POISON PILL TAKE-OVER DEFENCES: A REVIEW OF DYNAMICS CORPORATION OF AMERICA v. CTS CORPORATION (1986-1987)

PAUL LATIMER*

SYNOPSIS

Defensive measures introduced by company directors to resist take-over bids seek to defeat the market for corporate control by making the company in effect take-over-proof. Measures such as strategic share issues to friendly parties, amendment of the company's articles of association and other uses or abuses of directors' powers may be consistent with the legal requirements of company directors as fiduciary agents if exercised bona fide for the benefit of the company as a whole. Defensive tactics which produce higher prices from bidders are to the advantage of company members, and are in line with N.C.S.C. (National Company and Securities Commission) expectations of directors of target companies. However defensive measures which entrench management by defeating the bid "at all costs", or those introduced by directors without good faith and reasonable investigation, or those which are plain unreasonable, may cause real losses to company members and will be or should be rejected by the courts.

This article analyses from the Australian perspective the major 1986/87 American litigation involving the ultimately successful take-over of CTS Corporation by Dynamics Corporation of America. Two ultimately unsuccessful poison pill take-over defences were considered by the United States District Court and the United States Court of Appeals for the Seventh Circuit in a judgment authored by former "Chicago economist" Judge Richard A. Posner in judgments of economic and legal relevance to Australian law in their application of policy considerations in line with those previously espoused by the N.C.S.C. in its function of the maintenance of an efficient, competitive and informed securities market.

INTRODUCTION

Economic theory concentrating on take-overs argues that the market for corporate control provides the mechanism by which corporate assets will be

* B.A., Dip.Ed.(N.S.W.), LL.M.(Syd.), Barrister and Solicitor, Senior Lecturer in Law (Business Law and Securities Regulation), Department of Accounting and Finance, Monash University. Visiting Scholar in Securities Regulation, New York University Law School and Columbia Law School, Fall Semester, 1986. The writer acknowledges the helpful updating and unreported public information provided by each of the corporations in this case, and comments from two of the judges involved, but of course accepts full responsibility for the contents of the article.

transferred to those who will use them most efficiently. The take-over entrepreneur often alleges that it can reverse the waste and inefficiency by corporate management which has led to inadequate corporate values and returns. Incumbent management (sometimes humiliated by a take-over), trade unions and the popular press often view take-overs as greedy empire building with shareholders, employees, products and geographic location and tradition sacrificed for a quick profit to the entrepreneur.

Defensive measures raised in response to take-over bids raise important issues concerning the duties of corporate management and the whole question of "corporate governance", a matter currently under review by the American Law Institute,[1] paralleled by a similar Monash University study.[2] Defensive strategies designed to make a target company take-over proof — such as those graphically described in the United States' jargon as poison pills, shark repellents, white knights and sale of the company's crown jewels to leave behind scorched earth[3] — raise important issues affecting the duties of corporate management, and to whom these duties are owed. The duties of company directors, found in the common law and s. 229 of the *Companies Act* 1981 (Cth.) and Codes revolve around the basic principle to act "bona fide for the benefit of the company as a whole".[4] As fiduciaries, directors are under subjective duties of honesty and good faith, and objective duties not to place themselves in a position where their duties might conflict with their private interests.[5] Such conflict of interests are especially relevant in the take-over context, where the law requires directors not to frustrate offers before the company's members have had an adequate opportunity to consider them. In the words of the N.C.S.C.'s Commentary on the responsibilities of directors of target companies:[6]

> Legal principles require directors, among their other duties, to ensure that a company's affairs are conducted for the benefit of members as a whole.

[1] The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, various releases (Philadelphia, 1980 to date).

[2] Faculty of Law, Monash University, *Principles of Corporate Governance*, 1986-1988. See further, H.A.J. Ford, *Principles of Company Law* (Sydney, Butterworths, 4th ed., 1986) para. [2044]-[2047]; G.F.K. Santow, *Defensive Measures Against Company Take-overs* (1979) 53 A.L.J. 374; T. Steel, *Defensive Tactics in Company Takeovers* (1986) 4 C. & S.L.J. 30; M.A. Caravaglia, *Shark Repellents, Golden Parachutes, Crown Jewels and Imagination: Defending Against Hostile Takeovers in Australia and the United States* (1986) 14 A.B.L.R. 348.

