University of Dayton Law Review

Volume 14 | Number 3 Article 8

5-1-1989

Poison Pills: Is the Flip-in Flipping Out?

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POISON PILLS: IS THE FLIP-IN FLIPPING OUT?

I. INTRODUCTION

Over the last fifteen years, battles[1] for corporate control have been "[w]aged with the intensity of military campaigns and the weaponry of seemingly bottomless bankrolls."[2] Contests for control have led to the development by corporate management of new, complex and ingenious defensive tactics.[3] From the continuing development of defensive strategies[4] to thwart hostile tender offers, there has evolved a unique, contro-

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1. The battle is joined when a bidder initiates a tender offer. Although the definition of a tender offer has been elusive, the tender offer process begins when a target corporation's shareholders are publicly invited or solicited to sell their shares to the bidder for cash or securities. CLARK, CORPORATE LAW 531–34 (1986); *see* Wurczinger, *Toward a Definition of "Tender Offer,"* 19 HARV. J. ON LEGIS. 191 (1982); Symposium, *The Elusive Definition of a Tender Offer,* 7 J. CORP. L. 503 (1982). Courts are conservative in deciding what constitutes a tender offer, but invariably will conclude an activity constitutes a tender offer when "large-scale purchase programs [are] accompanied by active and widespread solicitation or pressure on shareholders to accept or reject the offer quickly." Greene & Junewicz, *A Reappraisal of Current Regulation of Mergers and Acquisitions,* 132 U. PA. L. REV. 647, 663 (1984) (footnote omitted).

2. Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 258 (2d Cir. 1984).

3. *See* Reisner, *Corporate Takeovers: A Glossary of Terms and Tactics,* CASE & COM., Nov.-Dec. 1984, at 35.

4. These defensive tactics fall into two categories: financial and structural. Financial defenses, usually adopted by the board in response to a takeover bid, are designed to reduce the attractiveness of the target to a bidder. A structural defense, implemented to make changes in control more difficult, is placed in the bylaws or charter before the initiation of a tender offer. *See* Green & Junewicz, *supra* note 1, at 701–06; Comment, *Two-Tiered Tender Offers and the Poison Pill: The Propriety of a Patent Takeover Defense,* 17 PAC. L.J. 890, 899–905 (1986). A variety of financial defenses to corporate takeovers are available to the board of directors of the target company. One extreme action is known as the "scorched earth" defense where management may decide to liquidate the company in whole or in part. *See, e.g.,* Joseph Seagram & Sons v. Abrams, 510 F. Supp. 860 (S.D.N.Y. 1981). Another option, known as the "Crown Jewel" sale, is to sell an attractive subsidiary or asset to a friendly suitor. *See, e.g.,* Marshall Field & Co. v. Icahn, 537 F. Supp. 413 (S.D.N.Y. 1982). The board of directors may also choose to launch a tender offer for the stock of the bidder which is referred to as the "Pac-Man" defense. *See, e.g.,* Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623 (D. Md. 1982). As with financial defenses, there are a variety of structural responses available to target management. First, the board may adopt a "staggered board" terms strategy. The terms of directors expire at different times which requires at least two successive annual meetings to elect a majority of the board. Another option available is that the board of directors can recommend to shareholders that a "supermajority provision" be added to the charter. This provision requires that more than the minimum vote required by law (usually a majority of two-thirds) be obtained to approve any merger or sale of the corporation. *See* Green & Junewicz, *supra* note 1, at 703. Fair-price provisions "which set[] forth pricing and procedural requirements for the purchase of shares" are another option to management. *Id.* (footnotes omitted). Other defenses include white knights, cyanide capsules, golden parachutes, and corporate suicide. For a full discussion of these defenses, see generally CLARK, CORPORATE LAW § 13.6 (1988); A. FLEISCHER, JR., TENDER OFFERS: DEFENSES, RESPONSES, AND PLANNING (1983); WINTER, STUMPF & HAWKINS, SHARK REPELLANTS AND GOLDEN PARACHUTES: A HANDBOOK FOR THE PRACTITIONER § 1.1 (1986); Finkestein, *Antitakeover Pro-*

versial tactic known as the poison pill.[5] The poison pill is one of the most innovative, confusing and now popular defensive weapons designed to avert a hostile takeover. "[I]ts very complexity is designed to create uncertainty on the part of a potential acquiror."[6]

