

September 2, 1987

To Our Clients

Proposed Delaware Takeover Defense Stock Redemption StatuteIntroduction

A proposed amendment to the Delaware corporate law would permit Delaware corporations to redeem common stock held by persons who intend to greenmail them or put them "in play" at the lesser of the fair value of the common stock or the average price paid by the acquiror during the previous year. This proposal may provide Delaware corporations with a useful takeover defense in some situations, but we are concerned it will not be effective. In any event, it is not sufficient to protect corporations and their shareholders against abusive takeover tactics and junk bond, bust-up takeovers. It is hoped that this proposal will not divert Delaware from enacting meaningful takeover legislation. We recommend that Delaware adopt the New York type statute that deters bust-up takeovers and the Ohio type statute that affirms the right of a company to remain independent.

Section 151(b) of the Delaware General Corporation Law now permits a corporation which has a governmental license or franchise to conduct its business conditioned upon some or all of the holders of its stock possessing

prescribed qualifications, to have a charter provision providing that its stock is subject to redemption by the corporation to the extent necessary to prevent the loss of such license or franchise or to reinstate it. The proposal would expand Section 151 to permit redemption by the corporation whenever a two-thirds majority of the independent outside directors and a two-thirds majority of the full board conclude (1) that the holder intends to obtain a short-term gain from greenmail or to cause the corporation to enter into a transaction that is not in the long-term interests of the corporation and its stockholders or (2) that the holder's ownership of the stock is causing or is likely to cause a material adverse impact on the corporation's business or prospects, including the impairment of the corporation's relationships with its customers or its ability to maintain its competitive position. These expanded redemption provisions would be applicable to all Delaware corporations which did not "opt out" of its coverage by charter amendment.

The text of the proposed amendment is attached as an appendix. It is loosely based upon a provision in the Connecticut insurance laws that makes the stock of Connecticut insurers subject to redemption at its fair price if the board of directors determines that the stockholder being redeemed fails to meet the prescribed licensing qualifications or otherwise fails to obtain necessary regulatory approvals.

Potential Risks

There is a danger that directors will be exposed to personal liability. In view of the exposure to personal damage suits seeking substantial amounts, boards of directors would be extremely reluctant to exercise the redemption power. The directors would face not an amorphous "class" litigation, but a highly-motivated action by an individual who would be able to show an actual, readily determinable loss.* Furthermore, a board's decision to redeem would be attacked as a breach of its duty of loyalty and, accordingly, board members would not be shielded from liability for monetary damages even if the corporation's charter had been amended to conform with the recent Delaware legislation regarding director and officer liability; only a further -- and highly unlikely -- amendment to the Delaware law eliminating any liability for wrongful redemption (such as by making appraisal the exclusive remedy) could fully protect directors.

The market effect of the proposal is unknown. Potential redemption at the average price paid if a stockholder (including institutional holders) were to support or

* Damages could be measured by the difference between the redemption price and the market price on the date of redemption or the difference between the redemption price and a premium price subsequently paid upon a change of control, plus carrying costs and related fees and expenses.

join in a proposal to restructure or merge a company, is such an extreme penalty that it might depress the trading price and affect the marketability of a company's stock. The reaction of institutional investors and the effect on the market would have to be considered by a board in determining whether to propose a charter amendment to opt out of the statute.

In view of the current interest in one share-one vote and the SEC's "all holders" rulemaking response to Unocal's exclusionary self-tender offer, it seems inevitable that a Delaware forced redemption statute would generate substantial controversy at the SEC and in Congress and could even impel Congress to seek to preempt a broad range of state statutes in this area.

Insufficient Defense to Current Takeover Abuses

The Supreme Court of Delaware has held that a board of directors of a target company has the right, in the proper exercise of its fiduciary duty, to reject a takeover bid and seek to preserve the company's independence. What is needed is a statutory approach to assist boards of directors to protect their companies and shareholders from inadequate or ill-timed takeovers.

The redemption proposal, standing alone, does not provide sufficient protection. Raiders will simply adjust their tactics to avoid the reach of the statute. They will disclaim any intent to seek greenmail or destabilize the corporation for "short-term" gain and claim that their only purpose is an acquisition at a premium price. Indeed, T. Boone Pickens, who in recent weeks has disclosed accumulations or intentions to accumulate positions in Boeing, Singer and Newmont, has now proposed to acquire all of Newmont after having accumulated 9.9% of its stock. If Pickens were simultaneously to disclose both his acquisition proposal and his accumulation, then notwithstanding his history and the Unocal case's characterization of his past actions, one could not be certain that the proposed statute would protect directors who were to authorize a redemption of his Newmont shares.

Recommended Approach

Hence, even if the redemption statute were to be adopted, it should be part of a broader package. The Delaware legislature should consider adopting the approach enacted by seven states, including New York. This approach establishes a five-year freeze on second-step mergers

between a company and a 10% stockholder* unless approved by the board of directors before the acquisition of the 10% stake. Unlike the redemption proposal, this statute addresses the junk bond, bust-up takeover by denying the raider the ability to reach the assets of the target to repay the takeover financing.

We also recommend that the Delaware legislature adopt the portion of the Ohio statute that permits a board faced with a takeover bid to consider a range of factors, including the interests of the corporation's employees, suppliers, creditors, customers and communities which it serves, as well as the long-term interests of the corporation and its shareholders.