[3] or set out more fully by the National Companies and Securities Commission (hereafter N.C.S.C.), *Defensive Schemes and the Duties of Directors* (Discussion Paper, October 1986) at p.15 as (i) inter-company shareholdings between associated companies; (ii) inter-company shareholdings between non-associated companies; (iii) obtaining a foreign shareholder; (iv) placements; (v) employee share plans; (vi) superannuation funds; (vii) restructuring capital; (viii) re-deployment of assets; (ix) article amendment defences.

[4] *Allen* v. *Gold Reefs of West Africa, Limited* [1900] 1 Ch. 656 at p.671; *Mills* v. *Mills* (1938) 60 C.L.R. 150 esp. pp.185-186; *Marchesi* v. *Barnes and Keogh* [1970] V.R. 434; *Howard Smith Ltd.* v. *Ampol Petroleum Ltd.* [1974] A.C. 821; *Coleman* v. *Myers* [1977] 2 N.Z.L.R. 225; in the American Context, expressed as the "business judgment rule": see fn 29 and accompanying text.

[5] L.C.B. Gower, J.B. Cronin, A.J. Easson and Lord Wedderburn of Charlton, *Gower's Principles of Modern Company Law* (London, Stevens & Sons, 4th ed., 1979), pp.576-577.

[6] N.C.S.C. Commentary: Responsibilities of Directors of Target Companies, Release No. 403, reproduced in CCH *Australian Company Law and Practice* P80-806.

In a target company, they should also ensure that members are able to assess the fairness of a bid and that an offeror – or a competing bidder – offers the highest possible price. Defensive tactics designed merely to frustrate takeover offers may cause real losses to members, whereas defensive tactics which produce higher prices from bidders can only be to members' advantage. The directors of a company do not have a general mandate from members to ensure that the company remains "independent" at all costs.

The analysis of poison pill take-over defences by former "Chicago economist" and now United States Circuit Judge Richard A. Posner in the 1986/87 Dynamics Corporation of America/CTS Corporation hostile take-over should be recognised by Australian readers, both for its not uncommon facts and its acknowledgement of the financial economics literature on take-over defences, and for the arguments for and against its rejection of the first poison pill and its qualified upholding of the second poison pill if capable of substantiation. The judgments offer guidance on tests of validity for poison pills so long as compatible with the operation of free market forces to contribute to the health and the efficiency of the national economy. In its conclusion, the case also illustrates the effect of the defensive strategies involved in affecting the profitability of the target company and ultimately driving down the price of its shares.

Dynamics Corporation of America v. *CTS Corporation et. al.,* involved a hostile take-over which was litigated in the United States District Court[7] and on appeal in the United States Court of Appeals for the Seventh Circuit, and on Constitutional grounds in the United States Supreme Court. It has given rise to at least nine judgments in the course of 1986-1987[8] some of which, when distilled, contain important judicial guidance for Australian courts on the limits of take-over defence strategies in the light of the common law fiduciary duties placed on company directors. Action was instituted

[7] United States District Court, Northern District of Illinois, Getzendanner, District Judge.

[8] I: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* 637 F.Supp. 389 (N.D. Ill., 9 April 1986);

II: *Dynamics Corporation of America* v. *CTS Corporation et. al.* 637 F.Supp. 406; Federal Securities Law Reports P92,736 (N.D. Ill., 17 April 1986);

III: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* 635 F.Supp. 1174; Federal Securities Law Reports P92,743 (N.D. Ill., 3 May 1986);

IV: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* Federal Securities Law Reports P92,765 (N.D. Ill., 3 May 1986);

