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The Role of the Board in Turbulent Times . . .

Responding to Unsolicited Takeover Offers

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Skeptical investors and depressed stock prices have recently left many companies undervalued and exposed to unsolicited acquisition offers. Directors of a potential target company should be familiar with their fiduciary duties regarding extraordinary corporate transactions, as well as judicial standards of review under state corporate laws. Board members also should assess and update their company's governance profile and improve communications with investors and gatekeepers.

This report is the fifth in The Conference Board series "The Role of the Board in Turbulent Times."¹ It provides an overview of issues a board may consider in evaluating a corporation's governance profile given the potential increase in unsolicited offers resulting from the current market environment.

Today's M&A Market

During the last two years, due to credit shortages and extreme stock price volatility, the mergers and acquisitions (M&A) market has registered a severe downturn in terms of numbers of completed transactions and deal value (Chart 1, p. 2). Preliminary data indicate that the negative

trend continues in 2009, with aggregate deal value for Q1 down 27 percent from the previous quarter and 40 percent from the first quarter of 2008.²

Nevertheless, current market conditions permit some companies to be "put in play" more easily than before. Hostile offers have accounted for 47 percent of the M&A transactions that took place in the United States during the first two months of 2009, compared with 24 percent in all of 2008 and 7 percent in 2004.³ The following factors, in particular, have driven a surge in unsolicited acquisitions:

- A greater number of companies with undervalued stock prices, surplus assets, or constrained performance – often resulting from short-term liquidity issues – that may invite bargain hunting by strategic acquirers capable of obtaining financing or using their equity currency to pursue growth opportunities.

¹ Also see Matteo Tonello, *The Role of the Board in Turbulent Times: Overseeing Risk Management and Executive Compensation*, The Conference Board, Executive Action 292, December 2008; Mark S. Bergman, *The Role of the Board in Turbulent Times: Assessing Corporate Strategy*, The Conference Board, Executive Action 294, January 2009; Robin Bergen, *The Role of the Board in Turbulent Times: Overseeing Internal Investigations*, The Conference Board, Executive Action 297, February 2009; and Damien J. Park and Matteo Tonello, *The Role of the Board in Turbulent Times: Avoiding Shareholder Activism*, The Conference Board, Executive Action 300, April 2009.

² See *U.S. Stock Market Report*, Thomson Reuters, March 19, 2009.

³ See Heidi N. Moore, "The Demise of Poison Pills?," *Wall Street Journal*, February 24, 2009, citing FactSet data.

- The pressure to actively seek strategic synergies, including cost- or capital-expenditure savings, resulting from sluggish consumer demand and lower production levels.
- Decreased presence of structural takeover protections (e.g., shareholder rights plans, staggered boards, and advance notice provisions), which companies have discarded under pressure from proxy advisory groups and activist shareholders.
- Unprecedented levels of investment fatigue and the disappointing performance of institutional shareholders, which may now be more inclined to seek immediate, short-term positive returns (at times by offering support to activism initiatives).⁴

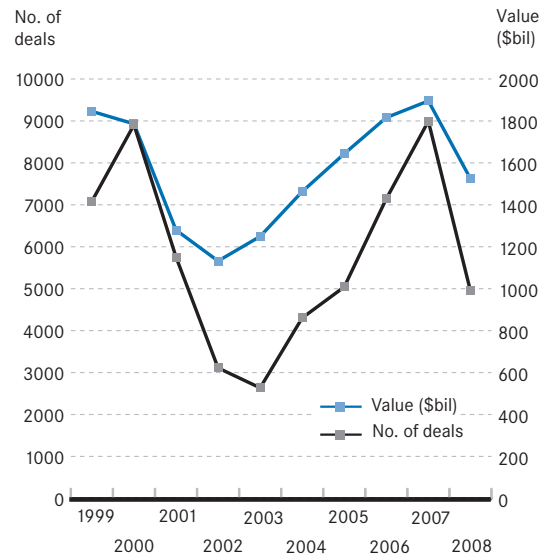
Unsolicited acquisition offers come in many forms, but usually involve one or more of the following elements.

Negotiated acquisition A bidder may engage the target’s board of directors in a negotiation of the terms of the proposed acquisition. The offer may be private or public. Such a transaction is generally subject to approval by both the board and shareholders. The final agreement may be a one-step merger agreement (with board approval followed by a shareholder vote) or a two-step merger agreement (with board approval followed first by a “front-end” tender offer made directly to shareholders and then a “back-end” merger).

Tender offer Instead of negotiating with the board, a bidder may take its offer directly to the target’s shareholders by launching a tender offer. However, even if the bidder acquires a majority stake of the corporation, it may be unable to cash out minority holders.

Proxy contest for control Rather than buying shares in the market, a bidder may seek to influence or take control of the board through a proxy contest—either for a majority of the board or for minority representation. In some situations, a tender offer is coupled with a proxy contest to circumscribe a shareholder rights plan or other defensive provisions.

