard as the Unocal test.
216. See supra notes 26, 36-39 and accompanying text.
218. See id. at 1385-86; Paramount Communications Inc. v. Time, 571 A.2d 1140, 1153 (Del. 1989).
219. See Chesapeake Corp. v. Shore, 771 A.2d 293, 329 (Del. Ch. 2000) ("[O]ne must acknowledge that Unitrin mandates that a court afford a reasonable degree of deference to a properly functioning board that identifies a threat and adopts proportionate defenses after a careful and good-faith inquiry.").
How, then, is it that defensive tactics survive scrutiny under the reasonableness prong of the *Unocal* test? It is because Delaware courts have accepted the notion that “substantive coercion” presents a cognizable threat under the *Unocal* test, thereby causing tremendous mischief in the law of hostile takeovers.

The term “substantive coercion” was coined in 1989 by Professors Gilson and Kraakman. In assessing the effectiveness of the *Unocal* test, they presented “a typology of threats” that might be posed by a hostile offer:

> [O]ur analysis suggests that the variety of “threats” discussed by the courts might be usefully grouped into three categories: (i) opportunity loss, or the Anderson, Clayton dilemma that a hostile offer might deprive target shareholders of the opportunity to select a superior alternative offered by target management; (ii) structural coercion, or the risk that disparate treatment of non-tendering shareholders might distort shareholders’ tender decisions; and, finally, (iii) substantive coercion, or the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management’s representations of intrinsic value.

The authors’ use of the term “substantive coercion” was unfortunate. The term was not intended to suggest that substantive coercion was coercive in the ordinary sense of the word. The authors present the nature of the threat as follows:

The only threat posed by a non-coercive offer that management considers unfair, ill-timed, or underpriced, is the threat that something will lead shareholders to accept it. But since such a threat is not structurally coercive, it will warrant a defensive response only if the offer is substantively coercive in that shareholders might somehow be led to accept unfavorable substantive terms voluntarily. Put another way, substantive coercion posits a likely mistake by target shareholders who would not accept the terms of an acquirer’s offer if they knew what management knew about their own company, about the acquisitions market, or about management itself. In addition, since target management can be expected to tell shareholders, loudly and often, what it knows, substantive coercion must also generally posit that shareholders do not believe what management says about the real value of the company.

The authors are not advocates of the concept of substantive coercion. To the contrary, they believe that “substantive coercion is a slippery concept” and note that such a claim “is always a delicate argument for the management of a target firm to make.” They also argue that shareholders as a class do not view substantive coercion as an issue. In fact, they call upon the courts to engage in “meaningful judicial review”

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221. *See supra* note 204 and accompanying text.
223. *Id.*
224. *Id.* at 259-60 (emphasis added).
225. *Id.* at 274.
226. *Id.* at 262.
227. “From the external perspective of shareholders and the market, which cannot distinguish when management’s representations about future value are correct from when they are self-serving, hostile offers that are structurally non-coercive cannot pose a threat; accordingly, defensive tactics that preclude such offers can
The Delaware Supreme Court readily embraced substantive coercion in *Time*, but without the caution urged by Professors Gilson and Kraakman. This was unfortunate. Claims of substantive coercion are very easy to make; yet while such claims are inherently dubious, they are nevertheless difficult to prove or disprove. If courts accept substantive coercion as a cognizable threat—and particularly if they do so uncritically—then one might expect to find the claim being made regularly, or even universally. This has, in fact, transpired. Substantive coercion currently serves as the foundation of a universal “just say no” defense. Given the ubiquity of substantive coercion claims, it should be clear that skepticism is appropriate. Yet the courts remain inexplicably deferential. Substantive coercion is simply not coercion in any meaningful sense of the term.

only be harmful.” Gilson & Kraakman, *supra* note 45, at 265.

228. *Id.* at 274.


As a starting point, it is important to recognize that substantive coercion can be invoked by a corporate board in almost every situation. There is virtually no CEO in America who does not believe that the market is not valuing her company properly. Moreover, one hopes that directors and officers can always say that they know more about the company than the company’s stockholders—after all, they are paid to know more. Thus, the threat that stockholders will be confused or wrongly eschew management’s advice is omnipresent.