V: *Dynamics Corporation of America* v. *CTS Corporation* 794 F.2d. 250; Federal Securities Law Reports P92,768 (7th Cir. 28 May 1986, amended 9 June 1986) before Bauer, Chief Judge and Cudahy and Posner, Circuit Judges;

VI: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* 638 F.Supp. 802; Federal Securities Law Reports P92,992 (N.D. Ill., 20 June 1986);

VII: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* 643 F.Supp. 215 (N.D. Ill., 7 August 1986);

VIII: *Dynamics Corporation of America* v. *CTS Corporation, et. al.* Federal Securities Law Reports P92,993 (7th Cir. 3 November 1986);

IX: *CTS Corporation* v. *Dynamics Corporation of America*; *Indiana* v. *Dynamics Corporation of America* 55 L.W. 4478 (U.S. Supreme Court 21 April 1987).

The decisions are noted by, e.g., S. Gitelman, 54 *University of Chicago Law Review* 657 (1987); H.F. Mulligan, 62 *Notre Dame Law Review* 412 (1987); M.J. Choate, 63 *Chicago-Kent Law Review* 345 (1987).

on 10 March 1986 by Dynamics Corporation of America (hereafter the "offeror"), a company at the time holding 9.7% of the capital of the target company CTS Corporation (a company celebrating its 90th anniversary, now engaged in components for electronics, hereafter the "target company"), to challenge the adoption of three different poison pill plans designed to ward off the offeror's bid.

The take-over bid involved a partial offer dated 10 March 1986, for one million shares, or $US43 for 18% more of the shares to take the bidder's holding from 9.6% to 27.5%, coupled with the waging of a proxy contest for control of the target's Board. As so often confirmed by economic theory based on market experience, the target was indeed a company under seige by the market. The offeror's holding went back to 1980, a year before the take-over by present management. Bad feeling existed between the companies which had been fuelled by the failure of a major acquisition, as well as other acquisitions, described judicially by Posner J. as "flops", which had been opposed all along by the offeror, and declining returns since that time. Hence the target was fearful that if successful the offeror would decimate the company and would be willing and eager to sell off its shares to any purchaser that would offer it a good profit as a proved short-run profit maximiser, not caring about the long-run health of the company, and would engage in self-dealing generally. In fact, the offeror had planned to field new directors until its ambitions appeared thwarted by the placement of the first poison pill by the target's management.

In response to the offeror's hostile bid of 10 March 1986, and its announcement that it would run candidates as directors for the board of directors election scheduled two weeks hence, the internal management group, with no study of the offer's business or financial implications on its price, and with no consultation with the five (of eight) outside directors, rejected the bid out of hand on the day it was lodged.[9] The next day the target retained a leading merchant banker as adviser for the express purpose of defeating the bid, with the extra incentive for success of a bonus of $US75,000. On the fourth day the target's Chairman, without consultation with the Board, wrote to shareholders urging their rejection of the bid. Twelve days later the poison pill was delivered by the merchant banker.

FIRST POISON PILL

The first poison pill was designed to inflict immediate economic loss on the hostile offeror and to force negotiation by the offeror with the target's management. It had no element of maximisation of shareholder wealth, but instead operated only as a barrier to the bid precluding a hostile take-over at any price. In effect, it allowed management to take the shareholders hostage: "To buy (the target), you must buy out its management."[10] When

[9] "judgment first, trial later, as the Queen of Hearts said in *Alice in Wonderland,*" per Posner J., in *Dynamics Corporation of America* v. *CTS Corporation*, V, p.93,760.
[10] *ibid.*, p. 93,762 per Posner J.

any person or group acquired 15% or more of the common shares of the target, the pill was triggered giving the existing shareholders a "flip-in" or a dividend distribution of one "right" per share which entitled all holders (other than the acquirer, whose rights became null and void) to purchase a unit of the target's securities (common stock and debentures) at 25% of the then market price.[11] Because of the advantageous terms of the "flip-in" pill, there would be little likelihood of shareholders not triggering the pill.

