MERGERS & ACQUISITIONS

Rights Plans: 25 Years Later, Still the Most Effective Defense

The rights plan continues to important in assisting boards of directors in fulfilling their fiduciary duties in a takeover context. The legal validity of rights plans has been upheld time and again by the courts and many state statutes expressly authorize them.

by Andrew R. Brownstein and Gordon S. Moodie

The first issue of INSIGHTS, published in July 1987, contained an article entitled "Rights Plans: Still the Most Effective Defense" by Andrew Brownstein, co-author of this article. That article asserted that rights plans were the most effective counterbalance to coercive takeover techniques yet developed, and that their legality was established under Delaware law. The subject was reviewed by Mr. Brownstein, with the same conclusions, in the tenth anniversary issue of this publication.

We continue to hold these views today. In fact, the importance of a rights plan in assisting a board of directors fulfill its fiduciary duties in a takeover context has only increased. The legal validity of rights plans is now very clear—their use has been upheld time and again in the courts and many state statutes expressly authorize them. Both the essential value of rights plans in practice and the legality of their use were vividly demonstrated in the landmark *Airgas v. Air Products* case. Over the past twenty-five years, the rights plan has survived and thrived.

This special 25th anniversary issue of INSIGHTS offers an opportunity to take stock of the rights plan. First, we briefly review what has changed—and what has not—in the M&A environment to show why rights plans continue to be of critical importance. Second, we look at recent uses of rights plans—most notably by Airgas—to illustrate their flexibility and importance. And third, we offer some suggestions on how boards can most effectively use a rights plan in practice.

The Reason for Rights Plans Remains Unchanged

The basic reason why a rights plan is a necessary tool has not changed. Delaware statutory law provides, as it has for decades, that a corporation is managed by or under the direction of its board of directors.[1] Delaware courts have made clear that a board of directors addressing a pending takeover bid has a fiduciary obligation to determine whether the offer is in the best interests of the corporation and its stockholders.

It bears emphasis that this is an affirmative obligation under Delaware law. A board that remains passive in the face of a takeover offer and delegates the decision to shareholders has not complied with its legal obligations. In *Smith v. Van Gorkom*, the Delaware Supreme Court squarely rejected the view that directors could "take a noncommittal position on the merger and simply leave the decision to shareholders."[2] In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court stated in no uncertain terms that "a board of directors is not a passive instrumentality."[3] The central and active role of the board of directors in the takeover

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context has been a consistent theme in Delaware jurisprudence.[4]

The reason why rights plans have been and continue to be so important is that they enable a board to fulfill its fiduciary obligation by opposing a takeover offer determined to be inadequate. Without a rights plan or other protection, a hostile bidder in a tender offer has no need to bargain with or even interact with a company's board, relegating the board to bystander status at a most critical juncture in the life of the corporation that is fundamentally at odds with the board's fiduciary obligations. The rights plan provides a board of directors with the central role and bargaining power in a takeover situation that are commensurate with its duties under law.

The Usefulness of Rights Plans Has Only Increased

Developments in the M&A environment over the past 25 years have increased the value of rights plans to boards of directors. Shares are traded more frequently than ever, with the average holding period of U.S. equities traded on the NYSE falling from approximately three years in the 1980 to less than one year today.[5] There has been substantial growth in the number and influence of investors specializing in merger arbitrage, with assets under management in such funds growing from approximately $2 billion in 1997 to $27 billion in the fourth quarter of 2011.[6] The target of an unsolicited offer will often find that a substantial portion, perhaps even a majority, of its stockholder base is soon comprised of such specialist arbitrage investors, who are generally looking for a short-term gain.

Indeed, the Court in *Airgas* acknowledged that arbitrageurs held a majority of Airgas' shares and that these investors may have desired to tender into the Air Products offer.[7] Merger-driven investors put tremendous pressure on boards of directors to focus on their short-term time horizons, notwithstanding the board's fiduciary duty to consider the interests of all shareholders—both short and long term. The rights plan enables the board to respond to a takeover in the manner that it determines is in the best interests of the company and all of its stockholders.