Chart 1
Ten-year merger completion record, 1999–2008
(U.S. only)



Source: Thomson Reuters, as listed in “2008 M&A Profile,” *Mergers & Acquisitions*, February 2009.

Complying with Fiduciary Duties

An unsolicited offer may come unexpectedly, requiring a board to act quickly. As such, directors should have an understanding of their fiduciary duties, particularly regarding extraordinary business transactions affecting corporate control.

Duty of care The duty of care generally requires that directors act on a fully informed basis (i.e., make a good-faith effort to become knowledgeable of all relevant facts reasonably available at the time when the business decision is made). In meeting the standard of care, the Delaware statute generally protects directors who rely in good faith on information and guidance received from the corporation’s officers and retained external professionals (such as investment bankers and legal counsel).⁵

⁴ See “Buying on the Dips: What Sorts of Deals Are Still Being Done in Today’s Difficult Climate?” *The Economist*, May 7, 2009.

⁵ See 8 Del. C. § 141(e).

Recent Cases of Unsolicited Acquisition Offers

The following examples of unsolicited offers submitted within the last year illustrate scenarios that may recur in the coming months:

Genentech (*unsolicited bid by majority shareholder*) In summer 2008, Roche Holding Ltd. publicly offered to enter into a transaction to purchase all of the outstanding shares of Genentech, Inc., at \$89 per share, representing an 8.8 percent premium to market price on the day the offer was made. At the time, Roche held a majority position in Genentech and shares of Genentech had been trading down more than 20 percent since the beginning of 2007. Genentech's board formed a special committee to consider a potential transaction and rejected Roche's initial offer.

Unable to agree to a deal with Genentech's board, Roche launched a hostile tender offer at a lower price, \$86, in January 2009. Genentech recommended against tendering and Roche raised its offer to \$93 in February. Subsequently, Roche and Genentech negotiated an acquisition at \$95 per share, which closed in March.

CV Therapeutics (*unsolicited bid leading to acquisition by "white knight"*) In November 2008, Astellas Pharma Inc. made a nonpublic offer to purchase CV Therapeutics, Inc., for \$16 per share, representing nearly an 80 percent premium over the company's then closing price of around \$9.

After CV Therapeutics rebuffed these early attempts, Astellas went public with an unsolicited offer in January 2009. Astellas subsequently filed notice to run a slate of nominees to CV Therapeutics's classified board and launched a tender offer at \$16 per share. The bidder also filed suit in the Delaware Court of Chancery, challenging provisions in CV Therapeutics' advance notice bylaws and its shareholder rights plan. However, before the scheduled closing of Astellas's offer, CV Therapeutics entered into a negotiated merger agreement with an apparent "white knight," Gilead Sciences, Inc., at \$20 per share. Astellas subsequently withdrew its tender offer.

Terra Industries (*two-tiered unsolicited bids*) In January 2009, in another unsolicited bid situation, CF Industries Holdings, Inc., made an all-stock bid for Terra Industries

Inc. for \$2.1 billion, valuing Terra at \$20 per share. At the time, Terra had been trading at around \$17 a share, down nearly 68 percent from a high of \$54 in summer 2008.

Unable to reach an agreement, CF Industries announced its intention to commence an exchange offer. In preparation for a potential proxy contest, the bidder also nominated a slate of three nominees to Terra's classified board, under the company's advance notice provisions. At the time, Terra did not have a rights plan in place.

Meanwhile, CF Industries's stock price slumped and, following its summer 2008 peak in the \$160 range, was trading at around \$50 per share in January 2009. As CF Industries geared up for its bid to acquire Terra, Agrium Inc., a Canadian company, sent a public letter to CF Industries proposing a cash and stock deal valued at \$72 per share. The offer was expressly contingent on CF Industries dropping its bid to acquire Terra. CF responded by rejecting Agrium's offer and reiterating its interest in Terra. In March 2009, Agrium launched an exchange offer and bumped up the cash component of its original bid, raising the proposed deal value to around \$74 per share.

Having missed the advance notice deadline to run a competing slate to the board, Agrium opted for a withhold campaign for the three CF Industries directors up for election at the company's annual meeting in late April 2009. The election resulted in a 20 percent withhold vote against the incumbents.

These and other recent transactions (including InBev's successful bid for Anheuser-Busch and Microsoft's unsuccessful bid for Yahoo), illustrate that, although unsolicited bids may result in a sale to the bidder or to a "white knight," a target company can also reemerge independent and intact. To have the greatest influence over the outcome, directors of potential targets must be proactive and prepared in advance of any unsolicited approach.

