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The Bebchuk Bylaw

Devilish...but brilliant

IT COULD PROVE TO BE the stiletto that slips between M&A's regulatory and judicial ribs and stills the beating heart of all takeover defenses: the shareholder rights plan itself. "It's brilliant," says one renowned litigator. "Devilish. But brilliant." Adds senior M&A academic Lawrence Hamermesh: "This is far more defensible than anything we've seen before."

What is it that has discerning experts either extremely worried or ebullient, depending on whether they hail from the red or blue states of corporate governance? It is the Bebchuk bylaw proposal.

A Harvard law professor, Lucian Bebchuk's bylaw has now been scrutinized by both the SEC and Vice-Chancellor Stephen Lamb and has been blunted by neither. The SEC refused to issue a no-action letter, despite voluminous opinion letters from Richards, Layton & Finger and Sullivan & Cromwell arguing that CA could rightfully exclude the proposal from its proxy materials as a violation of Delaware law. Vice-Chancellor Lamb said on June 22, 2006 that there is "no reason to believe that this bylaw is obviously invalid" and that the issue of its legality is "an important, undecided one" that was not yet ripe for adjudication. As a result, CA, Inc has now placed the proposal on the ballot for its annual meeting, usually held in late August but, at press time, not yet scheduled.

The bylaw would require CA's board of directors to set up a pill only with a unanimous vote. To extend the pill beyond a year would also require every director to vote in favor of such an amendment. Sounds innocuous enough. The board would still have all power over whether to set up a pill, and would be required simply to review that decision every year. How could anyone object to the one simple requirement that such important decisions be made by a unanimous board?

The old generation of pill bylaws, known as mandatory shareholder redemption proposals, typically gave the board 90 days before it would have to redeem the pill in the face of an offer that exceeded a specified minimum. These were never litigated, but were widely seen as going too far and giving too much power to shareholders at the expense of directors, who are statutorily required to manage the business and affairs of Delaware corporations.

Professor Bebchuck's bylaw expressly leaves the power

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"This is the part of capitalism I hate."

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over pills in the hands of directors and merely exercises the shareholders' right to pass bylaws that dictate the voting requirements to which directors must adhere for board action to be valid. With its appealing logic and seeming deference to directorial power, the proposed bylaw is much more likely to survive a challenge to its procedural components than were its ancestors, deftly shielding itself as it does behind provisions of the Delaware statute that give shareholders the right to pass bylaws governing the voting thresholds required for official board action while leaving the actual decision about rights plans with the board of directors.

"The legal issues raised by the Disney case are like cotton candy compared to the issues raised by the Bebchuk bylaw," said Ted Mirvis of Wachtell at a recent M&A conference.

What's more, it is not just the pill that is at stake. Shareholder rights plans dependent on a unanimous board vote might also serve to defang the staggered board as well. As it now stands, a board with staggered terms cannot be completely replaced at one annual stockholder vote. Would-be acquirors typically have to get at least two slates of nominees elected over at least two years to get majority control of a board. But with this bylaw in place, all they would have to do is get one director elected who opposes adopting or extending the pill.

Not only outsiders but also longstanding institutional shareholders could take advantage of the bylaw. Says Professor Bebchuk: "Suppose the directors of a company are viewed by shareholders as taking an excessively obstructionist attitude to a premium offer. When the next director election comes, instead of electing a slate nominated by the outside bidder and giving it the keys to the company, shareholders could elect a slate of directors nominated by a large blockholder whose interests are aligned with other shareholders. These directors would be able to influence the decision whether to keep the pill when the advisability of doing so is next reviewed."

The proposed bylaw, in short, could change M&A as we know it. "The legal issues raised by the Disney case are like cotton candy compared to the issues raised by the Bebchuk bylaw," Ted Mirvis of Wachtell said at a recent M&A conference.

'A Natural Choice'

Professor Bebchuk, represented by Grant & Eisenhofer in this matter, is the William J. Friedman and Alicia Townsend Friedman professor of law, economics and finance and the director of the Program on Corporate Governance at Harvard Law School. CA, Inc., formerly known as Computer Associates, is incorporated in Delaware with headquarters in Islandia, NY. It is an information technology management software provider, recently in the headlines owing to a $2.2 billion accounting fraud that resulted in a guilty plea for securities fraud and obstruction of justice by the former CEO, Sanjay Kumar.

"I've been writing for a long time about takeover defenses, as well as about greater shareholder involvement in adopting corporate governance arrangements," says Professor Bebchuk. "I have come to the view that shareholders' interests could be served by increased use of their power to initiate and adopt bylaw amendments. I could have written an article on the subject, but I thought that submitting some model bylaws to companies would be an effective way of highlighting this issue to practitioners and academics. The pill was a natural choice for one of these model bylaws."

On March 23, 2006, Professor Bebchuk submitted to CA, Inc. his proposed bylaw and supporting statement for inclusion in the company's 2006 proxy statement. The first section of the bylaw would require a unanimous vote of the board of directors both to set up a pill in the first place and to amend it later to extend its term. No pill would last longer than one year unless, again, every member of the board voted to prolong its life. In effect, this would mean that only a unanimous board could set up a pill and only for one year at a time. The second section exempts from the bylaw's requirements any pill ratified by the stockholders. The third section would require a unanimous vote of the board to repeal or change the bylaw itself.

"What I tried to do," says Professor Bebchuk, "was to develop a bylaw that would limit the potential for abuse of the poison pill in ways that would be consistent with both the letter and the spirit of Delaware corporate law. To this end, the bylaw was designed not to prevent a board from maintaining a pill indefinitely but only to regulate the process through which a board may decide to do so. "

(See "Lucian Bebchuk Proposal", page 3, for the text of the bylaw and the professor's supporting statement.)

LUCIAN BEBCHUK'S SHAREHOLDER PROPOSAL

A professor at Harvard Law School and director of its Program on Corporate Governance, Professor Lucian Bebchuk has a new poison pill bylaw that was recently the subject of a Court of Chancery ruling and will go before its first set of shareholders when the giant and somewhat troubled software company, CA, Inc., has its annual meeting usually held at the end of the summer.

Here is the text of his letter to CA, Inc., the proposal itself, and the professor's supporting statement:

Lucian Bebchuk
1545 Massachusetts Avenue, Cambridge, MA 02138
Telefax (617) 812 – 0554
March 23, 2006

VIA OVERNIGHT MAIL
CA, Inc.
ATTN: Secretary
One CA Plaza, Islandia, New York 11749

Re: Shareholder Proposal of Lucian Bebchuk

Dear Mr. Handal:

I am the owner of 140 shares of common stock of CA, Inc. (the "Company"), which I have continuously held for more than 1 year as of today's date. I intend to continue to hold these securities through the date of the Company's 2006 annual meeting of shareholders.

Pursuant to Rule 14a-8, I enclose herewith a shareholder proposal and supporting statement (the "Proposal") for inclusion in the Company's proxy materials and for presentation to a vote of shareholders at the Company's 2006 annual meeting of shareholders.

Please let me know if you would like to discuss the Proposal or if you have any questions.

Sincerely,
Lucian Bebchuk

....

It is hereby RESOLVED that pursuant to Section 109 of the Delaware General Corporation Law, 8 Del. C. Section 109, and Article IX of the Company's By-Laws, the Company's By-Laws are hereby amended by adding Article XI as follows:

Section 1. Notwithstanding anything in these By-laws to the contrary, the adoption of any stockholder rights plan, rights agreement or any other form of "poison pill" which is designed to or has the effect of making an acquisition of large holdings of the Company's shares of stock more difficult or expensive ("Stockholder Rights Plan") or the amendment of any such Stockholder Rights Plan which has the effect of extending the term of the Stockholder Rights Plan or any rights or options provided thereunder, shall require the affirmative vote of all the members of the Board of Directors, and any Stockholder Rights Plan so adopted or amended and any rights or options provided thereunder shall expire no later than one year following the later of the date of its adoption and the date of its last such amendment.

Section 2. Section 1 of this Article shall not apply to any Stockholder Rights Plan ratified by the stockholders.

Section 3. Notwithstanding anything in these By-laws to the contrary, a decision by the Board of Directors to amend or repeal this Article shall require the affirmative vote of all the members of the Board of Directors.

This By-law Amendment shall be effective immediately and automatically as of the date it is approved by the vote of stockholders in accordance with Article IX of the Company's By-laws.

SUPPORTING STATEMENT

I believe that poison pills adopted by the Board of Directors without ratification by stockholders can deny stockholders the ability to make their own decisions regarding whether or not to accept a premium acquisition offer for their stock and, under certain circumstances, could reduce stockholder value. In my view, when one or more directors do not support a decision to adopt or extend a pill, the board should not make such a decision without obtaining shareholder ratification for the pill. Additionally, I believe that it is undesirable for a poison pill not ratified by the stockholders to remain in place indefinitely without periodic determinations by the Board of Directors that maintaining the pill continues to be advisable.

The proposed By-law amendment would not preclude the Board from adopting or maintaining a poison pill not ratified by the stockholders for as long as the Board deems necessary consistent with the exercise of its fiduciary duties, but would simply ensure that the Board not do so without the unanimous vote of the directors and without considering, within one year following the last decision to adopt or extend the pill, whether continuing to maintain the pill is in the best interests of the Company and its stockholders.

I urge you to vote "yes" to support the adoption of this proposal.

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continued

No Action?

Less then a month after Professor Bebchuk submitted his proposed bylaw, CA announced on April 21, 2006 that it planned to exclude the professor's proposal from the company's 2006 proxy materials. CA maintained that the proposal, if adopted by its shareholders, would force the company to violate Delaware law. CA asked the SEC's Division of Corporation Finance for a no-action letter stating that the division would not recommend an enforcement action against the company for refusing to put Professor Bebchuk's proposal to a vote of CA stockholders. CA's advisors at Sullivan & Cromwell and Richards, Layton & Finger each sent opinion letters to the SEC, both hammering away at the fact that Section 2 of the Bebchuk Bylaw exempts from its purview those stockholder rights plans that have been ratified by stockholders.

"It's brilliant. Devilish. But brilliant."

Professor Bebchuk says it is incorrect to describe his bylaw as one that prevents a company from keeping a pill beyond one year without shareholder approval: "Getting shareholder approval would be one way to keep a pill in place beyond one year. But the bylaw and my supporting statement are very clear that the board can on its own keep the pill indefinitely as long as the unanimity and periodic review requirements are satisfied."

Professor Hamermesh of Widener University is not surprised that the two law firms concentrated so intently on Section 2 of the Bebchuk proposal since that section is more vulnerable to attack: "There's a good reason for this—the other section is the one where Lucian has been able to identify ways in which the statute more clearly supports what are limitations on a board's range of motion."

Sullivan & Cromwell's letter lists as its central reason the proposal should be excluded the fact that shareholders would usurp the board's power over the pill:

> The Proposal, if adopted, would amend the Company's by-laws so as to prohibit the Company's Board of Directors (the "Board") from exercising its statutorily delegated authority to adopt a rights plan that would by its terms expire more than one year from the date of adoption, or from amending any such plan (including the Company's existing rights plan) to extend its term by more than one year, unless in each case the plan or amendment were ratified by the Company's stockholders under Section 2 thereof (the "Proposed By-law"). In substance, therefore, the Proposed By-law would dictate to the Board the maximum duration of any new rights plan, or of any extension of an existing rights plan, that the Board may adopt without further corporate action.

Richards, Layton & Finger, similarly, argues that "[i]n connection with the adoption of a stockholder rights plan or the extension of the term of an existing rights plan by the board of directors of the Company (the "Board'), the bylaw proposed for adoption pursuant to the Proposal (the "Rights Plan Bylaw") would purport to require the Board to provide for the termination of such plan or amendment within one year from the later of its adoption and amendment unless the plan or amendment is ratified by the Company's stockholders."

Both law firms then proceed to pummel mercilessly this alleged usurpation of the board's powers and responsibilities. Each firm argues that the Bebchuk bylaw runs afoul of two sections of the Delaware General Corporation Law: Section 157, which, they argue, explicitly gives the directors rather than the stockholders the power to create and issue stockholder rights and options; and Section 141(a), which, they maintain, places in the directors the exclusive responsibility for managing the business of the corporation. Finally, the two firms maintain, the Bebchuk bylaw would wrongfully limit the board's exercise of its fiduciary duty of care, which requires directors to protect stockholders from unfair takeover offers.

Richards, Layton & Finger, for example, parses Section 157 as follows:

> Under Section 157 of the General Corporation Law, the power to create and issue rights and to determine the duration for which rights may be issued and maintained is explicitly vested in the directors, not in stockholders or others. The provisions of Section 157 are themselves quite instructive for what they say <u>and</u> for what they do not say:
>
> (a) <u>Subject to any provisions in the certificate of incorporation</u> [*it does not say "or bylaws"*], every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to

acquire from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors [*It does not say "or stockholders."*]

(b) The terms upon which, including the time or times which may be limited or unlimited in duration, at or within which, and the consideration (including a formula by which such consideration may be determined) for which any such shares may be acquired from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options [*it does not say "or in the bylaws"*], and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors [*it does not say "or stockholders"*] as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.

Not to be outdone, Sullivan & Cromwell also homes in on Section 2 of the bylaw and attacks it for wrongfully usurping directorial power under Section 141:

Delaware courts have acknowledged that the authority to manage a corporation's affairs resides with the directors. The Supreme Court of Delaware holds as "a cardinal precept of the General Corporation Law of the State of Delaware", that "directors rather than shareholders, manage the business and affairs of the corporation". *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984). Section 141(a) makes clear that a restriction on that authority is only permissible if it is set forth in a provision of the DGCL or a company's certificate of incorporation. Unlike other sections of the DGCL, Section 141(a) makes no reference to the by-laws; therefore, we do not believe stockholders can limit a director's managerial authority under Section 141(a) by virtue of a by-law provision. *Compare*, e.g., DGCL Section 141(b), (c), Section 202(b) and Section 211(a). In drawing the distinction between the role of directors and stockholders, the Delaware Court of Chancery has noted that under the corporation law of Delaware, directors are not obligated to "follow the wishes of a majority of shares" in exercising their powers to manage the firm. *Paramount Communications Inc. v. Time Inc.*, C.A. Nos 10866, 10935, slip op. at 77-78 (Del. Ch. July 14, 1989), aff'd, 571 A.2d 1140 (Del. 1989). This is precisely what this Proposed By-law seeks to do.