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Shareholder activists also have become more prominent as well as bolder and more sophisticated in their approaches over the past 25 years. Activists have used derivatives to accumulate significant positions in companies without public disclosure, as Children's Investment Fund did when it acquired an undisclosed 14.1 percent interest in CSX Corporation, and Pershing Square and Vornado Realty Trust did when they acquired a nearly 27 percent stake in JC Penney before disclosing their position.[8] In addition, activists may coordinate their efforts through so-called "wolf pack" behavior, such as the "Topps Full Value Committee," a joint undertaking by two activist funds who waged a proxy fight at The Topps Company, garnering the support of three proxy advisory firms and forcing the board to run three dissident directors on the company slate.[9] A number of approaches have emerged in rights plan drafting to address these tactics, but the issues are complex and a company implementing a rights plan must carefully consider its approach.

The rise of proxy advisory firms such as ISS from non-existence 25 years ago to a position of enormous power and influence today is another very important development. These firms categorically oppose certain rights plans and recommend that their clients vote against or withhold votes from directors who implement plans that do not satisfy their established parameters, without due consideration of the circumstances faced by the company adopting the plan. For example, Institutional Shareholder Services (ISS) categorically recommends that shareholders vote against or withhold votes from the entire slate of directors if the board adopts a plan with a term of greater than one year without providing for a shareholder vote or if the plan contains certain other features.[10] The increasing power and prominence of these proxy advisory firms has been a major factor in the dramatic decline of standard 10-year plans, with more and more companies choosing to have a plan "on the shelf" for implementation in a takeover situation as and when needed.

A troubling development from the perspective of the power of boards of directors to defeat inadequate takeover offers is the decline in staggered boards. As of March 2012, only 126 companies in the S&P 500 had a staggered board—a decline of over 60 percent from 1997.[11] A rights plan provides directors with maximum strength in resisting an inadequate offer when it is coupled with an effectively staggered board because the acquiror must win two proxy contests in order to obtain a board majority. As a result, the hostile bidder's nominees in the first election, if successful, will join the incumbents in evaluating the bidder's offer. It is remarkable that in the past three years we have twice seen an acquiror's nominees join the incumbents in resisting an offer—both in Terra Industries' long-running takeover battle with CF Industries Holdings and in Airgas. Had the boards in those cases not been staggered, the outcomes may have been very different.

The Rights Plan in Action—Airgas

The Airgas takeover battle offers an object lesson in the proper use of a rights plan by a board of directors resisting a takeover bid it concludes is inadequate, and the decision of the Chancery Court—while predictable in its outcome given established precedent—offers a comprehensive statement of the legal standards that Delaware courts will apply when evaluating a board's use of a rights plan in a takeover context. An abbreviated summary of the takeover battle and judicial decision yields important insights on the law and practice surrounding rights plans.

Airgas is the country's premier packaged gas company and was founded in 1982 by its current President and CEO, Peter McCausland. Between its initial public offering in 1986 and the close of trading on the day prior to Air Products' unsolicited offer in February 2010, Airgas' absolute total shareholder return was 4,201 percent—roughly 18 percent on a compounded annual basis—which put it ahead of 94 percent of the S&P 500 during that time. Airgas experienced its first significant year-on-year decline in EBITDA in 22 years in calendar year 2009 as a result of the significant recession, and reported third quarter earnings on January 28, 2010, of $0.65, two cents lower than its low-end guidance. This resulted in a stock price drop of 10 percent, which numerous analysts saw as an overreaction, and the public announcement by Air Products a few days later of a $60 per share offer. The Air Products public offer was $2 lower than an initial private overture that Airgas' Board had considered and rejected as inadequate.

The Airgas Board considered Air Products' offer together with its financial advisors, and concluded that it grossly undervalued the company. Air Products responded by, among other things, initiating a tender offer and running a proxy contest for three seats on Airgas' staggered board, and was successful in obtaining those seats at Airgas' annual meeting in September 2010. Air Products' director nominees ran on a campaign of taking a "fresh look" at the Air Products offer.

Following election to the Airgas Board, the Air Products nominees requested that the Board obtain a third financial advisor to evaluate the offer, and Credit Suisse was retained for this purpose. In December 2010, Air Products increased its offer to $70, stating that this was its "best and final" offer. The Airgas Board, together with its three financial advisors, considered the offer and unanimously concluded that it grossly undervalued the company. As Chancellor Chandler pointed out in his decision, "The Air Products Nominees were some of the most vocal opponents of the $70 offer." Air Products kept its offer in place while it pursued litigation in the Delaware Chancery Court to force the Airgas Board to redeem the rights plan notwithstanding the board's determination that the offer was inadequate.