Duty of loyalty The fiduciary duty of loyalty requires directors to act with the undivided purpose of advancing the best interests of the corporation. Fiduciary duties run to the corporation and its shareholders as a body, rather than to any particular class or series of stock. Therefore, directors elected by the holders of a specific class or series of stock are not exempted from the duty of loyalty to all shareholders. As part of this duty, board members are also expected to act in good faith.⁶

Since the response by a corporate board to an unsolicited bid may lead to litigation, directors should become familiar with how, in practice, a court measures compliance with fiduciary duties. Delaware courts, in particular, tend to rely on one of the following standards of review. The applicable standard may depend on the nature of the transaction, as well as the presence of potential conflicts of interest. Specifically, when the unsolicited offer prompts the corporation to adopt defensive measures or involves a sale-of-control or interested transaction or a proxy contest, Delaware courts may apply a heightened standard of review in lieu of the traditional business judgment rule.

Baseline standard: The business judgment rule This is the baseline presumption courts employ in reviewing director conduct and may apply even to transactions involving corporate control (including a decision “not to pursue a merger opportunity”⁷). The rule focuses on the process leading to a decision rather than the substance of such decision. In general, the deliberation of a board of directors is sustained by the courts unless the decision:

1. is the product of bad faith;
2. regards an interested transaction;
3. was made without due care; or
4. lacks a rational business purpose.

If the plaintiff rebuts the business judgment rule presumption by showing that any of those four factors exist, the directors of the corporation may have the burden of showing that their conduct was entirely fair, with respect to both process and price.⁸

Defensive measures: The *Unocal* standard When a board adopts defensive measures in anticipation of (or in response to) a possible hostile takeover attempt, an intermediate standard of review applies. The *Unocal* standard shifts the initial burden of proof to directors and requires the board to show that the defensive tactic was:

1. adopted in response to a reasonably perceived threat to corporate policy and effectiveness;
2. not draconian (i.e., neither coercive nor preclusive); and
3. proportionate to the threat posed.⁹

Defensive measures include not only measures that could entrench a board as it is currently composed (such as the traditional poison pill: see p. 6), but also those designed to protect a transaction favored by the board (such as the “lock-up” provisions commonly included in merger agreements).

Sale-of-control transactions: The *Revlon* standard¹⁰ Similarly, the business judgment rule gives way to an intermediate standard of judicial review of sale-of-control transactions. When the sale or breakup of a corporation appears inevitable, the focus of a director’s duties changes from pursuing the long-term interests of the corporation to maximizing short-term value for all shareholders (i.e., obtaining the best selling price reasonably available in the market). Determining the exact bounds of the applicability of this doctrine is nuanced; however, a recent decision held that *Revlon*

⁶ See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006). For a discussion of the duty of care and the duty of loyalty under Delaware law, also see Matteo Tonello and Carolyn K. Brancato, *Corporate Governance Handbook 2007: Legal Standards and Board Practices*, The Conference Board, Research Report 1405, 2007, p. 11.

⁷ *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009).

⁸ See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

⁹ See *Unocal Corp. v. Mesa Petro. Co.*, 493 A.2d 946, 954 (Del. 1985); *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995).

¹⁰ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

was not implicated merely because a corporation was “in play.”¹¹ To fulfill their *Revlon* duty, directors must show that they have acted reasonably and on a fully informed basis. The relevant standard is reasonableness, not perfection.¹²

Interested transactions: The “entire fairness” standard

An “interested transaction” occurs when a majority of the board (or a controlling shareholder) appears “on both sides of” the transaction or derives a “personal financial benefit from [the transaction] in the sense of self-dealing.”¹³ If a transaction is considered interested, directors are subject to the burden of proving the entire fairness of their actions—both as to dealing (i.e., how the transaction was initiated, structured, and negotiated) and substance.¹⁴ Generally, acquisitions by a controlling shareholder are considered interested transactions subject to the entire fairness standard.¹⁵ Although a decision “not to pursue a merger opportunity” is subject to the business judgment rule, if that decision is an interested one, the entire fairness standard of review may apply.¹⁶ Similarly, as discussed, the entire fairness standard is used by courts if the plaintiff rebuts the business judgment rule presumption.

Proxy contests: The *Blasius* standard Board action, even if legally permissible, may be struck down by the courts if it is “inequitable.” This general principle¹⁷ may be applied in matters relating to shareholder voting. Courts have stated that when a proxy contest takes place, directors acting with “the primary purpose of impeding the exercise of shareholder voting power” should bear “the heavy burden of demonstrating a compelling justification” for such action.¹⁸ This standard—a more exacting enhanced scrutiny standard than *Unocal* or *Revlon*—is often referred to as the *Blasius* standard of review.

Assessing the Corporation’s Governance Profile

In addition to understanding their fiduciary duties, directors should become familiar with the corporation’s governance profile and the tactics that can be used to protect shareholders’ interest during a takeover attempt. This includes reviewing existing organizational (charter and bylaws) provisions and understanding how investors and gatekeepers (proxy advisors and governance rating agencies, in particular) could perceive and react to possible amendments. It should be noted that the provisions discussed below are not simply intended to thwart unsolicited offers. For the most part, these protections are designed to give directors and shareholders enough time to obtain the information necessary to make a rational business decision with respect to the offer, as well as to explore all alternatives.