In general, poison pills are issued when the target's board creates a new class of preferred stock and distributes shares of the new preferred stock to the common stock shareholders as a dividend.[7] The preferred stock will contain either conversion[8] or redemption[9] privileges, which are not exercisable until the occurrence of a specified "triggering event."[10] Another method of implementing a poison pill involves giving the target company's common shareholders, as a dividend, rights or warrants, instead of preferred stock.[11] The rights issued as a dividend are also restricted to certain triggering events.[12] The poison pill rights plan generally will exclude the acquiror from exercising such rights; if the rights are exercised, they will have a highly dilutive effect on the acquiror's interest.[13] The rights may be redeemed by the target company's board for nominal consideration. Thus, bids approved by management, whether friendly or hostile, are not foreclosed by the poison pill rights plan.[14]

Since poison pill plans have been introduced,[15] courts have strug-

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tection 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 (1984); Weiss, *Defensive Responses to Tender Offers and the Williams Act's Prohibitions Against Manipulation*, 35 VAND. L. REV. 1087 (1982).

5. The moniker refers to the sting or poison that the bidder must swallow to complete the acquisition which may cause severe economic repercussions. *See* CLARK, *supra* note 1, at 574–75.

6. Moran v. Household Int'l, Inc., 490 A.2d 1059, 1066 (Del. Ch.), *aff'd*, 500 A.2d 1346 (Del. 1985).

7. CLARK, *supra* note 1, at 574–75.

8. The holder of the preferred stock would be able to convert the stock into voting stock of the acquiror. *Id.* at 574.

9. The redemption privilege allows the preferred stockholder to redeem these preferred shares for a substantial price. *Id.* at 575.

10. Dawson, Pence & Stone, *Poison Pills Defensive Measures*, 42 BUS. LAW. 423 (1987). The "triggering event" occurs when an acquiror accumulates a certain percentage of the target's common stock. *Id.* This percentage is usually set at 20 to 30% of outstanding common shares.

11. CLARK, *supra* note 1, at 575. "The holder of the right would be entitled to buy new preferred stock on certain terms," for example, $200 worth of the acquiring company's equity for $100. *Id.*

12. These triggering events are usually the same as with poison pill preferred stock. *See supra* note 10 and accompanying text.

13. CLARK, *supra* note 1, at 574.

14. Note, *Poison Pill Rights: Toward A Two-Step Analysis of Directors' Fidelity to Their Fiduciary Duties*, 56 GEO. WASH. L. REV. 373, 375 (1988).

15. Lenox, Inc. first used a poison pill plan in response to a tender offer by Brown-Forman Distillers Corp. The Lenox board rejected the offer as inadequate and declared a dividend on Lenox's common shares which contained characteristics of a poison pill. *See* Brown-Forman Distillers Corp. v. Lenox, Inc., No. 83-2116 (D.N.J. June 20, 1983); *see also* Wall St. J., June 16,

gled to develop an acceptable and consistent test for determining the validity of these techniques designed to avert corporate takeovers. Some courts have protected and encouraged the use of some poison pill plans by applying the business judgment rule.[16] Other courts have invalidated poison pills by considering the effect of the plans on basic stockholder rights[17] or on the statutory distribution of power within the corporation.[18] These courts have applied anti-discrimination statutes to invalidate certain poison pill plans.[19]

This comment begins with an examination of the general characteristics of the poison pill, in particular, the so called "flip-in"[20] provision included in some plans. This comment will then provide a background of and analyze the important cases interpreting the validity of the poison pill and the struggle by various courts to define a workable test to guide this emerging area of the law. The business judgment rule, as applied to poison pills, and traditional reluctance of courts to interfere in the corporate boardroom will also be discussed. The emerging trend by courts to scrutinize the mechanisms adopted by boards of directors will then be examined. Finally, this comment will contend that the business judgment rule should be merely the first step in a poison pill analysis and that courts must look further and determine the effects of the poison pill, which may impinge upon basic shareholder rights.

II. CHARACTERISTICS OF THE POISON PILL

The primary purpose of a poison pill provision is to alleviate the element of coercion which has been associated with tender offers.[21] In

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1983, at 2, col. 2. *See generally* Chittur, *Wall Street's Teddy Bear: The "Poison Pill" as a Takeover Defense*, 11 J. CORP. L. 25 (1985).

16. The business judgment rule has been defined in court decisions. "It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); *see* KNEPPER & BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 179–207 (1988). However, the business judgment rule has been modified in the takeover context. *See infra* notes 46–86 and accompanying text.