*Id.*


Although the Delaware Supreme Court has not yet explicitly addressed the question, many argue that a board can now use the poison pill to implement a “just say no” defense against a hostile takeover. This means that the shareholders’ only recourse in the face of a board’s flat refusal to redeem the poison pill is to replace the directors. In doctrinal terms, the basis for this argument is the interpretive gloss that *Time* and *Unitrin* have added to the enhanced judicial scrutiny of defensive tactics articulated in *Unocal*.

*Id.* (citations omitted).

233. See *Chesapeake*, 771 A.2d at 327. (“[T]he use of this threat as a justification for aggressive defensive measures could easily be subject to abuse. The only way to protect stockholders is for courts to ensure that the threat is real and that the board asserting the threat is not imagining or exaggerating it.”)

234. One can discern in the use of the term “substantive coercion” a subtle semantic argument employed to enhance the credibility of the poison pill and other defensive tactics: they have always been permitted to combat coercive offers, and while an all-cash, all-shares offer may eliminate *structural* coercion, it cannot eliminate *substantive* coercion. The courts realize that it sounds much better to permit management to protect shareholders from (substantive) coercion than to permit management to prevent shareholders from making investment mistakes.

Of course, the argument does not persuade shareholders. While shareholders generally do invite protection from a structurally coercive offer, they do not relish interference premised on a substantively coercive offer. See Gilson & Kraakman, *supra* note 45, at 263 (“The fact that shareholders—and the securities
As the Delaware Chancery Court had realized before being "corrected" by the Delaware Supreme Court, an all-cash, all-shares offer does not pose any real threat. To hold otherwise by recognizing substantive coercion as a legally cognizable threat is to empower every target company to claim that any hostile offer poses a threat to the company. This effectively eviscerates the reasonableness prong of the Unocal test.

2. The Poison Pill is Disproportionate

The second prong of the Unocal test requires a board to establish that any defensive response was reasonable in relation to the threat posed. This sounds practical: unreasonable responses will not be upheld. But that is not how the proportionality test operates. The court will first inquire as to whether the result was "draconian" by being "coercive" or "preclusive"; if it was not, then the court will determine only whether the response was "within the range of reasonableness." Again, it is the board's judgment that prevails, and courts will not substitute their own judgment in such matters. The "judicial review" that occurs under the proportionality test is therefore as limited as the review under the reasonableness test.

If the Unitrin court had only gone so far, the proportionality test might have retained some meaning. However, the court went significantly further. It noted that "the cases applying Unocal reveal[] a direct correlation between findings of proportionality or disproportionality and the judicial determination of whether a defensive response was draconian because it was either coercive or preclusive," strongly suggesting that non-draconian tactics will generally be upheld. The court went on to explain the rationale for the "range of reasonableness" standard, which is "a need of the board of directors for latitude in discharging its fiduciary duties," and expressly noted a "concomitant requirement . . . [of] judicial restraint" in such matters. Moreover, while the Delaware Supreme Court remanded the case for further findings on the proportionality test, it suggested the appropriate answer by noting that "the Court of Chancery's holding in Shamrock, cited with approval by this Court in Time, appears to be persuasive support for the proportionality of the multiple defenses Unitrin's board adopted." The Delaware Supreme Court did not hide its predisposition against a muscular proportionality review.

The proportionality analysis in Unitrin was unfair in two important respects. First, it failed to recognize that the poison pill is a draconian defensive response. In addition, it failed to recognize that the continued use of the poison pill in the face of an all-cash, all-shares offer—market—are likely to accept a structurally non-coercive offer, despite management's claims of value, is compelling evidence of the shareholders' belief that the ability of the managers to improve on the offer's terms is outweighed by the risk that managers have misrepresented either their abilities or their intentions.

235. See supra note 92 and accompanying text.
236. Chesapeake, 771 A.2d at 329 ("Allowing . . . directors to use a broad substantive coercion defense without a serious examination of the legitimacy of that defense would undercut the purpose the Unocal standard of review was established to serve.").
238. See id. at 1385-86.
239. See supra note 219 and accompanying text.
240. Unitrin, 651 A.2d at 1387.
241. Id. at 1388.
242. Id.
243. Id. at 1389.
shares offer is not within the range of reasonableness.

A defensive response can be draconian by being either coercive or preclusive. Although the court defined neither term, the poison pill would satisfy either term under any reasonable definition. The poison pill is as coercive a device as the classic two-tier tender offer. Instead of being a two-tier, front-loaded offer that compels shareholders to tender against their own wishes, it is essentially a two-tier, back-loaded offer that compels shareholders not to tender despite their desire to do so. It may be reasonable to use a coercive defense against a coercive offer, such as a two-tier, front-loaded tender offer—a case of “fighting fire with fire.” However, employing a defense as coercive as the poison pill against a non-coercive offer must be considered draconian.