Provisions relating to stock acquisitions

As discussed, rather than negotiating with the board, a bidder may make a tender offer directly to shareholders. The best-known defensive mechanism against harmful accumulations of stock is the rights plan. However, business combination statutes, such as Section 203 of the Delaware General Corporation Law (DGCL) (see p. 8) as well as provisions included in the corporation’s organizational documents, may also address hostile tender offers.

11 See *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427 (Del. Ch. July 29, 2008). For example, in *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140 (Del. 1989) the Delaware court stated that two circumstances may implicate a *Revlon* duty to conduct an auction: (1) When a corporation “initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear breakup of the company”; or (2) when, in response to a bidder’s offer, a corporation “abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company.” The type of consideration used to finance M&A transactions is also relevant. A stock-for-stock merger will not trigger *Revlon* duties if the acquiring corporation does not have a controlling shareholder. See *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994).

12 See *Paramount Communications Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

13 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1987).

14 See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983).

15 An acquisition by a controlling shareholder structured as a two-step transaction (i.e., a tender offer followed by a merger) and accomplished without a board-approved merger agreement may be subject to the business judgment rule, instead of the entire fairness test, but only if structured in a non-coercive fashion. See *In re Pure Resources, Inc. S’holders Litig.*, 808 A.2d 421 (Del. Ch. 2002).

16 *Gantler v. Stephens*, 965 A.2d 695, 706 (Del. 2009).

17 Referred to as the “Schnell” test. See *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971).

18 *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988).

Rights plans Shareholder rights plans, also known as “poison pills,” generally discourage the acquisition of a significant ownership interest in the target corporation by granting existing shareholders the right to purchase additional shares of the target if any person or entity acquires a certain ownership percentage without board approval (usually between 10 and 20 percent); therefore, they do not prevent any sudden accumulation of stock below the designated threshold. Upon the triggering acquisition, all shareholders other than the acquiror can use their rights to purchase or receive additional stock or other consideration at a very favorable price (typically, half market price). The result is that the bidder’s ownership stake is severely diluted. This dilution is intended to deter any person from pursuing a stock accumulation strategy for the purpose of gaining control of the business.

If a corporation does not have a shareholder rights plan, directors should consider, in consultation with their financial and legal advisors and based on an analysis of the market circumstances, whether they should at least design one to be placed “on the shelf” and implemented promptly, when needed. For those companies that have fully adopted a rights plan (rather than having one “on the shelf”), one advantage is that it also serves the purpose of preventing “acquisition creep” (when an acquirer slowly expands its ownership position in the corporation through stock accumulations¹⁹) as well as the sudden purchase of a large block of stock, which puts the company “in play” with little or no notice.²⁰ The downside of having a poison pill in place for a long period of time is that it may draw criticism and unwanted attention from RiskMetrics and other governance and proxy service organizations.

Voting guidelines by RiskMetrics discourage companies from maintaining shareholder rights plans designed for the sole purpose of entrenching management. Even though RiskMetrics recommends that, as a general

principle, voting shareholders evaluate management-proposed rights plans on a case-by-case basis, the 2009 guidelines describe a number of standards investors can use to assess the merit of each plan. Specifically, the plan should: a) include a 20 percent or higher trigger; b) be limited in duration; and c) provide a mechanism for shareholder removal.²¹ Furthermore, with respect to this last point, RiskMetrics notes that it will recommend a withhold campaign against the board of directors if the corporation does not provide some mechanism for the shareholders to ratify or remove the rights plan after 12 months.²²

Limitations Rights plans do not prevent a bidder from running a proxy contest. Thus, in many instances, a bidder seeking to circumscribe the board may run a proxy contest in conjunction with the tender offer and condition the close of the offer on the redemption of the rights plan.

Standard of review As discussed, the adoption of a rights plan and its use to fend off an unsolicited offer generally is subject to the *Unocal* standard of review. Ultimately, the effectiveness of a rights plan may depend on the board’s ability under *Unocal* to refuse to redeem the plan. It is unclear under that standard, however, how long a board can “just say no” to such an offer and refuse to redeem a rights plan.

Early Delaware cases recognized the concept of “substantive coercion”—i.e., the threat posed to shareholders who do not have (access to) enough public information to understand the intrinsic value of the corporation—as a justification for retaining a poison pill. For example, in *Shamrock Holdings, Inc. v. Polaroid Corp.*,²³ the Delaware Court of Chancery found that a corporation was entitled to continuing to use certain defensive measures against an otherwise noncoercive tender offer when the corporation feared that shareholders did not possess sufficient information to value the corporation and make an informed choice whether to tender.

¹⁹ See, for example, *Creo Inc. v. Printcafe Software, Inc.*, C.A. No. 20164 (Del. Ch. Feb. 21, 2003) (Chandler, C.) (transcript), which involves the use of a rights plan to prevent a 45 percent holder from purchasing additional shares to take a majority position in order to facilitate a third-party transaction.