17. Some forms of poison pill plans will have a dilutory effect on voting rights and equity on particular shareholders (i.e. acquiror) as well as those common shareholders who have transferred or failed to exercise their rights under a poison pill plan. *See infra* notes 87–123 and accompanying text.

18. The very nature of poison pill plans may put the decision of whether to sell the corporation in the hands of the board of directors instead of the shareholders (owners). *See infra* notes 43–44 and accompanying text.

19. *Id.*

20. *See infra* notes 37–39 and accompanying text.

21. Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101, 113 (1979). Lipton points out that in almost every tender offer in the past five years, the holders of the majority of the shares will tender. "[T]he special dynamics of a tender offer are such that the decision of shareholders is almost always a foregone conclusion–they will tender, therefore, it is misleading to speak of a free shareholder choice at all." *Id.*

recent years partial[22] and two-tiered[23] tender offers have exacerbated the coercive nature of the tender offer process. The shareholder who does not accept the tender offer finds himself, in both situations, in an inferior position.[24] In the partial tender offer, the shareholder will become a minority shareholder subject to the abuses of the acquiror. The shareholder who refuses the two-tiered tender offer will find himself "squeezed out" by being forced to accept a lower buyout price than the tendering shareholders.[25]

Since the first poison pill, five basic provisions have evolved that are generally attached to or contained within the preferred stock or rights.[26] First, the flip-over provision permits stock rights holders of the target corporation to purchase stock in the acquiring corporation at a cost substantially below market price after the acquisition.[27] A second feature, the backend provision, allows the target corporation's stockholders to receive stock and/or debt of the target and/or cash, usually at a premium over the market price of the target's stock.[28] Third, convertible preferred stock provisions permit stockholders of the target corporation to convert their shares in the target into voting shares of the acquiror. If this combination does not occur, stockholders are given the power to redeem their preferred stock for cash payments from the target.[29] A fourth feature of a typical poison pill entails a voting provision which confers upon the target shareholders superior voting rights to those of the acquiror.[30]

The focus of this comment will be on the final feature of poison

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22. A partial tender offer occurs when the bidder acquires a bare majority in the target with no intention of any second step to acquire the remaining shares. CLARK, *supra* note 1, at 545; *see also* Comment, *Delaware's Attempt to Swallow a New Take-Over Defense: The Poison Pill Preferred Stock*, 10 DEL. J. CORP. L. 569, 572–73 (1985).

23. *See* Minvis, *Two-Tier Pricing: Some Appraisal and "Entire Fairness" Valuation Issues*, 38 BUS. LAW. 485 (1983). 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." *Id.*; *see also* Comment, *Two-Tiered Tender Offers and the Poison Pill: The Propriety of a Potent Takeover Defense*, 17 PAC. L.J. 890 (1986).

24. *See* Note, *Protecting Shareholders Against Partial and Two-Tiered Takeovers: The "Poison Pill" Preferred*, 97 HARV. L. REV. 1964, 1966 (1985).

25. Comment, *supra* note 22, at 571–72.

26. *See supra* notes 8–15 and accompanying text.

27. Dawson, Pence & Stone, *supra* note 10, at 426–28.

28. Dawson, Pence & Stone, *supra* note 10, at 428–29; *see, e.g.*, MacAndrews & Forbes v. Revlon, Inc., 501 A.2d 1239 (Del. Ch.), *aff'd mem.*, 505 A.2d 454 (Del. 1985).

29. Dawson, Pence & Stone, *supra* note 10, at 429–30; *see, e.g.*, Brown-Forman Distillers Corp. v. Lenox, Inc., No. 83-2116 (D.N.J. June 20, 1983). The Lenox plan implemented this type of pill. *Id.*

30. Dawson, Pence & Stone, *supra* note 10, at 430. These super voting privileges are limited to specified circumstances for the purported purpose of severely diluting the voting power of the bidder seeking control. *Id.*; *see, e.g.*, Minstar Acquiring Corp. v. AMF, Inc., 621 F. Supp. 1252 (S.D.N.Y. 1985).

pill plans, the flip-in provision.[31] Flip-in provisions allow target common shareholders, except the acquiror, to purchase stock and/or debt of the target corporation at bargain prices.[32] This tactic has the effect of diluting an acquiror's investment in the target company and may prevent the acquiror from purchasing a substantial block of the target's stock on the open market.[33]

Courts have struggled to articulate a viable test to determine the validity of poison pill plans. The early cases applied the business judgment rule to the decision of the board of directors to implement the plan.[34] Commentators who have supported the business judgment rule test[35] assert that a takeover bid is just another major business decision.[36] Conversely, other commentators[37] assert that responding to a tender offer is a prerogative of the shareholder, and as such, a rule of managerial passivity[38] should be imposed.[39]

III. COURT DECISIONS

The common thread in poison pill cases appears to be the confusion and uncertainty created by the dynamic nature of poison pill plans.