But is that precisely what the bylaw seeks to do? Professor Bebchuk says it is precisely what the bylaw does not do. The bylaw does not place decisions to issue pills in shareholder hands nor does it require the board to follow shareholders' orders, he points out. The bylaw focuses on the voting and review requirements to be imposed on the board when it, and it alone, decides whether to install and maintain a pill. Section 141(b) of the DGCL expressly permits shareholders to adopt bylaws specifying a supermajority requirement for a given type of board decisions. "The version of my model bylaw submitted to CA requires unanimity," Professor Bebchuk says, "but a version that requires a significant supermajority would also work well." Either approach, he believes, is sanctioned by Section 141(b), which reads as follows:

Section 141(b) The board of directors of a corporation shall consist of 1 or more members, each of whom shall be a natural person. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal. Any director may resign at any time upon notice given in

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"I could have written an article on the subject, but I thought that submitting some model bylaws to companies would be an effective way of highlighting this issue to practitioners and academics. The pill was a natural choice for one of these model bylaws."
—*Lucian Bebchuk*

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continued

> writing or by electronic transmission to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than 1/3 of the total number of directors except that when a board of 1 director is authorized under this section, then 1 director shall constitute a quorum. ***The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number***. (emphasis added)

Both law firms pummel mercilessly this alleged usurpation of the board's powers and responsibilities.

Both Sullivan & Cromwell and Richards, Layton & Finger bemoan what they see as the proposed bylaw's infringement of a board's duty to defend its company against unfair takeover offers. In the words of the latter:

> A requirement that the Board provide for the termination of any stockholder rights plan or amendment to extend the term of a rights plan within one year from the later of its adoption or last extension unless the amendment or plan is ratified by stockholders in all cases, thereby subjecting the plan's efficacy to such stockholder approval, effectively limits the ability of the Company's directors to utilize a powerful and effective tool in reacting to unfair or inequitable takeover tactics, even if the Board determines in the good faith exercise of its fiduciary duties that a rights plan would be in the best interests of stockholders and the most effective means of dealing with such a threat... Submitting to a stockholder vote the question of whether to adopt or extend a rights plan in such circumstances significantly diminishes the ability of the Board to respond as necessary to protect the interests of the Company and its stockholders. When the Company faces a significant threat, such as inequitable takeover tactics, the directors' ability to negotiate effectively, to react expeditiously and to maintain its defensive devices could be critical to discharging their fiduciary duties.

Says Professor Bebchuk: "Although CA's brief asserts that the bylaw would undermine the board's ability to block 'bad offers,' it never explains why the bylaw would have such an effect. If a year passes and the board continues to view an offer as 'bad,' the bylaw would not prevent it from continuing to block the offer. There is no reason to expect a periodic review requirement to lead to the acceptance of offers that the board views as unfair, inadequate, or otherwise undesirable."

A Masterful Job

On May 11, 2006, Professor Bebchuk, represented by Grant & Eisenhofer, filed suit in Delaware's Chancery Court, seeking a declaratory judgment that the proposed bylaw would not violate Delaware law if enacted. The SEC staff, citing the pending litigation, refused to issue no-action relief, expressing "no view with respect to CA's intention to omit the [proposal] from the proxy materials relating to its next annual meeting of security holders."

On June 22, 2006, Vice Chancellor Lamb declared that "[b]ecause the proposed bylaw has not yet been adopted by the stockholders and because no other compelling justification exists to trigger this court's jurisdiction, the court concludes that the issue in this case is not yet ripe for consideration." Although the vice chancellor ultimately refused to rule on the validity of the bylaw, M&A experts say that the briefs, the oral argument, and the opinion itself yield important insights into the potential future course of this compelling issue. Says one seasoned court watcher: "Lamb's performance at oral argument is typical of him—a masterful job. The lawyers had never even thought of some of the questions he asked."

The defendant's opening pre-hearing brief starts with the proposition that the Bebchuk bylaw would prohibit CA's board from adopting a rights plan expiring more than one year from the date of adoption unless ratified by the company's stockholders. It goes on to argue that the bylaw would "divest the Board of its statutory right to create and determine the terms of rights and options issued with respect to corporate stock," as well as "usurp the Board's power to mange the business and affairs of the corporation" and "hinder the board's ability to exercise its fiduciary duty of care when responding to an

unfair takeover offer."

But Professor Bebchuk points out that these arguments are inapplicable to his bylaw, which, by design, does not prevent boards from retaining a pill indefinitely. Represented by Grant & Eisenhofer, Professor Bebchuk maintains in his brief that CA's argument is "factually incorrect":

> CA argues that the Proposed Bylaw would violate Section 141(a) (Def. Br. At 12-17) because it would "substantially limit" the "board's ability to exercise its business discretion on whether to adopt or extend a rights plan in the context of a sale of the corporation," (Def. Br. at 14)... CA simply ignores a fundamental aspect of the Proposed Bylaw which the accompanying supporting statement makes explicit:
>
> > The proposed By-law amendment ***would not preclude the Board from adopting or maintaining a poison pill not ratified by the stockholders for as long as the Board deems necessary consistent with the exercise of its fiduciary duties***, but would simply ensure that the Board not do so without the unanimous vote of the directors and without considering, within one year following the last decision to adopt or extend the pill, whether continuing to maintain the pill is in the best interests of the Company and its stockholders.
>
> Barry Decl., Ex. A (emphasis supplied). The Proposed bylaw would in no way hinder the directors from exercising their fiduciary duty to thwart an inadequate or coercive tender offer. Nowhere does the Proposed Bylaw require that a Board-enacted poison pill ever be put to a shareholder vote. Moreover, the Proposed Bylaw itself also affirmatively provides that it may be repealed or amended by the Board. Id. (at Section 3). Thus, the only "limitation" the Proposed Bylaw would place upon the Board is that the Board itself must periodically reconsider whether maintaining a poison pill remains in the best interests of shareholders.

CA relies on the same arguments set forth by Sullivan & Cromwell and Richards, Layton & Finger in their letters to the SEC, that the proposed bylaw would violate Section 157 and Section 141(a), and would infringe on the board's exercise of its fiduciary duty of care.

There is also in the briefs a more clear acknowledgment that the bylaw is not subject to a shareholder vote and more of a focus on the fact that the board cannot from the outset adopt a pill with a term any longer than one year. CA notes that the proposal decrees that any rights plan "shall expire" no later than one year after its adoption or last amendment. Section 157, CA argues, gives the board the power to set the terms of any such plan, including the "limited or unlimited... duration" of any pill.

This may be the Achilles' heel of the proposal. "By imposing a substantive one-year limit on the duration of any rights plan adopted by the Board," CA writes, "the Proposed Bylaw would eviscerate the Board's statutory power to set the 'time or times which may be limited or unlimited in duration' during which rights may be exercised. The Proposed Bylaw is thus 'inconsistent with' Delaware law and invalid." Adds Widener's Professor Hamermesh: "Limiting the duration of the unanimously board-adopted pill to one year is where the proposal probably overreaches. If the proposed bylaw had been limited to the unanimity requirement, the defenders of the board would have had a very difficult row to hoe indeed."

"Lamb's performance at oral argument is typical of him—a masterful job. The lawyers had never even thought of some of the questions he asked."

In their briefs, the two sides also skirmish over the meaning of Section 109 and Section 102, which read as follows:

§ 102. Contents of certificate of incorporation

(b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

(1) Any provision for the management of the business and for the conduct of the affairs of the corporation, and any provision creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders, or any class of the stockholders, or the members of a nonstock corporation; if such provisions are not contrary to the laws of this State. Any provision which is required or permitted by any section of this chapter to be stated in the bylaws may instead be stated in the certificate of incorporation...

§ 109. Bylaws.

(a) The original or other bylaws of a corporation may be adopted, amended or repealed by

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continued

the incorporators, by the initial directors if they were named in the certificate of incorporation, or, before a corporation has received any payment for any of its stock, by its board of directors. After a corporation has received any payment for any of its stock, the power to adopt, amend or repeal bylaws shall be in the stockholders entitled to vote, or, in the case of a nonstock corporation, in its members entitled to vote; provided, however, any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors or, in the case of a nonstock corporation, upon its governing body by whatever name designated. The fact that such power has been so conferred upon the directors or governing body, as the case may be, shall not divest the stockholders or members of the power, nor limit their power to adopt, amend or repeal bylaws. (b) The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees. (8 Del. C. 1953, § 109; 56 Del. Laws, c. 50; 59 Del. Laws, c. 437, § 1.)

Says Lawrence Hamermesh: "If the proposed bylaw had been limited to the unanimity requirement, the defenders of the board would have had a very difficult row to hoe indeed."

Professor Bebchuk and his lawyers argue that Section 109 of Delaware's statute grants shareholders authority broad enough to encompass the proposed bylaw. "Nothing in Delaware law precludes corporations from adopting bylaws that establish bounds within which the directors may, by resolution, exercise their business judgment in implementing a poison pill," Professor Bebchuk maintains in his brief. It dismisses CA's argument that Section 109 only applies to those areas specifically mentioned in other sections of Delaware's corporate statute as legitimate subject matter for shareholder bylaws.

CA, on the other hand, insists that the confluence of Section 102(b)(1) and Section 109 is the key to the meaning of each. "[T]here is an important distinction between the language of Section 102 of the DGCL, which regulates certificates of incorporation, and Section 109, which regulates bylaws," the defendant argues. The former decrees that the charter may contain any provision "creating, defining, limiting and regulating the powers of the corporation, the directors, and the stockholders…" The latter says that bylaws may contain any provision "relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees." In other words, CA maintains, limits on the power of the board must be in the certificate of incorporation. Bylaws are meant only to address procedural and organizational matters. Therefore, since this bylaw limits the power of the board to set an unlimited term for a shareholder rights plan, it is invalid on its face.

Says one senior M&A expert: "This is their best technical argument."

Not surprisingly, Professor Bebchuk disagrees with CA's argument that a bylaw can only govern issues for which bylaws are explicitly permitted in other sections of the DGCL through a phrase such as "unless otherwise specified in the bylaws." "If this argument were correct," he maintains, "Section 109 wouldn't be needed at all. The section, which sets up a general category of issues that could be governed by a bylaw, should be understood to provide guidance beyond that already provided by other provisions authorizing bylaws concerning specific issues."

Uproar in Delaware

Even if a court sees the proposed bylaw as shifting some power over the pill from directors to shareholders, Professor Bebchuk and his advisors maintained, such a shift is now permitted under the law of Delaware. Their brief begins with precisely what M&A experts feared would happen after Chancellor William Chandler's recent decision in the News Corp. case that roiled the M&A bar so violently as the year 2006 began (see "Uproar in Delaware," *The M&A Journal*, Vol. 6, No. 7).

The first sentence of the plaintiff's pre-hearing brief is as follows: "The fundamental question in this case—whether Delaware law prohibits shareholders from limiting the discretion of a board of directors in enacting poison pills—has already been answered by this court. In *Unisuper v. News Corp.*, 2005 WL 3529317 at *6 (Del. Ch.) ("News Corp."), Chancellor Chandler held that shareholders may exercise their rights (in that case by contract) to impose restrictions on a board's ability to exercise its discretion in adopting a poison pill. In denying the defendants'

motion to dismiss in that case, Chancellor Chandler necessarily rejected the very arguments advanced by Defendant CA, Inc. ("CA" or the "Company") here."

The plaintiff's brief emphatically quotes from the chancellor's opinion what has so quickly become its most famous passage:

> Delaware's corporation law vests managerial power in the board of directors because it is not feasible for shareholders, the owners of the corporation, to exercise day-to-day power over the company's business and affairs. ***Nonetheless, when shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way.*** This is because the board's power—which is that of an agent's with regard to its principal—derives from the shareholders, who are the ultimate holders of power under Delaware law. (emphasis added).

One can almost hear a collective groan from those M&A experts who predicted at the time of the ruling that shareholders would grab this very passage from the News Corp. battlefield and wave it forever as their new regimental colors.

The defendants struggle mightily to distinguish News Corp. from this case, the first company since the chancellor's decision to grapple with the power it would seem to confer on shareholders. In its opening brief, the defendant seeks to discredit the validity of the same passage cited by the plaintiff. "[T]he court suggests that directors are obligated to follow the wishes of the holders of a majority of the corporation's shares since directors are mere agents of stockholders. This proposition is contrary to a long line of Delaware Supreme Court cases, holding that directors, not stockholders, manage the business and affairs of Delaware corporations," the defendant asserts.

CA also argues, both in its opening brief and its reply brief, not only that *News Corp.* is not the law of Delaware but also that the facts of News Corp. are so different from the instant case that it is inapposite. In *News Corp.*, the defendant points out, the board entered into a contract with stockholders to limit the board's managerial authority over a stockholder rights plan. Here, the defendant maintains, the board is not voluntarily entering into an agreement but is instead the potential victim of a power grab by shareholders.

"The facts alleged in *News Corp.* are entirely distinct from the instant case," the defendant argues in its pre-hearing reply brief. News Corp., an Australian corporation, announced plans to reincorporate in Delaware, the defendant recounts. An Australian proxy advisor company and an advisor to Australian pension funds worried that, unlike Australia, Delaware allows a board to set up a pill without shareholder approval. They asked News Corp. to agree to put in its charter a provision restricting the board's ability to issue a pill without shareholder approval. News Corp. agreed only to adopt a board policy that any rights plan enacted without a shareholder vote would last only one year. Two weeks after its rebirth in Delaware, News Corp. adopted a pill and announced that its policy would apply in the future only "if appropriate in light of the facts and circumstances existing at such time." Certain shareholders sued in Delaware and the case was heard by the chancellor himself.

CA notes that in certifying the interlocutory appeal of News Corp. the chancellor wrote:

> [F]or purposes of this appeal, *defendants have conceded that there was a contract*. In fact, it is beyond dispute that there was a "package" of contracts and promises made between plaintiffs and the Company in the months leading up to News Corp.'s re-incorporation as a Delaware corporation. It also is uncontroverted, at this stage, that without these "agreements" the re-incorporation would not have occurred.
>
> News Corp. thus finds itself in a stew of its own making. News Corp easily could have included language in the Press Release or Letter to Shareholders... stating that the Company's board *reserved the right to rescind the board policy. Id* at *1-2 (emphasis in original).