²⁰ See, for example, *Ryan v. Lyondell Chem. Co.*, 2008 WL 2923427 (Del. Ch. July 29, 2008), which involves a sudden purchase of a large block of shares that puts the company in play.

²¹ *U. S. Corporate Governance Policy: 2009 Updates*, RiskMetrics Group, November 25, 2008, p. 15 (available at www.riskmetrics.com).

²² *Ibid.*

²³ 559 A.2d 278 (Del. Ch. 1989).

The court noted that the “unusual circumstances of this case [i.e., the lack of information concerning the value to the corporation of pending litigation] appear to justify some level of defensive response.”²⁴

More recently, however, Delaware courts have become more skeptical of this doctrine and restricted its latitude.²⁵ The concept of substantive coercion could nonetheless resurface in today’s financial market, as depressed stock prices may not adequately reflect the true value of the corporation as a going concern.

Use of plans Governance analysts report that the number of companies in the S&P 500 having rights plans in place has fallen from approximately 57 percent in 2003 to 21 percent in 2008 (Chart 2).²⁶ Of course, this figure does not reflect those with a rights plan “on the shelf,” ready to be implemented if necessary.

Recent developments While rights plans were first introduced nearly 25 years ago, corporations and their advisors continue to update them in response to developments in the marketplace.

- Derivative positions: Investors may use certain types of derivative instruments to conceal their relative voting power at a shareholder meeting.²⁷ Rights plans are sometimes drafted so that derivative positions are also taken into account in computing the level of stock ownership a person holds. Because of the fluid nature of derivative instruments, however, a board should remain aware that a rights plan could be inadvertently triggered.

24 *Id.* at 290.

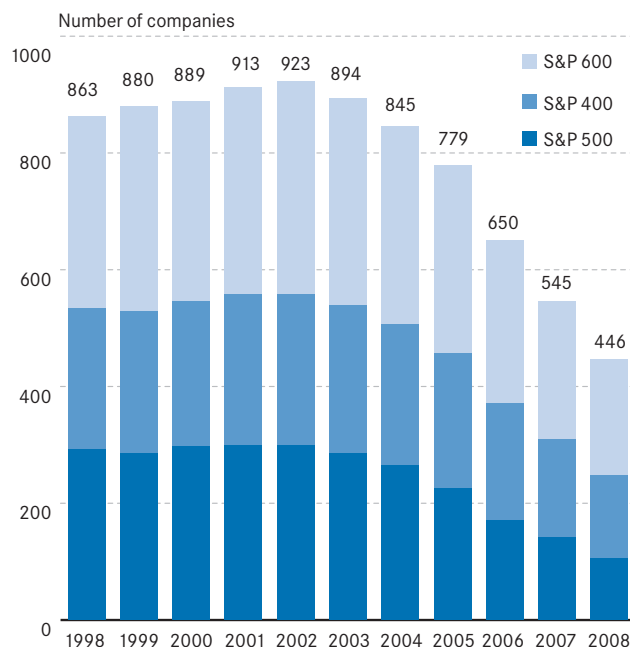
25 See *Chesapeake Corp. v. Shore*, 771 A.2d 293, 332 (Del. Ch. 2000), which finds insufficient factual evidence to show that shareholders were potentially confused about the company’s value and notes that the company had sufficient informational access to the market, as well as the “opportunity to address the confusion issue through more complete and consistent disclosures to its stockholders”; *Next Level Commc’ns, Inc. v. Motorola, Inc.*, 834 A.2d 828, 851 (Del. Ch. 2003): “[T]he court finds no substantive coercion in the Tender...[a]ll of the information needed for a shareholder to evaluate Next Level’s prospects and value is included in Motorola’s Offer to Purchase. Further, much of Next Level’s ‘confidential information’ regarding imminent sales has since been disclosed to stockholders....”

26 “Poison Pills in Force Year Over Year,” SharkRepellent.net (subscription required).

27 See, generally, *CSX Corp. v. The Children’s Inv. Fund Mgmt. (UK) LLP*, 562 F.Supp. 2d 511 (S.D.N.Y. 2008), which addresses “total return equity swaps” entered into by two activist investors as a means to conceal their relative economic positions.

Chart 2

Poison pills in force at year end, 1999–2008



Source: “Poison Pills in Force Year over Year,” SharkRepellent.net, April 2009. (Subscription required.)