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31. *See supra* note 21 and accompanying text.

32. *Id.*

33. The flip-in, when triggered, allows each right holder, except the acquiring shareholder, to purchase additional shares in the target thereby diluting the acquiring shareholder's equity in the target and preventing the purchase of a substantial block of shares in the open market. Dawson, Pence & Stone, *supra* note 10, at 428.

34. Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); *see infra* notes 39–60 and accompanying text.

35. *See, e.g.*, Lipton, *supra* note 21, at 101. "[S]o long as the directors act in good faith and on a reasonable basis, their decision to accept or reject a takeover bid should not be subject to being second guessed." *Id.* at 121. "Once the directors have properly determined that a takeover should be rejected they may take any reasonable action to accomplish this purpose . . . ." *Id.* at 123.

36. *See, e.g.*, Northwest Indus. v. B.F. Goodrich Co., 301 F. Supp. 706 (N.D. Ill. 1969). "[M]anagement has the responsibility to oppose offers which, in its best judgment, are detrimental to the company or its stockholders. . . . After [making a carefully considered decision], the company may then take any step not forbidden by law to counter the attempted capture." *Id.* at 712–13.

37. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981).

38. *Id.* at 1194–1204. The Management Passivity Rule imposes on the board of directors a complete prohibition of all defensive measures. *See* CLARK, *supra* note 1, at 580–82 (five possible rules that could be employed to govern the behavior of target company directors in the takeover context).

39. Easterbrook & Fischel, *supra* note 37, at 1194–1204. Replacement of existing management is a frequent occurrence in a successful takeover.

> Given the serious and unavoidable conflict of interest that inheres in any decision on one's own ouster, courts ought not to make available to a manager resisting a tender offer–and, in effect, fighting against his own replacement–the same deference accorded to the decisions of a manager in good standing.

Id. at 1198.

However, two distinct trends by courts have emerged in the analysis of takeover defense strategies.[40] The first judicial approach applies the business judgment rule, as developed in *Unocal Corp. v. Mesa Petroleum Co.*[41] and refined in *Dynamics Corp. of America v. CTS Corp.*[42] The second analytical approach taken by courts incorporates the business judgment rule, but also considers incumbent management's poison pill as an equally crucial focal point. Courts that have adopted the second approach have invalidated the defensive tactics designed to avert takeovers, holding that their creation violates anti-discrimination statutes.[43]

A. Business Judgment Rule

In *Unocal,* the Unocal board of directors adopted a "self-tender"[44] defensive strategy to deter a two-tiered, front loaded[45] tender offer initiated by Mesa Petroleum, a 13% minority shareholder of Unocal.[46] The self tender was extended to all common stock shareholders of Unocal, except Mesa.[47]

The Supreme Court of Delaware examined Unocal's self tender offer and recognized "the omnipresent specter that a board may be acting primarily in its own interests."[48] To prevent the lure of self-preservation, the *Unocal* court modified the business judgment rule by announcing "there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred."[49] According to the Delaware Supreme Court, the board of directors has the initial burden of showing that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed."[50] The board of directors could overcome its burden " 'by showing good faith and reasonable investiga-

40. *See infra* notes 43–120 and accompanying text.

41. 493 A.2d 946 (Del. 1985).

42. 805 F.2d 705 (7th Cir. 1986).

43. *See infra* notes 77–117 and accompanying text.

44. 493 A.2d at 950. Unocal's self-tender offer involved Unocal purchasing its own stock with a price of $72 per share. *Id.* at 951.

45. Dawson, Pence & Stone, *supra* note 10, at 428; *see, e.g.,* Dynamics Corp. of Am. v. CTS Corp., 635 F. Supp. 1174 (N.D. Ill. 1986) (upheld a poison pill with a flip-in provision). *But see* Amalgamated Sugar Co. v. N.L. Indus., 644 F. Supp. 1229 (S.D.N.Y 1986) (invalidating the flip-in provision).

46. *Unocal,* 493 A.2d at 949.

47. *Id.* at 951.

