ACHTELL, LIPTON, ROSEN & KATZ

September 7, 1984

To Our Clients

"Poison Pills"

The attached Harvard Law Review Note concludes that our Convertible Preferred Stock Dividend Plan and our Warrant Dividend Plan provide "legitimate protection against partial and two-tiered tender offers, and should therefore be deemed legitimate under both state fiduciary law and the Delaware corporation statute."

M. Lipton

Attachment

84-0072

PROTECTING SHAREHOLDERS AGAINST PARTIAL AND TWO-TIERED TAKEOVERS: THE "POISON PILL" PREFERRED

In the field of contested takeover bids, "the 'state of the art' is in constant flux. New strategies . . . appear with almost dazzling frequency."[1] The newest defensive weapon against hostile tender offers is "poison pill" preferred stock,[2] which is issued as a pro rata dividend to all holders of a target company's common stock.[3] The preferred stock typically carries special redemption and conversion privileges. The preferred holders are entitled to redeem their shares for cash if

---

[1] A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING at vii (rev. ed. 1981).

[2] The poison-pill preferred was originated by Lenox, Inc., in its battle with Brown-Forman Distillers Corp. *See* Wall St. J., June 16, 1983, at 2, col. 2. Issuance of the preferred has since been announced by Bell & Howell Co., *see* Wall St. J., July 18, 1983, at 7, col. 1, Enstar Corp., *see* Wall St. J., Aug. 16, 1983, at 12, col. 3, Superior Oil Co., *see* Wall St. J., Nov. 25, 1983, at 4, col. 2, and Warner Communications, Inc., *see* Wall St. J., Jan. 13, 1984, at 4, col. 1. Of these five corporations, Bell & Howell, Enstar, and Warner actually issued variants of such preferred stock. Although there is currently no definitive ruling on the legitimacy of the preferred stock dividend, a temporary restraining order was denied in Brown-Forman Distillers Corp. v. Lenox, Inc., No. 83-2116 (D.N.J. June 20, 1983), and a preliminary injunction was denied in National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Aug. 25, 1983), because the parties challenging the dividend were unable to demonstrate the probability of success on the merits.

Currently, legislation is pending before Congress that would require shareholder approval of any issuance of new securities during a tender offer when such securities would constitute more than 5% of the aggregate voting power of the company after issuance. *See* H.R. 5693, 98th Cong., 2d Sess. (1984). Because the poison-pill preferred typically represents about half the issuer's capital, *see infra* note 3, and votes in the same proportion, passage of this legislation would prevent issuance of the preferred once a tender offer has officially begun.

[3] Bell & Howell Co. issued one share of preferred for every 20 shares of common. *See* Wall St. J., July 18, 1983, at 7, col. 1. Because every dividend must be pro rata without even the slightest degree of discrimination, *see* Telvest, Inc. v. Olson, No. 5798, slip op. at 14–15 (Del. Ch. Mar. 8, 1979), Bell & Howell issued fractional shares of the preferred, *see* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 1 (Del. Ch. Aug. 25, 1983). Each preferred share was convertible into 20 shares of common, *see* Certificate of Designations, Preferences and Rights of $12 Convertible Preferred Stock of Bell & Howell Co. § 9 (filed July 20, 1983) [hereinafter cited as Certificate], *reprinted in* Finkelstein, *Antitakeover Protection Against Two-Tier and Partial Tender Offers: The Validity of Fair Price, Mandatory Bid, and Flip-Over Provisions under Delaware Law*, 11 SEC. REG. L.J. 291, 323 (1984), and carried a slightly higher dividend than the common in order to discourage conversion, *see id.* § 2, *reprinted in* Finkelstein, *supra*, at 315. After issuance, each common share sold at approximately half the old common price, and each preferred share sold at about 20 times the new common price. *See* *NYSE–Composite Transactions*, Wall St. J., Aug. 29, 1983, at 32, col. 2 (old common sold at $52 per share); *NYSE–Composite Transactions*, Wall St. J., Aug. 30, 1983, at 48, col. 2 (new common sold at $24.75 per share, new preferred at $485). It can therefore be estimated that Bell & Howell's preferred represented half its capital.

an outside entity acquires control[4] of the company,[5] and the redemption price is the highest price per share paid for the target's shares in the year the acquiring entity gained control.[6] In addition, the preferred shareholders are entitled to convert their shares into common stock of the target company[7] and into the common or convertible preferred stock of any controlling entity into which the target company is merged.[8]

Part I of this Note describes the effect of poison-pill preferred stock and concludes that it protects the target's shareholders against partial[9] and two-tiered[10] tender offers but does not discourage takeover bidders willing to acquire at least a sixty-five percent interest in the target. Part II considers the capacity of a company's board of directors to issue the preferred stock under state fiduciary law and argues that such issuance will constitute a breach of the directors' fiduciary duty to the shareholders only in extreme cases. Part III examines the preferred stock's validity under the Delaware corporation statute and concludes that it should pass statutory muster. Part IV analyzes the application of section 14(e) of the Williams Act[11] to

---

[4] Although ownership of 51% of the voting stock is necessary to provide absolute certainty of control, a substantially smaller percentage usually confers effective control. *See* Essex Universal Corp. v. Yates, 305 F.2d 572, 579 (2d Cir. 1962) (observing that a 28.3% owner is "almost certain to have share control as a practical matter"). Bell & Howell Co. defined 40% ownership as control for purposes of the special redemption and conversion privileges. *See* Wall St. J., July 18, 1983, at 7, col. 1.

[5] *See* Certificate, *supra* note 3, § 6, *reprinted in* Finkelstein, *supra* note 3, at 320.

[6] *See id.* § 6, *reprinted in* Finkelstein, *supra* note 3, at 322. The redemption price is the greater of either the highest price paid for the target's common stock multiplied by the number of common shares into which one preferred share is convertible or the highest price paid for the target's preferred stock. *See id.* Thus, the redemption price should usually be the same as the tender offer price.

[7] *See supra* note 3.

[8] *See* Certificate, *supra* note 3, § 10, *reprinted in* Finkelstein, *supra* note 3, at 328. Once a controlling shareholder announces a merger plan, redemption rights attached to the preferred are suspended and are supplanted by the conversion rights. *See id.* § 6, *reprinted in* Finkelstein, *supra* note 3, at 320. The preferred is convertible into the acquirer's stock at a ratio that values the preferred at the tender offer price. *See id.* § 10, *reprinted in* Finkelstein, *supra* note 3, at 328. The conversion privilege has little value if the acquirer is a nonpublic corporation. Preferred stockholders would be unlikely to exchange their liquid shares for stock that lacks a public market. Therefore, approval by 80% of the Bell & Howell preferred shareholders is required for any merger with a nonpublic corporation. *See id.* § 10, *reprinted in* Finkelstein, *supra* note 3, at 328–29. Approval by 80% of the preferred holders is also required to alter any of the rights attached to the preferred class. *See id.* § 3, *reprinted in* Finkelstein, *supra* note 3, at 317.

[9] A partial tender offer is an offer to buy at least a controlling interest in a corporation but less than all its shares. *See* Finkelstein, *supra* note 3, at 291.

[10] A two-tiered tender offer is "a partial tender offer . . . coupled with an announced plan to follow up with a second-step merger at a lower price per share." Mirvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485, 485 (1983).