"*News Corp.* is simply inapposite to the instant case," CA concludes. "The Court's opinion did not address Section 157. The board of News Corp. voluntarily contractually ceded a portion of its authority to shareholders. And, the arguably inequitable conduct by News Corp.'s board, putting News Corp. in a 'stew of its own making,' *id*. at *2, is factually distinct from Plaintiff's attempt unilaterally to seize control of CA's affairs by bylaw."

This is not likely to be the last debate on the merits and dispositive power of *News Corp.* Says Widener's Lawrence Hamermesh: "*Unisuper* is just not the compelling authority that one might assert it to be. It's an opinion with some loose language, to say the least, that I think will not stand the test of time." Adds another renowned M&A expert: "Notice what the vice chancellor says about *Unisuper*, that it might not be the law of

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Delaware. *Unisuper* will never be accepted in Delaware. That would turn it into the People's Republic of California, to paraphrase Vice Chancellor Strine."

A Household Name

And what does Vice Chancellor Lamb think of all this? First, his own history is intriguing. As a Skadden associate, he helped argue that the pill itself was an invalid incursion on shareholder territory and that a device that gave the board veto power over tender offers required shareholder approval for a change to the certificate of incorporation. This was the losing argument in the Household case (see "A Household Name," page 15) that legalized the shareholder rights plan.

One can almost hear a collective groan from those M&A experts who predicted at the time of the ruling that shareholders would grab this very passage from the News Corp. battlefield and wave it forever as their new regimental colors.

At the oral argument held in Wilmington on June 19, 2006, some moments seemed to bode well for the plaintiff, some did not. Despite his dismissal of the complaint as unripe, both the oral argument and his opinion place all the complexities of the question on display, revealing what each side will have to face in the future for it to prevail.

As the oral argument begins, Vice Chancellor Lamb immediately gets a concession from the CA lawyer, Sullivan & Cromwell's Robert Giuffra, Jr.: the defendants are not contesting the unanimity requirement in the proposed bylaw. Indeed, it would be virtually an impossible argument to make that Section 141(b) of the DGCL does anything but explicitly allow shareholder bylaws to set voting thresholds for board action:

> **Mr. Giuffra:**... In addition, it's a provision requiring a unanimous vote with respect to rights plans, and we're not challenging that piece of his provision before the Court today.
>
> **The Court:** Well, do you concede the legality of that part of the bylaw?
>
> **Mr. Giuffra:** For present purposes, Your Honor, yes, we do.

The vice chancellor is not satisfied and presses on.

> **The Court:** Well, in your reply brief you conceded, said you thought it was unwise but, nevertheless, permissible under 141(b). Did I misread that?
>
> **Mr. Giuffra:** That was our position, Your Honor. And we do think it's an unwise provision, but we believe that under 141(b) and subsequent and also case law, that it might well be permissible. So we're not challenging it.

Instantly, all that is left is whether the bylaw can legitimately require pills with no more than one-year terms that can be annually extended by the board.

If that was good news for the proponents of the bylaw, there were also some discouraging signs for those who hope that it eventually passes judicial muster. Professor Bebchuk's team relied heavily, for example, on Chancellor Chandler's recent ruling in *Unisuper*, but Vice Chancellor Lamb seems to cast some doubt on the precedential value of that ruling.

> **Mr. Giuffra:** … So if the board agrees to do something with the shareholders, yes, the board's powers can be limited. A board can limit its powers by entering into a loan agreement with a bank.
>
> **The Court:** Well, forget about the loan agreement. I mean, it's a conse—you're making a concession about *Unisuper* in a way. *Unisuper* is a decision by the Court of Chancery. It's not a Supreme Court decision, and it isn't *necessarily* true that the Supreme Court would agree, is it?
>
> **Mr. Giuffra:** Absolutely correct, Your Honor...

The defendant, for its part, seeks to exploit the difference between Section 109 and Section 102 of the DGCL. CA, Inc. maintains that Section 102, which deals with the permissible contents of the certificate of incorporation, is the only way to limit the powers of directors as profoundly as it says the Bebchuk bylaw would entail. This section, CA argues, is the far more grand arena in which directorial power is "created" and "defined." Section 109, in contrast, defines the more narrow world of bylaws, which are only meant to address more routine matters "relating to the business of the corporation" and "the conduct of its affairs.

Vice Chancellor Lamb may not see the division so starkly:

> **Mr. Giuffra:** I think it's important to also think about Section 102, because Section 102 talks about the power of a—what you can

do in terms of amending an article of incorporation. And it talks about the—on its face it refers to—that an article of—a certificate of incorporation can be amended by any provision that created—by provision that "creates, defines, limits, or regulates the power of the directors." If you look at [Section] 109, it talks about "relating to the business of the corporation." And if you want to regulate the powers of the board by limiting those powers and defining those powers and regulating those powers, the proper way under the statutory scheme would be to do it under [Section] 102(b)(1), which is the certificate of incorporation, because—

The Court: You know, I sort of—I mean, I get your argument that the language in 109 is different than 102, but it's not quite as different as you just put it, because it—109 speaks about bylaws relating to "the business of the corporation, the conduct of its affairs, and the rights or powers of its directors." So, I mean, it—it—the sort of textual issue is does the language "relating to the rights or powers of directors" create a more narrow universe of things that can be done with the 102 language about—which is, you know, conceivably broader—"creating, regulating," and so forth, "the rights or powers" of directors.

Still, the vice chancellor also challenges the plaintiff's interpretation of the interaction between the two sections. Grant & Eisenhofer's Michael Barry tries to capitalize on the above exchange between the court and Mr. Giuffra in an attempt to establish how expansive the territory is that bylaws can cover. But the vice chancellor stops him and focuses intently on the words "relating to" in Section 109, which might well imply that the world of Section 109 is a smaller place than that of Section 102, where the phrase "creating" is used instead:

Mr. Barry: {A]s the Court identified—the Section 109(b), which sets the terms of bylaws are very, very broad. As the Court identified, not only does it relate to authorized bylaws relating to the business of a corporation, but it also relates to, permits bylaws relating to the rights of directors. So to the extent we're talking about rights, the bylaws specifically contemplate that. Now—

The Court: What does "relating to" mean in that context?

Mr. Barry: What does "relating to" mean in that context? I think "relating to" means in that context, requires the Court to make a judicial determination as to whether the, the specific bylaw at issue relates to, as, under, under Section 109. It is our opinion that "relates to" is a rather broad, broad, broad statutory grant. There's no prohibition under certain, under, under Section 109 of any other subject matter, and the question what "relates to" is a question that the Court has to address.

The Court: All right, Well, I know I do. But in doing that, don't, isn't it sensible to contrast and compare the language with the language in 102 that begins with the scope of the charter provision?... 102 says charter provisions can "create, define, limit, or regulate"—or I may be getting the words mixed up—"the rights and duties of directors"... 102 says anything that can be in the bylaws can be in the charter. 109 doesn't say anything in the charter can be in the bylaws.

Mr. Barry: Agreed. But that doesn't mean that everything in the bylaws has to be specifically permitted by the—by other provisions of the DGCL. Otherwise, Section 109(b) would be completely superfluous.

The vice chancellor takes the same double-barreled approach to Section 157. While CA insists that Section 157 gives the board the power to adopt rights plans and implicitly bars shareholders from intruding on this terrain, the vice chancellor is not so sure. Says one M&A expert: "He says to Professor Bebchuk's lawyer that their side is saying the fact that the board has the power under Section 157 to issue rights plans doesn't mean that shareholders can't act at all with respect to that power. And he seems sympathetic to that line of reasoning."

The vice chancellor then asks Mr. Barry to respond to the slippery-slope argument. If shareholders have some residual power over the board's choices and processes on poison pills, where does it all end? Could shareholders adopt a bylaw that sets a pill's strike price at the market price, which would mean the pill was basically neutral? You're not trying to say, the vice chancellor asks, that shareholder could use the bylaw power to render a pill pointless?

"This was meant to be a softball question," one M&A litigator maintains. "He was looking for the guy to say, 'Of course not. We're not talking about making a pill useless.' But he doesn't say that. Lamb backs the guy into a corner and he doesn't get out of it."

The Court: ... The question is: Can a bylaw adopted by stockholders provide

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continued

that the power of directors to determine in their judgment not only the duration but the other terms upon which it is to be issued? For example . . . could you specify that that the exercise price in all circumstances be equal to market? By bylaw, could you say to the directors: 'You may issue any rights plan you want except it can't have any dilutive effect'?

Mr. Barry: That's—well—first off, I don't—that's not this bylaw. There may be restrictions on that kind of bylaw... [T]o the extent some day the Court is presented with a bylaw that overly restricts or prohibits the directors from issuing any poison pill or purports to define the conversion rate of a particular right, then that might—that might be a different case. That's not this case.

"Notice what the vice chancellor says about *Unisuper*, that it might not be the law of Delaware. *Unisuper* will never be accepted in Delaware.

The Court: Why is it different? I mean, is that a different—why would it present a different question under 157 is what I want to know.

Mr. Barry: Present a different question under 157, because then the—the extent to which the—the directors can be restricted in defining the terms might be—might be overly impactful.

At one point, deep into the oral argument, the vice chancellor addresses an issue that one M&A expert sees as a defining moment in the case:

The Court: At the same time, the case law, at least some of the case law, recognizes that rights plans are—fundamentally—devices for altering the power relations inside the corporation. It's a plan—it's a device that requires third-party acquirors to negotiate with the board of directors rather than offer—make offers—directly to stockholders. I mean, that's how it was litigated. That's how it's always been described. That's how it was justified . . . .

This becomes a central point in the ruling itself—"the single most important sentence in the opinion," as one expert put its. It comes at footnote 32, attached to the sentence in the decision that describes a pill, just as the vice chancellor did at oral argument, as a device to alter power arrangements within a corporation. The vice chancellor invokes William Allen, William Chandler III's predecessor at the Court of Chancery, as follows:

> As Chancellor Allen observed in *Paramount Communications Inc. v. Time Inc.*, 1989 Del. Ch. LEXIS 77, *88 n.22 (Del. Ch. July 14, 1989), a stockholder rights plan is "a control mechanism and not a device with independent business purposes."

Interestingly, the vice chancellor does not cite the Delaware Supreme Court affirmance of Chancellor Allen's ruling, which did not include or allude to the chancellor's point in the footnote. "What the vice chancellor is saying here is that the pill is a naked gimmick," says a senior M&A dealmaker. "It is a control mechanism and not a device with an independent business purpose. It is designed to shift power within the corporation. And since that is true, he implies that it is best for the board to have that power."

At this point in the argument, the vice chancellor seems to be saying: "The Delaware Supreme Court in *Household* said the board can adopt rights plans. It allowed the directors to take unilateral action to stand between a bidder and the stockholders. Given that holding, how could I possibly allow the stockholders through the device of a bylaw to reverse all that?… And yet… and yet… How bad can it be just to have the board vote unanimously before adopting or extending a pill and to review such decisions annually at one board meeting?"

Ripeness Is All

In the end, there was the little matter of ripeness:

The Court: You know, what you—all the things you're saying make me wonder if this case is even ripe. For you to be seeking an advisory opinion on a narrow issue—and you're reserving other issues that you might want to litigate later about this very bylaw. The bylaw hasn't even been approved by the stockholders. It's not in effect.

Mr. Giuffra: The bylaw has been submitted. We sought a no-action letter from the SEC.

The Court: Which they haven't given you.

Mr. Giuffra: Which they haven't given us because of this litigation, and the SEC has a policy that in the event of a litigation, the SEC will not rule on whether to grant a no-action

letter when it's a question of state law. And that's the question that's presented here. And our bylaw—our proxy has to be sent out on July 14th. So the issue is whether—

The Court: So you have sort of created this problem that you are now asking me to give the answer to, by sending a Delaware lawyer's opinion letter to the SEC, which now, under its regulations or its procedures, isn't even considering whether or not to issue the no-action letter until I decide.

Mr. Giuffra: Well, in fact, Your Honor—

The Court: Why not just put it on a ballot and let it be voted on, and if you think it's illegal, we'll litigate about it later?

Mr. Giuffra: Your Honor—Your Honor, the—the fact of the matter is that in other cases, corporations have done exactly what CA did in this case. They got an opinion from the Delaware lawyer. They have sent the opinion down to the SEC, and they have received a no-action letter. But Professor Bebchuk, obviously being aware of what the SEC's procedures are, commenced this litigation and, therefore, has prevented the SEC from issuing a no-action letter. So the company—

The Court: I mean—and I'm being a little—I really do have to say I don't understand the SEC's policy under this rule of theirs that something which is of debatable legality can be excluded under their rule just by getting a letter from someone. But in any event, I haven't been involved in that process for a long time. But it does raise issues of ripeness, frankly.

Mr. Giuffra: Well, Your Honor, we think—

The Court: And you're also telling me, as I understand what you're saying, Mr. Giuffra, that, you know, you're sort of keeping your powder dry on other aspects of this bylaw, and that all you're asking me to do is to decide whether or not some particular aspect of it is legal or illegal while maintaining your position that other parts of it, if it's subsequently adopted by the stockholders, may also be illegal.

Vice Chancellor Lamb rules that the issue is not yet ripe for consideration. But not without a lengthy explanation. His central reason for refusing to decide the issue is that the facts of the case are in flux and could prove extremely important. What's more, the legal issues are potent and complex. The first question is whether the bylaw is invalid on its face. Can the shareholders simply not pass such a bylaw without running afoul of Delaware law? If it is at least arguably permissible, how far can the bylaw go? To what degree can shareholders place limits on one of the board's powers? "If it were obviously invalid, he wouldn't worry about ripeness. And since he decides it's not ripe, he doesn't need the pages of analysis that he includes in the ruling. But he wants to set forth the difficulties of this question and he does a superb job of it," says one M&A expert.

