WACHTELL, LIPTON, ROSEN & KATZ

November 21, 1985

To Our Clients:

Share Purchase Rights Plans
("Poison Pills")

1. A Rights Plan is legal. A Rights Plan is within the business judgment of the board of directors. As the Supreme Court of Delaware says in Moran v. Household Int'l (No. 37, Nov. 19, 1985)

> "here we have a defensive mechanism adopted to ward off possible future advances and not a mechanism adopted in reaction to a specific threat. This distinguishing factor does not result in the Directors losing the protection of the business judgment rule. To the contrary, pre-planning for the contingency of a hostile takeover might reduce the risk that, under the pressure of a takeover bid, management will fail to exercise reasonable judgment. Therefore, in reviewing a pre-planned defensive mechanism it seems even more appropriate to apply the business judgment rule".

2. A Rights Plan does not change the fiduciary standards to be followed by the board of directors in deciding whether to accept or reject a takeover bid. In the words of the Supreme Court of Delaware, the board "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."

3. A Rights Plan is a reasonable defense against abusive takeover tactics. In the words of the Supreme Court of Delaware, "the directors reasonably believed Household was vulnerable to coercive acquisition techniques and adopted a reasonable defensive mechanism to protect itself."

4. A Rights Plan does not cause a decline in the price of the stock of a company that adopts it. Numerous investment banker studies of stock prices before and after adoption show no attributable decline.

5. A Rights Plan should be adopted before a company becomes a target.

6. Takeover entrepreneurs and speculators hate Rights Plans and are continuing their campaign to outlaw them. Witness the attached Wall Street Journal editorial. While Rights Plans do not prevent all takeovers, they do protect against abusive takeover tactics and they do deter bust-up, bootstrap, two-tier, junk bond takeovers. Naturally those who profit from these takeovers at the expense of American business, workers and communities, and whose wildly speculative activities threaten our entire economic system, oppose anything that restricts their activities. There is no stronger argument for implementing a Rights Plan now.

M. Lipton

Et Tu, Delaware?

The tiny state of Delaware has [b]een a titan in the corporate world. For 50 years, it has been the state of choice for incorporations because its corporate charter and courts have catered to the needs of the market. Its legal rules are aimed at efficiency, and investors feel most safe going with a Delaware company. Until now.

On Tuesday, the Delaware Supreme Court upheld a ruling giving management nearly carte blanche to force poison pills down the throats of shareholders. These anti-takeover provisions discourage changes in ownership, which means that shareholders will not be able to count on the "market for corporate control" to ensure that managers perform well. The result will be fewer takeovers, more entrenched managements and, it is not too much to fear, could eventually lead to European-style ossification of the nation's economy.

The case, Moran vs. Household International, upholds the use of a "flip-over" rights plan. This provision gives shareholders the right to buy $200 of [a]n acquirer's stock for $100 upon a [m]erger; the threat to potential raiders is, in no uncertain terms, that the takeover won't pay. Although Sir James Goldsmith overcame a similar provision adopted by Crown Zellerbach, John Moran, a director and major shareholder of Household International, opposed the poison pill because the major effect is to decrease radically the chances of a takeover.

The court said the rights plan is indeed a "preventive mechanism to ward off future advances." But the directors could adopt the plan and invoke the "business judgment rule" to protect themselves from any shareholder suits. This rule says that managers should be left free to make business decisions, good and bad, without the courts constantly second-guessing them. Even when it comes to fighting takeovers, the Delaware court says, "a board's duty is no different from any other responsibility it shoulders, and its decisions should be no less entitled to the respect they otherwise would be accorded in the realm of business judgment."

This view of the business judgment rule is precisely the problem with the court's decision. Managers get the protection of the rule because courts assume they are meeting their fiduciary duties to shareholders. One of these duties is the pledge not to act self-interestedly at the expense of the company. But, as Seventh Circuit Court of Appeals Judge Frank Easterbrook and University of Chicago law Prof. Daniel Fischel have argued in law-review articles, there is always a conflict when there is a possible takeover: Managers are fighting to keep their jobs, but it might be in the interests of shareholders to get a new set of managers. The Delaware Chancery Court recently voided a poison pill adopted by Revlon Inc. in its unsuccessful takeover defense, but only because a lockup was made in the heat of a takeover battle instead of in advance of battle, as in Household International.

The Delaware courts are losing sight of the fact that a corporation is based on a set of contracts between shareholders and managers, including that managers will act in the best interests of shareholders. But we suspect most Household International shareholders agree with Mr. Moran that the poison pill is a lousy idea. Proof is that the directors had considered asking shareholders to approve a fair price amendment (a poison pill that requires in excess of majority shareholder approval of a hostile takeover that involves buying only some shares at a premium), but backed off from the idea when a proxy solicitation consultant reported that shareholders might vote no.

The trial court heard evidence that shareholders get an average 30% price premium when there is a tender offer and the SEC filed a brief on behalf of Mr. Moran warning that the plan "would deprive shareholders of an opportunity to consider virtually all hostile tender offers." Yet the Delaware Supreme Court endorsed the trial court's view that "shareholders do not possess a contractual right to receive takeover bids." Shareholders do have a right to expect that managers won't entrench themselves.

As we have argued before, shareholders should have to approve any defensive tactic by managers ("Shareholders Know Best," Nov. 1). An SEC study last month found that managers do not even ask shareholders to approve poison pills that seriously jeopardize the chances of takeover, no doubt because the shareholders wouldn't approve. New owners think they can run things more profitably, and so are willing to pay dearly for the right to control the firm. The capital markets, which make billions available for takeovers, are in effect disciplining corporate managers. The result is better-run corporations.

So why is Delaware helping to stop takeovers? One reason may be that managers choose where to incorporate, and will go to the state that best helps them keep their jobs. But this is a shortsighted view. Investors want to invest in corporations that will make them money. They will not want to invest in Delaware-based corporations if that means there is little chance of a profitable takeover. This would be a problem for Delaware, which has been getting almost 20% of its revenues from incorporation fees and franchise taxes.

There is a way for the Delaware Legislature to keep the state's enviable record as a place to incorporate, and keep collecting incorporation revenue. The state lawmakers might consider changing the corporate charter to make it harder for managers to dispense poison pills without exposing these strategies to shareholder approval.