[11] 15 U.S.C. § 78n(e) (1982).

substantive defensive maneuvers and suggests that defensive tactics such as the issuance of poison-pill preferred stock are more properly regulated by state law.

I. Protection Against Partial and Two-Tiered Tender Offers

Any tender offer undeniably contains an element of coercion. Even a shareholder who opposes a takeover bid will nevertheless usually tender his stock to avoid being locked into a minority position under new management.[12] The two-tiered tender offer[13] is an attempt to purchase one hundred percent of the target company in a manner that maximizes the coercion inherent in the tender offer process. Instead of offering to buy all the target's shares at price X, the bidder offers to buy fifty-one percent of the shares at price $X + Y$ and announces its desire to acquire the remainder in a second-step merger at price $X - Y$.[14] Thus, the target's shareholders are induced to tender both by carrot (the premium offered in the first stage) and by stick (the lower price offered in the second).[15] The coercive nature of the two-tiered tender offer has been noted by courts,[16] commentators,[17] and an advisory committee of the Securities and Exchange Commission.[18]

The partial tender offer presents the target's shareholders with a similar dilemma.[19] In the partial tender offer, the potential acquiring

---

[12] *See* Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113–14 (1979); Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 COLUM. L. REV. 249, 307 (1983). Ohio recently moved to eliminate the coercion inherent in tender offers by making approval by holders of a majority of the common shares a prerequisite to acceptance of a tender offer. *See* OHIO REV. CODE ANN. § 1701.83.1 (Page Supp. 1982). Under the Ohio rule, shareholders can vote not to accept the offer and then tender anyway if the majority disagrees. Nevertheless, the Ohio approach is of questionable constitutionality in light of Edgar v. MITE Corp., 457 U.S. 624 (1982), in which the Supreme Court held that the Illinois Business Takeover Act placed an undue burden on interstate commerce; thus, such an approach is unlikely to remove the need for the preferred.

[13] *See supra* note 10.

[14] The right of dissenting shareholders to an equitable appraisal of the fair market value of their shares, *see, e.g.*, DEL. CODE ANN. tit. 8, § 262(a) (1983), places a floor on the second-tier price.

[15] *See* Schneiderman, *New Tender Techniques Key Legislative Concern*, N.Y.L.J., June 6, 1983, at 25, col. 2.

[16] *See* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982); Radol v. Thomas, 534 F. Supp. 1302, 1312 (S.D. Ohio 1982).

[17] *See* Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 337 (1974); Finkelstein, *supra* note 3, at 291–93; Lowenstein, *supra* note 12, at 308; Mirvis, *supra* note 10, at 489 & n.8. *But see* Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 727 (1982).

[18] *See* ADVISORY COMM. ON TENDER OFFERS, SEC. & EXCH. COMM'N, REPORT OF RECOMMENDATIONS 25–26 (1983).

[19] *See* Finkelstein, *supra* note 3, at 292–93 (asserting that minority shareholders will fear unfavorable second-step merger).

entity offers to buy a controlling — though not complete — interest in the target company. Holders of the target's shares are therefore faced with the choice of accepting the takeover premium or risking abuse at the hands of the new majority shareholder should the takeover bid succeed.[20] Although the costs of refusing to tender are less precisely defined in the case of partial tender offers than in that of two-tiered tender offers, the coercive effect is nevertheless substantial.

The issuance of poison-pill preferred stock inhibits both partial and two-tiered takeover bids. The redemption privilege attached to the stock discourages the making of partial tender offers by giving its holders the power to deplete the target company's assets substantially;[21] the conversion privilege discourages two-tiered tender offers by equalizing the prices of the tiers. Redemption and conversion options neutralize the coercive effects of partial and two-tiered tender offers by allowing shareholders to decline to tender their shares yet still receive the tender offer price in cash or its equivalent if the tender offer succeeds.

The issuance of preferred shares, however, should not discourage takeover bidders willing to acquire all, or a substantial majority, of the target's shares. For example, in the case of Bell & Howell Co., whose preferred stock represents fifty percent of the corporation's capital,[22] a bidder willing and able to acquire sixty-five percent of the company — half the common plus eighty percent of the preferred stock — can take absolutely any action it wants. Acquiring half the common stock gives the bidder control of the target, and obtaining eighty percent of the preferred stock allows the new preferred holder to eliminate the defensive terms of the preferred by charter amendment.[23]

There remains the problem of nontendering shareholders. If the bidder is willing to buy all of the preferred shares, the redemption terms present no obstacle as long as the tender offer succeeds. Shareholders desiring to liquidate their investments will simply accept the tender offer. If shareholders instead hold out in the hope that the takeover bid will fail and later decide to liquidate their investments, the bidder need only redeem the shares out of the target's treasury and replenish the treasury by repurchasing the shares from the treasury at the redemption price. Because the redemption price will

---

[20] In upholding board action to block a partial takeover bid, one court noted that an acquisition of a 51% interest would "subject the remaining shareholders to a captive status." Beebe v. Pacific Realty Trust, No. 83-228, slip op. at 8 (D. Or. Jan. 12, 1984).

[21] This is the "scorched earth" element of the preferred. *See* Wall St. J., Nov. 28, 1983, at 2, col. 3. For instance, Superior Oil Co., with working capital of of $650 million, would have had to pay $2 billion to redeem all its preferred shares. *See* Wall St. J., Nov. 25, 1983, at 4, col. 2.

[22] *See supra* note 3.

[23] *See* Certificate, *supra* note 3, § 3, *reprinted in* Finkelstein, *supra* note 3, at 317.

almost always equal the tender offer price,[24] the result will be as it would have been if the shareholders had all tendered.

The conversion privilege presents only a small obstacle to the bidder willing to purchase all of the preferred stock. If the bidder desires a second-stage merger, there is no way to prevent nontendering shareholders from diluting the ownership power of the acquiring company's shareholders in the acquiring company itself.[25] But if the bidder is willing to purchase all the preferred shares at a fair price, the holders of the few remaining untendered shares will not be able to effect a substantial dilution of control.[26] Moreover, dilution of control is not an unusual incident to mergers: shareholders of the expiring corporation are commonly allowed to exchange their shares for stock in the surviving corporation.[27]

II. State Fiduciary Law

Corporate directors have a fiduciary duty to act in the best interests of the corporation's shareholders.[28] This duty requires the directors to attempt to block takeovers that would be harmful to the target company[29] and to refrain from acting selfishly to preserve their own authority.[30] Because poison-pill preferred stock can thwart partial and two-tiered tender offers,[31] directors who issue such stock may be charged with seeking to perpetuate their own control and thus breaching their fiduciary duty.[32] The following analysis focuses on the standard by which the actions of directors should be judged and then applies that standard to directors' issuance of the poison-pill preferred.

---

[24] *See supra* note 6.

[25] This dilution is the "poison pill" element of the preferred. *See* Wall St. J., Nov. 28, 1983, at 2, col. 3. For instance, if Brown-Forman acquired a controlling interest in Lenox, conversions of Lenox preferred into Brown-Forman common had the potential to reduce the Brown family's control of Brown-Forman from 62% to about 30%. *See* Wall St. J., June 16, 1983, at 2 col. 2.

