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The Impact of State Statutes and Continuing Director Rights Plans

DANIEL A. NEFF*

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I. STATE STATUTES AND FIDUCIARY DUTIES OF DIRECTORS

As a general proposition, the current wave of takeover activity has produced surprisingly few significant new judicial decisions. The most recent important decisions—*Paramount Communications, Inc. v. QVC Network, Inc.*,[1] and *Unitrin, Inc. v. American General Corp.*[2]—are logical extensions of the Delaware Supreme Court's earlier decisions of *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[3] and *Unocal Corp. v. Mesa Petroleum Co.*[4]

However, one legal development which is quite significant, and which has largely gone unnoticed, is the emergence of state laws other than Delaware's and their impact on directors' duties in the takeover context. In response to a prior takeover wave, many state legislatures amended their corporate statutes. Recent court interpretations of some of these statutes have produced a number of decisions[5] which are more protective of directors' discretion in the takeover context than the enhanced scrutiny of directors' conduct required by the *Unocal* standard. These decisions carry out the intent of the state legislatures, and are strongly protective of incumbent directors and provide unsolicited acquirers limited opportunities to challenge directors' actions. Whether the philosophy underlying these statutes will somehow affect the judicial decision making of the Delaware courts is a question worth noting.

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* The contributions to this Article by my colleagues at Wachtell, Lipton, Rosen & Katz and John Elofson, a student at the Columbia University School of Law, are gratefully acknowledged.

1. 637 A.2d 34 (Del. 1993).
2. 651 A.2d 1361 (Del. 1995).
3. 506 A.2d 173 (Del. 1985)
4. 493 A.2d 946 (Del. 1985).
5. *See infra* pp. 3-7.

A. CTS Corp. v. Dynamics Corp. of America

In *CTS Corp. v. Dynamics Corp. of America*,[6] the United States Supreme Court upheld Indiana's "Control Share Acquisitions Statute,"[7] finding that it was not preempted by the Williams Act[8] and did not discriminate against interstate commerce in violation of the Commerce Clause.[9] The Court noted that "[s]o long as each State regulates voting rights only in the corporations it has created, each corporation will be subject to the law of only one State."[10] The Court stressed that "state regulation of corporate governance is regulation of entities whose very existence and attributes are a product of state law,"[11] and that it "is an accepted part of the business landscape in this country for States to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares."[12] The Court concluded that "[a] State has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs."[13]

B. Amanda Acquisition Corp. v. Universal Foods Corp.

In a subsequent decision, *Amanda Acquisition Corp. v. Universal Foods Corp.*,[14] the Seventh Circuit took its cue from *CTS* and upheld the Wisconsin Business Corporation Act[15] against constitutional challenge. The statute at issue in *Amanda* banned second-step mergers with a 10% or greater shareholder for three years after the 10% position is acquired unless, prior to the 10% stock acquisition, the Board of Directors of the target gives its approval.[16] The Wisconsin Act, in contrast to, for example, the Delaware Act,[17] does not contain an exception for acquisitions of a specified percentage of shares made pursuant to a tender offer.[18]

In *Amanda*, Judge Easterbrook left no doubt as to his personal views of the statute's desirability: "If our views of the wisdom of state

6. 481 U.S. 69 (1987).

7. IND. CODE ANN. § 23-1-42 (West 1989).

8. 15 U.S.C. §§ 78m(d)-(e) and 78n(d)-(f) (1994). The Williams Act is part of the federal securities laws.

9. U.S. CONST. art. I, § 8, cl. 3.

10. 481 U.S. at 89.

11. *Id.*

12. *Id.* at 91.

13. *Id.*

14. 877 F.2d 496 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989).

15. WIS. STAT. ANN. § 180.0726 (1992).

16. *See Amanda*, 877 F.2d at 498.