Certainly this first pill would have the effect of warding off the bid. In addition to diluting the offeror's holdings in the target (from 27.5% to 20.7%), thereby reducing its voting power in the forthcoming election for the Board of Directors, it would have inflicted a substantial capital loss on the offeror (estimated at about $A35m) and burdened the target with a new, long term fixed debt of about $A115m at a high rate of interest (13%) affecting its net profits and its financial health. Indeed, incurring such debt may have been seen by some creditors as default on their loans thereby enabling calling in of the loans and could have equally reduced stock values leading overall to lower earnings on the part of the target.

Assuming take-overs maximise wealth creation,[12] successful blocking of this bid would deprive the offeror of a growth opportunity that may never recur. Potential shareholder sellers to the offeror would lose the difference between the take-over price and the lowered price which would eventuate if the bid failed. If the bid succeeded, the offeree shareholders would be stampeded into a sale, notwithstanding the cooling off, delaying and disclosure provisions of the American take-over statute, the Williams Act. Conversion of the shareholder's equity securities (shares) into debt (debentures) would raise its debt-equity ratio, and if it were already too high, could dramatically increase the target's risk of bankruptcy.

On the advice of its merchant bankers, the target feared that the offeror's acquisition of over 27.7% of the shares would create a blocking position which would inter alia jeopardise the ability of target shareholders to sell their shares at a premium. Hence, after the courts' rejection of the first poison pill,[13] the target explored several settlement possibilities with the offeror such as a stock repurchase or a compromise list for the Board of Directors. Other poison pills were considered,[14] but the upshot was a decision to maximise the value of shareholders' shares (other than the offeror's holding) by outright sale of the entire company at the highest price by means of an orderly auction.

[11] This first pill also had a "flip-over provision" which was triggered on the acquisition of the target by merger, business combination, or the sale of all or the majority of its assets, and which, when triggered, entitled the holder (of target stock) to purchase $US150 stock of the acquiring company for an exercise price of $US75: hence the "flip-over" to the acquirer's stock: *Dynamics Corporation of America* v. *CTS Corporation et. al.*, II, p.93,576.

[12] as discussed in, for example, M.C. Jensen and R.S. Ruback, *The Market For Corporate Control: The Scientific Evidence* (1983) 11 *Journal of Financial Economics* 1.

[13] in *Dynamics Corporation of America* v. *CTS Corporation et. al.*, II, op. cit.

[14] such as (1) a "flip-over" plan to deter partial bids made with a view to a second step transaction in which the offeror acquires the whole company; (2) a self-dealing "flip-in" plan; and (3) an equity "flip-in" plan modelled on that approved in *Revlon, Inc. et. al.* v. *MacAndrews & Forbes Holdings, Inc.* 501 A. 2d. 1239 (Del. Ch. 1985), affirmed 505 A. 2d. 454 (1986): *Dynamics Corporation of America* v. *CTS Corporation, et. al.*, III, p.93,618.

SECOND POISON PILL

In conjunction with the proposed sale of the target, the management committee decided on the second poison pill featuring in this litigation. This was a "back end" shareholder rights plan designed to remain in force for one year only and to prevent the offeror interfering with the proposed sale by limiting its holdings to 27.5%. Because of the pill, if any shareholder acquired 28% of the common stock of the target, all the other shareholders would be entitled within five days to turn in their shares and receive a $US debenture (bond) payable after one year with interest at 10% p.a. in exchange for each share. The pill could be cancelled by the Board at any time, and self-cancelled if anyone made a cash bid for all outstanding shares at a price of $US50 or more. This second pill was upheld by the District Court and despite the scepticism of Posner J. to any take-over defence mechanism, was similarly upheld by the Circuit Court subject to remand to the District Court for further consideration of some three matters going to the issue of good faith by the target's management[15] to ensure that the $US50 was a reasonable reflection of the value of the target's stock rather than an unjustifiable deterrence of all takeovers. As the target's board could not support this share price, the offeror demanded that this second poison pill be redeemed.