[26] Although the Brown family was faced with a substantial dilution of control in Brown-Forman's attempt to acquire Lenox, *see supra* note 25, it was speculated that enough shares would be tendered to allow the Brown family to retain a 53% interest after the second-step merger. Brown-Forman was therefore reported to be ready to proceed with its offer. *See* Wall St. J., June 20, 1983, at 8, col. 3.

[27] *See, e.g.*, Sterling v. Mayflower Hotel Corp. 33 Del. Ch. 293, 303, 93 A.2d 107, 112 (Del. 1952) (observing that "merger ordinarily contemplates the continuance of the enterprise and of the stockholder's investment therein, though in altered form").

[28] *See, e.g.*, Guth v. Loft, Inc., 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Del. 1939).

[29] *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 381 (2d Cir. 1980); Heit v. Baird, 567 F.2d 1157, 1161 (1st Cir. 1977); Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706, 712 (N.D. Ill. 1969); Gerdes v. Reynolds, 28 N.Y.S.2d 622 (Sup. Ct. 1941) (holding directors liable in damages for neglecting to prevent a harmful takeover).

[30] *See, e.g.*, Schnell v. Chris-Craft Indus., 285 A.2d 437, 439 (Del. 1971).

[31] *See supra* p. 1967.

[32] *See* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 2 (Del. Ch. Aug. 25, 1983).

A. Judging Fiduciary Duty Claims

Courts review the decisions of corporate directors under the business judgment rule. According to the rule, directors' decisions are presumed to be based on sound business judgment; this presumption can be rebutted only by a showing of fraud, bad faith, or gross overreaching.[33] Courts are willing to defer to directors because it is the board's duty to manage the affairs of the corporation[34] and because courts often consider themselves ill-equipped to second-guess business decisions.[35] The presumption of sound business judgment allows the directors to prevail whenever they can articulate a rational, unselfish business purpose for their actions.[36] Not surprisingly, directors' decisions are seldom overturned when subjected to review under such a lenient standard.[37]

The business judgment rule does not apply when the board faces a conflict of interest.[38] In such cases, directors bear the burden of showing the "intrinsic fairness" of their actions. Normally, this showing entails a demonstration of the substantive fairness of the challenged transaction.[39] Nonetheless, because courts are ill-equipped to decide the complex business questions posed by takeover conflicts,[40] courts do not apply the "intrinsic fairness" test in this context. When a majority of the board consists of interested directors, the courts typically use motive as a surrogate for substance: the board bears the burden of proving that the challenged defensive tactic was motivated by a valid business purpose and that the valid purpose was the *primary* motivation for the board's defensive maneuver.[41]

It would seem that when directors act in response to hostile takeover bids, an inherent conflict of interest exists.[42] Nevertheless, when

---

[33] *See, e.g.*, Panter v. Marshall Field & Co., 646 F.2d 271, 293 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); Warshaw v. Calhoun, 43 Del. Ch. 148, 157, 221 A.2d 487, 492–93 (Del. 1966).

[34] *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1983).

[35] *See, e.g.*, Auerbach v. Bennett, 47 N.Y.2d 619, 630, 393 N.E.2d 994, 1000, 419 N.Y.S.2d 920, 926 (1979); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 822–23 (1981).

[36] *See, e.g.*, Johnson v. Trueblood, 629 F.2d 287, 292 (3d Cir. 1980), *cert. denied*, 450 U.S. 999 (1981); Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

[37] *See* E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 75–81 (1972). *But see* Arsht, *Fiduciary Responsibilities of Directors, Officers and Key Employees*, 4 DEL. J. CORP. L. 652, 657 (1979).

[38] *See, e.g.*, Cohen v. Ayers, 596 F.2d 733, 739–40 (7th Cir. 1979) (director-company contract).

[39] *See* Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 674, 676 (1979).

[40] *See* Gilson, *supra* note 35, at 828.

[41] *See, e.g.*, Treadway Cos. v. Care Corp., 638 F.2d 357, 382 n.47 (2d Cir. 1980).

[42] *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1175 (1981); Note, *Lock-Up Options: Toward a State Law Standard*, 96 HARV. L. REV. 1068, 1077 (1983).

the target's board includes a majority of "independent," nonmanagement directors, most courts hold that no conflict of interest exists and thus apply the more lenient business judgment rule,[43] because independent directors appear less likely than inside directors to devise defensive strategies on the basis of self-interest. Since most boards of directors include a majority of independent directors, the "primary purpose" test can be viewed as a rather limited exception to the generally applicable business judgment rule.

In practice, moreover, the "primary purpose" test differs little from the business judgement rule. Because proving primacy of purpose is extremely difficult, and because a strict application of the "primary purpose" test would thus render the board virtually unable to block any takeovers, including undesirable ones, courts are inclined to apply the "primary purpose" exception in a manner indistinguishable from the business judgment rule.[44] Even when courts recognize a conflict of interest and apply the "primary purpose" test, they seem satisfied if the directors merely articulate a rational basis for their actions.[45]

Yet courts need not be so lax in judging the conduct of directors charged with breaching their fiduciary duty.[46] A middle position may be taken between presuming the directors' good faith (the business judgment rule) and requiring directors to demonstrate a legitimate primary purpose: the directors should be required to articulate a *substantial*, unselfish business purpose for taking defensive action during a takeover attempt. This test would strike a proper balance between limiting the danger that directors will act selfishly and preserving the directors' discretion to fulfill their fiduciary duty by preventing undesirable takeovers. Although such a test would yield a finding against a board that could articulate only trivial purposes for its actions, the test would pose no serious impediment to directors who

---

[43] *See* Panter v. Marshall Field & Co., 646 F.2d 271, 294 (7th Cir.), *cert. denied*, 454 U.S. 1092 (1981); *Treadway Cos.*, 638 F.2d at 383; Buffalo Forge Co. v. Ogden Corp., 555 F. Supp. 892, 904 (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 104 S. Ct. 550 (1983); Martin Marietta Corp. v. Bendix Corp, 549 F. Supp. 623, 634 (D. Md. 1982); Whittaker Corp. v. Edgar, 535 F. Supp. 933, 951 (N.D. Ill. 1982). *But see* Klaus v. Hi-Shear Corp., 528 F.2d 225, 233–34 (9th Cir. 1975).

[44] *See* 1 A. FLEISCHER, TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING 163–66 (rev. ed. 1983) (noting that primary purpose test yields same results as business judgment rule); Gilson, *supra* note 35, at 829.

[45] For example, in Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964), the Delaware Supreme Court purported to apply the "primary purpose" test. *See id.* at 504–05, 199 A.2d at 555. But the court phrased the issue as "whether or not defendants satisfied the burden of proof of showing *reasonable* grounds to believe a danger to corporate policy and effectiveness existed." *Id.* at 506, 199 A.2d at 555 (emphasis added). Upon finding such reasonable grounds, the court approved the directors' conduct without considering whether their business purpose was primary. *See id.* at 506–08, 199 A.2d at 555–56.

[46] Application of the business judgment rule to defensive takeover tactics has been severely criticized. *See, e.g.*, Noble, *SEC Position on Takeovers*, N.Y. Times, May 1, 1984, at D2, col. 1.

act in good faith. The proposed standard is also sensitive to institutional considerations: it allows courts to focus on the peculiarly legal inquiry into motive rather than undertake an inquiry into substantive business fairness, and it places the burden of proof on the directors, in whose possession the evidence of motive lies.