"If the bylaw in question would inevitably be adopted in the proposed form, or was obviously invalid, the court might be more likely to act now," the vice chancellor declares. "But nothing on the record suggests either of those things. Absent some kind of precommitment among the stockholders to vote for the bylaw, the court cannot possibly know whether the bylaw will be adopted at the annual meeting. There is equally no reason to believe that this bylaw is obviously invalid, in the way that an attempt to adopt a bylaw that abolishes the board of directors, or, as was suggested at oral argument, attempts to force the board to meet only at the North Pole in the dead of winter, would be. On those unrealistic facts, the court might well feel compelled to exercise its discretion in advance of a vote in an effort to curb a wasteful proxy process. But that is not the situation.

How bad can it be just to have the board vote unanimously before adopting or extending a pill and to review such decisions annually at one board meeting?

"Rather, just as in *Stroud* and its progeny, the factual context in this case could be of the utmost importance. The excellent briefs of the parties and the court's own review of the divergent authorities concerning the validity of stockholder bylaws which limit a board of directors' exercise of one of its powers reveal both that the legal issue in this cause is fraught with tension and that any number of facts which might arise in the future could determine the course of this case as well as the court's analysis of this particular bylaw's validity."

The fact that he decides that the issue is not ripe for adjudication is not necessarily good news for either side in this debate. He notes pointedly, for example, the provision that would limit a CA pill to a one-year term unless a unanimous board votes to extend it beyond that time. "Unless a stockholder rights plan is ratified by the stockholders, therefore, the proposed bylaw seeks to

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continued

limit the power of the board to adopt, by majority vote, a poison pill of indefinite duration," the chancellor writes.

He seems to be implying that the proposed bylaw is not wholly innocent of the charge that it would limit the power of the board to adopt whatever sort of rights plan it pleases, reinforcing Professor Hamermesh's point that this clause may be the bylaw' weakest point.

On the other hand, he does not find the bylaw actually guilty of violating Delaware law either, and wonders what would be so bad about requiring boards to take an annual look at their pills, noting that they could amend or repeal them as they pleased, as long as they did so unanimously, an attribute of the bylaw that he describes as "useful to remember."

"If I were a board of directors today, I'd adopt a pill with a forty-year term—right now."

In the words of the vice chancellor:

> … From a purely legal standpoint, it is not necessarily clear that a bylaw limiting the duration of a board-authorized rights plan to one year is either facially illegal as an unauthorized impingement upon a board's powers under the DGCL or an unreasonable intrusion into the board's exercise of its fiduciary duties. The question of facial illegality would require the court to determine whether, among other things, stockholders may use their power to adopt bylaws to impose *any* limitation on a board's power by a simple resolution to adopt a rights plan, which, as our courts have recognized, is itself a device to alter power arrangements within a corporation. 32 [Herewith, the revealing Footnote 32.] It is clearly established that section 157 of the DGCL empowers boards of directors to adopt rights plans. It is less clear that the exercise of that power can never be the subject of a bylaw, whether enacted by the board of directors or the stockholders. Furthermore, the question of whether a bylaw unduly restricts the ability of a board of directors to exercise its fiduciary duties can only be examined in the context of an enacted bylaw that is said to actually threaten the board's ability to discharge its obligations to the corporation and its stockholders. Here, it is useful to remember, the proposed bylaw would allow the CA board to amend or repeal it by a unanimous vote...
>
> It is also the case that future factual developments could heavily influence the shape of any future litigation of this dispute. Most obviously, the CA stockholders might reject the proposed bylaw. Alternatively, CA and Bebchuk might, for example, come to an agreement by which the CA board adopts some restriction on the board's right to issue a poison pill, just as the dueling parties did in *Unisuper Limited v. News Corp.* Or, by the time this case ripens into a justiciable controversy, the operative issue might be whether a board may repeal a bylaw enacted with the express purpose of limiting its own power.

So what is likely to happen should this issue actually ripen and a board is faced with a Bebchuk bylaw approved by shareholders?

"Delaware doesn't like bright lines," says one experienced interpreter of its state courts. "Typically, when things get complicated they default back to the notion of whether it's reasonable. Is this bylaw unreasonable? It is very hard to say it is not reasonable. That's what's so brilliant about it. So the board has to look at the pill once a year and can only amend it with a unanimous vote: so what? The court might have to say, 'Look, our supreme court has said that directors have the power to set up pills and I cannot interfere with that.' But then how you jibe that with the words of Section 109 is a difficult question. Conceivably, the Chancery Court could say that the statute does not answer the question but it's clear that bylaws that are inconsistent with the law are invalid, including the common law of fiduciary duty, and it would be inconsistent with that law for anyone to adopt such a bylaw."

So what's a body to do? Says one M&A veteran: "Compare this bylaw to those mandatory redemption bylaws that would have required boards to redeem their pills after a certain period unless the shareholders voted to keep them in place. Those proposals were never actually litigated but there was never a chance in hell that Delaware would give shareholders the power to tell the board to fold its tents and go home. This bylaw has none of those flaws.'

However, he notes pointedly, the Bebchuk bylaw would only apply to new pills, not those already in place. Says this expert: "If I were a board of directors today, I'd adopt a pill with a forty-year term—right now."

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A Household Name

"You're reminding me of two years of my life I spent in some other pursuit"

—Vice Chancellor Stephen Lamb

In the midst of oral argument on June 19, 2006 in *Bebchuk v. CA, Inc.*, Vice Chancellor Lamb made a quiet reference, unremarked upon by those in his courtroom, to his own long history with the shareholder rights plan:

> **Robert J. Giuffra, Jr. (Sullivan & Cromwell):** Obviously in *Household*, the Court has said that the board has the power under [Section] 141 [of the Delaware corporate statute] and [Section] 157 to, to do rights plans.
>
> **The Court:** You're reminding me of two years of my life I spent in some other pursuit.

What was that pursuit? Nothing less than the legal battle that could have destroyed the pill virtually at its inception in 1985 but which, instead, established the rights plan not only as a valid takeover defense under Delaware law but soon the most popular shield for targets around the country. The case was, of course, the one that pitted Skadden against Wachtell yet again: *Moran v. Household Int'l, Inc.* On the disappointed Skadden team was one of the firm's young associates: Stephen P. Lamb.

Let us, if you will, dear reader, travel back in time to a place long ago and far away—exactly twenty-four years ago this July, to a muggy Houston, Texas. It is raining on a July night in 1982 as Martin Lipton arrives at the city's Warwick Hotel. The board of El Paso Natural Gas is to meet the next day, advised by Wachtell, to deal with a hostile tender offer by Burlington

Household Name ➔

Household Name

continued

Northern Railroad.

Mr. Lipton has flown in from Dallas, fresh from proposing a novel defense to another client facing the same sort of “bootstrap, two-tiered, coercive, front-end-loaded tender offer,” as Wachtell lawyers often derisively called such hostile bids. That client was General American Oil and its attacker was T. Boone Pickens. Mr. Lipton had found General American virtually defenseless, with not even a staggered board. What the company did have, however, was some authorized blank check preferred stock, which it could custom-tailor and issue without shareholder approval. Mr. Lipton suggested a simple but powerful move—add a fair-price provision to the blank check preferred to protect the shareholders from a low-ball second step. The foundation that controlled General American decided not to take his advice, so, as Mr. Lipton would describe it thirteen years later at the Seventh Tulane Corporate Law Institute held in New Orleans in 1995, “this security became academic.” Not for long.

It is getting close to midnight at Houston’s Warwick Hotel. The late James Fogelson, a Wachtell partner, is dreading the El Paso board meeting the next day. The company has no defenses, not even a staggered board. “Look,” he says to Mr. Lipton, “there’s nothing. Absolutely nothing. They’re just dead.” But Mr. Lipton has a question. “Do they have blank check preferred stock?” They do indeed. The company is about to go bankrupt, and its advisors are trying both to get an infusion of capital and to protect the 49 percent of the shares not targeted in the tender offer from a second-step squeeze-out.

The Wachtell team re-engineers the company’s blank check preferred stock so that 40 percent of the shares would remain in the hands of back-end shareholders. Burlington Northern asked the Delaware Chancery Court for a temporary restraining order. They argued that the stock that now had this fair-price provision grafted on to it was no longer true preferred stock, but the court denied the motion.

The issue was so new that the directors of El Paso were hard pressed during the depositions to define what it was that they had put in place, says one of the lawyers involved in the case. “We were amused at how clueless they were about the plan,” this lawyer recalls. With both parties in a rush, then-Chancellor Grover Brown hurried to write his opinion, even calling in his secretary to the office in Georgetown, Delaware on a Sunday, a rare occurrence. As he was putting the finishing touches to the ruling to be issued the following Monday, the former chancellor remembers, the parties notified him that they had reached a settlement.

Burlington Northern agreed to a capital infusion for El Paso and a fair price for the second step squeeze out. Although the court’s denial of a motion for a temporary restraining order was not a full ruling endorsing the use of blank check preferred stock in this way, it was at the least an encouragement to do so. Several Wachtell clients, including Bell & Howell Company and Enstar Corporation, took it on. “It proved to be useful in each case,” Mr. Lipton recalled in 1995.

Another evolutionary leap came a year later in 1983. Wachtell was now representing Lenox Inc. in its effort to dodge a takeover bid from Brown-Forman Distillers Corp. This time the target had no blank check preferred stock, so Wachtell used a convertible debenture instead, which freed the firm from any reliance on any particular security. Also, it was during this fight that the creature became known as a poison pill. According to Mr. Lipton, Martin Siegel of Kidder, Peabody, advising Lenox along with Wachtell, christened the device during an interview with *The Wall Street Journal.*

“Up to that point, we would have called it ‘The Assurance of Fair Treatment to All Shareholders,” Mr. Lipton said to laughter from his Tulane audience eleven years ago. “We then had a package on our back that weighed about 300 pounds, and not too many people were interested in picking up that package except those that were the target of a tender offer or that were about to become a target.” Mr. Lipton and his partners studiously avoided using the term ‘poison pill’ for months afterwards. “We gave up eventually.”

For the first two years of its life, the nascent pill was basically a fair-price provision swimming alongside either blank check preferred stock or convertible debentures. It was typically created in a rush to repel a hungrily circling predator. In 1984, the creature metamorphosed into one that could walk upright on dry land.

On July 19 of that year, with no particular threat in sight, Crown Zellerbach, a sluggish forest products company, set up a pill as a defense against possible future attacks. This time, Mr. Lipton turned it into a warrant, which could be issued to shareholders as a dividend. Unlike preferred stock, warrants do not disturb corporate balance sheets. What’s more, this pill had what became known as a flip-over provision. Still designed to protect shareholders from a low-ball

second-step squeeze out, this feature allowed shareholders in such a second-step merger to buy at a discount 25 percent of the market value of an acquiror's stock, painfully diluting the acquiror. This right would be triggered if anyone bought more than 20 percent of Crown Zellerbach stock. It was known as the "warrant dividend plan."

At first, the New York Stock Exchange would not permit the share purchase rights distributed under the warrant dividend plan to be listed on the exchange. A few days after Crown Zellerbach adopted the plan, NYSE changed its mind, but too late for the company. It became the only corporation whose rights under the plan were traded in the over-the-counter market.

The warrant dividend plan worked as follows: A company issues a dividend to its shareholders consisting of one warrant to buy one share of common stock for each share of common stock outstanding. The exercise price of the warrant is set at the long-term value of the company envisaged at that time. This price—in effect, the purchase price of a new share—would be set at somewhere between two and five times the current market rice. The warrants, which are stapled to and trade with the common stock, are exercisable when there is an acquisition of 20 percent or more of the company's common stock or an announcement of a tender for 30 percent or more of that stock.

If there should be a squeeze-out merger—if a raider acquired control and then merged or combined with the target so that the target was not the surviving corporation—each warrant would then become a warrant to buy that number of shares of common stock of the raider with a market value equal to twice the exercise price of the warrant. Thus, if the exercise price of the warrant was $200 and the raider's stock at the time of the merger was $50, then each warrant would be exercisable for eight shares of the raider's common stock. The warrants would have no effect on a raider willing to acquire control and await 100 percent ownership until after the warrants expired. In that case, the argument ran, the target's shareholders would still be able to hold on to their shares for enough time to realize the long-term value envisaged when the plan was adopted.

The late Sir James Goldsmith, the famously brilliant and irascible Anglo-French financier, zeroed in on Crown Zellerbach in December of 1984, announcing that he intended to acquire a substantial stake in the company. By March of that year, he held an 8.6 percent stake. In April, he offered $42.50 per share for 70 percent of Crown, as long as the board rescinded the rights plan. He also launched a proxy fight to elect directors and seek redemption of the pill. The Crown board rejected Goldsmith's offer, refused to rescind the pill, and announced a restructuring plan.

This effort was not well received in the market and the price of Crown shares did not rise as the board had hoped. Sir James abandoned his tender offer, but steadily increased his ownership stake to 19.9 percent, just below the pill's trigger. The board continued to refuse to rescind the pill and said it was determined to restructure the company. Sir James announced on May 15 that he had crossed the pill's 20 percent ownership threshold. Nor did he stop there. After negotiations with the board broke down for good in July, he bought yet more stock until he owned more than 50 percent of the company. In late July, the board formally yielded control of the company to him and gave him a majority of board seats. Then, Sir James simply did nothing. He did not do a second-step merger. The flip-over dangled uselessly for all to see.

Blaine Fogg of Skadden, who advised Sir James in his acquisition of Crown Zellerbach, described it at the time as the deal "which destroyed the Wachtell pill." Mr. Lipton was quoted as having said of the defeat at the hands of Sir James: "It was the worst disappointment of my life." Still, Mr. Lipton sent out a memo at the time, defending the pill: "The Rights Plan is not designed to prevent the purchase of control either in the open market or through a partial tender offer. It is designed to encourage negotiation with the board of directors and to protect the shareholders who wish to continue their equity investment from being squeezed out. It accomplished both of these objectives in the Crown situation. We continue to recommend the Rights Plan. We continue to believe that it is the fairest and best protection against abusive takeover tactics that has yet been developed."

Critics at the time argued that longtime shareholders loyal to management, employees, and other unsophisticated investors were left holding Crown stock when Sir James stopped buying. Institutional shareholders would have known that Crown's market price would fall as soon as he did so. Investors who wanted to join in whatever future Sir James planned for the company would have sold while he was still buying, and repurchased a stake once he had stopped and the price dropped.

