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Poison Pill Still a Viable Prescription in Delaware

By **Byron Egan**, **Alex Frutos** and **Mike Laussade**

On March 3, 2011, the Delaware Supreme Court issued a one-page order[1] affirming the Chancery Court's decision in *Yucaipa American Alliance Fund II, L.P. v. Riggio*,[2] which upheld the use of a shareholder rights plan—or "poison pill"—by the board of Barnes and Noble. The Supreme Court's decision is the latest in a series of recent opinions upholding the good faith implementation of rights plans under Delaware law. In an October 2010 opinion,[3] the Delaware Supreme Court upheld the Chancery Court's decision in *Selectica Inc. v. Versata Enters., Inc.*,[4] in which it validated the Selectica board's use of a rights plan in an effort to prevent the loss of Selectica's net operating loss carry forwards. And on February 15, 2011, the Delaware Court of Chancery issued its opinion in *Air Products & Chemicals, Inc. v. Airgas, Inc.*,[5] upholding the Airgas board's maintenance of its shareholder rights plan in response to an all-cash tender offer from Air Products.

As discussed in a prior **Jackson Walker L.L.P. Corporate & Securities e-Alert**, in evaluating the relevant boards' use of the poison pill, both the *Yucaipa* and *Selectica* opinions relied on the Delaware Supreme Court's formulation of "enhanced scrutiny," first set forth in *Unocal.*[6] In *Airgas*, the Chancery Court, also following *Unocal*, ruled in favor of the Airgas board, reaffirming the right of an independent board acting in good faith and after reasonable investigation to defend against a hostile tender offer.

This e-Alert focuses on the 158-page *Airgas* opinion, in which Chancellor William B. Chandler III provides a comprehensive summary of the Delaware courts' takeover jurisprudence. The *Airgas* opinion should be viewed—in conjunction with the Chancery Court and Supreme Court opinions in *Yucaipa* and *Selectica*—as both a strong reminder of the importance of good corporate process and a definitive confirmation that the poison pill defense remains a viable option for directors of Delaware corporations.

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In evaluating the Airgas board's response to the Air Products offer—which began as a $60-per-share, all stock offer but increased over a period of more than a year into an $70-per-share, all cash tender offer—Chancellor Chandler made it clear that, because of the potential entrenchment motive attributable to defensive board action, the appropriate standard of review in Delaware would be the enhanced level of scrutiny required under *Unocal.*[7]

Under the *Unocal* two-part test for enhanced judicial scrutiny, the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation in determining the existence of the threat) and (ii) the responsive

action taken was "reasonable in relation to the threat posed" (established by showing that the response to the threat was not "coercive" or "preclusive" and then by demonstrating that the response was within a "range of reasonable responses" to the threat perceived).[8] If the board meets this two-part test, their conduct will be reviewed under the business judgment rule.

Because the Air Products offer was neither "structurally coercive" (meaning, that it was not a two-tiered offer designed to punish stockholders for not tendering immediately) nor preclusive of a superior opportunity (since no other deal or recapitalization proposal was on the horizon), Chancellor Chandler's threat analysis centered on the question of whether or not the Air Products offer amounted to "substantive coercion" by creating a risk that stockholders might tender into an inadequate offer "in ignorance or based upon a mistaken belief."[9] Though openly skeptical of the broad formulation of substantive coercion adopted by the Delaware Supreme Court, Chancellor Chandler nevertheless found that because a significant portion of Airgas stock was held by merger arbitrageurs who had acquired Airgas stock with an eye toward profiting from the Air Products takeover bid, Air Products' $70-per-share cash tender offer represented a real risk that those arbitrageurs would tender in order to achieve short-term profit, and in doing so would effectively be forcing other stockholders to accept an inadequate price.