17. DEL. CODE. ANN. tit. 8, § 203(a)(2) (1991).

18. *See* WIS. STAT. ANN. § 180.0726.

law mattered, Wisconsin's takeover statute would not survive. Like our colleagues who decided *MITE* and *CTS*, we believe that antitakeover legislation injures shareholders."[19] But, he added, "[u]nless a federal statute or the Constitution bars the way, Wisconsin's choice must be respected."[20] Thus, the Seventh Circuit rejected preemption and Commerce Clause challenges to the Wisconsin law. With respect to the preemption challenge, the Seventh Circuit held that "[o]nly if the Williams Act gives investors a right to be the beneficiary of [tender] offers could Wisconsin's law run afoul of the federal rule."[21] However, the Court then noted that because "[i]nvestors have no right to receive tender offers . . . . and the Williams Act does not create a right to profit from the business of making tender offers,"[22] the Wisconsin law is not preempted.

Following the *CTS* decision, many states adopted a variety of takeover statutes. Typically, these statutes aim to make mergers more difficult to accomplish, or to effectively reduce the ability to second-guess directors' decisions made in the takeover context. Control share acquisition statutes typically deny voting rights to a purchaser who acquires in excess of 20% of the target's stock, unless such purchaser first obtains permission of the target's shareholders at a special meeting. "Moratorium" or "business combination" statutes provide that if a raider acquires a certain percentage of a target's stock, for example, 10% or more, the corporation cannot effect a second-step merger for a fixed period of time after such acquisition. This is the case unless the target's board approved such a transaction *prior* to the triggering acquisition, or unless another exception applies. Certain states have adopted statutes specifically rejecting *Unocal's* heightened standard for directors' conduct and affirming a company's right to reject, and defend against, inadequate offers. In addition, a number of states have adopted constituency statutes authorizing a board faced with a takeover to consider the effects the proposal might have on the company's employees, consumers, neighboring communities and other corporate constituencies.

The effect of these state statutes was not fully appreciated until the recent wave of takeover activity gave rise to a number of challenges to directors' conduct by raiders. In these cases, courts accord directors a greater degree of deference and a lesser degree of scrutiny, than Delaware's *Unocal* standard would provide.[23]

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19. 877 F.2d at 500.

20. *Id.* at 502.

21. *Id.* at 504.

22. *Id.* at 504-505.

23. Although the Delaware courts might reach the same outcome if presented with the same facts.

C. *The Delaware Law*

Delaware courts will not defer to board conduct using the traditional business judgment rule if the board adopts a defensive mechanism in response to an alleged threat to corporate control or policy.[24] In *Unocal* the Delaware Supreme Court decided that in these circumstances, board action is subject to judicial review under an 'enhanced scrutiny' standard, which looks both to the board's process and its action.[25] The board's decision-making process, including the information relied on, must satisfy the court's enhanced standard. In addition, the court, unlike its review under the traditional business judgment rule, will examine the reasonableness of the directors' decision.[26]

Instead of the presumption attending the traditional business judgment rule, the directors carry the burden of proving that their process and conduct satisfy the enhanced *Unocal* standard. In the context of a defensive device or transaction, this standard requires that the board meet a two-pronged test: First, the board must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed,"[27] which may be shown by the directors' good faith and reasonable investigation; second, the board must show that the defensive measure chosen was "reasonable in relation to the threat posed,"[28] which may be demonstrated by the objective reasonableness of the course chosen. Only if the directors can establish both prongs of the *Unocal* test will their actions receive the protections of the business judgment rule.

Notwithstanding the close scrutiny of a board's actions which *Unocal* requires, the Delaware Supreme Court's reversal of the Chancery Court's injunction in *Unitrin, Inc. v. American General Corp.*,[29] reaffirms Delaware case law granting a board reasonable latitude in responding to an unsolicited offer. However, *Unitrin* also demonstrates the unpredictability of the heavily fact-oriented decision-making necessitated by the *Unocal* standard, as the inquiry into "proportionality" creates significant uncertainty.