B. The Preferred Stock and Fiduciary Duty

Directors issuing poison-pill preferred stock should be able to satisfy the substantial business purpose test. When the preferred stock is issued before a specific takeover bid is made, the directors will be able to articulate a cogent, unselfish business purpose for their action: protecting shareholders from the coercive aspects of partial and two-tiered takeover bids.[47] Moreover, because the issuance of preferred stock discourages only those takeover bidders interested in acquiring less than sixty-five percent of the company and those inordinately concerned about the conversion privilege,[48] it is only marginally useful in preventing shifts in control. The limited deterrent effect constitutes circumstantial evidence that the board has not issued the preferred stock simply in order to maintain its control of the company.[49] Therefore, the board should be able to withstand challenge unless specific evidence demonstrates that the board acted for selfish reasons.

When the board issues poison-pill preferred stock in response to a partial or two-tiered tender offer, the board undeniably is motivated by a desire to preserve its control. Yet that desire is not necessarily selfish: the board is duty-bound to preserve its control when passivity would threaten the interests of its shareholders.[50] In the case of a reactive issuance, the increased danger that directors may be acting selfishly appears to be balanced by the need to protect the shareholders' interest in fending off the coercive takeover tactics that the preferred stock is designed to prevent; it would be anomalous to disallow the preferred stock in the situations in which it is most needed. The only real difference between prospective and reactive issuance of the preferred stock is that, in the latter case, the board has an opportunity to examine a specific takeover bid before acting. An obviously attractive bid may provide circumstantial evidence of the board's bad faith in opposing it.

If the terms of preferred stock are not narrowly tailored to prevent partial and two-tiered tender offers, however, it should be deemed illegitimate. Sometimes, for instance, protection against coercive par-

---

[47] *See supra* pp. 1966–67.

[48] *See supra* pp. 1967–68.

[49] The *Bell & Howell* court found it significant that the board's action was taken prior to the existence of any particular takeover bid. *See* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 10 (Del. Ch. Aug. 25, 1983).

[50] *See* cases cited *supra* note 29.

tial and two-tiered tender offers is unneccessary — as when a bidder has made a cash offer for all the target's shares.[51] Alternatively, the preferred stock may contain extreme terms that make *any* takeover impossible,[52] terms suggesting that the board acted simply for its own selfish ends. In both such cases, the board should be required to convince the court that it does indeed possess a substantial business purpose for its actions.

III. The Delaware Corporation Statute

The lenient standard of review applicable to questions of directors' discharge of their fiduciary duty[53] has created pressure to find other grounds on which to challenge corporate action. One such ground might be the Delaware corporation statute, and indeed there are several respects in which the issuance of preferred stock with special redemption and conversion rights could be argued to violate the statute: it represents an improper use of the board's power to issue "blank check" stock;[54] the supermajority voting rights it confers[55] improperly alter common voting rights on certain merger questions; and it improperly discriminates[56] against controlling shareholders.[57] Delaware

[51] Lenox's preferred was issued in response to a 100% cash offer by Brown-Forman. *See* Wall St. J., June 16, 1983, at 2, col. 2. Lenox argued that the special conversion rights of the preferred were necessary to allow target shareholders to maintain an equity investment of comparable value after any second-step merger. *See* Brown-Forman Distillers Corp. v. Lenox, Inc., No. 83-2116, slip op. at 2–3 (D.N.J. June 20, 1983). Since a holder of publicly traded stock has little interest in remaining a stockholder for its own sake, this would seem insufficient to satisfy the substantial business purpose test. Lenox's true motive seems to have been discouraging Brown-Forman's bid by threatening to dilute the Brown family's control of Brown-Forman. *See supra* note 25.

[52] It would be manifestly improper for the redemption or conversion price to be a multiple of the tender offer price.

[53] *See supra* pp. 1969–70.

[54] Blank-check stock is stock whose terms are fixed by board resolution at the time of issuance.

[55] *See supra* note 8.

[56] *See infra* notes 92–93.

[57] In addition to the grounds enumerated, the preferred has been challenged on two other grounds. First, it has been argued that the conversion privilege would unduly limit the board's discretion in negotiating mergers. *See* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 6 (Del. Ch. Aug. 25, 1983). Although the conversion privilege requires that any merger agreement allow preferred holders to convert into the acquirer's stock, this restriction on the board is less severe than others allowed by the Delaware courts. *See* Adams v. Clearance Corp., 35 Del. Ch. 459, 121 A.2d 302 (Del. 1956) (allowing directors to place into a voting trust stock that constituted substantially all the corporation's assets). Second, it has been argued that the redemption terms are improper because the redemption price would not be a matter of public record. *See Bell & Howell*, slip op. at 7. Since Delaware law merely requires that the price be "ascertainable," *see* Del. Code Ann. tit. 8, § 151(a) (1983), this view would seem to add an unwarranted element to the statutory terms.

statutory law, however, suggests that each of these arguments is of doubtful validity.

A. *Blank-Check Stock*

Blank-check stock was originally conceived as a device to facilitate the marketing of securities. Such stock allows the board to solicit capital in accordance with prevailing market conditions, without the delay engendered by charter amendments and shareholder votes.[58] One could argue, therefore, that blank-check stock lacking an investment purpose, such as poison-pill preferred stock, violates the Delaware statute.[59] Legislative intent and certain statutory analogies indicate, however, that the power to issue blank-check stock should be more expansive.

Three factors in particular suggest that the Delaware legislature intended to confer upon corporate boards of directors a broad power to issue blank-check stock. First, such preferred stock is issued pursuant to sections 102(a)(4) and 151(a) of the Delaware corporation statute.[60] These sections allow a corporation's board to issue preferred stock on such terms as it shall fix by resolution at the time of issuance, provided the power to do so is reserved in the corporate charter;[61] the language of the statute does not place *any* limitations on the board. This language contrasts sharply with that of other state statutes that explicitly limit the power of boards to issue blank-check stock.[62] Although this unqualified language should not prevent courts from creating limitations,[63] it suggests that such limitations should be sparing. Second, the Delaware corporation statute should be viewed as an enabling measure rather than a constraining one.[64] Its terms are to be liberally construed in order to provide maximum scope for

---

[58] *See* 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5284.1 (rev. ed. 1971).

[59] *See* Brief for Plaintiff in Support of Motion for Summary Judgment at 15–17, National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Mar. 12, 1984).

[60] *See* DEL. CODE ANN. tit. 8, §§ 102(a)(4), 151(a) (1983).

[61] Section 151(a) states:

> Every corporation may issue 1 or more classes or series of stock . . . which . . . may have such voting powers . . . and such designations, preferences, . . . or other special rights . . . as shall be stated . . . in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by the provisions of its certificate of incorporation.

Id. tit. 8, §151(a).

[62] *See, e.g.*, TEX. BUS. CORP. ACT ANN. art. 2.13 (Vernon 1980). These limitations protect the vested rights of other preferred series. When the rights of common stockholders — who elect the directors — are at issue, the case for limiting the blank-check power is weaker.

[63] *See* Berle, *Investors and the Revised Delaware Corporation Act*, 29 COLUM. L. REV. 563, 579 (1929).

