

POISON PILLS REVISITED

*By Adam Offenhartz, Eduardo Gallardo, Ross Wallin and Adam Chen (Gibson Dunn)**

Introduction

During the last decade, activist shareholders and corporate governance groups have been fairly successful in pressuring companies to voluntarily surrender a number of anti-takeover defenses, most notably the use of staggered boards and shareholder rights plans (also referred to as “poison pills”). In fact, according to FactSet SharkRepellent, between December 2002 and December 2009 the percentage of S&P 1500 companies with a staggered board decreased from 62.3% to 44.8%, and the percentage having a rights plan dropped from 61.6% to 23%. The success of activists and governance groups, at least as measured by these numbers, is partly attributable to the view held by certain groups that anti-takeover mechanisms are a reflection of poor corporate governance practices and, thus, antithetical to shareholder value. Also, given the healthy equity markets and high M&A transaction multiples, at least until recently companies may have been more willing to shed defense mechanisms as an easy give to appease activists and corporate governance groups. With respect to the termination of rights plans, companies also probably considered that, unless otherwise provided in the company’s organizational documents, the voluntary decision to terminate a rights plan did not restrict the board’s future ability to adopt a rights plan if it were to become the subject of an unsolicited tender offer.

Notwithstanding recent improvements in some financial indicators, the recent global financial turmoil has left many companies with still low market capitalizations and vulnerable to hostile bids. This has prompted many companies to reevaluate the status of their takeover defenses, particularly as activists broaden their agenda to include calls for an expansion of shareholders’ rights to call special meetings and to act by written consent. The rising levels of high profile hostile M&A activity in the U.S. and abroad also has rekindled interest among M&A practitioners and commentators concerning the state of the law, particularly Delaware state law, applicable to a target’s efforts to thwart an unsolicited bid. Delaware law in this area, particularly as it relates to a board’s decision not to redeem a rights plan in the face of a financially attractive all-cash bid, has seen no major case law or statutory development in a number of years. With the recent levels of hostile M&A activity and the concurrent expansion of shareholder activism, the time may be ripe for the Delaware Chancery Court to resolve some of the perceived tensions in this important area.

* Adam Offenhartz is a litigation partner in the New York office of Gibson, Dunn & Curtcher LLP who specializes in corporate control contests and mergers and acquisitions related litigation. Eduardo Gallardo is a corporate partner in the firm’s New York office who specializes in mergers and acquisitions and corporate governance. Ross Wallin is a senior litigation associate at the firm’s New York office who focuses on securities and corporate control litigation. Adam Chen is a litigation associate at the firm’s New York office. The authors of this article represented the special committee of iBasis during its dispute with KPN. This article was written in January, 2010. Please contact the authors for additional information at aoffenhartz@gibsondunn.com and egallardo@gibsondunn.com.

The Tension in Delaware Law

Under Delaware corporate law, most board actions are entitled to deference under the business judgment rule. However, defensive responses to hostile tender offers, such as shareholder rights plans, must pass what some view as the enhanced business judgment scrutiny of the *Unocal* test, first enunciated in the 1985 case *Unocal v. Mesa Petroleum Co.* To pass the test, and regain the deferential protection of the business judgment rule, the target board must show that (1) there are reasonable grounds to believe that a danger to corporate policy and effectiveness exists and (2) the adoption of the defensive measure is reasonable in relation to the threat posed.

In the context of a shareholder rights plan implemented in response to a structurally non-coercive tender offer, courts and commentators have struggled with the tension between allowing a shareholder the freedom to tender his or her own shares and a corporate board's ability to manage and control the company. Delaware courts have had a tumultuous relationship with shareholder rights plans. On the one hand, a shareholder rights plan can act as a powerful defensive mechanism to protect undervalued targets from opportunistic acquirers. On the other hand, a shareholder rights plan can prevent shareholders from choosing to sell their shares at what may be a premium to the market price. Underlying this tension is a fundamental question: who ultimately controls a company? Is it the board, which manages the affairs of the company, or shareholders, who own the company? When faced with an all cash, structurally non-coercive tender offer, can the target board enact a plain-vanilla shareholder rights plan if it deems the offer price to be inadequate and essentially "just say no" to the offer? Or must the board give shareholders the opportunity to tender their shares? These questions remain to some extent unanswered in Delaware law.

Much of the ambiguity surrounding the current state of the law on shareholder rights plans originates from the 1990 Delaware Supreme Court's decision in *Paramount Commc'ns v. Time Inc.* In *Time-Warner*, the Court applied the *Unocal* test to the defensive measures used by the Time board against a hostile offer from Paramount to preserve Time's long-planned merger with Warner Brothers. While *Time-Warner* did not directly address shareholder rights plans, the Court's decision had significant implications for shareholder rights plan jurisprudence. First, the Court recognized substantive coercion, or "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of [the company's] intrinsic value," as a reasonable threat to the corporation. In recognizing substantive coercion as a possible threat arising from a tender offer, *Time-Warner* expanded the scope of threats justifying a defensive response, making it easier for a company's board to justify the enactment of a shareholder rights plan under *Unocal*.