Chancellor Chandler rejected Air Products' request to require Airgas to redeem its rights plan, finding that under the *Unocal* standard of review, the Board's use of the rights plan was a reasonable response to the threat of the inadequate offer. Before issuing this ruling, Chancellor Chandler carried out an exacting review of the Airgas Board's decision-making process, investigating among other things the Board's decision to name a price at which it would negotiate for the sale of the company, its careful evaluation of each offer, its use of financial advisors to assess the offers, and its understanding of the company's strategic plan and prospects. Chancellor Chandler allowed discovery and supplemental discovery, held a week-long trial and a supplemental evidentiary hearing and reviewed hundreds of pages of post-trial memoranda. After this comprehensive review, Chancellor Chandler concluded that the Airgas board was a "quintessential example" of a board "acting in good faith and in accordance with their fiduciary duties" and wrote that he had "no choice" but to rule against Air Products.[12]

Lessons from *Airgas*

It is important to emphasize that the *Airgas* decision does not endorse a "just say never" response to a tender offer. The Airgas board did not say "never" or "just" do anything—it demonstrated tremendous stamina over a year-long period in carefully and impartially considering each Air Products offer, engaging in a contested election, working together with Air Products nominated directors, being involved in various litigations. At the same time, it oversaw outstanding business results quarter after quarter. The fact that judicial review focuses on process does not mean that the standard is easy to meet—a board's approach to evaluating and responding to an unsolicited offer will be scrutinized with the benefit of hindsight.

An interesting aspect of the *Airgas* decision is the candor with which Chancellor Chandler expressed discomfort with the outcome of the case as dictated by Delaware law, writing "I do not share the Airgas Board's confidence in its strategic analysis and I do not agree with their claims to superior inside information, but I am bound by Delaware Supreme Court precedent that, in my opinion, drives the result I reach."[13] Similarly, Air Products and a number of Airgas' own stockholders disagreed with the board's decision to oppose the offer. Nevertheless, Delaware law provides that the board's judgment—if arrived at through sound deliberative means and processes—will neither be set aside in favor of shareholder choice nor second-guessed by the court. The fact that Airgas' stock has for several months been trading well above the "best and final" Air Products offer price suggests that Delaware law has it right.

The *Airgas* decision decisively answered the question of whether rights plans have an "expiration date" under law: "pills do not—and cannot—have a set expiration date," wrote Chancellor Chandler.[14] A rights plan with an expiration date would afford boards of directors very little leverage from day one, as it would incentivize bidders to make lowball bids and then initiate litigation to disarm a company's defenses. The theory that rights plans must expire at some predetermined time also is based on a fundamentally mistaken view that the only reason directors rather than shareholders should be charged with decision-making in the face of a takeover offer is the greater access directors have to information about the company. Leaving aside the question of whether shareholders can ever have the same nuanced and granular understanding of a company as its directors, there are other very important reasons why boards and not shareholders are charged with decisionmaking in the face of a takeover: for example, the fact that the law imposes fiduciary duties upon directors and not shareholders, the deliberative processes that take place in the boardroom, and the board's capacity to present a united front when negotiating with a bidder.

For companies considering an unsolicited takeover offer, a takeaway from the *Airgas* decision is that a relatively low bid, coupled with litigation aimed at causing the target board to remove its defenses, is unlikely to succeed unless the target board makes an error that exposes its decisions to judicial overturn. The behavior of the Air Products nominees also raises a question for future bidders running a proxy contest of whether to nominate directors who promise to take a "fresh look" at the takeover offer, or whether to nominate directors who vow to turn the decision over to stockholders regardless of their view as to the merits of the offer. As Chancellor Chandler wrote in his decision: "Air Products could have proposed a slate of three Lucian Bebchuks. . . . In exercising their business judgment if elected to the board, these three academics might have reached different conclusions . . . . But the point is, Air Products chose to put up the slate that it did."[15]

Airgas also suggests that when a board carries out its fiduciary duties and in doing so rejects a hostile bid, the bidder that wishes to advance its offer without negotiating with the board should generally turn to the ballot box rather than the courtroom as its next line of attack. If the bidder cannot persuade existing directors to redeem the poison pill and accept the offer, it can wage a proxy contest—two in sequence if necessary—to obtain a majority of the board. *Airgas* emphasizes that any delay in the election resulting from the combination of a rights plan and a staggered board—even if significant—does not necessarily preclude a hostile acquisition, and is an insufficient reason for the court to step in and accelerate the hostile bidder's pathway to control. The fact that an unsolicited takeover attempt may be an arduous journey against a well-functioning board that has determined the offer to be inadequate is not grounds for judicial intervention in favor of the bidder.