- “NOL” rights plans: Companies have recently turned to rights plans with a low triggering percentage in an effort to protect the value of their net operating loss carry forwards (NOLs), which are used to offset future taxable income.²⁸ Under Section 382 of the Internal Revenue Code, companies may be unable to claim their NOLs when a “change in control” takes place – i.e., a holder (or a group of holders) of 5 percent of the corporation’s stock increases its ownership level by more than 50 percentage points within a rolling three-year period. A NOL rights plan generally functions like other poison pills, causing dilution if a shareholder goes above the triggering threshold of 5 percent. In addition to protecting NOLs, NOL rights plans have a greater defensive impact than other rights plans because of their low triggering percentage. Currently, RiskMetrics proxy guidelines provide for a case-by-case evaluation of NOL rights plans based on such factors as the triggering percentage, the value of the NOL, and the duration of the plan.²⁹

28 See, for example, Francesco Guerrero, “Citigroup in defensive mode with poison pill,” *Financial Times*, June 11, 2009, discussing the 3-year NOL rights plan adopted by Citigroup’s board in June 2009.

29 *U. S. Corporate Governance Policy: 2009 Updates*, p. 15.

Section 203 of the DGCL This section operates following an acquisition of 15 percent or more of a corporation's stock without board approval and creates significant hurdles for completing the back-end merger that is typically executed to eliminate the remaining public stub. Ultimately, the statutory provision incentivizes a bidder seeking a complete acquisition of a company to negotiate with the board. Other state jurisdictions have similar provisions.

Supermajority vote and fair-price requirements

Corporations may limit the effects of tender offers and other acquisitions of stock by including defensive provisions in the certificate of incorporation or other organizational documents. Such “business combination provisions” may impose a supermajority vote of shareholders or continuing director approval for any material business transactions. (Directors, however, should be mindful that RiskMetrics recommends voting *against* this type of charter amendment and, as of March 2009, that proposals to eliminate existing supermajority requirements were up 57 percent from the same period in 2008. See Table 1, p. 10.)³⁰ Alternatively, these provisions may allow a bidder to consummate the transaction without board approval or shareholder vote as long as the offer satisfies certain minimum price requirements.

Provisions related to proxy contests

Rather than (or in conjunction with) buying a controlling interest in the target through market purchases, a bidder may seek to influence or take control of the corporation by means of a proxy contest—for either a majority or a minority representation on the board. The most effective limitation on the vulnerability of a board to a proxy contest is a classified board structure. In addition, there are several significant provisions that directly address the ways in which a shareholder may effect a proxy contest for control.

Classified board structures In a classified board structure, the corporation's directors are placed into three separate classes and elected for staggered terms of three years. As a result, it takes two election cycles to replace a majority of board members. Moreover,

pursuant to Section 141(k) of the DGCL, unless otherwise provided in the charter, directors sitting on a classified board may be removed from office prior to the expiration of their term only if there is cause for removal. Without a classified board, a bidder can neutralize a rights plan or Section 203 defense in a single election cycle by gaining control of the board in a proxy contest; the new majority can then redeem the rights plan and waive the restrictions under Section 203 or simply agree to a negotiated transaction.

Implementation Pursuant to Section 141(d) of the DGCL, classified board provisions must be included in the certificate of incorporation (which may only be amended by bilateral action of the board and the shareholders), an initial bylaw, or a shareholder-adopted bylaw. Accordingly, a classified board cannot be implemented unilaterally by the board in the face of an unsolicited offer.

Limitations Although classified board structures generally require two election cycles to take control of a majority of the board, an ineffective classified structure may permit a bidder to end-run this effect by “packing” the board (i.e., increasing the board size and filling vacant seats with the bidder's nominees to establish a majority position in a single election) or otherwise limiting the effect of the classification.³¹ Accordingly, the strength of a classified board structure must be gauged to ensure it is effective.

Use of classified board structures The Conference Board reports that, as of 2008, approximately 37 percent of Fortune 1000 companies have a classified board structure.³² RiskMetrics advocates against the use of a classified board structure, labeling it as “problematic.”³³

Regardless of whether a corporation has a classified board, it is important to consider that shareholders may be able to engage in a proxy contest by way of three types of actions:

³¹ See, for example, *Frankino v. Gleason*, 1999 WL 1032773 (Del. Ch. Nov. 5, 1999), which provides an example of a successful attempt to “pack the board.”

³² Kevin F. Hallock, Matteo Tonello, and Judit Torok, *Directors' Compensation and Board Practices in 2008*, The Conference Board, Research Report 1439, December 2008, p. 36.

³³ U. S. *Corporate Governance Policy: 2009 Updates*, p. 7.

³⁰ 2009 U.S. *Proxy Voting Guidelines Summary*, RiskMetrics Group, December 24, 2008, p. 20.

1. through written consent;
2. at a special shareholder meeting; and
3. at the annual shareholder meeting.

Directors should discuss the following aspects of such actions.

Disallowing action by written consent Action by written consent in lieu of holding a shareholder meeting is the most potent tool to engage in a proxy contest. It gives shareholders with sufficient voting power the ability to take any action to the corporation, with little or no notice and without having to wait for a meeting to be convened. Recent surveys show that nearly 72 percent of the companies in the S&P 500 prohibit shareholder action by written consent.³⁴ Pursuant to Section 228 of the DGCL, the right to act by written consent may only be eliminated by an express provision in the certificate of incorporation, therefore requiring the support of shareholders. For this reason, it may not be a practical option if not implemented before a corporation is taken public.