In *Unitrin, Inc. Shareholders Litigation v. Unitrin, Inc.*,[30] the Delaware Chancery Court preliminarily enjoined a proposed buyback of ten million shares, or approximately twenty percent of Unitrin's outstanding shares, at the then current market price, but did not enjoin the board's

24. *See Unocal*, 493 A.2d at 946.
25. *See id.*
26. *See id.* at 955.
27. *Id.*
28. *Id.*
29. 651 A.2d 1361 (Del. 1995).
30. No. 13656, 1994 Del. Ch. LEXIS 187 (Del. Ch. Oct. 13, 1994).

adoption of a shareholder rights plan. The court decided that the first portion of the *Unocal* two-prong test—whether a threat to corporate policy exists—was satisfied. This was based on the board's conclusion that the price offered by the offeror, American General, in its publicly announced unsolicited acquisition proposal was inadequate, although the court considered the threat from American General's all cash offer "a mild one."[31] Rather, the court enjoined the repurchase program based on the second prong of *Unocal's* two-part test—proportionality.[32] The court found that, because the repurchase program would raise the Unitrin board's stock ownership from 23% to 28%, it would chill proxy contests. The court decided that this effect was not proportionate under *Unocal* because Unitrin had other defenses, which protected Unitrin shareholders from a coercive or inadequate offer.[33] The court thus read *Unocal* to authorize judicial inquiry into whether a *specific* defensive step is "necessary."

In a sweeping rejection of the Chancery Court's reasoning, the Delaware Supreme Court held that the lower court's reading of *Unocal* placed too heavy a burden on the directors to justify defensive conduct.[34] The Supreme Court ruled that, in applying *Unocal*, a court should engage in a two-step process: First, the court should determine whether the defensive steps were "coercive or preclusive;"[35] second, if the defensive steps were not "coercive or preclusive," then the court should determine whether the defensive conduct falls within a "range of reasonableness."[36] If there is no coercion or preclusion, and the conduct is within the "range of reasonableness," the defensive action will be upheld.[37]

On remand, the Delaware Supreme Court accordingly directed the Chancery Court to make a factual determination of "whether the Unitrin Repurchase Program would only inhibit American General's ability to wage a proxy fight and institute a merger or whether it was, in fact, preclusive."[38] If the repurchase program does not doom any American General proxy fight to failure, the Supreme Court held that the only question remaining will be "whether the Repurchase Program was

31. *See id.* at *24.
32. *See id.* at *33.
33. *See id.* t *32.
34. *See* Unitrin, Inc. v. Amer. Gen., 651 A.2d 1361, 1389-90.
35. A "preclusive" plan is one which deprives the stockholders of their right to receive tender offers and fundamentally restricts proxy contests. *See id.* at 1387.
36. *See id.* at 1387-88.
37. *See id.* at 1388.
38. On this issue, the Supreme Court itself found that a proxy contest would remain viable, noting that "[t]he key variable in a proxy contest would be the merit of American General's issues, not the size of its stockholdings." *Id.* at 1383.

within a range of reasonableness."[39] The Supreme Court then mapped out the factors that the Chancery Court should address to determine "reasonableness:"

> In considering whether the Repurchase Program was within a range of reasonableness the Court of Chancery should take into consideration whether: (1) it is a statutorily authorized form of business decision which a board of directors may routinely make in a non-takeover context; (2) as a defensive response to American General's Offer it was limited and corresponded in degree or magnitude to the degree or magnitude of the threat (*i.e.*, assuming the threat was relatively "mild," was the response relatively "mild?"); (3) with the Repurchase Program, the Unitrin Board properly recognized that all shareholders are not alike, and provided immediate liquidity to those shareholders who wanted it.[40]

The Delaware Supreme Court's decision in *Unitrin* thus reaffirms a board's discretion to act within a range of reasonably proportional responses to unsolicited offers, and rejects judicial identification of the "necessary" actions in this context.