48. *Id.* at 954. "From this it is now well established that in the acquisition of its shares a Delaware corporation may deal selectively with its stockholders, provided the directors have not acted out of a sole or primary purpose to entrench themselves in office." *Id.* at 953–54.

49. *Id.* at 954.

50. *Id.* at 955.

tion.' "[51] The *Unocal* court reasoned that, once the board's burden is satisfied, the burden shifts to the plaintiff challenging the board action to prove a breach of fiduciary duty by the directors.[52]

> Thus, unless it is shown by a preponderance of the evidence that the directors' decisions were primarily based on perpetuating themselves in office or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed, a Court will not substitute its judgment for that of the board.[53]

Moreover, the *Unocal* court held that a board's response to a takeover attempt is an ordinary business decision. However, the Delaware Supreme Court did not address the discriminatory exclusion of Mesa, a common shareholder of Unocal.[54]

The version of the modified business judgment rule set forth in *Unocal* was applied by the Delaware Supreme Court in *Moran v. Household International, Inc.*[55] Faced with the possibility of a "bust-up"[56] takeover attempt, the Household International board of directors adopted a poison pill containing a flip-over[57] provision solely as a preventive measure and not in response to an actual tender offer.[58] Moran, Household's largest single shareholder, contended that the board of directors was not authorized to adopt the poison pill plan.[59]

Concluding that the adoption of the poison pill plan was within the authority of the board of directors,[60] the *Moran* court validated the flip-over provision by applying the same business judgment rule that it had adopted in *Unocal*.[61]

The Delaware Supreme Court also responded to Moran's contention that the poison pill would result in "a fundamental transfer of power from the stockholders to the directors."[62] In so doing, the *Moran*

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51. *Id.* (quoting Cheff v. Mathes, 41 Del. Ch. 494, 506, 199 A.2d 548, 555 (1964)).
52. *Id.* at 958.
53. *Id.*
54. *Id.* at 958–59.
55. 500 A.2d 1346 (Del. 1985).
56. *Id.* at 1349. A " 'bust-up' takeover . . . refers to a situation in which one seeks to finance an acquisition by selling off pieces of the acquired company." *Id.* at 1349 n.4.
57. *See supra* note 19 and accompanying text. The flip-over provision adopted by Household permitted its common shareholders to buy $200 of stock of the acquiring company for $100. *Moran*, 500 A.2d at 1349.
58. *Moran*, 500 A.2d at 1349.
59. *Id.* at 1351.
60. *Id.* at 1355.
61. *Id.* "The 'directors must show [initially] that they had reasonable grounds for believing that a danger to corporate policy . . . existed . . . .' " *Id.* at 1356 (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985)). Only after this burden is met would the court apply the protections of the BJR. *Id.*
62. *Id.* at 1354.

court examined the effects the takeover defense would have on the corporation:

> The Rights Plan will result in no more of a structural change than any other defensive mechanism adopted by a board of directors. The Rights Plan does not destroy the assets of the corporation. The implementation of the Plan neither results in any outflow of money from the corporation nor impairs its financial flexibility. *It does not dilute earnings per share* . . . . Comparing the Rights Plan with other defensive mechanisms, it does less harm to the value structure . . . than do other mechanisms.[63]

An important factor for the *Moran* court was that the flip-over provision instituted by the board of Household International did not dilute earnings per share and did not adversely affect market price.[64] The court noted very significant distinctions between the flip-over and the flip-in provisions of poison pill plans.[65] Therefore, the question for the *Moran* court became whether the same approach should be applied when considering the validity of all poison pill plans, particularly when the differences among pill plans and their varied effects on the corporate shareholders are considered.

The modified business judgment rule test developed in *Unocal* and *Moran* was also adopted by the District Court for the Northern District of Illinois in *Dynamics Corp. of America v. CTS Corp.*[66] When Dynamics made a tender offer to acquire a 27.5% interest in CTS, the board of directors of CTS adopted a back-end rights plan.[67] The plan gave all common shareholders, except Dynamics, the right to turn in their shares and receive a $50 bond payable in any year.[68] The litigation that ensued involved a challenge based upon section 23-1-25-1(a) of the Indiana Code[69] which requires all shares of a class of stock to have preferences, limitations and relative rights identical to those of other shares of the same class of stock.[70] The district court upheld the validity of the rights plan,[71] finding that the decision of the board to take defensive measures to avert a takeover must be afforded the protection of the business judgment rule.[72]

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63. *Id.* (emphasis added).