In the end, Sir James sold most of the company's assets to James River Corporation. He netted some $400 million. Mr. Lipton said to the 1995 Tulane conference: "Everybody then said, 'Well,

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this pill is worthless, because he could just go ahead and buy half the company and just sit there. And, ultimately, while everybody said that the Crown Zellerbach pill didn't work, those shareholders who held on to their rights got about 40 percent more for the shares than Goldsmith paid in the original transaction in which he acquired 50 percent. So, in fact, the flip-over pill worked." Critics still say that this was more fortuitous than by design.

Household

In August of 1984, A month after the Crown Zellerbach pill was put in place, Wachtell found itself deeply involved in advising Household International about installing the same device to protect itself against a possible hostile bid by one of its own board members, John Moran.

The flip-over was at the heart of a controversy in the Household boardroom as the directors listened to Wachtell's presentations. Two directors objected strenuously and voted against the idea: Mr. Moran, who was contemplating a leveraged buyout of Household by the company of which he was chairman, the Dyson-Kissner-Moran Corporation, Household's largest shareholder; and John Whitehead, then-senior partner of Goldman, Sachs & Co. Ten years later, at Tulane, Mr. Lipton did an impression of a pompous Mr. Whitehead dismissing the idea of flip-over as beneath the company's dignity: "Well, I think it's most inappropriate for a big prominent company like Household to enact something like this," Mr. Lipton intoned. "I'm shocked that we would consider anything like this. I believe that it works, and I believe that it creates these benefits, but I certainly don't want to be associated with anything like this."

According to the minutes of the Household board meeting cited by the Delaware Supreme Court, Mr. Lipton "explained to the Board that his recommendation of the Plan was based on his understanding that the Board was concerned about the increasing frequency of 'bust-up' takeovers, the increasing takeover activity in the financial services industry, such as Leucadia's attempt to take over Arco, and the possible adverse effect this type of activity could have on employees and others concerned with and vital to the continuing successful operation of Household even in the absence of any actual bust-up takeover attempt." According to Mr. Moran, who was present at the meeting, the lawyers also told the board that the pill would mean that only a company the size of IBM could take over Household.

Since the Crown Zellerbach affair, Wachtell lawyers had changed the name of the device from a warrant to a right and the Household pill was thus officially known as the Preferred Share Purchase Rights Plan. It was embodied in a 48-page document entitled the Rights Agreement. The Delaware Supreme Court described it as follows:

> Basically, the Plan provides that Household common stockholders are entitled to the issuance of one Right per common share under certain triggering conditions. There are two triggering events that can activate the Rights. The first is the announcement of a tender offer for 30 percent of Household's shares ("30% trigger") and the second is the acquisition of 20 percent of Household's shares by any single entity or group ("20% trigger").
>
> If an announcement of a tender offer for 30 percent of Household's shares is made, the Rights are issued and are immediately exercisable to purchase 1/100 share of new preferred stock for $100 and are redeemable by the Board for $.50 per Right. If 20 percent of Household's shares are acquired by anyone, the Rights are issued and become non-redeemable and are exercisable to purchase 1/100 of a share of preferred. If a Right is not exercised for preferred, and thereafter, a merger or consolidation occurs, ***the Rights holder can exercise each Right to purchase $200 of the common stock of the tender offeror for $100***. This "flip-over" provision of the Rights Plan is at the heart of this controversy. (*emphasis added*)

On August 17, 1984, Mr. Moran asked Delaware's Court of Chancery to invalidate what was called "the preferred stock rights dividend plan." Citing the fact that Wachtell lawyers had told Household that with the pill only an IBM-sized behemoth would be any threat, Mr. Moran argued that the "sole purpose" of the pill was to "entrench management" and "deprive the stockholders of their valuable right to receive and consider offers."

In September and October of 1984, the two sides called on experts, presented exhibits and statistical studies. Skadden's Rodman Ward argued that "stockholders of Household have a right, under state and federal law, to receive tender offers for their stock which have not first been approved by the board... The Household board [cannot] eliminate or seriously impede that right without first obtaining the stockhold-

ers' consent through an amendment to the Household certificate."

Wachtell's George Katz maintained that the pill simply constituted "corporate action designed to deter takeover attempts deemed to be contrary to the shareholders' best interests, adopted... in good faith and for rational business purposes... of deterring disadvantageous tender offers and encouraging prospective acquirors to negotiate with the board of directors."

After two weeks of this, Vice Chancellor Joseph Walsh, only on the Chancery Court for eight months after 12 years on the Superior Court, asked the lawyers to address two issues: the application of the business judgment rule to the conduct of the Household board and the question of whether the warrant dividend plan was "so unusual and so unique" that it "falls outside the pale of the business judgment rule."

The vice chancellor ruled that the decision to adopt the pill was protected by the business judgment rule and, in November of 1985, the Delaware high court judges agreed. As Mr. Lipton recalled with a smile at the 1995 Tulane conference: "Fortunately for the future of our law firm, the court upheld the pill."

Flip-In

With the approval of the Delaware courts now firmly established, the pill developed rapidly. One of its most important characteristics, the flip-in provision, was invented by Skadden's Mr. Fogg and David Friedman, and Davis Polk's Joel Cohen and George Bason, Jr., now head of Davis Polk's M&A practice.

For their client, Sea-Land Corporation, which was faced with a very determined Harold Simmons, Skadden and Davis Polk created a pill with an ownership flip-in provision that addressed the problem raised in the Crown Zellerbach deal: a raider buys control of a company but does not cash out the remaining shareholders. If anyone triggered the pill by buying more than 40 percent or more of Sea-Land's stock, the company's other shareholders would receive rights to buy Sea-Land stock at a discount, diluting the predator.

In January of 1986, according to Skadden's David Friedman and Mr. Fogg, Sea-Land entered into a settlement agreement with Mr. Simmons, after he threatened to conduct a proxy contest. Sea-Land would nominate at its 1986 annual meeting three Simmons directors—Mr. Simmons himself, Admiral Elmo Zumwalt, Jr., who had served as chief of United States Naval Operations, and J. Landis Martin, a partner at Kirkland & Ellis, which represented Mr. Simmons. Says Mr. Fogg: "I recall quite clearly meeting with Simmons and saying, 'Here is all the data on Sea-Land you have been requesting, so put up or shut up—make a full and fair offer for all the Sea-Land stock or go away.' "

It worked.

CSX appeared on the scene, Mr. Simmons did nothing further, Sea-Land was sold to CSX, and the three Simmons nominees withdrew their names from consideration. The flip-in was born. "In Sea-Land," says Mr. Fogg, "the flip-in worked just as it was supposed to—it stopped Simmons from buying control on the cheap and enabled Sea-Land to find a white knight willing and able to pay a full and fair price to all the Sea-Land shareholders. The flip-in was trailblazing because it was a significant and untested extension of the rights plan just validated in *Household*."

As for the flip-over, it was the very failure of the Wachtell pill to deter the takeover of Crown Zellerbach by Sir James that helped keep it alive. The Delaware Supreme Court in *Moran v. Household Int'l, Inc.* pointed to Sir James's victory as evidence that the pill was not a magic bullet against all takeovers. Had it been foolproof the pill at this stage might have died in Delaware.

The state high court wrote in 1985:

> Appellants' contention that stockholders will lose their right to receive and accept tender offers seems to be premised upon an understanding of the Rights Plan which is illustrated by the SEC *amicus brief* which states: "The Chancery Court's decision seriously underestimates the impact of this plan. In fact, as we discuss below, the Rights Plan will deter not only two-tier offers, but virtually all hostile tender offers."
>
> The fallacy of that contention is apparent when we look at the recent takeover of Crown Zellerbach, which has a similar Rights Plan, by Sir James Goldsmith. Wall Street Journal, July 26, 1985, at 3, 12. The evidence at trial also evidenced many methods around the Plan ranging from tendering with a condition that the Board redeem the Rights, tendering with a high minimum condition of shares and Rights, tendering and soliciting consents to remove the Board and redeem the Rights, to acquiring 50% of the shares and causing Household to self-tender for the Rights. One could also form a group of up to 19.9% and solicit proxies for consents to remove the Board and redeem the Rights. These are but a few of the methods by which Household can still be acquired by a hostile tender offer.

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In yet another ironic twist, after all the doubts about the flip-in, it is the original flip-over about which Vice Chancellor Lamb has expressed some doubts as to its validity. There is one argument in particular made by Skadden that Vice Chancellor may still believe should have prevailed, at least he did when he joined the court in the late 1990s.

The Skadden team, with the future vice chancellor as a key player, argued that Section 157—later so central to the arguments of both sides in the vice chancellor's CA, Inc. case—gives a corporation the power to grant its own shareholders rights to purchase stock in their own company. But the flip-over provision of the pill gives stockholders the right to purchase stock in an attacking company, which, after all, by definition belongs to another group of stockholders with their own board of directors. What possible power can the directors of one company have to unleash their own shareholders on another company? How can they give their own people the right to buy stock at a discount in a wholly separate entity? Why can't that separate entity just say no?

The Delaware Supreme Court summarized Skadden's argument as follows:

> [A]ppellants contend that Section 157 authorizes the issuance of Rights "entitling holders thereof to purchase from the corporation any shares of *its* capital stock of any class..." (emphasis added). Therefore, their contention continues, the plain language of the statute does not authorize Household to issue rights to purchase another's capital stock upon a merger or consolidation.

Well, precisely.

The opinion does not actually directly refute this contention, at least not to Vice Chancellor Lamb's satisfaction. We spoke to Mr. Lamb just after he had been name to the Court of Chancery in YEAR (see "A Quiet Lamb?", *The M&A Journal*, Vol. 1, No. 1).

Looking back on the Household fight, Mr. Lamb was still wondering how it could be that the directors of one company can be allowed send their own shareholders to plunder the stock of another company at a discounted price that they unilaterally determine in advance. He rolled his eyes and smiled: "I just don't know."

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A Firm Opinion

A Letter from Richards, Layton & Finger

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April 21, 2006

CA, Inc.
One CA Plaza
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Re: Bylaw Amendment Proposal Submitted By Lucian Bebchuk

Ladies and Gentlemen:

We have acted as special Delaware counsel to CA, Inc., a Delaware corporation (the "Company"), in connection with a proposal (the "Proposal") submitted by Lucian Bebchuk (the "Proponent") which the Proponent intends to present at the Company's 2006 annual meeting of stockholders. In this connection, you have requested our opinion as to a certain matter under the General Corporation of the State of Delaware (the "General Corporation Law").

For purposes of rendering our opinion as expressed herein, we have been furnished and have reviewed the following documents: (i) the Restated Certificate of Incorporation of the Company, as amended through March 8, 2006

(the "Certificate"); (ii) the By-Laws of the Company, dated March 7, 2006; and (iii) the Proposal and its supporting statement.

[The section of the letter dealing with the documents relied on for this opinion has been omitted for reasons of space. The text of the bylaw has also been omitted from this excerpt; the full text of the proposed bylaw appears on page 3.]

In connection with the adoption of a stockholder rights plan or the extension of the term of an existing rights plan by the board of directors of the Company (the "Board"), the bylaw proposed for adoption pursuant to the Proposal (the "Rights Plan Bylaw") would purport to require the Board to provide for the termination of such plan or amendment within one year from the later of its adoption and amendment unless the plan or amendment is ratified by the Company's stockholders.

Discussion

You have asked our opinion as to whether the Rights Plan, if adopted by the stockholders, would be valid under the General Corporation Law. For the reasons set forth below, in our opinion the Rights Plan Bylaw, if adopted by the stockholders, would not be valid under the General Corporation Law.

In reaching this opinion, we start from the proposition that, as a general matter, the stockholders of a Delaware corporation have the power to amend the bylaws. This power, however, is not unlimited and is subject to the express limitations set forth in 8 Del. C. Section 109(b), which provides:

> The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.

(Emphasis added). We turn, therefore, to consideration of whether the Rights Plan Bylaw is "inconsistent with law or with the certificate of incorporation."

The Rights Plan Bylaw Violates Section 157 of the General Corporation Law.

Under Section 157 of the General Corporation Law, the power to create and issue rights and to determine the duration for which rights may be issued and maintained is explicitly vested in the directors, not in stockholders or others. The provisions of Section 157 are themselves quite instructive for what they say and for what they do not say:

> **(a)** Subject to any provisions in the certificate of incorporation [*it does not say "or bylaws"*], every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to acquire from the corporation any shares of its capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors [*It does not say "or stockholders."*]
>
> **(b)** The terms upon which, including the time or times which may be limited or unlimited in duration, at or within which, and the consideration (including a formula by which such consideration may be determined) for which any such shares may be acquired from the corporation upon the exercise of any such right or option, shall be such as shall be stated in the certificate of incorporation, or in a resolution adopted by the board of directors providing for the creation and issue of such rights or options [*it does not say "or in the bylaws"*], and, in every case, shall be set forth or incorporated by reference in the instrument or instruments evidencing such rights or options. In the absence of actual fraud in the transaction, the judgment of the directors [*it does not say "or stockholders"*] as to the consideration for the issuance of such rights or options and the sufficiency thereof shall be conclusive.

8 Del. C. Section 157 (emphasis added). Accordingly, the questions of whether to create and issue rights and for what duration the rights may be issued and maintained are to be determined by the board, not by the stockholders or others (acting through a bylaw or otherwise). Indeed, in a recent decision, James v. Furman, C.A. No. 597-N, slip op. at 11 (Del. Ch. Nov. 16, 2004), the Delaware Court of Chancery declined to dismiss a claim that the board of directors of Greenbrier Companies, Inc. ("Greenbrier") had impermissibly delegated to Greenbrier officers and counsel the authority to make changes to the terms of a rights plan in violation of Section 157 of the General Corporation Law. Thus, Furman confirms that decisions with respect to rights plans are committed to the discretion of the board of directors by statute.