Chancellor Chandler turned next to the question of whether the Airgas board's decision to keep its poison pill in place was reasonable in relation to the threat posed by the Air Products offer. Citing *Unitrin*, he first evaluated whether the board's decision was "draconian, by being either preclusive or coercive,"[10] and determined that (a) it was not coercive, as it was not designed to force stockholders into accepting an alternative, management-supported transaction, and (b) it was not preclusive, as it still afforded Air Products a "meaningful or real world shot at securing the support of enough stockholders to change the target board's composition and remove the obstructing defenses."[11]

On the question of preclusiveness, Chancellor Chandler acknowledged that Airgas's poison pill, together with its staggered board, could delay a potential acquirer for more than a year, as they would have to wage and win two successive proxy battles in order to gain control of the board, and further emphasized that he was not conferring upon boards an ability to "just say never." But his analysis was ultimately controlled by the Delaware Supreme Court's stance, recently reaffirmed by their 2010 holding in *Selectica*, "that the combination of a classified board and a Rights Plan is not preclusive, and that the combination may only 'delay—but not prevent—a hostile acquiror from obtaining control of the board.'"[12]

Having established that the Air Products tender offer represented a legitimate threat under *Unocal*, and that the Airgas board's decision to keep its pill in place was neither preclusive nor coercive, Chancellor Chandler moved on to the final question posed by the second prong of the *Unocal* test—whether the board's response "'fell within a range of reasonable responses to the threat' posed."[13] On this issue, the Chancellor appeared to give extraordinary weight to the fact that the board's defensive actions were supported not only by the continuing directors that had been in place since before the first Air Products offer, but by all three Air Products nominees that were placed on the board following Air Products' first successful proxy contest in September of 2010. The fact that the Air Products nominees joined the Airgas board and, after reviewing the board's valuation analysis and appointing both their own outside legal counsel and an additional financial advisor, ultimately sided with the existing board in supporting the pill, demonstrated exactly the sort of robust corporate process necessary to support the board's defensive measures as being within the range of reasonableness.

That being established, Chancellor Chandler ultimately decided for Airgas, endorsing "Delaware's long understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact-finding and enhanced

scrutiny of their defensive actions)."[14]

This validation of the poison pill was not without limits. Chancellor Chandler clearly suggested that at some point in any bidding process, it may become incumbent upon a board to redeem a rights plan and allow a tender offer to proceed, and that, but for the constraints of precedent, he may very well have been inclined to force such a redemption in this case. Further, the fact that the Airgas board was not purely staggered, since the entire board could effectively be removed by a 67% vote—coupled with the demonstrable threat of likely tender by short-term minded merger arbitrageurs and the absence of any management-sponsored alternative other than the status quo—made it much easier for the Chancellor to characterize the Airgas board's strategy as a non-preclusive, non-coercive response to a credible threat.

Only because the Airgas board—a majority of which was independent—conducted a good faith investigation in reliance upon advice from outside legal counsel and multiple financial advisers was Chancellor Chandler willing to uphold the board's actions in response to a structurally non-coercive, all-cash tender offer. As such, this decision—particularly when coupled with the Delaware Supreme Court's affirmations of the Chancery Court's reasoning in both *Yucaipa* and *Selectica*—serves as a stark reminder that good corporate process will always be critical to the Delaware courts' analysis of any challenged transaction.

Jackson Walker's corporate attorneys have extensive experience in all areas of corporate governance, and are committed to helping corporations develop sound practices that best enable officers and directors to fulfill their fiduciary duties when evaluating transactions in control. For more information about developments in this area and how they affect your business, please contact any one of the following Jackson Walker corporate attorneys:

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[1] Yucaipa American Alliance Fund II, L.P. v. Riggio, No. 565, 2010 (Del. Mar. 3, 2011).
[2] C.A. No. 5465-VCS (Del. Ch. Aug. 12, 2010).
[3] Versata Enterprises, Inc. and Trilogy, Inc. v. Selectica, Inc., 5 A.3d 586, 604 (Del. 2010).
[4] C.A. No. 4241-VCN (Del. Ch. Feb. 26, 2010).
[5] C.A. No. 5249-CC (Del. Ch. 2011).
[6] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
[7] *Id.*
[8] *Id.* at 954–55 (Del. 1985); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387-88 (Del. 1995).
[9] *Airgas*, C.A. No. 5249-CC at 93 (quoting *Unitrin,* 651 A.2d at 1384).
[10] *Id.* at 1367.
[11] *Airgas*, C.A. No. 5249-CC, at 128–29.
[12] *Id*. at 125 (quoting *Selectica*, 5 A.3d at 604 (Del. 2010)).
[13]

Id.at 79 (quoting *Unitrin*, 651 A.2d at 1367).

[14] *Id*. at 152.

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