D. *Recent Decisions Under Other States' Laws*

Under the *Unocal* standard, courts have rendered decisions which give directors reasonable latitude to use defensive measures in the takeover context. These decisions have been reached after a thorough review of the directors' conduct, and of the information which the directors themselves analyzed in reaching their decision. Several recent cases demonstrate the differences between the Delaware approach and the approaches of certain other jurisdictions.

In *WLR Foods, Inc. v. Tyson Foods, Inc.*,[41] which arose out of Tyson Food's attempted hostile takeover of WLR Foods, the Fourth Circuit affirmed the federal district court's decision based on Virginia's Business Judgment Statute.[42] The Virginia statute sets forth a subjective standard of care for directors,[43] which intentionally excludes any reference to the reasonableness of the director's conduct. The Fourth Circuit found that "it is precisely such a comparison between a director and the hypothetical reasonable person that the Virginia legislature explicitly chose to reject when it enacted [the standard of care]."[44] Thus, "the actions of a director are to be judged by his or her good faith in perform-

39. *Id.* at 1389.
40. *Id.*
41. 65 F.3d 1172 (4th Cir. 1995), *cert. denied*, 116 S. Ct. 921 (1996).
42. VA. CODE ANN. § 13.1-690 (Michie 1993).
43. "A director shall discharge his duties as a director . . . in accordance with his good faith business judgment of the best interests of the corporation." VA. CODE ANN. § 13.1-690(A).
44. *WLR Foods*, 65 F.3d at 1185.

ing corporate duties, and not by the substantive merit of the director's decisions themselves. . . . Directors' actions in Virginia are not to be judged for their reasonableness."[45]

Tyson Foods, the hostile bidder, argued that in order to determine whether the directors' decisions were made in good faith, it was necessary to know the substantive content of the information that was available to them.[46] The district court rejected this argument and the Fourth Circuit concurred, finding that the district court did not abuse its discretion in denying Tyson Foods' discovery requests as to the substantive content of the recommendations made to WLR's board of directors by its advisors.[47] Rather, Tyson Foods was entitled to discover only the "procedural indicia of whether the directors resorted in good faith to an informed decisionmaking process."[48] This included, for example, information as to what topics were discussed at Board meetings and when advisors were hired, but not information regarding the substantive advice rendered by advisors. From a practical standpoint, however, a bidder will find it extraordinarily difficult or impossible to establish director misconduct without having access to the information the target's directors considered.

The State of Ohio has adopted a significant amount of takeover legislation, including a Control Share Acquisition Statute[49] and a Business Combination Statute.[50] Ohio also adopted a statute providing that any violation of the directors' duties relating to an actual or potential change in control of the corporation, including a determination to resist the change in control, must be proven by clear and convincing evidence.[51] In addition, the Ohio corporate law includes a very broad constituency statute,[52] which requires a director to consider the interests of the corporation's shareholders and permits the director to consider: (1) "The interests of the corporation's employees, suppliers, creditors, and customers; (2) [t]he economy of the state and nation; (3) [c]ommunity and societal considerations; (4) [t]he long-term as well as short-term interests of the corporation and its shareholders, including the possibility that these interests may be best served by the continued independence of the corporation."[53]

45. *Id.*
46. *See id.*
47. *See id.* at 1185-86.
48. *Id.* at 1186.
49. OHIO REV. CODE ANN. § 1701.831 (Anderson 1992).
50. OHIO REV. CODE ANN. §§ 1704.01-1704.07.
51. *See id.* § 1701.59(C).
52. *See id.* § 1701.59(E).
53. *Id.*