64. *Id.*

65. While a flip-over provision does not dilute earnings per share, a flip-in provision will have this effect on the acquiring shareholder who is excluded from the rights plans. *See supra* note 32 and accompanying text.

66. 635 F. Supp. 1174 (N.D. Ill. 1986).

67. *Id.* at 1176–77.

68. *Id.* at 1177.

69. IND. CODE ANN. § 23-1-25-1(a) (West 1989).

70. Dynamics Corp. of Am. v. CTS Corp., 805 F.2d 705, 718 (7th Cir. 1986).

71. *CTS Corp.*, 635 F. Supp. at 1181.

72. *CTS Corp.*, 805 F.2d at 705.

The Seventh Circuit Court of Appeals remanded the *CTS Corp.* case for further inquiry as to whether the rights plan was adopted in good faith and pursuant to a reasonable investigation.[73] Writing for the court, Judge Posner also reasoned that the rights plan adopted by the CTS board did not run afoul of section 23-1-25-1(a), the Indiana anti-discrimination statute.[74] The court found that, "[a]lthough Dynamics' [anti-discrimination] argument is consistent with the language of the statute . . . . [t]he Indiana Code forbids discrimination between shares but is silent on discrimination between shareholders." [75] To resolve the issue, the Seventh Circuit Court of Appeals reviewed Delaware law, which allows discrimination between shareholders in certain circumstances.[76]

In his decision, Judge Posner reasoned that, if Dynamics' discrimination argument was accepted it would mean that the Indiana Legislature had "unwittingly facilitated takeovers by outlawing poison pills."[77] Since the statute was designed to deter takeovers,[78] the appellate court followed the reasoning of Delaware law and allowed discrimination between shareholders.[79] However, Judge Posner stated that a different result might be reached if the poison pill singled out and discriminated against Dynamics alone; the CTS poison pill affected *any* shareholder who acquired a 28% interest or more in the corporation.[80]

The decisions discussed above have applied and developed the modified business judgment rule.[81] Is the modified business judgment rule standard applicable to a flip-in provision that dilutes voting power and equity? Should flip-in poision pill provisions be judged by the business judgment rule or should the discriminatory effects of these tactics designed to avert hostile takeovers be an equally critical focal point? A judicial trend has emerged that not only scrutinizes the actions of the board of directors of the target corporation in a takeover situation, but also examines the effect the poison pill has on shareholders.

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73. *Id.* at 709.

74. *Id.* at 718; *see* IND. CODE ANN. § 23-1-25-1(a) (West 1989) (all shares of a class must have preferences, limitations, and relative rights identical with those of other shares of the same class).

75. *CTS Corp.*, 805 F.2d at 718 (citations omitted).

76. Providence & Worcester Co. v. Baker, 378 A.2d 121 (Del. 1977) (distinguished between discrimination among shares and discrimination among shareholders and permitted shareholder discrimination if the discrimination resulted from a defensive measure in response to a hostile takeover).

77. *CTS Corp.*, 805 F.2d at 718.

78. *Id.*

79. *Id.*

80. *Id.*

81. *See supra* notes 39–75 and accompanying text.

B. An Emerging Trend

A trend has emerged whereby the judiciary will not only scrutinize the board of director's actions in implementing poison pill plans and the protections afforded by the modified business judgment rule, but also will examine the effect on shareholders of the flip-in provision of poison pill plans as well as any conflict between the flip-in provision and anti-discrimination statutes.

In *Amalgamated Sugar Co. v. NL Industries*,[82] the District Court for the Southern District of New York enjoined the implementation of a poison pill plan adopted by the NL Industries board of directors.[83] Without applying the business judgment rule,[84] the court ruled that the rights plan adopted by the board of directors, which utilized a flip-in provision that diluted the voting rights and equity of the acquiring shareholder, was *ultra vires* under a New Jersey law proscribing discrimination among shareholders of the same class or series.[85] After an earlier takeover attempt the board of directors of NL Industries, fearing the possibility of another takeover threat, adopted a rights plan that contained a flip-in as well as a flip-over provision.[86] The flip-in provision provided that after a certain "triggering event"[87] all rights holders would be entitled to purchase $100 of NL Industries stock for $50.[88] Under the plan, the acquiring shareholder would not have any such rights.