Rights Plans Post-*Airgas*

International Paper's recent acquisition of Temple-Inland exemplifies the fact that a rights plan, while a potent tool, does not stop all takeovers. International Paper bid $30.60 a share for the entire company in June 2011. Temple-Inland, which had a staggered board, recommended against International Paper's bid and adopted a rights plan. In September 2011, back-to-back bad news arrived in the form of a chemical discharge at a Temple-Inland plant and a lawsuit related to the company's former banking subsidiary. International Paper raised its offer to $32 a share, and the board agreed to the acquisition. Here, the rights plan and staggered board enabled the board to delay the acquisition and extract a higher bid from International Paper notwithstanding the multiple unexpected setbacks faced by the company.[16]

The experience of Ralcorp, which instituted a rights plan to respond to a tender offer that the market viewed as inadequate, is a contrasting example. In May 2011, ConAgra made an unsolicited, all-cash offer of $86 per share of Ralcorp stock. Ralcorp responded by adopting a shareholder rights plan and announcing a spin off of its Post Foods division. With Ralcorp's stock trading above the offer price, it appeared that the board had the backing of shareholders. Throughout the summer of 2011, ConAgra raised its bid to $94 per share and imposed a deadline on Ralcorp's board. Ralcorp's board continued to reject the offer as inadequate and stated that the company could create more value for shareholders by sticking to its long-term plan. The contrasting outcome to Temple-Inland illustrates that the rights plan is a tool a board uses to implement its judgment as to the best course of action for the company and its shareholders, not a device that results in the same outcome in every case.

Companies are increasingly customizing their rights plans to meet the takeover threat at hand. Consider the case of Cracker Barrel, which adopted a rights plan to prevent Sardar Biglari from acquiring creeping control over the company and from using his stake in the company to influence a proxy fight over his election to the board. The plan's 10 percent trigger was below the 20 percent threshold that ISS recommends as a minimum in its policy statement. Although this reduced the likelihood that shareholders would approve the plan (which they did not), it also ensured that Biglari could not acquire a larger stake until after shareholders had an opportunity to vote on his election to the board. Cracker Barrel's shareholders voted overwhelmingly in favor of the incumbent directors and against Biglari's election to the board.[17]

Practice Points

Airgas settled any remaining legal controversy over the validity of a properly used rights plan. But in doing so, it elevated the importance of factual disputes and process. A board engaged in a takeover battle can expect courts to focus on its process after the fact and with the benefit of hindsight—for example, whether it considered each unsolicited offer carefully and thoroughly, whether it retained independent advisors, whether it was sufficiently knowledgeable regarding the company's business plan, whether company projections were supportable, whether there were any conflicts of interest, etc. Careful planning and preparedness is crucial to avoid a misstep that could become decisive in litigation.

Because rights plans can be adopted on very short notice, a well-prepared board need not install a rights plan in advance. In an article in INSIGHTS in 1997, Andrew Brownstein pointed out that establishing or renewing a rights plan on a long-term, pre-takeover basis may create controversy without offsetting benefit relative to installing a rights plan as and when needed. This is even more true today as proxy advisory firms categorically oppose directors who adopt a longer-term rights plan without giving shareholders a vote on the plan. A board generally should not tie its hands by adopting a weak rights plan or a policy on rights plans that would limit its options, and instead retain the flexibility to adopt a rights plan that is customized to a specific takeover threat if and when presented.

It is important to bear in mind that rights plans never have been form documents. This is especially the case today. Each company and situation is unique, and rights plans must be tailored carefully to suit the circumstances at hand. Decisions about the duration of a plan, the threshold, whether to commit the plan to a shareholder vote, how to address potential group behavior and many other features of a rights plan should be customized on a company-by-company and situation-by-situation basis. It also is very important for boards to have a well developed message to shareholders and other constituents explaining why the board concluded that adopting a rights plan was in the best interest of shareholders, and generally to take a proactive communications approach.