The Delaware courts have repeatedly held that stockholders or others cannot direct, supplant or be delegated the decision-making authority of a board of directors with respect to functions specifically assigned to directors by statute. See, e.g., Jackson v. Turnbull, C.A. No. 13042, slip op. at 10 (Del. Ch. Feb. 8, 1994), aff'd 653 A.2d 306 (Del. 1994) (finding that an investment advisor

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cannot supplant the decision making of a board of directors with respect to setting the amount of consideration to be received in a merger approved pursuant to section 251(b) of the General Corporation Law); Smith v. Van Gorkom, 488 A.2d 306 (Del. 1985) (finding that stockholders cannot assume the board's statutory responsibility under section 251 of the General Corporation Law to determine that a merger agreement is advisable); Field v. Carlisle Corp., 68 A.2d 817, 820 (Del. Ch. 1949) (finding that an appraiser cannot be delegated the board's statutory responsibility under Section 152 of the General Corporation Law to fix the consideration to be received by a corporation for the issuance of its stock); Clark Mem'l College v. Monaghan Land Co., 257 A.2d 234, 235 (Del. Ch. 1969) (finding that officers cannot be delegated the board's statutory obligation to negotiate a binding agreement for the sale of all of a corporation's assets pursuant to section 271 of the General Corporation Law); accord Nagy v. Bistricer, 770 A.2d 43, 60-65 (Del. Ch. 2000); 2 William Meade Fletcher, Cyclopedia of the Law of Private Corporations Sections 495-99 (perm. ed. rev. vol. 2005) (hereinafter "Fletcher"). Adopting and extending a stockholder rights plan and setting the duration of such a plan or extension are functions specifically assigned to the board of directors of a Delaware corporation by statute—i.e., by Section 157 of the General Corporation Law. Accordingly, absent a provision in the corporations certificate of incorporation to the contrary, a board of directors of a Delaware corporation cannot be directed to exercise such authority in any particular way, be divested of such authority or delegate to stockholders or others the authority to exercise such power. But see Unisuper Ltd. v. News Corp., C.A. No. 1699-N, slip op. at 15-17 (Del. Ch. Dec. 20, 2005).[1]

Moreover, certain dictum in the News Corp. decision is directly contrary to prior decisions of the Delaware Supreme Court. In News Corp., the Delaware Court of Chancery stated: "Nonetheless, when shareholders exercise their right to vote in order to assert control over the business and affairs of the corporation the board must give way. This is because the board's power—which is that of an agent's with regard to its principal—derives from the shareholders, who are the ultimate holders of power under Delaware law." Slip op. at 17. Thus, the Court suggests that directors are obligated to follow the wishes of a majority of the corporation's shares since directors are mere agents of the stockholders. This proposition is contrary to a long line of Delaware Supreme Court cases, supra, pp. 6-7, holding that directors, not stockholders, manage the business and affairs of Delaware corporations, and to the Delaware Supreme Court's decision in Leonard Loventhal Account v. Hilton Hotels Corp., 780 A.2d 245, 249 (Del. 2001), infra p. 11, in which the Court noted that requiring a board of directors to submit a stockholder rights plan to a vote of stockholders was wholly inconsistent with Delaware law. In addition, the News court failed to account for the dispositive impact of 8 Del. C. Section 157 (discussed, supra, at pp. 3-5)

The Rights Plan Bylaw Violates Section 141(a) of the General Corporation Law

The power of a board of directors to adopt and maintain a rights plan derives not only from

[1] In Unisuper Ltd. v. News Corp., C.A. No 1699 slip op. at 15-17 (Del. Ch. Dec. 20, 2005), the Delaware Court of Chancery held that a board of directors of a Delaware corporation could agree, by adopting a board policy and promising not to subsequently revoke the policy, to submit the final decision on whether or not to adopt a stockholder rights plan to a vote of the corporation's stockholders. Similarly, in In re Nat'l Intergroup, Inc. Rights Plan Litig., C.A. Nos. 11484, 11511 (Del. Ch. July 3, 1990), the Court of Chancery found that a board of directors could agree by a contract with its stockholders not to adopt a new stockholder rights plan or extend the term of its existing plan without a stockholder vote. Thus, each of News Corp. and In re Nat'l Intergroup involved a board of directors exercising its discretion to make a contractual agreement with stockholders to limit its managerial authority with respect to the efficacy of a stockholder rights plan. Boards of directors frequently limit their discretion by contract. For example, loan agreements often limit the ability of the board of directors to take certain actions without lender approval. See, e.g., John C. Coates & Bradley C. Faris, Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives, 56 Bus. Law 1323, 1331 (Aug. 2001) (hereinafter referred to as "Coates and Faris") (noting that the Delaware Supreme Court's decision in Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d. 1281 (Del. 1998), should not be construed as prohibiting such contractual agreements because to read the case otherwise "would be absurd, as it would render unenforceable normal loan agreements (which frequently limit a board's authority to authorize certain corporate actions, such as dividends), and golden parachutes (which limit a board's ability to terminate an executive's employment with severance compensation). However, a voluntary agreement by a board of directors to contractually limit its discretion with respect to the efficacy of a stockholder rights plan is distinguishable from the instant case in which the manner in which the Board may exercise its discretion is purported to be dictated by stockholders. In the latter case, the Board is impermissibly divested of the authority to exercise its own business judgment on whether limiting its discretion with respect to the efficacy of a stockholder rights plan is advisable and in the best interests of the Company and its stockholders, whereas in the former case the board is not divested of such discretion. For this reason, News Corp. and In re Nat'l Intergroup are distinguishable from the instant case.

Section 157 of the General Corporation Law, but also from Section 141(a) of the General Corporation Law. See Moran v. Household Int'l, Inc. 500 A.2d 1346, 1356 (Del. 1985) ("The directors adopted the [Rights] Plan pursuant to statutory authority in 8 Del. C. Sections 141, 151 [and] 157."); Hilton Hotels, slip op. at 12 ("Under Moran and Revlon, the Hilton board has the power to adopt the Plan under 8 Del. C. Sections 141 and 122(13). As Moran clearly held, the power to issue the Rights to purchase the Preferred Shares is conferred by 8 Del. C. Section 157.") (footnote omitted). Section 141(a) of the General Corporation Law provides:

> The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provide in this chapter or in its certificate of incorporation.

8 Del. C. Section 141(a). Significantly, if there is to be any variation from the mandate of 8 Del. C. Section 141(a), it can only be as "otherwise provided in this chapter or in its certificate of incorporation." See, e.g., Lehrman v. Cohen, 222 A.2d 800, 808 (Del. 1966). The Certificate does not provide for management of the Company by persons other than directors, and the phrase "except as otherwise provided in this chapter" does not include bylaws adopted pursuant to Section 109(b) of the General Corporation Law. See, infra, pp. 12-17 (addressing the interplay between Sections 141(a) and 109(b)). Thus, the Board possesses the full power and authority to manage the business and affairs of the Company. To the extent the Rights Plan Bylaw purports to deprive the Board of such authority by prohibiting the Board from adopting a stockholder rights plan with a term of more than one year, or from extending an existing rights plan for more than one year, unless in each case the plan or extension is ratified by the Company's stockholders, the Rights Plan is inconsistent with Section 141(a) and the Certificate.

The distinction implicit in Section 141(a) of the General Corporation Law between the role of stockholders and the role of the board of directors is well established. As the Delaware Supreme Court consistently has stated, "a cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation." Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984). See also McMullin v. Beran, 765 A.2d 910, 916 (Del. 2000) ("One of the fundamental principles of the Delaware General Corporation Law statute is that the business affairs of a corporation are managed by or under the direction of its board of directors.") (citing 8 Del. C. Section 141(a)); Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1291 (Del. 1998) ("One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation.") (footnote omitted). This principle has long been recognized in Delaware. Thus, in Abercrombie v. Davies, 123 A.2d 893, 898 (Del. Ch. 1956), rev'd on other grounds, 130 A.2d 338 (Del. 1957), the Court of Chancery stated that "there can be no doubt that in certain areas the directors rather than the stockholders or others are granted the power by the state to deal with questions of management policy." Similarly, in Maldonado v. Flynn, 413 A2d 1251, 1255 (Del. Ch. 1980), rev'd on other grounds sub nom., Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981), the Court of Chancery stated:

> [T]he board of directors of a corporation, as the repository of the power of corporate governance, is empowered to make the business decisions of the corporation. The directors, not the stockholders are the managers of the business affairs of the corporation.

See also 8 Del. C. Section 141(a); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985); Adams v. Clearance Corp., 121A.2d 302 (Del. 1956); Mayer v. Adams, 141 A.2d 458 (Del. 1958). The rationale for these statements is as follows:

> Stockholders are the equitable owners of the corporation's assets. However, the corporation is the legal owners of its property and the stockholders do not have any specific interest in the assets of the corporation. Instead, they have the right to share in the profits of the company and in the distribution of its assets on liquidation. Consistent with this division of interests, the directors rather than the stockholders manage the business and affairs of the corporation and the directors, in carrying out their duties, act as fiduciaries for the company and its stockholders.

Norte & Co. v. Manor Healthcare Corp., C.A. Nos. 6827, 6831, slip op. at 9 (Del. Ch. Nov. 21, 1985) (citations omitted); Paramount Communications Inc. v. Time Inc., C.A. Nos. 10866, 10935, slip op. at 77-78 (Del. Ch. July 14, 1989), aff'd, 571 A.2d 1140 (Del. 1989) ("The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares."); but see Unisuper Ltd. v. News Corp., supra, n. 1. We believe that the extensive body of Delaware case law regarding

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rights plans and directors' fiduciary duties is inconsistent with the concept of stockholder-dictated action controlling the duration, adoption or extension of a rights plan.

The Rights Plan Bylaw Substantially Limits the Board's Discretion

In addition to the prohibition on delegation to, or the usurpation by, stockholders or others of decision-making with respect to matters reserved by statute to the discretion of the board of directors, stockholders or others cannot substantially limit the board's ability to make a business judgment on matters of management policy. See, e.g., Chapin v. Benwood Found, Inc., 4021 A.2d 1205, 1211 (Del. Ch. 1979), aff'd sub nom, Harrison v. Chapin, 415 A.2d 1068 (Del. 1980) (finding that the court could not "give legal sanction to agreements which have the effect of removing from directors in a very substantial way their duty to use their own best judgment on management matters" (citing Abercrombie v. Davies, 123 A.2d 893, 899 (Del. Ch. 1956), rev'd in part on other grounds, 130 A.2d 338 (Del. Ch. 1957)); Grimes v. Donald, 673 A.2d 1207, 1214 (Del. 1996) (same); Canal Capital Corp. v. French, C.A. No. 11764, slip op. at 4 (Del. Ch. July 2, 1992) (same); accord Rodman Ward, Jr. et al., 1 Folk on the General Corporation Law Section 141.1.3, at GCL-IV-15 (200602 Supp.) (hereinafter "Folk") (stating that it is the responsibility and duty of directors to determine corporate goals); Fletcher, Section 495 p. 529 ("The directors of the corporation do not have the power to delegate to others those duties which are at the focal point of the management of the corporation.")

A board's ability to exercise its business discretion on whether to adopt or extend a rights plan in the context of a sale of the corporation is a fundamental matter of management policy that cannot be substantially limited under Delaware law. In Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998), the Delaware Supreme Court held that a future board's ability to redeem a rights plan implicated a fundamental "matter [] of management policy"—the "sale of [a] corporation"—and therefore could not be substantially restricted under Delaware law by contract. Id. at 1292. Specifically, the Delaware Supreme Court held:

> One of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and affairs of a corporation. Section 141(a) requires that any limitation on the board's authority be set out in the certificate of incorporation. The Quickturn certificate of incorporation contains no provision purporting to limit the authority of the board in any way. The [contested provision], however, would prevent a newly elected board of directors from completely discharging its fundamental management duties to the corporation and its stockholders for six months. While the [contested provision] limits the board of directors' authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board's power in an area of fundamental importance to shareholders—negotiating a possible sale of the corporation. Therefore, we hold that the [contested provision] is invalid under Section 141(a), which confers upon any newly elected board of directors full power to manage and direct the business and affairs of [the] Delaware corporation.

Id. at 1291-1292 (emphasis added, and internal citations omitted0: see also Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1191 (Del. Ch. 1998) (finding that a "dead hand" provision of a rights plan impermissibly interfered with a current board's authority under Section 141(a) "to protect fully the corporation's (and its shareholders') interests in a transaction [for the sale of a corporation]" (footnote omitted); Davis Acquisition, Inc. v. NWA, Inc., C.A. No. 10761, slip op. at 7 (Del. Ch. Apr. 25, 1989) (adoption of a rights plan "is a defensive measure that the board has legal power to take" in connection with the "sale" of a corporation) (emphasis added); Moran v. Household Int'l, Inc., 490 A.2d 1059, 1083 (Del. Ch. 1985) (finding that "the adoption of the Rights Plan is an appropriate exercise of managerial judgment under the business judgment rule" in connection with the "sale" of a corporation). By divesting the Board of the ability to adopt a stockholder rights plan with a term of more than one year, or to amend an existing plan to extend its term for more than one year, unless in each case the plan or amendment is ratified by the Company's stockholders, the Rights Plan Bylaw indisputably would limit the Board's authority with respect to "an area of fundamental importance to the stockholders—negotiating a possible sale of the corporation." Quickturn, 721 A.2d at 1291-92.