THIRD POISON PILL

In line with the substantiation requirements of the judgment of Posner J., the target's board redeemed the second poison pill on 20 November 1986 and installed in its place a third poison pill ("a new Shareholder Rights Plan"). Apart from a reduced and justifiable price of $US35, all the provisions of the second poison pill were carried forward including the triggering percentage of 28% (based on the 27.5% of the target's common stock now held by the offeror). The offeror immediately filed in court a motion for preliminary injunctive relief against the operation of this third poison pill on most of the same grounds as it had for the second poison pill. However, as part of the Settlement Agreement, this litigation regarding the third poison pill was dismissed, and the pill itself expired by its own terms on 23 April 1987.

SETTLEMENT

However, while the offeror's court challenge was pending the target received an offer on 16 December 1986 from a second bidder to acquire the corporation in exchange for securities in the second bidder to be valued at $US35 per share. This competition spurred the auction for corporate control related to the goal posited by Posner J. of stockholder wealth maximisation, and the auction had commenced. On the same day the target notified the offeror of the second bid, and the offeror responded with two proposals to acquire the target, one of which would have given the target's shareholders securi-

[15] discussed in text accompanying footnotes 31 to 35.

ties in the offeror valued at $US37.50 per share. This increased price forced the second bidder out of the auction for corporate control.

Due diligence investigations conducted by the offeror's legal and merchant banking advisers failed in that the respective advisers found themselves unable to render an opinion that a merger between offeror and target with the issue of securities in the offeror to the target would be fair to the shareholders of the offeror. At this stage the parties seriously entered settlement negotiations, culminating in a settlement with the offeror on 3 March 1987 seen by both parties to be in the best interests of the target and its shareholders, in respect of all claims, disputes and all litigation except the appeal then pending before the United States Supreme Court regarding the constitutionality of the Indiana Statute.[16] In particular, the Settlement Agreement restricted the offeror's shareholding to not more than 35% of the target's common shares for one year following the 1987 Annual General Meeting. The offeror was given an option to purchase shares of the target up to 35% at an option price equal to the average closing price for target shares on the New York Stock Exchange for the five days preceding the settlement date or $US29.63.[17] The offeror was also given three seats on the Board reduced from eight to seven members (the majority of whom were members of the previous Board). Although the Settlement gave the offeror effective control at 35%, and three out of seven of the Board, it also introduced at the offeror's insistence an 80% vote of approval during this one year period for constitutional changes to the target such as amending the memorandum and articles and adopting poison pill shareholder rights plans thereby restricting the

[16] To limit the number of successful take-overs and to therefore protect intra-state corporations and their shareholders, Indiana amended the *Indiana Business Corporation Law, Ind. Code* ss. 23-1-17-1 et. seq. (Supp. 1986) on 4 March 1986 (six days before the bidder's partial offer). Essentially this amendment provides that the acquisition of "control shares", which brings the bidder's voting power above a threshold of 20%, 33⅓% or 50%, does not include voting rights unless and until granted by resolution approved by the remaining disinterested shareholders. In other words, acquisition becomes conditional on approval by the majority of the existing shareholders within fifty days of the acquirer notifying the target company. The Constitutional challenge to this law, ultimately unsuccessful, paralleled the poison pill proceedings. Although the District Court (*Dynamics Corporation of America*, II), and the Court of Appeals for the Seventh Circuit (*Dynamics Corporation of America*, V) upheld the argument of the offeror, the decision of the United States Supreme Court upheld the validity of the Indiana Act:
(1) the federal Williams Act does not pre-empt the Indiana Act, even though there is a possibility of delay added to some take-overs;
(2) the Indiana Act does not discriminate against out-of-state offerors even though it may affect some interstate corporations and does not breach the United States' Constitution's Commerce Clause;
(3) in any case, States, with the power to create corporations, can regulate such matters as the rights that are acquired by purchasing their shares.
With this judgment in favour of the target, the 1,020,000 shares purchased by the offeror in April 1986 were accordingly disenfranchised under the Indiana Act. They failed to gain franchise at the Annual Shareholders' Meeting on 22 May 1987.