When the certificate of incorporation does not prohibit shareholders from acting by written consent, the board can at least avoid any precipitous decision and provide some time to respond to the attempted action. This is typically achieved by way of a bylaw provision requiring shareholders to provide notice to the board before acting by written consent and giving the board a number of days (often, ten) after delivery of such notice to set a record date.³⁵ Taken in conjunction with the board's authority to set the record date up to ten days after the date of the resolution to set the record date,³⁶ a shareholder's solicitation can be delayed by several days (at times, as many as 20).

Limiting the ability to call special meetings Shareholders may also seek to act prior to the next election cycle by calling a special shareholder meeting. There is no explicit statutory provision in the DGCL empowering shareholders

to call a special meeting. However, RiskMetrics advocates for such a right and recommends voting *against* any proposals to restrict or prohibit it.³⁷

Short of vesting exclusive authority to convene shareholder meetings with the directors, the organizational documents may provide some protection by setting certain prerequisites for shareholders to call a special meeting. Such prerequisites may include minimum shareholder ownership thresholds and compliance with advance notice provisions (as discussed below).

Adopting advance notice bylaws The DGCL requires that corporations hold an annual meeting for electing directors.³⁸ Shareholder action at the annual meeting can be regulated through the use of an advance notice provision. Advance notice provisions impose a series of informational requirements for shareholders to follow to properly bring proposals or nominations before a meeting. Although the primary rationale for these provisions is to ensure that all shareholders receive sufficient information on the matters being put to a vote, advance notice provisions also may be viewed as defensive in nature.

Standard of review The Delaware courts generally consider whether an advance notice requirement constitutes a reasonable limitation—both facially and as applied under the circumstances—on the ability of shareholders to nominate candidates for election or make proposals at an annual meeting.³⁹ The courts, however, have not established clear parameters for making such determinations. For example, judges have treated a 60-day advance notice period as valid⁴⁰ and suggested that longer notice periods may also be reasonable⁴¹

³⁴ "Takeover Defense Trend Analysis," SharkRepellant.net (subscription required).

³⁵ See *Nomad Acquisition Corp. v. Damon Corp.*, 1988 WL 383667 (Del. Ch. Sept. 20, 1988), which finds that a bylaw imposing a similar 10-day notice period on the use of written consents did not unreasonably delay the effectiveness of such consents.

³⁶ 8 Del. C. § 213(b).

³⁷ *U. S. Corporate Governance Policy: 2009 Updates*, p. 20.

³⁸ 8 Del. C. § 211(c).

³⁹ See, for example, *Hubbard v. Hollywood Park Realty Enters, Inc.*, 1991 WL 3151, *11 (Del. Ch. Jan. 14, 1991).

⁴⁰ See *Nomad Acquisition Corp. v. Damon Corp.*, 1988 WL 383667, at *8 (Del. Ch. Sept. 20, 1988).

⁴¹ See, generally, *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 42 (Del. Ch. 1998), *aff'd* on other grounds, *Quickturn Design Syst., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998), which notes, in dicta, that a bylaw requiring shareholders to provide notice of director nominees 90 days in advance of a shareholder meeting are "commonplace."; *Oliver Press Partners, LLC v. Decker*, 2005 WL 3441364 (Del. Ch. Dec. 22, 2005), which dismisses a facial challenge to a 120-day advance notice bylaw on other grounds without discussing its validity.

Under RiskMetrics’s voting guidelines, to be reasonable, the company’s deadline for shareholder notice must not be more than 60 days prior to the meeting, with a submittal window of at least 30 days prior to the deadline.⁴²

Derivative positions One important consideration in crafting advance notice provisions is whether derivative positions should be disclosed so that shareholders can adequately be informed of the economic interests of proponents and nominees.

Recent trends There has been a recent trend toward expanding the disclosures required by advance notice provisions. A second generation of advance notice provisions now require: the completion of company-drafted director nominee questionnaires; submission of undertakings by nominees to comply with corporate policies; periodic disclosure of derivative positions; and compensation disclosure. The Delaware courts have yet to address the legality of these provisions; however, litigation has already been filed in connection with them.⁴³ RiskMetrics, on its part, has indicated that it supports additional efforts by companies to ensure full disclosure in regard to a proponent’s economic and voting position in the company so long as the informational requirements are reasonable and aimed at providing shareholders with the necessary information to review such proposals.⁴⁴

Alternative transactions

The board of directors of a target company faced with an unsolicited bid may also consider seeking an alternative transaction. This can be pursued through a variety of routes, including:

- raising capital through the issuance of debt or equity;
- the sale of the company to a more favored bidder (the so-called “white knight”); or
- a stock buyback or other capital restructuring program aimed at distributing any available cash that would otherwise make the company an attractive target.

⁴² U.S. Corporate Governance Policy: 2009 Updates, p. 14.