The Rights Plan Bylaw Limits the Board's Exercise of its Fiduciary Duty of Care

A board's fiduciary duty of care also is implicated when it is faced with an unfair takeover offer. Directors of Delaware corporations have a

fiduciary duty to protect the corporation's stockholders from an unfair takeover offer. See, e.g., MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc., 501 A.2d 1239, 1247 (Del Ch. 1985), aff'd 506 A.2d 173 (Del. 1985). ("In the face of a hostile acquisition, the directors have the right, even the duty, to adopt defensive measures to defeat a takeover attempt which is perceived as being contrary to the best interests of the corporation and its shareholders."); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (finding in the context of corporate takeovers that a board has a duty to "protect the corporate enterprise, which includes [] [protecting] shareholders, from [] harm"); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) ("Newmont's directors [have] both the duty and the responsibility to oppose the threats presented by Ivanhoe and Gold Fields."); see, e.g., 1 R. Franklin Balotti & Jesse A. Finkelstein, Delaware Law of Corporations and Business Organizations, at 4-35 (3d ed. 2006) (hereinafter "Balotti & Finkelstein") ("The predominant view is that the target board has a duty to oppose tender offers which would be harmful to the corporation.");[2] 10 Corporate Counsel Weekly (BNA), No. 20, at 7 (May 17, 1995) (in which former Delaware Supreme Court Justice Andrew G.T. Moore II is quoted as stating that "failure to adopt a pill under certain circumstances could in itself be a breach of the duty of loyalty and care."). The duty to protect stockholders from harm derives from the fiduciary duty of care. See Unocal, 493 A.2d at 955 ("As we have noted, [the directors'] duty of care extends to protecting the corporation and its owners from perceived harm whether a threat originates from third parties or other shareholders."); Gilbert v. El Paso Co., 575 A.2d 1131, 1146 (Del. 1990) (finding that the duty of "care... prevent[s] a board from being a passive instrumentality in the face of a perceived threat to corporate control"). Thus, circumscribing the Board's ability to adopt a stockholder rights plan with a term of more than one year, or to extend an existing plan for more than one year could impair the Board's exercise of its fiduciary duty of care.[3]

A requirement that the Board provide for the termination of any stockholder rights plan or amendment to extend the term of a rights plan within one year from the later of its adoption or last extension unless the amendment or plan is ratified by stockholders in all cases, thereby subjecting the plan's efficacy to such stockholder approval, effectively limits the ability of the Company's directors to utilize a powerful and effective tool in reacting to unfair or inequitable takeover tactics, even if the Board determines in the good faith exercise of its fiduciary duties that a rights plan would be in the best interests of stockholders and the most effective means of dealing with such a threat. See, e.g., In re Pure Resources Inc., S'holders Litig., 808 A.2d 421, 431 (Del. Ch. 2002), aff'd 812 A.2d 224 (Del.) (TABLE) (noting that the adoption of a rights plan is the "de rigueur tool of a board responding to a third-party tender offer" and is quite effective at giving a target board under pressure room to breathe); Malpiede v. Townson, 780 A.2d 1075, 1089 (Del. 2001) (noting that a "routine strategy" for fending off unsolicited advances and negotiating for a better transaction is to adopt a poison pill); In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 481 (Del. Ch. 2000) ("The primary purpose of a poison pill is to enable the target board of directors to prevent the acquisition of a majority of the company's stock through an inadequate and/or coercive tender offer. The pill gives the target board leverage to negotiate with a would-be acquirer so as to improve the offer as well as the breathing room to explore alternatives to and examine the merits of an unsolicited bid."). Submitting to a stockholder vote the question of whether to adopt or extend a rights plan in such circumstances significantly diminishes the ability of the Board to respond as necessary to protect the interests of the Company and its stockholders. When the Company faces a significant threat, such as inequitable takeover tactics, the directors' ability to negotiate effectively, to react expeditiously and to maintain its defensive devices could be critical to discharging their fiduciary duties.

For this reason, the Delaware courts have zealously guarded the board's prerogatives in this area versus the wishes of the stockholders and others. See, e.g., Quickturn, 721 A.2d at 1291 ("this Court upheld the adoption of the Rights Plan in Moran

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[2] Messrs. Balotti and Finkelstein are directors of Richards, Layton & Finger, P.A.

[3] In News Corp., the Delaware Court of Chancery also held that a board of directors could effectively agree by a contract with the corporation's stockholders what is advisable and in the best interests of the corporation and its stockholders and that any such agreement did not operate as an impermissible limitation on the board of directors' ability to exercise its fiduciary duties under Delaware law. Slip op. at 20-22. However, the case of a board agreeing with stockholders what is advisable and in the best interests of the corporation and its stockholders is distinguishable from the case of stockholders unilaterally limiting the board of directors' ability to exercise its fiduciary duties as the Rights Plan Bylaw would purport to accomplish

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as a legitimate exercise of business judgment by the board of directors") (emphasis added; footnote omitted); Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1186 (Del. Ch. 1998) ("It [is] settled that a corporate board [may] permissibly adopt a poison pill..."), Davis Acquisition, Inc. v. NWA, Inc., C.A. No 10761, slip op. at 7 (Del. Ch. Apr. 25, 1989) (adoption of a rights plan "is a defensive measure that the board has legal power to take" (emphasis added); see also Martin Lipton, "Pills, Polls, and Professors Redux," 69 U. Chi. L. Rev., 1037, 1061 (Summer 2002) ("It is inconsistent with existing Delaware law for a board... to delegate to shareholders in a referendum the fiduciary decision of whether to leave [a] pill... in place."); 2 David A. Drexler et al., Delaware Corporation Law and Practice Section 17.06, at 17-30 (2005) (hereinafter "Drexler") ("Section 157 imposes upon the directors the duty to exercise final authority with respect to options and rights.") (emphasis added). The Delaware Supreme Court has addressed this issue explicitly:

> Moran addressed a fundamental question of corporate law in the context of takeovers: whether a board of directors has the power to adopt unilaterally a rights plan the effect of which was to interpose the board between the shareholders and the proponents of a tender offer. The power recognized in Moran would have been meaningless if the rights plan required shareholder approval. Indeed it is difficult to harmonize Moran's basic holding with a contention that questions a Board's prerogative to unilaterally establish a rights plan.

Hilton, 780 A.2d at 249. The fact that individual stockholders or even a majority of stockholders oppose the board's decision does not affect the board's authority. As the Court of Chancery has explained:

> The corporation law does not operate on the theory that directors, in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders are charged with the duty to manage the firm.

Paramount Communications Inc., slip op. at 77-78.

The Rights Plan Bylaw is Void

Whether the Board's authority with respect to the adoption, extension and duration of a stockholder rights plan arises under 8 Del. C. Section 157 or 141(a), the common law of fiduciary duties, or some combination thereof, in our view it cannot be overridden by a stockholder-adopted bylaw. See Frantz Mfg. Co. v. EAC Indus., 501 A.2d 401, 407 (Del. 1985) ("A bylaw that is inconsistent with any statute or rule of common law… is void…"); Quickturn, 721 A.2d at 1291-92; Carmody, 723 A.2d at 1191. See also Coates and Faris, Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives, 56 Bus. Law. At 1333-1334 ("One of the most enduring principles of the Delaware common law of corporations is that shareholders cannot limit a board in the exercise of business judgment regarding matters conferred to the board's discretion by law or charter. Had the Delaware legislature intended to allow shareholders to abrogate this rule via bylaw, it could have made this clear.") (footnotes omitted); Lawrence A. Hamermesh, Corporate Democracy and Stockholder-Adopted Bylaws: Taking Back The Street?, 73 Tul. L. Rev. 409, 479 (Dec. 1998) (hereinafter referred to as "Hamermesh-Tulane Law Review") ("stockholders lack the general authority to adopt by-laws that directly limit the managerial power of directors"); Charles F. Richards, Jr. & Robert J. Stearn, Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny Under Delaware Law, 54 Bus. Law, 607, 621 (Feb. 1999) (hereinafter referred to as "Richards and Stearn")[4] ("Based on the authority vested in the board of directors by sections 141(a) and 157, the Delaware courts have repeatedly deferred to directorial prerogative and discretion in the context of adoption, maintenance, and redemption of rights plans, subject only to the fact-specific Unocal/Unitrin proportionality test. The body of law so developed is wholly inconsistent with the concept of shareholder-dictated action regarding a rights plan...") (footnote omitted).

The drafters of the General Corporation Law did provide for specific mechanisms pursuant to which stockholders could limit the power of a board of directors to manage the business and affairs of a corporation. As discussed above, Section 141(a) provides that the board of directors shall manage the business and affairs of the corporation "except as may be otherwise provided in this chapter or in its certificate of incorporation." In addition, in forming a corporation under the close corporation statute, the stockholders thereof may either act by written agreement to restrict the discretion of the board of directors, 8

[4] Messrs. Richards and Stearn are directors of Richards, Layton & Finger, P.A.

Del. C. Section 350, or elect in the certificate of incorporation to permit the stockholders to manage the business and affairs of the corporation directly, 8 Del. C. Section 351. However, this permitted restriction on the discretion of the directors is only applicable to close corporations. Chapin v. Benwood Found., Inc., 402 A.2d 1205 (Del. Ch. 1979), aff'd sub nom., Harrison v. Chapin, 415 "A.2d 1068 (Del. 1980). See also 2 Drexler Section 43.02, at 43-6 (Section 350 exempts agreements of stockholders in close corporations from the rule that stockholders may not restrict or interfere with powers of board).

Commentators Supporting the Validity of the Rights Plan Bylaw Misinterpret Delaware Law

We are aware that several commentators have expressed the view that bylaws such as the Rights Plan Bylaw should be valid under Delaware law.[5] See, e.g., Leonard Chazen, The Shareholder Rights By-Law: Giving Shareholders a Decisive Voice, 5 Corporate Governance Advisor 8 (1997); Jonathan R. Macey, The Legality and Utility of the Shareholder Rights Bylaw, 26 Hofstra L. Rev. 835 (Summer 1998).[6] According to Messrs. Chazen and Macey, such bylaws would not be invalid under Section 141(a) of the General Corporation Law because Section 141(a)'s broad grant of authority to the board of directors is qualified by the phrase "except as may be otherwise provided in this chapter," which in their view includes (and thus permits) bylaws adopted pursuant to Section 109(b), and because a narrower reading of Section 141(a) would improperly negate Section 109(b)'s broad grant of authority for stockholders to adopt bylaws relating to the rights and powers of stockholders and directors. See Chazen, The Shareholder Rights By-Law: Giving Shareholders A Decisive Voice at 8, 17; Macey, The Legality and Utility of the Shareholder By-Law Amendments and the Poison Pill: The Market for Corporate Control and Economic Efficiency, 24 J. Corp. L. 433, 441-451 (Winter 1999) (same). Cf. Gordon, "Just Say Never?" Poison Pills, Deadhand Pills, and Shareholder –Adopted Bylaws: An Essay for Warren Buffet, 19 Cardozo L. Rev. at 547 ("Under prevailing modes of corporate statutory interpretation in Delaware, in which different statutes have 'equal dignity' or 'independent legal significance,' nothing can be resolved about the scope of section 109(b) from the reference in section 141(a) to the articles alone, not the bylaws.') (footnote omitted); Ronald J. Gilson, Unocal Fifteen Years Later (And What We Can Do About It), 26 Del. J. Corp. L. 491, 509 (2001 ("Under the equal dignity doctrine, the fact that two sections [(Section 141(a) and 109(b)] cover the same ground results not in a conflict, but in alternative approaches to the same problem.") (footnote omitted). Although no Delaware case has directly addressed the interplay of sections 141(a) and 109(b) in this context, we are of the view that these commentators have misconstrued Section 109(b) and the "except as may be otherwise provided in this chapter" language of Section 141(a).[7]

First, most commentators on the General Corporation Law agree that the "except as may be otherwise provided in this chapter" language of Section 141(a) refers only to specific provisions of the General Corporation Law, which expressly authorize a departure from the general rule of management by directors, and not to open-ended provisions such as Section 109(b). See Balotti & Finkelstein, at 4-6 (suggesting that such language references close corporation provisions of the General Corporation Law); Drexler Section 13.01

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[5] There is no Delaware case that specifically addresses the validity or invalidity of the Rights Plan Bylaw or of a similar bylaw. See, e.g., Coates and Faris, Second Generation Shareholder Bylaws: Post-Quickturn Alternatives, 56 Bus. Law at 1329; Richards and Stearn, Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny under Delaware Law, 54 Bus. Law. At 607; Lawrence A. Hamermesh, The Shareholder Rights By-Law: Doubts from Delaware, 5 Corporate Governance Advisor 9 (1997). However, the Delaware Supreme Court's decision in Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998), strongly supports the conclusion that the Rights Plan Bylaw would not be valid under Delaware law.

[6] Mr. Chazen is an attorney who has represented Mr. Guy P. Wyser-Pratte, who has advocated adoption of bylaws similar to the Rights Plan Bylaw. Mr. Macey has been Mr. Wyser-Pratte's nominee in several threatened proxy fights, including threatened proxy fights involving Telxon Corporation and Rexene Corporation.

[7] In Hollinger Int'l, Inc. v. Conrad Black, C.A. No. 183-N (Del. Ch. Feb. 26, 2004), the Court of Chancery held that a stockholder-adopted bylaw amendment that disbanded most of the committees of the board of directors of Hollinger International Inc. did not violate Section 141(a) of the General Corporation Law. The Court found that Section 109 of the General Corporation Law (which expressly provides stockholders with the authority to amend a corporation's bylaws) when read together with Section 141(c)(2) (which expressly provides for the regulation of board committees through the adoption of bylaws) permitted the stockholder-adopted bylaw at issue. We do not believe that the Hollinger decision permits stockholders to make decisions in areas such as the adoption of rights plans pursuant to Section 157 of the General Corporation Law, which is specifically reserved to the board of directors by statute. Unlike the bylaw amendments at issue in Hollinger, there is no statutory basis for stockholders, through amendment to the bylaws or otherwise, to place conditions or restrictions on the power of the board to adopt or extend a rights plan.

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[1], at 13-2 (suggesting that such language references Sections 14(c), 226, 291 and close corporation provisions); Folk at GCL-IV-11-12 (suggesting that such language references Sections 107, 226 and close corporation provisions); Hamermesh, The Shareholder Rights By-Law: Doubts from Delaware at 11 (The exception in Section 141(a) "addresses the narrow instances in which the General Corporation Law explicitly departs from the director management rule, as in Section 291 (authorizing appointment of a receiver for a corporation 'to take charge of its assets, estate, effects, business and affairs'), and Section 226 (permitting appointment of a custodian to exercise the powers of a receiver under Section 291). The fact that Section 141(a) is drafted to allow these limited, explicit departures from the director management norm cannot be read to allow an implied, open-ended invitation to depart from that norm through by-law provisions adopted by stockholders.") Indeed, several commentators specifically concluded that a bylaw similar to the Rights Plan Bylaw could not be accomplished under Section 109(b), notwithstanding that statute's arguably broad language. See Coates and Faris, Second-Generation Shareholder Bylaws: Post-Quickturn Alternatives, 56 Bus Law. At 1335 ("[F]irst generation shareholder bylaws are likely to be struck down under Delaware law because they limit the board's authority to manage the business and affairs of the company. If the Delaware Supreme Court's decision in Quickturn does not lead one to this result, the text, history, and common law development of Delaware law does."); Hamermesh, The Shareholder Rights By-Law: Doubts From Delaware, at 13 ("Given the statutory governance scheme reflected in section 141(a)..., that by-law proposal is an attempt that impermissibly intrudes upon the authority of the board of directors. It cannot be accomplished by a by-law provision despite the superficially broad subject matter reach of the statute (Section 109(b)) that governs the content of by-laws."); Richards and Stearn, Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny under Delaware Law, 54 Bus. Law at 624-625 ("If the Delaware General Assembly intended in section 141(a) to permit shareholders to enact by-laws restricting the authority of the board of directors to manage the business and affairs of the corporation, it easily could have so stated in section 141(a), as other jurisdictions have done. It did not.") (footnote omitted). See also Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back The Street?, 73 Tul. L. Rev. at 430 ("[T]he most reasonable reading of [Sections 109(b) and 141(a)] precludes reliance on Section 109(b) as an independent source of authority for a by-law that directly limits the managerial power of the board of directors.") (footnote omitted). Thus, there is significant support for the view that the "except as may be otherwise provided in this chapter" language of Section 141(a) does not include bylaws adopted under Section 109 (except perhaps if such bylaws are also adopted pursuant to Section 141(c), which is not applicable here). See, supra n. 7.