[17] Tuesday 24 February .... NYSE average closing price: $US29.000
Tuesday 3 March 1987 Settlement Agreement
Monday 2 March .... NYSE average closing price: $US29.500
Friday 27 February 29.875
Thursday 26 February 29.875
Wednesday 25 February 29.875

offeror's 43% control of the Board. This was introduced precisely because the offeror had only minority representation on the Board, did not control the vote of the Board, and would have been at risk in being outvoted on certain matters of significance to the target and to the offeror's investment in the target without this 80% protection. Undoubtedly recognising the unjustifiable barriers and expense to corporate control erected by its earlier poison pills, the target also agreed to reimburse the offeror some $US2 million for its legal fees and other expenses relating to the target. Reflecting compromises on both sides, the Settlement shows both sides agreeing that the first priority was and is to return the target to profitability after the large losses reported in 1986.

The lessons for Australian securities law are to be drawn from the judgments relating to the first two pills, and the dicta issuing therein.

JUDGING POISON PILLS

The arguments against anti-take-over regulation see value in the discipline upon corporate management imposed by the operation of the market for corporate control. Hence, believing in its ability to achieve a more profitable use of corporate assets, the offeror is prepared to offer a price in excess of the market price. In the words of then Professor Richard A. Posner:[18]

> [T]he coalescence of ownership and control is not a necessary condition of efficient management. What is necessary . . . is that there be methods — the tender offer, the proxy fight, voluntary acquisition — by which investors (usually, in this context, other large corporations) can obtain control of the board of directors and oust the present management. It is unimportant whether these mechanisms are employed often; indeed, the more effective a threat is as a deterrent, the less often it has to be carried out.

Judge Posner expressed the arguments for and against defensive, take-over tactics in these words:[19]

> The whole issue of permissable defensive tactics in the face of a tender offer is immensely contentious, and it is no business of ours, whose duty on the branch of the appeal is only to predict how the Indiana courts would evaluate CTS's poison pill maneuver, to choose sides. There are two polar positions in the debate. One views hostile takeovers as a bad thing, on a variety of grounds such as that they make managers of companies that are potential targets of takeover bids worry too much about short-term financial results and that they promote absentee ownership and control. See, e.g. Scherer, *Takeovers: Present and Future Dangers,* Brookings Rev. (winter-spring 1986), at 15; Herman, Corporate Control, Corporate Power 100-01 (1981). Whether or not Dynamics ever merges CTS into it, the parties seem agreed that if the tender offer succeeds, Dynamics, as by far the largest shareholder of CTS, will probably be able to elect a majority of the board of directors. Dynamics is a New York corporation with headquarters in Connecticut, CTS an Indiana corporation with headquarters

[18] R.A. Posner, *Economic Analysis of Law* (2nd ed., London, Little Brown, 1977), pp.303-305.
[19] *Dynamics Corporation of America* v. *CTS Corporation,* V, pp.93,757 - 93,758.

in Indiana. The record is not clear on where the firm's assets and employees are concentrated, and indeed reveals little about the companies except that CTS is a manufacturer of electronic and electromechanical components and Dynamics a diversified manufacturer of consumer and industrial products and that both are large companies whose stock is traded on the New York Stock Exchange.

The other pole is that all resistance to takeover attempts is bad. See, e.g. Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer,* 94 Harv. L. Rev. 1161 (1981); Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers,* 33 Stan. L. Rev. 819 (1981); cf. SEC Office of Chief Economist, *A Study on the Economics of Poison Pills,* FED. SEC. L. REP. (CCH) P83,971 (March 5, 1986). The market price of publicly traded stock impounds all available information about the value of the stock, and anyone who offers a higher price (Dynamics' tender offer price was $43, and when the offer was made CTS's stock was trading at $36) thereby offers an unequivocal benefit to the shareholders of the target firm, which management if it is really a fiduciary of the shareholders should embrace rather than oppose. In that way the market for corporate control will be kept fluid and corporate assets will be transferred, with a minimum of friction, to those who value them the most, as measured by the prices they offer. See also Ginsburg & Robinson, *The Case Against Federal Intervention in the Market for Corporate Control,* Brookings Rev. (winter-spring 1986), at 9.