[64] *See* Dodd, *Statutory Developments in Business Corporation Law*, 50 HARV. L. REV. 27, 43 (1936).

managerial discretion.[65] Finally, the statute allows shareholders opposing an expansive blank-check power to confine or deny that power when they vote on the charter provision from which the power derives.[66] The statute therefore contemplates that substantive limitations on the board's power should be set by the shareholders themselves rather than by courts construing the terms of the statute.

An affirmative reason for believing that the board is endowed with the power to defend against partial and two-tiered takeover bids is suggested by a comparison to other statutory powers enjoyed by the board.[67] The board enjoys veto power over transactions, such as mergers and liquidations, that result in a transfer of all the corporation's assets to another party.[68] It would therefore seem proper to give the directors broad discretion in dealing with sale by takeover bid.

Finally, special preferred stock is consistent with other restrictions that the Delaware statute allows to be placed on shareholders. From the shareholders' perspective, the preferred stock is functionally similar to a restraint on alienation. "Reasonable" restraints on alienation are authorized by the Delaware statute.[69] The issuance of the preferred stock would seem to involve such a reasonable restriction because shareholders are prevented from accepting partial and two-tiered takeover bids only in order to protect other shareholders from being coerced into tendering.[70]

There is, of course, a danger that the board will use the blank-check power to advantage itself at the expense of those who hold the existing stock. Evaluating the board's actions in this context requires an inquiry largely indistinguishable from that applicable to claims of breach of fiduciary duty. In view of the laxity of fiduciary duty standards,[71] however, the courts may wish to fashion a stricter rule in the statutory context. This Note has suggested that, to prevail against claims of breach of fiduciary duty in the takeover context, the board should be required to demonstrate a substantial, rather than

---

[65] *See* E. FOLK, *supra* note 37, at xii.

[66] *See* DEL. CODE ANN. tit. 8, §151(a) (1983); N. LATTIN, P. JENNINGS & R. BUXBAUM, CORPORATIONS 1188 (1968) (stating that shareholders who wish to limit the blank-check power should do so in the charter). The enabling provision in Bell & Howell's charter, for instance, simply mirrored the words of § 151(a). *See* Brief for Defendant in Opposition to Motion for Summary Judgment at 24–25, National Educ. Corp. v. Bell & Howell Co., No. 7278 (Del. Ch. Apr. 19, 1984).

[67] The preferred stock offers protection to minority shareholders similar to that offered by supermajority vote requirements for mergers, which have been upheld by the Delaware courts. *See* Seibert v. Gulton Indus., No. 5361 (Del. Ch. June 21, 1979), *aff'd*, 414 A.2d 822 (Del. 1980).

[68] *See* DEL. CODE ANN. tit. 8, §§ 251(b), 271(a) (1983).

[69] *See id.* tit. 8, § 202(c)(4).

[70] *See supra* pp. 1966–67.

[71] *See supra* pp. 1969–70.

merely a rational, business purpose.[72] It has also been argued here that poison-pill preferred stock meets this standard.[73] Thus, such preferred stock should be legitimate under a more rigorous test whether that test is applied under the broad rubric of fiduciary duty or under more technical statutory requirements.

B. Supermajority Voting Rights

The poison-pill preferred stock carries with it supermajority voting rights that allow its holders to block mergers with nonpublic corporations unless four-fifths of the holders assent to such a merger.[74] In *Telvest, Inc. v. Olson*,[75] the Delaware Court of Chancery held[76] that it was improper to issue preferred stock with supermajority voting rights fixed by board resolution, because such stock altered the voting rights attached to common shares.[77] Although one could argue that *Telvest* invalidates the poison-pill preferred,[78] this view seems erroneous[79] for two reasons. First, voting rights attached to the preferred stock do not "alter" the voting rights attached to the common within the meaning of section 242(c)(2) of the Delaware corporation statute.[80] Second, even if one assumes an alteration of the voting rights attached to the common, issuing the preferred stock would still

---

[72] *See supra* p. 1970.

[73] *See supra* p. 1971.

[74] *See supra* note 8.

[75] No. 5798 (Del. Ch. Mar. 8, 1979).

[76] This was an alternative holding. The "preferred" stock at issue in *Telvest* carried no distinctive rights other than supermajority voting rights. Because it had been issued as a pro rata dividend to common holders, the stock's sole effect was to raise the percentage required to approve certain mergers from 51% to 80%. Therefore, the *Telvest* court initially disallowed the issuance on the ground that the counterfeit nature of the preferred dividend was an improper attempt to alter common voting rights. *See id.* at 8. By contrast, the poison-pill preferred possesses priority on dividends, *see* Certificate, *supra* note 3, § 4, *reprinted in* Finkelstein, *supra* note 3, at 318, and on dissolution, *see id.* § 8, *reprinted in* Finkelstein, *supra* note 3, at 323, and is also entitled to a dividend that is higher than the common's, *see id.* § 2, *reprinted in* Finkelstein, *supra* note 3, at 315. These privileges clearly establish the poison-pill preferred as a true preferred class, *see In re* Louisville Gas & Elec. Co., 77 F. Supp. 176, 178–79 (D. Del. 1948); Starring v. American Hair & Felt Co., 21 Del. Ch. 380, 385, 191 A. 887, 890, *aff'd*, 21 Del. Ch. 431, 2 A.2d 249 (Del. 1937), and remove it from the scope of *Telvest's* initial holding.

[77] *See Telvest*, No. 5798, slip op. at 13–14.

[78] *See* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 5 (Del. Ch. Aug. 25, 1983).

[79] *See* Sparks, *Fundamental Corporate Changes: Charter Amendment*, 6 DEL. J. CORP. L. 500, 510 (1981). Indeed, the *Bell & Howell* court referred to *Telvest*'s alternative holding, *see supra* note 76, as "an unfortunate insinuation flowing from perhaps improvident language hastily used in an unreported decision on an emergency injunction application." *Bell & Howell*, slip op. at 5.

[80] DEL. CODE ANN. tit. 8, § 242(c)(2) (1983). If the terms of newly issued stock do not "alter" the rights of preexisting classes, the adversely affected class has no right to vote on such terms, and such terms may therefore be created by board resolution.

be valid because the Delaware statute now allows the board to amend the charter by resolution in the case of newly issued stock.

As a general matter, a board may materially change the prerogatives associated with preexisting classes of stock by issuing new stock with terms that operate to the detriment of the old stock.[81] The Delaware Supreme Court has specifically held that the board does not "alter" the rights attached to preexisting classes when it issues a new class of stock with superior rights.[82] Thus, the Delaware courts have suggested that, if the board is willing to commit the corporation to a bona fide new class of stock, the board may adversely affect preexisting rights without "altering" them within the meaning of section 242(c)(2) of the Delaware corporation statute.

There is good reason to believe that the board's broad power to affect the rights attached to preexisting classes of stock by issuing new stock allows it to alter the voting rights attached to such preexisting stock. Under Delaware law, there is a strong presumption that preferred stock will carry substantial voting rights. If the board resolution creating preferred stock were silent on the matter of voting rights,[83] holders of preferred stock would be entitled to vote on all matters of corporate governance.[84] Thus, the presumption that voting rights attach to the preferred stock would indicate that there is no reason not to extend to the specific question of voting rights the general rule permitting the board to burden the rights attached to the common stock through the terms of preferred stock. Moreover, if common voting rights can be burdened to the extent of attaching fifty-one percent voting rights to the preferred stock on all issues of corporate governance, arguably they may also be burdened to a somewhat greater degree (eighty percent class vote of the preferred stock) on one issue of special interest to the preferred class and of minimal interest to the common shareholders: mergers with nonpublic corporations.