This panoply of statutes, and their underlying philosophy, came into play when United Dominion Industries made a hostile bid for Commercial Intertech Corporation in the summer of 1996. Commercial Intertech responded to United Dominion's tender offer by declaring a spin-off distribution of its crown jewel subsidiary.[54] United Dominion sought to enjoin the spin-off, which was scheduled to occur prior to the special shareholders' meeting which had been requested to vote on United Dominion's tender offer, as required under Ohio's Control Share Acquisition Statute.[55] Noting that nothing in the Statute prevents a board from taking defensive action *before* the special shareholders meeting, a federal district court in Ohio refused to permit United Dominion to even amend its complaint to seek to enjoin the spinoff. The court also referred to statutory provisions giving an Ohio corporation the right to "resist a change or potential change in control of the corporation if the directors, by majority vote of a quorum determine that the change or potential change is opposed to or not in the best interests of the corporation."[56]

The recent battle over Conrail between its competing suitors, CSX and Norfolk Southern, demonstrates the importance of Pennsylvania's various takeover statutes. Conrail entered into a merger agreement with CSX, and sought to preserve and complete that merger in the face of higher-valued bids by Norfolk Southern.[57] Norfolk Southern asserted that the board of directors of Conrail violated its fiduciary duties to its shareholders and sought to enjoin the lower-valued Conrail/CSX transaction.

The federal district court in Philadelphia denied Norfolk Southern's request[58] and made a number of pointed observations about the difference between the corporate laws of Pennsylvania and those of Delaware. The court observed that Pennsylvania statutory law stands expressly against the proposition that the sole or primary consideration by a board in considering competing offers is which offeror provides the best short-range price or profit for shareholders. The Court described as "myopic" the *Unocal* and *Revlon* doctrines that "because stockholders are at least

54. *See* United Dominion Indus. Ltd. v. Commercial Intertech Corp., 943 F. Supp. 857 (S.D. Ohio 1996).

55. *See id.* at 860; OHIO REV. CODE ANN. § 1701.831(c).

56. *See* OHIO REV. CODE ANN. § 1701.59(B). In contrast, the Delaware Chancery Court enjoined a planned spin-off of Pillsbury's Burger King subsidiary, which was part of Pillsbury's defense against a hostile tender offer by Grand Metropolitan PLC. *See* Grand Metro. Pub. Ltd. Co. v. Pillsbury Co., 558 A.2d 1049, 1061 (Del. Ch. 1988).

57. *See* Richard Tomkins, *Battle for Conrail Reaches Stalemate*, FIN. POST, Feb. 14, 1997, at 58.

58. *See* Karen Donovan, *Titans Clash in Takeover Battle in PA*, NAT'L LAW J., Jan. 20, 1997, at A1.

in theory the owners of the corporation that only their interests should be considered or at a minimum must be given the highest priority and importance." In reaching its decision, the court relied on a number of Pennsylvania statutory provisions which (i) authorize directors to consider the effects of any action on a variety of corporate constituents and do not require that directors weigh the interests of any particular constituent group, including shareholders, more heavily than the interests of another; and (ii) reject the applicability of *Unocal's* enhanced scrutiny of directors' actions, and reaffirm the applicability of the traditional business judgment rule, in the change of control context.[59]

II. CONTINUING DIRECTORS AND SHAREHOLDERS' RIGHTS PLANS

In recent years, a number of companies have adopted shareholder rights plans ("poison pills") which include continuing director ("dead hand") provisions. These provisions prevent the redemption of share purchase rights issued under a rights plan, unless that action is approved by a majority of "continuing directors."[60] Such provisions can have a chilling effect on proxy contests, which are part of the usual strategy for a hostile acquisition. Since the emergence and widespread validation of rights plans by courts and legislatures throughout the country, hostile bidders have routinely included, as part of any takeover attempt, a proxy contest to remove the target's directors whose refusal to redeem the rights plan would otherwise block the takeover.