⁴³ See, for example, *Complaint, TRT Holdings, Inc. v. Gaylord Entm’t Co.*, C.A. No. 4320-VCL (Del. Ch. Jan. 9, 2009). This case was settled out of court.

⁴⁴ U.S. Corporate Governance Policy: 2009 Updates, p. 14.

Table 1
Shareholder Proposals Targeting Takeover Defenses

Proxy Filed as of March 31, 2009

<i>Defense</i>	<i>2009</i>	<i>2008</i>	<i>Percent Change</i>
Declassify Board	42	43	-2.3%
Allow Shareholders to Call Special Meetings	33	14	135.7%
Allow Cumulative Voting	18	10	80.0%
Eliminate Supermajority Provisions	11	7	57.1%
Anti-Poison	4	2	100.0%

Source: John Laide, “Governance Activists Escalate Battle against Takeover Defenses,” SharkRepellent.net, April 2, 2009.

Of course, it is the responsibility of directors to ensure that the alternative transaction procures greater economic value to shareholders than the unsolicited offer.

Practical Guidance: A Checklist

Given today’s heightened exposure to the risk of unsolicited offers, it is important for corporate directors to discuss what the corporation can do to avoid becoming the target of a harmful takeover attempt and determine the most appropriate course of action should the company be approached by an unsolicited bidder.

The following is a checklist of critical issues directors should consider.

Assemble a solid team of experts Operating in the M&A market has traditionally required a wide range of expertise that the board may not have internally. The need for skills and preparedness is only accentuated by the challenges of the current economic and financial environment. In particular, directors should ensure they have ready access to in-house and outside legal and financial advice as well as experts in investor relations and proxy solicitation.

Understand shareholder base and intentions Board members and senior executives should have a full understanding of shareholders’ intentions, as they may be

critical both from a preventive standpoint and in determining the right defensive strategy. Stock surveillance firms and proxy solicitors may help the corporation actively monitor the larger investors as well as those who engage in large accumulations of stock or extraordinary trading patterns. The company should also consider investigating groups of investors or other possible (undisclosed) voting arrangements to determine whether a bidder is acting alone or has the support of others.

Maintain proactive external relations Credibility with institutions, analysts and proxy advisors may be crucial in responding to unsolicited bids, so it is important to maintain good lines of communication. Investor relations teams, in particular, can help corporate leaders identify key shareholder allies and nurture those relationships, for example, by regularly informing them—in compliance with Regulation FD and insider trading rules—on new business decisions affecting strategy and long-term shareholder value as well as the financial metrics and valuations on which those decisions were based. Similarly, a proactive outreach to governance analysts and proxy advisors is essential to communicate and persuade on the rationale for adopting defensive devices that could otherwise become the subject of public criticism.

Review certificate of incorporation and bylaws A board should review charter and bylaw provisions for the purpose of assessing the strength of the corporation’s general defensive profile. Structural and procedural defenses should be updated so that they reflect legal developments and, when possible, best practices. In doing so, directors should be mindful of the following considerations.

Some defensive actions (e.g., classified board structures or disabling action by written consent) can only be adopted bilaterally through a board resolution and subsequent shareholder approval. Others, such as bylaw provisions and poison pills, may be adopted unilaterally by the directors, but may be helpful only if already in place when the company receives the unsolicited bid.

- If the decision is to depart from governance standards that are widely supported by proxy advisory firms and influential shareholder groups, the reasons why directors believe doing so is in the shareholders’ best interests should be clearly articulated.

- Many legal advisors recommend that the company should consider addressing instances of undisclosed derivative/hedging positions (such as cash-settled swaps) and the vulnerability resulting from depressed stock valuations. A bylaw requiring that the advance notice of shareholder proposals or nominations be accompanied by more detailed disclosure of all equity (including synthetic and temporary) holdings as well as a poison pill of limited duration may help to achieve these goals.

Develop coherent procedures and a unified response

The board of directors should be comfortable that the company has ad hoc internal communication and reporting procedures to deal effectively with the threats of a hostile takeover. Most important, any evidence of a potential bidder should be promptly escalated to the top (at a minimum, the chairman of the board, the governance committee chair, and the CEO should be informed) so that it receives the appropriate level of attention. For the purpose of developing an actionable response plan, board members should seek the close collaboration of senior management, albeit while remaining mindful of potential conflicts of interest.

Although a board receiving an unsolicited bid will face a number of decisions, directors ultimately choose from among three possible outcomes:

1. Sale to the bidder
2. An alternative transaction
3. Remaining independent

To fulfill their fiduciary duties of care and loyalty, directors should decide the corporation’s response to the bidder based on a thorough discussion and understanding of the implications of each alternative. This may require reassessing strategic goals in light of macroeconomic trends and industry developments as well as exploring alternative approaches to business growth.

The foregoing is not intended to be an exhaustive list of all considerations for boards of directors of companies facing unsolicited acquisition offers. This report is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content.

About the Author

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