Finally, even if the preferred stock's supermajority voting rights "alter" common voting rights within the meaning of section 242(c)(2) of the Delaware statute, the board may still create such supermajority rights by resolution. Because the voting rights attached to common stock are always fixed in the charter, any alteration of these rights

---

[81] *See* Shanik v. White Sewing Mach. Corp., 25 Del. Ch. 371, 19 A.2d 831 (Del. 1941); Morris v. American Pub. Util. Co., 14 Del. Ch. 136, 122 A. 696 (1923).

[82] *See* Hartford Accident & Indem. Co. v. W.S. Dickey Clay Mfg. Co., 26 Del. Ch. 411, 24 A.2d 315 (Del. 1942).

[83] In fact, the holders of the preferred are explicitly granted the right to vote on all matters of corporate governance. *See* Certificate, *supra* note 3, § 3, *reprinted in* Finkelstein, *supra* note 3, at 316.

[84] *See* Rice & Hutchins, Inc. v. Triplex Shoe Co., 16 Del. Ch. 298, 313, 147 A. 317, 324 (1929), *aff'd*, 17 Del. Ch. 356, 152 A. 342 (Del. 1930); Morris v. American Pub. Util. Co., 14 Del. Ch. 136, 155, 122 A. 696, 705 (1923).

requires a charter amendment.[85] Section 151(a) grants the board plenary power to attach voting rights to blank-check stock by resolution.[86] The Delaware legislature has recently supplemented this power by specifying in section 151(g) that the board can amend the charter simply by filing a copy of the board's resolution setting the terms of newly issued stock.[87] Notwithstanding the unambiguous language of section 151(g), it might be argued that this provision does not permit the board to alter the rights of those who hold preexisting classes of stock, but only to fix the rights of the shareholders of the new class of stock.[88] Nonetheless, because section 151(g) appears to have been passed in reaction to the holding of *Telvest*,[89] the plain language of the statute should be taken seriously: the board has the power to amend the charter by issuing blank-check stock, even if such stock effectively alters the rights attached to preexisting classes of stock.[90]

C. Discrimination Against the Acquirer

An entity acquiring control[91] of the corporation issuing the preferred stock does not possess the same redemption[92] and conversion[93]

---

[85] When such an amendment is accomplished by shareholder vote, it must be approved by a majority of the common shares voting separately as a class. *See* DEL. CODE ANN. tit. 8, § 242(c)(2) (1983).

[86] *See id.* tit. 8, § 151(a).

[87] *See* 64 DEL. LAWS 112, § 10 (1983) (amending DEL. CODE ANN. tit. 8, § 151(g) (1983)).

[88] *Cf.* Berle, *supra* note 63, at 568 (expressing concern that the board might be able to change the terms of blank-check stock at any time because the board can ordinarily change by resolution that which it has provided by resolution).

[89] *Telvest* was decided in 1979, *see* Telvest, Inc. v. Olson, No. 5798 (Del. Ch. Mar. 8, 1979), and § 151(g) was amended in 1983, *see* 64 DEL. LAWS 112, §10 (1983) (amending DEL. CODE ANN. tit. 8, § 151(g) (1983)).

[90] The doctrine of "independent legal significance" holds that, if action can be accomplished in either of two ways, it need not satisfy the prerequisites of both. *See* Orzeck v. Engelhart, 41 Del. Ch. 361, 365–66, 195 A.2d 375, 377 (Del. 1963); Hariton v. Arco Elec., Inc., 41 Del. Ch. 74, 76, 188 A.2d 123, 125 (Del. 1963); Field v. Allyn, 457 A.2d 1089, 1098 (Del. Ch. 1983), *aff'd*, 467 A.2d 1274 (Del. 1983). The fact that a charter amendment accomplished by shareholder vote would have to be approved by the common shares as a class, *see supra* note 85, should not prevent the board from amending the charter by resolution.

[91] For a discussion of control, see note 4.

[92] For a description of the redemption privilege, see p. 1965. Affording an acquiring company this privilege would lead to a substantial liquidation of company assets. *See supra* p. 1967 & note 21. Because the only limitation on such liquidation would be a company's duty not to impair its capital by redeeming stock, *see* DEL CODE ANN. tit. 8, § 160(a)(1) (1983), a controlling entity is denied the redemption privilege. *See* Certificate, *supra* note 3, § 6, *reprinted in* Finkelstein, *supra* note 3, at 319–20.

[93] For a description of the conversion privilege, see p. 1965. If an acquiring entity were freely allowed to convert its preferred shares into common, it would be able to circumvent the defensive mechanisms of the preferred by purchasing all the preferred, converting it into common, and squeezing out the remaining common holders with the control thus obtained. Consequently, for one year following acquisition, a controlling entity is denied the right to convert its preferred shares into common. *See* Certificate, *supra* note 3, § 9, *reprinted in* Finkelstein, *supra* note 3, at 323.

privileges that other preferred stockholders do. Because section 151 of the Delaware statute refers to classes and series, and suggests that the terms relating to each share within a class must be uniform,[94] the preferred stock's terms arguably constitute improper discrimination against a controlling shareholder.[95] In *Providence & Worcester Co. v. Baker*,[96] however, the Delaware Supreme Court upheld a voting scheme in which every common shareholder received one vote for each of his first fifty shares and one vote for every block of twenty shares thereafter — a scheme that limited a 28% shareholder to 3% of the voting power.[97] According to the Court, limitations triggered by the identity and the ownership power of a shareholder are not improper because "these restrictions are limitations upon the voting rights of the shareholder, not variations in the voting power of the stock *per se*."[98]

Providence & Worcester suggests that the preferred stock's terms are valid because the discrimination against the acquirer is based on its status as a controlling entity and does not affect the quality of individual shares. Moreover, the *Providence & Worcester* court noted that section 212(a) of the Delaware corporation statute specifically empowers the board to deviate from the one share-one vote standard.[99] The provisions dealing with redemption[100] and conversion[101] allow the board similar discretion.

IV. THE WILLIAMS ACT

The object of the poison-pill preferred is to eliminate the coercive aspects of partial and two-tiered takeover bids.[102] Because this maneuver forces the raider to bid for more of the target than originally desired, it might be argued that the preferred stock distorts the market and thus is "manipulative" in violation of section 14(e) of the Williams Act.[103] In *Mobil Corp. v. Marathon Oil Co.*,[104] the Sixth Circuit held

---

[94] *See* DEL. CODE ANN. tit. 8, § 151(a) (1983).

[95] *See* National Educ. Corp. v. Bell & Howell Co., No. 7278, slip op. at 6 (Del. Ch. Aug. 25, 1983).

[96] 378 A.2d 121 (Del. 1977), *rev'g* 364 A.2d 838 (Del. Ch. 1976).

[97] *See* Baker v. Providence & Worcester Co., 364 A.2d 838, 840–41 (Del. Ch. 1976).

[98] *Providence & Worcester*, 378 A.2d at 123.

[99] *See id.*; DEL. CODE ANN. tit. 8, § 212(a) (1983) ("Unless otherwise provided . . . each stockholder shall be entitled to 1 vote for each share of capital stock . . . .").