Neither courts nor commentators have yet considered in much detail the permissibility of continuing directors provisions. The one case that has directly addressed the question suggests that such provisions are invalid under New York law.[61] However, there is no case applying Delaware law which indicates whether such provisions are permissible.[62] There is similarly almost no authority on the question of whether "watered down" continuing director provisions[63] are acceptable.

A. *The Legal Standard Under Which Continuing Director Rights Plans are Analyzed*

Delaware courts have applied *Unocal* to board decisions both to adopt, and not to redeem, rights plans.[64] Because such plans "are, by

59. *See* PA CONS. STAT. ANN. § 1502(a)(18) (1995).

60. *See* Unitrin, Inc. v. Am. Gen., 651 A.2d at 1369 n.6. "Continuing directors" are generally those who held office before the takeover bidder emerged.

61. *See infra* notes 76-79 and accompanying text.

62. *See infra* notes 80-101 and accompanying text.

63. "Watered down" provisions are those which are effective for only a limited time, or only in some change of control situations.

64. *See, e.g.*, Moran v. Household Int'l, Inc., 500 A.2d 1346, 1354 (Del. 1985).

definition, defensive,"[65] and therefore raise the spectre of management entrenchment, courts have found that they warrant heightened judicial scrutiny.[66] The *Unocal* standard applies whether or not the plan at issue was adopted in reaction to an immediate threat to management control of the corporation.[67]

When a rights plan is challenged, a board has the burden of demonstrating that its plan is not "preclusive" or "draconian"[68] and that its decision to adopt the plan falls within a "range of reasonableness."[69] If plaintiffs can demonstrate that the "primary purpose" of a challenged rights plan was to impede a shareholder vote, the board will have to show a "compelling justification" for the decision; otherwise, the board might be found to have breached the duty of loyalty.[70] This doctrine is held to be a "specific expression" of the *Unocal* test as applied to the election context, rather than a separate, more stringent standard.[71]

B. *Case Law on Continuing Director Rights Plans*

One of the few cases to have directly addressed the validity of a continuing director provision is *Bank of New York Co., Inc. v. Irving Bank Corp.*[72] There, the New York Supreme Court enjoined the use of a provision of the defendant corporation's rights plan which allowed the board to redeem the rights only if: (1) it had a majority of continuing directors; or (2) if the new directors immediately succeeded continuing directors and (a) were elected by a two-thirds majority, or (b) were elected when no merger proposal was pending.[73] According to the court, this element of the plan ran afoul of § 620 of the New York Business Corporation Law, requiring all restrictions on a board's power to be placed in the Certificate of Incorporation.[74] The court, however, was less concerned that the plan limited the board's power than that it did so in a discriminatory way:

> The evil of [the provision] is not that it deprives a Board of certain powers; it is that it is selective in the deprivation. In other words, the present Board members could have the powers, if they were reelected

65. *See* Moore Corp. Ltd. v. Wallace Computer Servs., Inc., 907 F. Supp. 1545, 1556 (D. Del. 1995).
66. *See id.* at 1554.
67. *See* Unitrin, Inc. v. Am. Gen., 651 A.2d 1361; *Moran*, 500 A.2d at 1350.
68. *See* Unitrin, Inc. v. Am. Gen., 651 A.2d at 1387-88.
69. *See id.* at 1388.
70. *See* Sutton Holding Corp. v. DeSoto, Inc., Civ. A. No. 12051, 1991 WL 80223, at *1 (Del. Ch. May 14, 1991); Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).
71. *See* Shamrock Holdings v. Polaroid Corp., 559 A.2d 278, 286 (Del. Ch. 1989). This is so, despite the potential need for a board to show a compelling justification for its actions.
72. 528 N.Y.S.2d 482 (Sup. Ct. 1988).
73. *See id.* at 483.
74. *See* N.Y. BUS. CORP. LAW § 620 (McKinney 1986).

to the Board, but the insurgents would not if they were elected by the same plurality. Those new members of the Board approved by the current Board would have the powers, but those not so approved would not.[75]