Second, the *Time-Warner* court went out of its way to criticize the Chancery Court's 1988 decision in *City Capital Associates v. Interco, Inc.* In *Interco*, the target board implemented a shareholder rights plan to block a non-coercive tender offer to continue with the board's current business plan, which was almost equivalent in value to the tender offer. The Delaware Chancery Court pushed for a shareholder choice model, holding that the "the relative closeness of the values" presented by the board's business proposal and the tender offer constituted only a mild threat for price inadequacy which did not justify the use of a shareholder rights plan. The *Time-Warner* court expressly criticized *Interco* and the Chancery Court's

application of the *Unocal* test, stating that the lower court had incorrectly substituted its own judgment in evaluating the financial sufficiency of the tender offer. The *Time-Warner* Court emphasized that in conducting the *Unocal* analysis a court cannot interject its own evaluations of a tender offer but must focus on the board's evaluation of the offer.

The Court's apparent repudiation of *Interco* and its adoption of substantive coercion as a viable threat for purposes of the *Unocal* test have caused some commentators to opine that the scope of threats justifying a shareholder rights plan has expanded while the range of disproportionate responses has narrowed. In other words, the company's board, and not shareholders, has ultimate control of the corporation. They argue that Delaware jurisprudence has removed much of the *Unocal* test's original "bite" and that Delaware law permits the use of a shareholder rights plan to indefinitely block a structurally non-coercive tender offer. These commentators have suggested that the current state of Delaware law allows a target board to "just say no" to an inadequately priced tender offer by enacting a shareholder rights plan, effectively stopping shareholders from tendering their shares at the board's discretion.

In response, others have argued that *Time-Warner* and subsequent cases should not be read to have entirely obliterated the distinction between the *Unocal* test and the business judgment rule. Proponents of this view focus on the 2000 decision in *Chesapeake Corp. v. Shore*, in which Delaware Vice-Chancellor Leo Strine noted that "[a]llowing [] directors to use a broad substantive coercion defense without a serious examination of the legitimacy of that defense would undercut the purpose the *Unocal* standard of review was established to serve" and that "[t]he only way to protect stockholders is for courts to ensure that the threat is real and that the board asserting the threat is not imagining or exaggerating it." Advocates of enhanced *Unocal* review point out that *Time-Warner* never explicitly overruled *Interco*, which suggests to them that *Interco* may have been incorrectly analyzed but correctly decided. Opponents of the "just say no" policy further emphasize the importance of giving shareholders a choice on whether to accept a tender offer after the board has made its case opposing such offer.

KPN's Bid for iBasis, Inc.

The recent litigation between Koninklijke KPN N.V. and iBasis, Inc. brought the tension between shareholder choice and board control in *Unocal* analysis to the forefront. iBasis' majority shareholder KPN made a tender offer of \$1.55 per share for all outstanding shares on July 13, 2009. This price represented a 19.2% premium over iBasis' previous business day's closing price. In response, the iBasis board convened a special committee to evaluate the tender offer. Concluding that the offer price was grossly inadequate, the special committee recommended, and the iBasis board implemented, a shareholder rights plan to block KPN's tender offer. Litigation between the parties, involving several issues, including whether the shareholder rights plan should be struck down, quickly ensued.

The litigation between KPN and iBasis highlighted the murkiness in the current Delaware jurisprudence concerning shareholder rights plan, and placed squarely at issue whether *Time-Warner* should be read as an endorsement of "just say no." iBasis argued that, while *Time-Warner* did not overrule *Unocal*, it clarified that a board could implement a plain-vanilla shareholder rights plan in response to a non-structurally coercive all cash, all shares, tender offer, particularly in cases where the target, within a reasonable period of time, could acquire control of

the target board through a proxy contest and redeem the plan. iBasis effectively adopted a view favoring tempered corporate control of a company with appropriate checks (the proxy process) that would allow shareholders to overrule a board's decision. iBasis also argued that the iBasis special committee justifiably relied on its advisors, the special committee reasonably concluded that the KPN offer was inadequate and posed a threat to shareholders (both because the price was too low and because KPN's disclosure was lacking), the shareholder rights plan was not a disproportionate response to KPN's offer and the iBasis board was not seeking to entrench themselves by adopting the shareholder rights plan, all of which justified the implementation of the plan. During the pendency of KPN's offer, the Special Committee also indicated to KPN that there would be a price at which it would be willing to give a favorable recommendation of the offer.

KPN took a different view of *Time-Warner*, arguing that that the current law in Delaware required the redemption of a shareholder rights plan (that should never have been implemented in the first place) when a company is facing a non-structurally coercive tender offer. KPN emphasized the importance of giving shareholders the option to tender their shares after the target board and the acquirer have had the time to make their cases for and against the offer before the shareholders.

The dispute between iBasis and KPN was settled before the Delaware Chancery Court issued a ruling. Following trial, post-trial briefing, oral argument and post argument letter briefing, KPN agreed to raise its offer to \$3.00 per share (representing a premium of 130.8% over the closing price of iBasis shares the last trading day prior to the announcement of KPN's tender offer), in exchange for the iBasis special committee agreeing to terminate the rights plan and recommend that shareholders tender. Due to the settlement, the conflict between shareholder choice and board control that arise when a company faces a non-coercive tender offer remains an open issue. However, it might not be long before the Delaware courts provide additional guidance given the increase in hostile M&A activity and the signaling by Delaware jurists and commentators that the time is right to bring further clarity to this subject.