The poison pill is also preclusive. As discussed, it is designed to prevent shareholders from entertaining a hostile bid. It also has the effect of preventing potential hostile bidders from making tender offers in the first place, since they know they cannot proceed as long as the poison pill remains in place. Empirically, there can be no greater evidence of its preclusiveness than the fact that no bidder has ever been willing to ingest the economic poison of the poison pill.

The courts are not unaware of this. Rather, they implicitly deem the poison pill non-

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244. See Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 716 (7th Cir. 1986).

245. This was, no doubt, the idea behind the holding in Unocal, where a two-tier, front-loaded tender offer was countered with a discriminatory self-tender, the goal of which was either to defeat the offer or to provide additional consideration on the back-end. See supra notes 29-30 and accompanying text. The self-tender was tailored specifically to the evils presented by the initial tender offer. Thus, while it may have been a very aggressive defense, it was nevertheless reasonable in relation to the threat.

246. The flip-over pill may not itself be preclusive if one is willing to forego a second-stage transaction. This is why Sir James Goldsmith was able to trigger the flip-over poison pill in his attempt to acquire Crown Zellerback. See supra notes 68-70 and accompanying text. Current flip-in and back-end poison pills, however, do not require a second-stage transaction to be effective.

247. The two-tier, front-loaded tender offer results in tendering shareholders receiving more than non-tendering shareholders. Thus, shareholders are coerced into tendering. See supra notes 202-203 and accompanying text. The poison pill is similarly coercive—albeit in the opposite direction. See supra notes 244-245 and accompanying text. However, the poison pill does not simply result in non-tendering shareholders receiving more than tendering shareholders. Rather, it prevents the transactions from occurring at all. This is because shareholders would rather hold out for the back-end consideration than tender at the front-end. Since all shareholders come to the same conclusion, no front-end transaction is ever consummated and, therefore, no back-end transaction is ever possible. Obviously, then, the poison pill has as its goal not the fair treatment of shareholders, but the prevention of hostile takeovers.

248. See supra notes 12-16 and accompanying text.

249. 1 TAKEOVER DEFENSE, supra note 5, § 5.01[B][1], at 5-8 (“[T]he level of dilution [the flip-in pill] would inflict on both the voting power and the economic value of the stock of a raider who unilaterally crossed the ownership trigger level has proven universally unacceptable—indeed, the trigger has never been pulled . . . .”). Poison pill triggers have been pulled in two cases previously discussed, one involving a flip-over pill, see supra notes 68-70 and accompanying text, and one involving an early version of the flip-in pill, see supra notes 114-115 and accompanying text. However, because of the structure of the poison pills in those cases, the acquirers were not required to ingest any economic poison as a result of pulling those triggers. It would have taken additional action on their part for their interests to have been diluted. See supra notes 114, 246 and accompanying text. No one has ever triggered the dilutive effect of the poison pill. See supra note 12.
preclusive because of the availability of proxy contests to replace the directors with new directors who could redeem the Rights.\textsuperscript{250} This does not alter the fact that the poison pill is undeniably preclusive for so long as it remains intact. If this does not qualify as preclusive, it becomes difficult to imagine a defensive measure that would.\textsuperscript{251} Thus, the prohibition against preclusive defensive measures is rendered meaningless.

In addition to being draconian, the poison pill is not reasonable in relation to the threat typically posed in modern offers, i.e., substantive coercion. The Delaware Court of Chancery did not originally accept substantive coercion as a cognizable threat.\textsuperscript{252} Since being overruled by the Delaware Supreme Court,\textsuperscript{253} the Delaware Court of Chancery has characterized the threat of substantive coercion as a “mild” one.\textsuperscript{254} A mild threat calls for

\textsuperscript{250} See Ronald S. Gilson, \textit{Unocal Fifteen Years Later (and what we can do about it)}, 26 \textit{Del. J. Corp. L.} 491, 500-01 (2001).

\textsuperscript{251} Id. (footnotes omitted).