[100] *See* DEL. CODE ANN. tit. 8, § 151(b) (1983) (providing that redemption rights are subject to "such adjustments, as shall be stated . . . in the resolution or resolutions providing for the issue of such stock").

[101] *See id.* tit. 8, § 151(e) (providing that conversion rights are subject to "such adjustments as shall be stated . . . in the resolution or resolutions providing for the issue of such stock").

[102] *See supra* pp. 1966–67.

[103] 15 U.S.C. § 78n(e) (1982).

[104] 669 F.2d 366 (6th Cir. 1981).

that defensive takeover tactics, even if fully disclosed, are subject to the strictures of the Williams Act. Although the recent district court opinion in *Data Probe Acquisition Corp. v. Datatab, Inc.*[105] followed the Sixth Circuit's lead, *Marathon* has been rejected by most courts[106] and commentators.[107] The accepted meaning of "manipulation" and the legislative history of section 14(e) suggest that substantive defensive tactics are beyond the scope of the Williams Act.

A. The Supreme Court's View of the General Problem of "Manipulation"

Section 14(e) of the Williams Act prohibits "manipulative acts or practices, in connection with any tender offer."[108] As the Supreme Court noted in *Ernst & Ernst v. Hochfelder*,[109] "manipulation" is "virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities."[110] The Court clarified the meaning of "manipulation" in *Santa Fe Industries, Inc. v. Green*:[111] the term "refers generally to practices such as wash sales, matched orders, or rigged prices, that are intended to mislead investors by artificially affecting market activity."[112] Thus, the core notion of "manipulation" involves the misleading of investors by causing them to buy or sell at inaccurate, deceptive prices.[113]

---

[105] 568 F. Supp. 1538 (S.D.N.Y), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984). Although the Second Circuit reversed the district court, no attempt was made to address the central arguments in the lower court's opinion.

[106] *See* Dan River, Inc. v. Icahn, 701 F.2d 278, 287–88 & n.10 (4th Cir. 1983); Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982); Marshall Field & Co. v. Icahn, 537 F. Supp. 413, 422 (S.D.N.Y. 1982); *see also* Panter v. Marshall Field & Co., 646 F.2d 271, 283 (7th Cir.) (taking a position implicitly contrary to *Marathon* by making misrepresentation a requisite element of any section 14(e) claim), *cert. denied*, 454 U.S. 1092 (1981); Lewis v. McGraw, 619 F.2d 192, 195 (2d Cir.) (same), *cert. denied*, 449 U.S. 951 (1980).

[107] *See* Nathan, *Lock-Ups and Leg-Ups: The Search for Security in the Acquisitions Marketplace*, 13 INST. ON SEC. REG. 1, 31–32 (1982); Prentice, *Target Board Abuse of Defensive Tactics: Can Federal Law Be Mobilized to Overcome the Business Judgment Rule?*, 8 DEL. J. CORP. L. 337, 353–58 (1983); Note, *supra* note 42, at 1069–74 ; Note, *Tender Offer Defensive Tactics and the Business Judgment Rule*, 58 N.Y.U. L. REV. 621, 639 (1983) [hereinafter cited as Note, *Tender Offer Tactics*]; Bialkin, *Court Casts Cloud over Option Tactics in Takeovers*, Legal Times of Wash., Jan. 11, 1982, at 19, col. 1. *But see* Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibition Against Manipulation*, 35 VAND. L. REV. 1087 (1982); Note, *Target Defensive Tactics as Manipulative under Section 14(e)*, 84 COLUM. L. REV. 228 (1984).

[108] 15 U.S.C. § 78n(e) (1982). Thus, the Williams Act, by its clear terms, poses no barrier to the issuance of poison-pill preferred stock before a specific takeover bid is made.

[109] 425 U.S. 185 (1976).

[110] *Id.* at 199.

[111] 430 U.S. 462 (1977).

[112] *Id.* at 476.

[113] *See* Note, *Tender Offer Tactics*, *supra* note 107, at 634. The prohibition on manipulation

The *Marathon* court, purporting to rely on *Ernst & Ernst* and *Santa Fe*, defined "manipulation" as "an affecting of the market for, or price of, securities by *artificial* means, i.e., means unrelated to the natural forces of supply and demand."[114] *Marathon* thereby construed the term to cover *any* artificial market effect, including the blocking of a takeover in the context of full disclosure.[115] Yet the definition given in *Ernst & Ernst* and the examples discussed in *Santa Fe*[116] clearly limit manipulation to actions that deceptively affect market price.[117] Because poison-pill preferred stock does not deceive investors, it does not qualify as "manipulation" under the Williams Act. Consequently, *Marathon*'s unjustified extension of the term has been described by one court as "an exceptionally strained interpretation of *Santa Fe*."[118]

B. Construing Section 14(e)

1. Legislative History. — Although *Ernst & Ernst* and *Santa Fe* were decided under rule 10b-5[119] rather than under section 14(e) of the Williams Act, the *Marathon* court made no attempt to distinguish the purposes of these provisions based upon legislative and administrative history. *Marathon* was thus dismissed by one commentator as an "*ex cathedra*" pronouncement on "manipulation."[120] The district court in *Data Probe* sought to remedy this defect. Judge Sofaer noted that Congress did not wish to discourage tender offers and that the Williams Act was intended to be neutral as between the bidder and the target's management.[121] He therefore concluded that the Williams Act had a purpose beyond requiring full disclosure: permitting shareholders to act on the information disclosed.[122] This second purpose

---

is designed to prevent devices "used to persuade the public that activity in a security is the reflection of a genuine demand instead of a mirage." 3 L. Loss, Securities Regulation 1549–50 (2d ed. 1961) (quoting S. Rep. No. 1455, 73d Cong., 2d Sess. 54 (1934)). Manipulation in the context of a tender offer is illustrated by Atchley v. Qonaar Corp., 704 F.2d 355 (7th Cir. 1983), in which the court held that management had depressed the market price for the target company's shares and had then made a tender offer at an artificially low price. *See id.* at 356.

[114] Mobil Corp. v. Marathon Oil Co., 669 F.2d 366, 374 (6th Cir. 1981).

[115] The *Marathon* court held stock and asset lock-up options invalid because they "completely block[ed]" market activity. *Id.*

[116] *See supra* p. 1979.

[117] To be sure, requiring the bidder to bid for 65% of the target instead of 51% will cause the stock's price to rise; but the Williams Act is intended to protect a target's shareholders, not a takeover bidder. *See* Piper v. Chris-Craft Indus., 430 U.S. 1, 28 (1977). The shareholders' only complaint may be that they have been denied the opportunity to tender.

[118] Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 630 (D. Md. 1982).

[119] 17 C.F.R. § 240.10b-5 (1983).

[120] Note, *supra* note 42, at 1082.

[121] *See* Data Probe Acquisition Corp. v. Datatab, Inc., 568 F. Supp. 1538, 1546–47 (S.D.N.Y.), *rev'd*, 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984.)