Finally, a company with a staggered board should consider very carefully before yielding to shareholder pressure to de-stagger. A rights plan is most effective when combined with a staggered board—most obviously because a bidder must win multiple proxy contests to gain board control, giving the company a longer period of time to demonstrate its stand-alone value or to consider other alternatives. For example, Airgas significantly increased its net sales and net earnings per common share in the year after Air Products' directors won election to the Airgas Board. For similar reasons, structural defenses that limit election contests to annual meetings, as opposed to special meetings or shareholder action by written consent, are also beneficial for targets to maintain.

An additional reason that staggered boards are beneficial is that if a bidder is successful in having its nominees elected to a target's board, those nominees will interact and exchange views with incumbent directors, giving them a fuller understanding of the company and a new perspective on the takeover offer. The new directors may find, as they did in the cases of *Terra Industries* and *Airgas*, that the incumbents' view as to the inadequacy of the takeover offer is compelling and may themselves come to share that view.

Conclusion

Rights plans are, and have been for over twenty-five years, an indispensable tool for boards of directors in discharging their fiduciary duties in a takeover context. Both as a matter of judicial economy and of enabling the board to fulfill its legal duties, the Delaware courts are right to focus on the integrity of board decisionmaking rather than the substance of a board's value assessments when it comes to using a rights plan in the takeover context. Consistent with the recommendation in the INSIGHTS article 25 years ago, all companies should seriously consider developing a rights plan that can be implemented in a takeover situation to help the board fulfill its fiduciary duties to all stockholders.

Notes

1. Delaware General Corporation Law §141(a).
2. *Smith v. Van Gorkom*, 488 A.2d 858, 888 (Del. 1985).
3. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985).
4. *See, e.g., Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1281 (Del. 1989) ("a board of directors... may not avoid its active and direct duty of oversight in a matter as significant as the sale of corporate control"); *Grimes v. Donald*, 1995 WL 54441 (Jan. 11, 1995, revised Jan. 19, 1995) ("[t]he board may not either formally or effectively abdicate its statutory power and its fiduciary duty to manage or direct the management of the business and affairs of this corporation.")
5. NYSE Factbook, available at *http://www.nyxdata.com/factbook.*
6. *See http://www.barclayhedge.com/research/indices/ghs/mum/Merger_Arbitrage.html.*
7. *Air Products & Chemicals, Inc. v. Airgas, Inc.*, 16 A.3d 48, 105 (Del. Ch. 2011).
8. *See CSX Corporation v. The Children's Investment Fund Management* (UK) LLP, *et al.*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) and Andrew Ross Sorkin, "Big Investors Appear Out of Thin Air," New York Times (November 1, 2010).
9. *See* "Topps and The Topps Full Value Committee Reach Settlement" (July 28, 2006), available at *http://www.globenewswire.com/newsroom/news.html?d=102921.*
10. *See* ISS 2011 Policy Guidelines, § 1.4.
11. *Sharkrepellant.net.* 296 companies in the S&P 500 had a staggered board in 1997, according to IRRC. Other metrics also show that the staggered board is on the decline. In 1987, 223 of the Fortune 500 had a staggered board, according to IRRC, while data from *Sharkrepellant.net* show that only 105 Fortune 500 companies had a staggered board in March 2012.
12. *Airgas*, 16 A.3d at 129.
13. *Id.* at 113.
14. *Id.* at 129.
15. *Id.* at 123.
16. *See, e.g.*, Michael J. De La Merced, *Turmoil Helped Push Temple-Inland Into Deal With International Paper*, N.Y. Times Dealbook (Sept. 6, 2011, 4:28 p.m.) (Temple-Inland decided to hold negotiations when bad news mounted); Michael J. De La Merced, *International Paper Wins Temple-Inland*, N.Y. Times Dealbook (Sept. 6, 2011, 9:50 a.m.) (analysts had not expected the companies to come to terms until late in the fourth quarter of 2011 or first quarter of 2012); Christopher Donville, *International Paper To Buy Temple-Inland For $3.7 Billion*, Bloomberg (Sept. 6, 2011) (International Paper's CEO said that the company "made accommodations" for the chemical discharge and lawsuit "in our valuations").
17. *See* "Cracker Barrel Shareholders Reject Biglari's Bid for Seat," Wall Street Journal (Dec. 21, 2011).