\textsuperscript{252} Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990), discussed \textit{supra} notes 92-98 and accompanying text, provides a good example of the impotence of proportionality review. In that case, Time was able to resist an all-cash, all- shares offer based on threats along the lines of substantive coercion. The court did not take issue with Paramount’s claim that Time’s response would “preclud[e] Time’s shareholders from accepting the tender offer or receiving a control premium in the immediately foreseeable future,” responding instead that, technically, Time’s actions “did not preclude Paramount from making an offer for the combined Time-Warner company,”—even though this was, at the time, a practical impossibility. \textit{Id.} at 1154-55.

The Delaware Supreme Court seems to be suggesting that the term “preclusive” must be taken literally: defensive action is not preclusive unless it technically prevents all possible offers from proceeding. Strictly speaking, there can be no such thing, since a bidder could always offer more and/or accept less in a tender offer. The only type of measure that even comes close to being strictly preclusive is one that prevents a proxy contest from being able to succeed. See Gilson, \textit{supra} note 250, at 501 (“\textit{Unocal} . . . identifies the circumstance when \textit{Unocal} allows a target to block a tender offer by declining to ‘pull the pill’ — if a proxy fight is not ‘mathematically impossible’ or ‘realistically unattainable.’”). However, even that limited possibility has been watered down by the court’s insistence that outside directors’ stock holdings cannot be counted along with officers’ holdings because “it cannot be presumed that the prestige and perquisites of holding a director’s office or a motive to strengthen collective power prevails over a stockholder-director’s economic interest,” \textit{Unitrin}, 651 A.2d at 1380. Thus, it seems that only action taken to ensure that officers’ stock holdings can veto a proxy contest or transaction—a rare situation, to say the least—will qualify as preclusive.

\textsuperscript{253} See \textit{supra} note 92 and accompanying text.

\textsuperscript{254} See, \textit{e.g.}, \textit{Unitrin}, 651 A.2d at 1375 (quoting Delaware Court of Chancery); Chesapeake Corp. v. Shore, 771 A.2d 293, 331-32 (Del. Ch. 2000).
a moderate response.\textsuperscript{255} If the threat is that shareholders may make a mistake, then the proportionate response would be to release information to enlighten shareholders.\textsuperscript{256} As the ultimate takeover defense, which can block virtually any takeover, the poison pill is clearly more than a moderate response. Thus, the poison pill simply cannot be considered proportional to a threat as mild as substantive coercion.

The poison pill, as it is employed today, cannot withstand scrutiny under a fair application of the \textit{Unocal} test, even as subsequently limited by \textit{Time} and \textit{Unitrin}. It is draconian in that it is both coercive and preclusive, and it is not within the range of reasonableness in relation to the minimal threat posed by most modern hostile bids, i.e., substantive coercion. In most cases, a company's refusal to pull the poison pill should be declared a breach of the directors' fiduciary duties. If courts will not invalidate the poison pill, they must at least recognize its inherent legitimacy issues and cease granting excessive deference to management.

\textbf{IV. CONCLUSION}

It is unfortunate but undeniable that the poison pill is a legal defense against hostile
takeovers. It is equally unfortunate and undeniable that courts are quite deferential in their review of companies’ use of the poison pill. As a result, hostile takeovers are far more difficult to effect and incumbent managements are less accountable for their performance.

This Article has sought to demonstrate that state corporate law did not authorize the poison pill when it was first implemented. It has also sought to establish that contemporary uses of the poison pill remain illegitimate. While it might be too much to hope that courts would reconsider the legality of the poison pill, it should not be too much to hope that courts would reconsider their deference to management with respect to the poison pill.

The poison pill is undeniably the most potent defense mechanism; far more than an equal to nearly all hostile takeover tactics. It has the power to prevent not only coercive or otherwise problematic hostile takeovers, but also non-coercive and otherwise beneficial hostile takeovers. Given the “omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders,” management should not be given broad discretion to employ the poison pill against hostile takeovers.

As modified by Time and Unitrin, the Unocal test provides shareholders with little more protection than does the business judgment rule. This is inappropriate. Courts must take seriously their self-imposed duty to provide “judicial examination at the threshold before the protections of the business judgment rule may be conferred.” While this Article has sought to demonstrate that the poison pill could not withstand such judicial examination, it is hoped at least that this article has shown that the poison pill is problematic under any reasonable standard. Thus, the courts cannot continue to allow management the deference they have thus far shown with respect to the poison pill. They must be willing to provide the “enhanced scrutiny” that Unocal promised years ago.

258. Id.