[122] *See id.* at 1545.

required that the Act's proscription of manipulation apply to substantive defensive tactics that unduly obstruct shareholder choice.[123]

The legislative history of section 14(e) does not support Judge Sofaer's construction. The Supreme Court has often noted that the basic purpose of federal securities law is the substitution of full disclosure for the principle of *caveat emptor*.[124] When the battle for corporate control is waged by proxy, both sides must make full disclosure under rule 14a-9.[125] With the emergence of the cash tender offer as a popular method of waging corporate warfare,[126] a significant gap appeared in federal securities law — a gap the Williams Act was designed to close by requiring full disclosure in connection with tender offers.[127] Section 14(e) prohibited manipulation as well as nondisclosure because such practices are closely related variants of common law fraud.[128] Beyond mere nondisclosure or verbal deceptions, "manipulation" connotes the creation of deceptive market situations. As Senator Williams noted, "[The Williams Act] is designed solely to require full and fair disclosure for the benefit of investors."[129]

The comments on "neutrality" in the Williams Act's legislative history do not indicate that the Act was intended to prohibit defensive takeover tactics. Indeed, the Act was originally conceived as a tool to aid management against "corporate raiders":[130] it contained a 20-day notice provision to provide warning of tender offers and allow time for defensive maneuvers.[131] The notice provision was eliminated in order not to *add* weapons to management's arsenal; in its final form, the Act was neutral in the sense that its pro-management bias had been eliminated.[132] Thus, the comments from the legislative

---

[123] *See id.* at 1559. Although this Note argues that the Williams Act does not apply to defensive tactics of management, this is not to suggest that issuance of the preferred is contrary to Judge Sofaer's standard. Because the preferred places only marginal restrictions on takeover bids and provides substantial protection against abusive takeover practices, it does not "unduly" obstruct shareholder choice.

[124] *See* Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972); SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

[125] 17 C.F.R. § 240.14a-9 (1983).

[126] At the time he introduced the Williams Act, Senator Williams noted that there had been eight cash tender offers "involving listed companies" in 1960 and 107 such offers in 1966. *See* 113 CONG. REC. 24,664 (1967) (remarks of Sen. Harrison A. Williams).

[127] *See* Piper v. Chris-Craft Indus., 430 U.S. 1, 22 (1977); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 2, *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812; S. REP. NO. 550, 90th Cong., 1st Sess. 2 (1967); 113 CONG. REC. 24, 664 (1967) (remarks of Sen. Williams).

[128] *See* Santa Fe Indus. v. Green, 430 U.S. 462, 477 (1977) (finding § 14(e)'s proscription of manipulation consistent with policy of full disclosure, because nondisclosure is usually essential to the success of any manipulative scheme).

[129] 113 CONG. REC. 24,664 (1967) (remarks of Sen. Williams).

[130] *See* 111 CONG. REC. 28,257 (1965) (remarks of Sen. Williams).

[131] *See id.* at 28,259 (original bill as introduced by Sen. Williams).

[132] *See* Note, *The Williams Amendments*, 23 VAND. L. REV. 700, 703 (1970); Schneiderman, *supra* note 15, at 39, cols. 2–3.

history on neutrality are stated in negative terms: "The bill avoids tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. It is designed to require full and fair disclosure . . . ."[133]

2. *Preemption.* — To support his view of the Williams Act's legislative history, Judge Sofaer relied heavily on *Edgar v. MITE Corp.*,[134] in which the Supreme Court held that the Illinois Business Takeover Act violated the commerce clause.[135] Justice White, writing for a plurality in *MITE Corp.*, also declared that three provisions of the Illinois statute were preempted by the Williams Act: the provision requiring potential takeover bidders to notify both the secretary of state of Illinois and the target company about the offer at least twenty business days before making such offer, the provision empowering the secretary to hold hearings on the substantive merits of the offer, and the provision allowing the secretary to block any takeover bid that contains inequitable terms.[136]

The first two grounds of preemption do not suggest that the Williams Act was intended to prohibit defensive tactics. As noted, the original version of the Act contained a 20-day notice provision that was specifically excised to prevent the statute from adding weapons to management's arsenal. The *MITE Corp.* plurality considered the provisions on notification and administrative hearings to be similar weapons and therefore concluded that the provisions conflicted directly with the Williams Act, as construed in light of its legislative history.[137] The plurality gave no indication, however, that it sought to prohibit defensive measures not addressed by the statute.

The third ground of preemption is more troubling. Justice White stated that the Williams Act was not intended to provide the investor with protection at the expense of autonomy and that there was no justification for allowing the Illinois secretary of state to pass on the substantive fairness of tender offers.[138] Although Justice White's comments might be interpreted to suggest that management should also be prevented from interfering with shareholder autonomy, the finding of preemption in *MITE Corp.* should be understood instead as one defining the boundary of permissible *state* regulation.[139] Because the

---

133 H.R. REP. NO. 1711, 90th Cong., 2d Sess. 4, *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813; S. REP. NO. 550, 90th Cong., 1st Sess. 3 (1967); 113 CONG. REC. 24,664 (1967) (remarks of Sen. Williams).

134 457 U.S. 624 (1982) (plurality opinion).

135 *See id.* at 643.

136 *See id.* at 634–40.

137 The plurality agreed with the Seventh Circuit's holding that the Illinois Act was unconstitutional under the supremacy clause, *see id.* at 624, 630, 634 (citing with approval MITE Corp. v. Dixon, 633 F.2d 486 (7th Cir. 1980), although it framed its own holding in terms of preemption. *See id.* at 639.

138 *See id.* at 639–40.

139 The Second Circuit adopted this view on appeal in *Data Probe*. *See* Data Probe

target's board has a duty to protect shareholders against undesirable tender offers, its power to act should not be affected by the Williams Act's restrictions on state legislation.

3. Federalism. — A broad reading of *MITE Corp.* would federalize the law of fiduciary duty and thus conflict with the established notion that state law should govern internal corporate affairs.[140] Because the Williams Act is silent with regard to substantive defensive measures, states should retain their traditional authority to regulate relations between shareholders and management under section 28(a) of the Securities Exchange Act of 1934.[141] Thus, in *Santa Fe Industries, Inc. v. Green*,[142] the Supreme Court noted that actions that are essentially claims for breach of fiduciary duty must be resolved according to state law.[143] Claims that management has improperly adopted defensive tactics in order to deny shareholders the ability to tender their shares would seem to fall into this category. Therefore, "manipulation" should be given the meaning it usually has in securities law, and should not be construed to extend to defensive tactics such as the poison-pill preferred. Any suggestions for revising the law of fiduciary duty in regard to takeovers should be addressed to state courts and legislatures.

IV. CONCLUSION

This Note has argued that the issuance of poison-pill preferred stock provides legitimate protection against partial and two-tiered tender offers, and should therefore be deemed legitimate under both state fiduciary law and the Delaware corporation statute. The Williams Act should not apply to issuance of such preferred stock. The multiplicity of challenges to the poison-pill preferred has resulted from dissatisfaction with the lax standard for judicial review of breach of fiduciary duty claims. In response, this Note has suggested that board action in the takeover context should be judged under a "substantial business purpose" test. The application of this test, which is more rigorous than the business judgment rule, should do nothing to undercut the legitimacy of the poison-pill preferred.

Acquisition Corp. v. Datatab, Inc., 722 F.2d 1, 5 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984).

[140] *See, e.g.*, Wall St. J., Mar. 14, 1984, at 4, col. 1 (comments of John Shad, Chairman of the SEC).

[141] 15 U.S.C. § 78bb(a) (1982).

[142] 430 U.S. 462 (1977).

[143] *See id.* at 478–79.