Unlike the precedents provided by the New York and Ohio statutes for our recommended approach, the Connecticut insurance company statute is a weak precedent for the redemption proposal. The Connecticut statute can be distinguished by the long tradition of extensive state regulation of insurance companies, including the universal requirement that a state agency approve transfers of "control," defined to mean stock positions of as little as 5%. Furthermore, like the very narrow redemption power presently permitted

* While New York established a 20% threshold for an interested stockholder, we recommend the 10% threshold adopted by New Jersey and four other states.

under Delaware law to be included in corporate charters, the basis for the redemption power in the Connecticut statute is linked to the qualifications to be licensed, which affects the fundamental ability of a regulated corporation to operate as a going concern. There is no precedent for such redemption power in the case of industrial or service corporations generally.

Drafting Issues

Determination of intention to greenmail or put company into play. As noted above, this standard may be ineffective against a raider who takes precautions to avoid its reach. Since this basis for redeeming the raider's stock depends upon the subjective intent of the raider, it will be difficult for a board to redeem the stock of a raider who expressly disclaims such intent, unless such raider's mere presence as a shareholder can reasonably be said to materially adversely impact the corporation. Furthermore, while it is appropriate for a board of directors, in determining what course of action to take, to consider the long-term interests of the corporation and its stockholders, this proposal would authorize a board to redeem the stock of anyone -- whether a greenmailer, an arbitrageur or

a long-term stockholder who supports a corporate restructuring* -- who seeks a "short-term" gain. In this respect it is so extreme that one may expect the courts to construe it narrowly.

Pricing. A redemption price formula that is based upon the fair value of the stock as determined by the board but limited to no more than the average price paid by the raider in the last year may well be viewed as overly harsh. On the other hand, a market-price-based redemption provision, by giving the raider the benefit of the increase in market price that his actions have generated, would obviously be a less effective deterrent than the cost-based model. One possible compromise would be a redemption price based upon the market price prior to the first public disclosure of the raider's position or proposal.

Procedures. The proposed statute is silent on the procedures for redemption. The provisions of the Connecticut statute should be considered. Connecticut provides for a written warning to the raider prior to board action and a 30-day notice period of the redemption date (although upon the corporation setting aside the redemption price, the

* As proposed, the statute would subject to redemption the shares held by institutional investors who support a proxy fight by a group proposing a new slate of directors who would approve a restructuring.

rights of the raider terminate with respect to such shares other than to receive the redemption price and dividends to the redemption date). The Connecticut statute also provides that court appraisal of the value of the redeemed shares is the shareholder's exclusive remedy. Only if Delaware were to adopt this approach would the directors be fully protected from liability.

Limitations on other corporate repurchases. The proposed redemption statute may unduly limit the board's authority to repurchase shares under circumstances that, in the board's view, justify a price higher than the statutory redemption price. Read in conjunction with present Section 160(a)(2), which prohibits the purchase of shares that are redeemable at the corporation's option for more than the redemption price, the proposed statute could preclude a corporation from repurchasing its shares at a price above the redemption price under circumstances which would not be considered "greenmail." As such it may prevent perfectly legitimate transactions.

Effective Date. While the statute is drafted to be effective as of the announcement of its consideration, it is unclear what this means. It is also not clear whether it is proper to make subject to redemption shares acquired before a statute becomes effective. The Connecticut statute

applies to shares the beneficial ownership of which is acquired after the effective date.

Conclusion

Delaware should as soon as possible enact legislation to protect against takeover abuses. The best protection would be provided by a combination of a New York type statute that imposes a five-year prohibition on a second-step merger following an unapproved acquisition of 10% of the target's shares and a statutory recognition of the right of directors of the target to reject a takeover on the basis of "long-term interests 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."

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AppendixText of Proposed Delaware Redemption Statute

Unless the certificate otherwise provides, any stock held by an existing stockholder may be redeemed by the corporation if a two-thirds majority of the independent outside directors and a two-thirds majority of the entire board of directors conclude that the ownership of the corporation's stock by such stockholder is intended to cause the corporation to repurchase the stock owned by such stockholder, or to cause the corporation to take action or enter into a transaction or series of transactions intended to provide such stockholder with short-term financial gain under circumstances where such two-thirds majorities determine that the best long-term interests of the corporation and its stockholders would not be served by taking such action or entering into such transactions or series of transactions at that time, or determine that such ownership is causing or reasonably likely to cause a material adverse impact (including, but not limited to, loss or threat of loss of any license or franchise from a governmental agency to conduct its business, loss or threat of loss of any membership in a national securities exchange, impairment of relationships with customers, or impairment of the corporation's ability to maintain its competitive position) on the business or prospects of the corporation.

This section shall not apply to, and no power to redeem pursuant to this section shall be conferred on, any corporation the board of directors of which does not contain at least two independent outside directors.

Any stock redeemed pursuant to this section may be redeemed for consideration in the form of cash, property or rights, including securities of the same or another corporation, having a value equal to the fair value of such stock as determined by the board of directors, but in no event greater than the average price per share paid for all of the stock of the corporation held by the stockholder whose stock is redeemed, which stock has been acquired during the year preceeding the determination, multiplied by the number of shares redeemed. In the absence of actual fraud, the judgment of the directors as to the value of the consideration for the redeemed stock shall be conclusive.

The Court of Chancery is hereby vested with the exclusive jurisdiction to determine the validity of any redemption of stock pursuant to this section.

This Act shall be effective as of [date of announcement of consideration of amendment].