Plaintiffs in Delaware courts have raised objections to continuing director provisions on several occasions, but no clear holding has yet emerged. In *Davis Acquisition, Inc. v. NWA, Inc.*,[76] the Delaware Chancery Court considered a rights plan which could not be redeemed for a period of 180 days following the election of a board with a majority of noncontinuing directors. The plaintiffs moved for a preliminary injunction against the use of this plan, arguing that use of this provision was an intentional manipulation of the shareholder voting process under *Blasius Industries, Inc. v. Atlas Corp.*,[77] and that it was beyond the power of the incumbent board to so limit the authority of future directors.[78] In support of the latter point, the plaintiffs contended that Delaware courts' acceptance of rights plans under *Moran* is predicated on the assumption that directors will have the ability to make a judgment whether or not to redeem a plan at the time a tender offer is made, and that the defendants' plan would compromise this ability.[79] In addition, the plaintiffs asserted that the plan "discriminate[d] between possible future boards based upon who nominates a majority of the new board."[80] In response, the defendants claimed that the plan was acceptable under *Moran* and *Unocal*, particularly because it was only effective for a limited time. The defendants also pointed out that the directors had announced their willingness to explore extraordinary transactions; thus, the principal issue for shareholders was which set of directors should be responsible for such a process.[81]

After having outlined the arguments, however, the court declined to resolve them. The court denied the plaintiffs' request for a preliminary injunction, not because the plan was likely to be upheld at trial,[82] but because it found that the mere existence of the continuing director provision would not unduly influence the proxy contest in which the parties were engaged.[83] The court was quite concerned that the grant of a preliminary injunction during the pendency of an election may have an

75. *Bank of New York*, 528 N.Y.S.2d at 485.
76. Civ. A. No. 10761, 1989 WL 40845 (Del. Ch. Apr. 25, 1989).
77. *See id.* at *1, *2.
78. *See id.* at *2.
79. *See id.*
80. *Id.*
81. *See id.* at *3.
82. *See id.* at *7. The court expressly reserved judgment on this point.
83. *See id.* at *5-7.

impact on the election's outcome.[84] However, the court also sought to avoid creating any impression that in denying the preliminary injunction, it implicitly approved the continuing director redemption provisions.[85] Rather, the court committed to determine the validity of the redemption provisions within forty-five days of the annual meeting, and required that the shareholders be advised that litigation challenging the validity of the redemption provisions was pending.[86]

In *Prime Computer, Inc. v. Allen*,[87] a would-be acquiror brought a challenge to the continuing director provisions of a rights plan, which could only be redeemed by a majority of the continuing directors, though this requirement would be waived if an all-cash, all-shares offer was made.[88] The court, however, held that its preliminary injunction against a consent solicitation by-law adopted by the target company rendered a decision on the plan's legality unnecessary.[89]

In *Sutton Holding Corp. v. DeSoto, Inc.*,[90] the Delaware Chancery Court considered a somewhat analogous situation involving a provision—adopted in the midst of a proxy contest—which provided that a corporation could not terminate its pension plans nor amend them to reduce benefits for five years following a change in control of the corporation.[91] A change in control was deemed to have occurred when an acquiror became a beneficial owner of 35% of the voting stock of the company without the approval of two-thirds of the entire board and a majority of the continuing directors, or when one-third or more of the board consisted of members not nominated by the incumbent board.[92]

The Chancery Court indicated that the adoption of this provision probably amounted to an intentional attempt to coerce the exercise of the shareholder franchise, and thus constituted a violation of the directors' duty of loyalty.[93] Though this conclusion was dictum, the court's reasoning lends support to the proposition that continuing director provisions are impermissible: "The most critical defect [of the plan], in my opinion, is the fact that the 'enemy' here, the raider, includes anyone that the shareholders elect but that the board has not nominated."[94] This language suggests the court believed that continuing director provisions