Amalgamated Sugar proposed a full cash tender offer to the board of directors of NL Industries on the condition that all rights under the rights plan be redeemed.[89] The board refused, stating that "the inherent value of the company's component businesses is significantly greater than the price proposed."[90] Amalgamated brought suit to enjoin the rights plan, arguing that the plan violated New Jersey's anti-discrimination statute.[91]

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82. 644 F. Supp. 1229 (S.D.N.Y. 1986).

83. *Id.* at 1240.

84. *Id.* at 1230. The actions of the board of NL Industries were not before the court. The only issue to be decided was whether the adoption of the rights plan by the directors of NL Industries was *ultra vires*. *Id.*

85. *Id.* at 1234.

86. *Id.* at 1231–32.

87. *Id.* at 1232. Under the rights plan the flip-in provision would be triggered by the announcement that a shareholder owned 20% or more of NL Industries common stock. The flip-over provision likewise would be triggered if a tender offer for 30% or more of NL Industries stock was initiated. *Id.*

88. *Id.*

89. *Id.* at 1233.

90. *Id.*

91. *Id.*

The district court ruled that the flip-in provision of the rights plan, when implemented, would discriminate among shareholders of the same class or series in violation of New Jersey's anti-discrimination statute.[92] The *NL Industries* court found that the flip-in provision effected a dilution of the voting rights and equity of the acquiring shareholder.[93] "It is a dilution that affects voting power and it is a dilution that affects equity."[94]

The *NL Industries* court predicated the injunction on the diluting effects to voting power and equity to the acquiring shareholders of the target corporation. When the rights plan is triggered "there suddenly exist votes that did not exist before which have the effect of upsetting normal corporate structure."[95] Further, the court found that the flip-in provision subjects an acquiring person's equity to discriminatory dilution.[96]

The *NL Industries* court also examined the discriminatory effect of the plan if the rights under the plan were issued as dividends to all shareholders.[97] "It is axiomatic under the laws of New Jersey, and most other jurisdictions, that dividends paid to shareholders of a class must be the same to each shareholder."[98] Under the rights plan, a 20% shareholder and all other shareholders would receive a dividend.[99] However, District Judge Broderick found that, "[o]nce there is a second trigger what they received changes in value according to whom the shareholder is. I do not believe that this is permissible."[100] Judge Broderick noted that the rights certificates "in the hands of the acquirer differ from those in the hands of all other shareholders."[101]

The district court in *NL Industries* relied heavily upon the *Moran* decision.[102] The *Moran* court's validation of the particular pill in question was predicated on the fact that the rights plan did not dilute voting power or equity, and did not alter the corporate structure any more

92. *Id.* at 1234.

93. *Id.*

94. *Id.*

95. *See id.* If the triggering event occurred when NL stock was trading at $12.50 per share, the rights would entitle each shareholder except Amalgamated to purchase eight additional common shares. *Id.* at 1233.

96. *Id.* If, for example, an "acquirer had paid $450,000,000 for 60 percent of the outstanding common shares of NLI, the triggering flip-in provision would reduce the acquirer's equity to $279,000,000." *Id.*

97. *Id.* at 1236.

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* at 1237; *see supra* notes 52–60 and accompanying text. The *Moran* court validated a flip-over provision. 644 F. Supp. at 1237.

than other defensive mechanisms.[103] This rights plan, Judge Broderick noted, certainly diluted earnings per share and voting, and had an effect on corporate structure as to make it completely safe from tender offer for ten years.[104] The *NL Industries* court ultimately granted the preliminary injunction against the implementation of the poison pill rights plan passed by the board.[105]

In a more recent case, the United States District Court for the Western District of Wisconsin examined the modified business judgment rule and the anti-discrimination argument in the takeover context. In *R.D. Smith & Co. v. Preway,*[106] the board of directors of Preway adopted a rights plan with a flip-in provision which was intended to make it difficult to acquire control of the corporation.[107] The rights plan was adopted in response to the filing by R.D. Smith & Co. of a schedule 13 G statement with the SEC.[108] The schedule disclosed that R.D. Smith had acquired a 15% minority interest in Preway.[109] The flip-in provision was triggered when an acquiring shareholder obtained a 25% or more interest in Preway.[110]

R.D. Smith & Co. sought a preliminary injunction against Preway's poison pill plan, claiming that (1) Preway's board of directors breached its fiduciary duty to shareholders in adopting the plan, and (2) the poison pill plan violated the Wisconsin statute prohibiting discrimination among shareholders.[111] The district court denied the preliminary injunction of Preway's poison pill plan. Though it found R.D. Smith & Co. would be able to succeed on the merits of its claim, it was unable to show irreparable harm.[112]

The *Preway* court, however, applied the same modified business judgment rule as first set forth in *Unocal*[113] and later refined in *Moran.*[114] If the protections of the modified business judgment rule are to

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103. 644 F. Supp. at 1239.