Second, most commentators believe that Section 109's purportedly broad grant of authority for stockholders to adopt bylaws relating to the rights and powers of stockholders and directors relates to bylaws that govern procedural or organizational matters, and not substantive decisions governing the corporation's business and affairs. See Balotti & Finkelstein, Section 1.10, at 1-14 ("The by-laws of a corporation have been characterized as the proper place to set forth 'the self-imposed rules and regulations deemed expedient for… the… convenient functioning' of the corporation."); Richards and Stearn, Shareholder By-Laws Requiring Boards of Directors to Dismantle Rights Plans Are Unlikely to Survive Scrutiny under Delaware Law, 54 Bus. Law. At 625-27 (supporting procedural/substantive distinction); Hamermesh, The Shareholder Rights By-Law: Doubts from Delaware, at 14 no. 20 ("A by-law removing an entire category of business decisions from board authority... is quite distinct from a by-law that merely governs how board decisions are to be made, and poses a distinct challenge to the allocation of management authority specified by Section 1412(a)."). See also id. at 10 ("by-laws of Delaware corporations do not customarily prescribe or limit the substantive content of business decisions"). Such an interpretation of Section 109(b) would harmonize Sections 109(b) and 141(a) without running afoul of Section 141(a)'s mandate that the corporation's business and affairs be managed by or under the direction of the board of directors. But see Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back The Street? 73 Tul. L. Rev., at 444 (suggesting that procedural/substantive distinction does not necessarily "provide a coherent analytical structure" and that "it is preferable to read section 141(a) as an absolute preclusion against by-law limits on director management authority, in the absence of explicit statutory authority for such limits out-

side of section 109(b)") (footnote omitted).

Mr. Macey suggests that, as a threshold matter, bylaws such as the Rights Plan Bylaw do not improperly interfere with directorial authority to manage the business and affairs of the corporation:

> Under section 109(b), shareholders retain the power to adopt, amend, and repeal corporate bylaws. This specific empowerment of shareholders should trump any vague, general norms about directors' power to run the firm, particularly because the shareholders rights bylaw does not interfere with directors' ability to make strategic decisions about the firm's operation...
>
> * * *
>
> [T]here is a strong argument that a company that adopts a shareholder rights bylaw is still managed under the direction of its board anyway.

Macey, The Legality and Utility of the Shareholder Rights Bylaw, 26 Hofstra L. Rev. at 867-69 (footnotes omitted).

This suggestion is inconsistent with Delaware law. The assertion that bylaws such as the Rights Plan Bylaw do not interfere with the directors' authority to manage the business and affairs of the corporation is incorrect, since "[f]or over a decade now, it has been settled that the term 'business and affairs' of the corporation includes... adoption of measures intended to deter or preclude unsolicited tender offers." Hamermesh, The Shareholder Rights By-Law: Doubts from Delaware, at 9. See also Quickturn, 721 A.2d at 1292 (provision of rights plan limiting future board's ability to redeem rights impermissibly interfered with future board's authority under Section 141(a) to manage business and affairs of corporation); Carmody, 723 A2d at 1191 (complaint challenging provision of rights plan prohibiting future board from redeeming rights stated claim that provision impermissibly interfered with board's authority under Section 141(a) to manage business and affairs of corporation).

We are aware that the Supreme Court of the State of Oklahoma has concluded that, under Oklahoma law, stockholders may adopt bylaws that restrict the board of directors' authority to create and implement shareholder rights plans. Int'l Bhd. Of Teamsters Gen. Fund v. Fleming Cos., 975 P2d 907, 908 (Okla. 1999). We do not believe, however, that the Oklahoma Supreme Court's decision would be persuasive to a Delaware court.

First, we note that the Oklahoma Supreme Court did not view the Oklahoma analogue to Section 141(a) as being "of primary concern" to its decision and concluded, without analysis, that the authority of directors under the Oklahoma analogue to Section 141(a) was subject to "shareholder oversight" under the Oklahoma analogue to Section 109(b). For the reasons stated herein, we believe that a Delaware court would construe Sections 141(a) and 109(b) differently. Indeed, although the Oklahoma Supreme Court observed that "Oklahoma and Delaware have substantially similar corporation acts" and relied in part upon Delaware case law, the Court failed even to acknowledge the substantial body of Delaware case law concerning the board of directors' duty under Section 141(a) to manage the business and affairs of the corporation, including in the context of takeover proposals.

Second, we note that the Oklahoma Supreme Court determined that the authority granted under the Oklahoma analogue to Section 157 was not limited to the board of directors, a position with which, for the reasons stated herein, we believe a Delaware court would not agree under Delaware law. Moreover, the Oklahoma court ignored the substantial body of Delaware case law concerning rights plans, analogized a rights plan to a stock option plan, and relied upon, among other things, an inapposite Delaware case concerning shareholder ratification of board action that was contrary to the terms of a stock option plan.

Finally, we note that the Oklahoma Supreme Court was expressly influenced by the fact that the Oklahoma legislature had not adopted a "shareholder rights plan endorsement statute," a fact that we believe would not be persuasive to a Delaware court given the extensive and established case law in Delaware upholding the authority of the board of directors to adopt and implement rights plans. Accordingly, we are of the view that a Delaware court would not find the reasoning or conclusions of the Oklahoma Supreme Court to be persuasive. See, e.g., Andrew R. Brownstein & Igor Kirman, Can a Board Say No When Shareholders Say Yes? Responding to Majority Vote Resolutions, 60 Bus. Law. 23, 58 (Nov. 2004) ("[T]he consensus view among commentators is that the Fleming precedent would not be followed in Delaware and that a board of directors' ability to adopt a poison pill in the context of a sale of the corporation is a fundamental matter of management policy that cannot be substantially limited under Delaware law."); Hamermesh, Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back The Street?, 73 Tul. L. Rev. at 435-36 ("the Fleming by-

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law and similar direct attempts to limit specific management decisions should be rejected by the courts"); Michael D. Goldman et al., Fleming Must Be Read Narrowly, 21 Bank and Corp. Governance L. Rep. 1102 (1999) ("while the relevant Oklahoma statutes are similar to their Delaware counterparts, it is unlikely that a Delaware court would reach the same conclusion as the Oklahoma court").

We note that the Securities and Exchange Commission (the "SEC") previously has accepted the view that stockholder proposals similar to the Proposal, if implemented, would violate Delaware law. Toys "R" Us, Inc., 2002 SEC No-Action Letter, LEXIS 571, at *1 (Apr. 9, 2002); see also Mattel, Inc., 2002 SEC No-Action Letter, LEXIS 497, at *1 (March 27, 2002) ("The proposal requests a bylaw to prevent Mattel from enacting or maintaining a shareholder rights plan without shareholder approval. There appears to be some basis for your view that Mattel may exclude the proposal under rule 14a-8(i)(2). We note that in the opinion of your Delaware counsel, Richards, Layton & Finger, implementation of the proposal would cause Mattel to violate state law. Accordingly, we will not recommend enforcement action to the Commission if Mattel omits the proposal from its proxy materials in reliance on rule 14a-8(i)(2).").

Conclusion

Based upon and subject to the foregoing, and subject to the limitations stated herein, it is our opinion that the Rights Plan Bylaw, if adopted by the stockholders, would not be valid under the General Corporation Law.

The foregoing opinion is limited to the General Corporation Law. We have not considered and express no opinion on any other laws or the laws of any other state or jurisdiction, including federal laws regulating securities or any other federal laws, or the rules and regulations of stock exchanges or of any other regulatory body.

The foregoing opinion is rendered solely for your benefit in connection with the matters addressed herein. We understand that you may furnish a copy of this opinion letter to the SEC and the Proponent in connection with the matters addressed herein, and we consent to your doing so. Except as stated in this paragraph, this opinion letter may not be furnished or quoted to, not may the foregoing opinion be relied upon by, any other person or entity for any purpose without our prior written consent.

Very truly yours,
Richards, Layton & Finger, P.A.
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Hedge Funds and Hart-Scott

FOCUSED ON SPEED AND ANONYMITY in making investments, hedge funds are often constrained by the Hart-Scott-Rodino Act (HSR Act). Hedge fund managers frequently seek to make quick, secret acquisitions of voting securities before other investors become aware of an opportunity. However, if the investments are substantial and result in holdings of voting securities valued above $56.7 million (unless certain exemptions apply), the HSR Act requires disclosure and a 15- to 30-day waiting period before completing the transaction. HSR-notified transactions are disclosed to the U.S. Federal Trade Commission (FTC) and Department of Justice (DOJ)—and possibly the public—depending on whether the acquiring party requests early termination.

While these constraints may be frustrating for hedge fund managers, failure to comply with HSR notification regulations can result in substantial penalties. In September 2005, the FTC fined a hedge fund (controlled by manager Scott Sacane) $350,000 for failing to report two separate acquisitions, including a purchase of $100 million in voting securities of a target corporation.

The FTC has not announced additional enforcement actions since September 2005, but it is actively monitoring hedge funds' HSR compli-

ance. A recent letter to the editor of *The Daily Deal* (published in June 2006) from Marian Bruno, director of the FTC Pre-Merger Notification Office, confirmed that the FTC is closely examining the application of HSR rules to hedge funds, aiming to emphasize enforcement and facilitate compliance.

Despite the obstacles the HSR Act imposes, certain transactions that exceed the basic HSR filing thresholds may be free from filing notification if specific rules or exemptions apply. Hedge fund clients considering the possibility of making substantial investments may benefit from consultation with legal counsel to determine if exemptions are available. For example, HSR regulations permit the following types of transactions to proceed without notification:

- **Investment Only:** Acquisitions that result in holdings of less than 10 percent of an issuer's voting securities may qualify for the "investment-only" exemption under HSR regulations. The investment must be purely passive, and the acquirer must not have the intent or means to influence the activities of the issuer. Hedge funds are often deemed activist investors and may struggle to meet the requirements of this exemption. However, in certain situations where the investment is truly passive, the investment-only exemption may apply. This is an area of concern to the FTC, and it is expected that the FTC may soon challenge funds that have claimed the exemption for investments that were not truly passive.

- **Independent Investment Vehicle:** An entity that is not "controlled" by any superior fund entity (as defined under HSR regulations) may be free to acquire voting securities or interests valued at less than $226.8 million if that entity falls below the "size-of-person" threshold (holding assets valued below $11.3 million) and has no regularly prepared balance sheet. Logistical constraints and the capital structure of a fund may preclude the utility of this exemption, but complex funds set up with a series of related entities may be able to take advantage of this special exemption.

- **Acquisition of Derivatives:** In lieu of an acquisition of voting securities, a fund may contract to purchase financial derivatives tied to the market price of a target company stock. Under HSR rules, this type of contract is exempt from reporting requirements as long as the derivative does not convey beneficial ownership of the target company stock. However, the derivative contract allows the fund to wager on the future price of a stock with an independent third party, such as an investment bank, and then collect—or pay—the difference when the derivative matures. This type of investment requires some level of disclosure (to an investment bank as opposed to the government), but may nonetheless allow a fund to take a financial position tied to a promising stock without acquiring the stock (and without having another party acquire the stock on its behalf).

Whether exemptions will render a given investment free from HSR notification requirements is a complex and fact-intensive question. And in all events, HSR compliance must be carefully managed with the guidance of counsel. However, hedge fund clients may, under certain circumstances, be able to take advantage of valid exemptions to acquire securities rapidly without observing HSR waiting periods.

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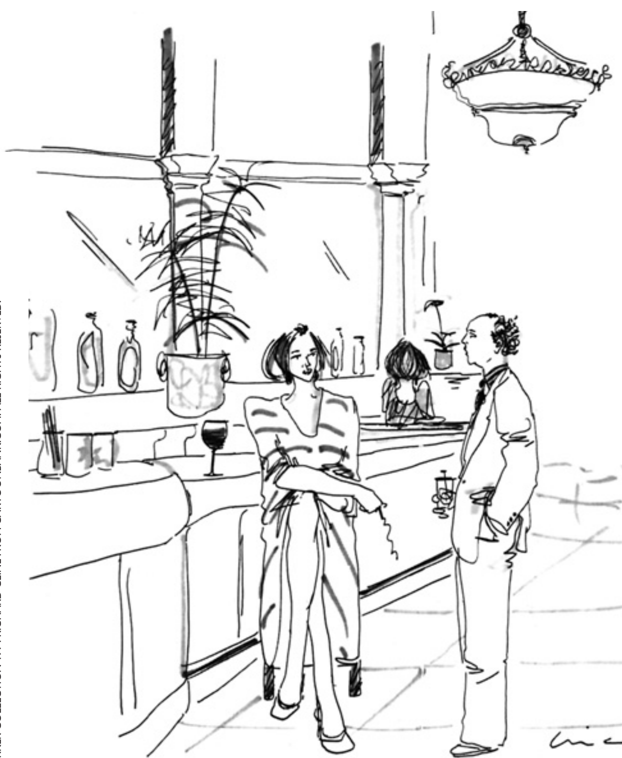

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