84. *see id.* at *6.
85. *See id.* at *7.
86. *See id.*
87. 1988 WL 5277 (Del. Ch. Jan. 25, 1988), *aff'd*, 540 A.2d 417 (Del. 1988).
88. *See id.* at *2.
89. *See id.* at *8.
90. Civ. A. No. 12051, 1991 WL 80223 (Del. Ch. May 14, 1991).
91. *See id.* at *1.
92. *See id.*
93. *See id.*
94. *Id.* at *1 n.3.

are designed to impede would-be raiders who are supported by shareholders but opposed by incumbent management, and therefore bring into doubt the good faith of incumbents who use such provisions.

Because of the unique facts of the case, however, the court may have been inclined to find a breach of fiduciary duty. The target company's pension plan had a surplus which amounted to 50% of the value of the company's market capitalization.[95] Both the incumbent board and the challengers had announced their intent to terminate the plan and distribute the excess to shareholders.[96] Implementation of the continuing directors provisions of the pension plans, though, would have made this difficult, if not impossible, for the challengers. In this situation, the continuing directors provisions may have appeared explicable only as a cynical attempt to manipulate the shareholder voting process: the provisions' sole effect would then be to prevent the challengers from taking an apparently popular action which the incumbents meant to take as well.[97]

III. CONCLUSION

In *Moran v. Household Int'l, Inc.*,[98] the Delaware Supreme Court upheld the rights plan at issue in part because the acquiror could have reduced the plan's impact by:

> [(1)] tendering with a condition that the Board redeem the Rights, [(2)] tendering with a high minimum condition of shares and Rights,[99] [(3)] tendering and soliciting consents to remove the Board and redeem the Rights, [(4)] acquiring 50% of the shares and causing [the target company] to self-tender for the Rights. . . . [or (5) forming a group holding shares just short of the plan's trigger] and solicit[ing] proxies for consents to remove the Board and redeem the Rights.[100]

An effective continuing director provision would eliminate some of these options, but not all. Tendering on the condition that the rights be redeemed, at least, would remain available but may be impractical in view of the ability of incumbent directors to deny requests for redemption. Tendering with a high minimum condition could conceivably be effective in certain circumstances, although the minimum condition may need to be set at a level which is so high that the offer's viability is

95. *See id.* at *2.

96. *See id.*

97. In most cases, however, incumbent directors will be able to raise a colorable argument that their rights plan was intended to serve some legitimate policy interest. In such cases, a claim of breach of the duty of loyalty will be more difficult to sustain.

98. 500 A.2d 1346 (Del. 1985).

99. In these circumstances the bidder would bear the economic cost of the rights which it did not acquire.

100. *Moran*, 500 A.2d at 1354.

highly questionable. The continuing director provision would, however, negate or significantly limit the effectiveness of the tactic which hostile bidders have invariably used in seeking to acquire companies which have rights plans—a tender offer or public acquisition proposal coupled with a proxy contest or consent solicitation to remove the target's directors and redeem the rights.

The board of a target company, which seeks to sustain a continuing director provision, could argue that the provision is valid because it does not eliminate the duties of those directors. Such an argument could rely on the following language from the Delaware Supreme Court's opinion in *Moran*:

> [T]he Rights Plan [at issue] 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.[101]

However, this passage may be construed to imply that each director must have a voice in a decision to redeem, or to refuse redemption of, rights, as each owes fiduciary duties to the shareholders. However, this conclusion is far from obvious, especially since this factor was only one of several considered by the court.

A further question is how a court in a state other than Delaware, where rights plans are validated by corporate statute rather than judicial precedent, would regard a continuing director provision. Such a court may not look to the *Moran* case and the history of and rationale for upholding the validity of such instruments, but instead may rely on a legislative determination that authorizes rights plans as a matter of policy, without the sophisticated discussion of the nuances of rights plans in which the Delaware courts have engaged.

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101. *Id.*