104. *Id.*

105. *Id.* at 1240.

106. 644 F. Supp. 868 (W.D. Wis. 1986).

107. *Id.* at 870. The rights plan contained a flip-over provision as well. *Id.* at 871.

108. *Id.* at 870. The SEC requires this schedule when a shareholder acquires 10% or more of a corporation.

109. *Id.*

110. *Id.* at 871. The flip-over provision was triggered when a tender offer was received for 30% or more of the voting shares. *Id.*

111. *Id.* at 869; *see* WIS. STAT. § 180.12(3) (Supp. 1989) ("All shares of the same class shall be identical . . . ."). This statute is very similar to the New Jersey statute discussed in the *NL Industries* case. 644 F. Supp. at 1237.

112. 644 F. Supp. at 878. In order for the district court to order a preliminary injunction, a moving party must prove three things: (1) no adequate remedy at law; (2) a danger of irreparable harm; and (3) the likelihood of success on the merits. *Id.* at 871.

113. *See supra* notes 42–51 and accompanying text.

114. *See supra* notes 52–60 and accompanying text.

be given to the board, the process by which the directors adopted the rights plan must be examined.[115] The *Preway* court relied heavily upon the *CTS Corp.*[116] decision in determining the legal standard governing a corporate board of directors which adopts a defensive mechanism in response to a takeover threat.[117] The court ruled that Preway's adoption of the poison pill was merely perfunctory; therefore, Preway was unable to meet the good faith and reasonable investigation requirement.[118]

The *Preway* court also discussed the anti-discrimination argument presented in *NL Industries.*[119] The district court stated that the New Jersey statute at issue in *NL Industries* was similar to the Wisconsin anti-discrimination statute.[120] Section 180.12(3) of the Wisconsin Statutes[121] permits differences in voting rights between different classes or series of stock, but does not allow discrimination among shareholders of the same class and series.[122] The district court found Preway's plan, like NL Industries' plan, was discriminatory, particulary since the flip-in provision diluted the acquiring shareholder's voting power and equity.[123] The *Preway* court was also concerned, like the *NL Industries* court, that the issuance of the rights in the form of a dividend was a separate source of unlawful discrimination against a 20% or more shareholder.[124]

IV. CONCLUSION

A viable test has finally been developed to determine the validity of the ever changing, ever complex poison pill plans. The analysis developed in *R.D. Smith & Co. v. Preway*[125] is a two-part test involving the modified business judgment rule, as developed in *Unocal Corp. v. Mesa Petroleum Co.*[126] and *Moran v. Household International, Inc.*,[127]

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115. *Preway*, 644 F. Supp. at 875.

116. *See supra* notes 62–76 and accompanying text.

117. *Preway*, 644 F. Supp. at 876. The directors had to prove that they adopted the plan in good faith and with reasonable investigation and "show that the defensive mechanism was reasonable in relation to the threat posed. Once the directors satisfy this burden . . . their actions are entitled to the presumptions of the business judgment rule . . . ." *Id.* at 876 (quoting Dynamics Corp. of Am. v. CTS Corp., 635 F. Supp. 1174 (N.D. Ill. 1986)).

118. *Id.* at 877.

119. *See supra* notes 77–100 and accompanying text.

120. *Preway*, 644 F. Supp. at 873; *see supra* note 106 and accompanying text.

121. WIS. STAT. § 180.12(3) (Supp. 1989).

122. 644 F. Supp. at 873–74.

123. *Id.* at 873.

124. *Id.* at 874. This form of discrimination involves the issuance of dividends with the flip-in rights attached to all shareholders except the acquiring shareholder.

125. 644 F. Supp. 868 (W.D. Wis. 1986).

126. 493 A.2d 946 (Del. 1985).

127. 500 A.2d 1346 (Del. 1985).

but goes even further and examines the effects the poison pill plan has on all shareholders. Under the *Preway* analysis, the poison pill cannot violate anti-discrimination statutes as it relates to the rights between shareholders and shares.

The *Preway* decision clearly signals that courts will closely scrutinize poison pill plans to ensure protection for all shareholders while, at the same time, affording the board of directors some protection from hostile takeovers.

J. Kurt Denkewalter