The duties of good faith, honesty and the avoidance of conflict of interest situations imposed by company law compatible with these principles which characterise the fiduciary duties of company directors owed to the shareholders[20] forms the basis of the legal analysis of the role of directors – and other corporate officers – during a take-over. Recognising that the shareholders own the company and that it is not for directors to preempt the shareholders' franchise, the common law imposes on directors stringent fidicuiary duties to the company.[21] Under corporate governance principles, corporate management is given broad discretion to respond to take-over situations, and the duty of complete loyalty expected of directors does not require complete passivity.[22] Observance of these aforementioned fiduciary duties can certainly be compatible with tactics designed to raise the price of a bid to the benefit of the company, but is incompatible with tactics designed to block a bid. But the courts have required take-over defensive measures to be reasonably related to the overriding goal of shareholder wealth maximisation and, for example, the U.S. courts have not written targets' management a blank cheque endorsed with the "business judgment rule".[23]

Indeed, the Delaware courts have been quite emphatic that defensive measures in general and poison pills in particular are within the power of

[20] See text accompanying fn. 1 to 6, supra.

[21] i.e. duties owed to the company, not to themselves: supra, footnote 4.

[22] E.g. The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations,* Advisory Group Draft No.7 (September 17, 1986), Philadelphia, U.S.A., ss. 6.12; *Dynamics Corporation of America* v. *CTS Corporation* V, p. 93,758, per Posner J.

[23] *Dynamics Corporation of America* v. *CTS Corporation,* V, pp.93,759 - 93,760 per Posner J; as codified by the American Law Institute, set out at text accompanying footnote 29.

the board of directors of a target corporation, E.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings Inc.,* 506 A. 2d 173, 180 (Del. 1986). But at the same time these courts have insisted that the measures be plausibly related to the goal of stockholder wealth maximisation. See *id.* ("when a board implements anti-takeover measures . . . [the] potential for conflict [of interest] places upon the directors the burden of proving that they had reasonable grounds for believing there was a danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation"); *Moran* v. *Household Int'l, Inc.* 500 A. 2d. 1346, 1356 (Del. 1985) ("when the business judgment rule applies to adoption of a defensive mechanism, the initial burden [of proving that the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company] will lie with the directors"); *Unocal Corp. v. Mesa Petroleum Co.,* 493 A. 2d. 946, 954 (Del. 1985) ("Because of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred"). The shifting of burdens adopted in these decisions was anticipated by Judge Cudahy's dissenting opinion in *Panter v. Marshall Field & Co.,* 646 F. 2d 271, 299-304 (7th Cir. 1981). See also *Hanson Trust PLC v. ML SCM Acquisition Inc.,* 781 F. 2d 264, 273 (2d Cir. 1986) (dictum).

A lock-up device introduced by management is designed to protect negotiated transactions from market competition by placing any subsequent bidder at a disadvantage and by definition disenfranchises shareholders from corporate control. The three pills developed in this case help to make the distinction between defensive measures considered "good" and those considered "bad"[24] or in the words of the N.C.S.C., defensive measures defined as defensive tactics (good) compared to those defined as defensive strategies (bad).[25] Defensive tactics frequently result in an increase in the offer price, the emergence of an alternative bidder and/or the release of "new" information about the target, and as such can be related to shareholder wealth maximisation to "level the playing field" for corporate control. Defensive measures, classed as defensive strategies, may be detrimental to shareholders and may involve losses to shareholders by reducing the probability of a bid, and/or by reducing the value of a bid. Such pills may be enjoined if they unreasonably block a take-over bid. The duty of directors to the shareholders is to increase shareholder welfare; management for whatever purpose must not be allowed to take the shareholders hostage.[26] Assuming one valid purpose is to protect minority shareholders, the pill should only be triggered by a transaction creating a majority shareholder, or one that attempts to squeeze out minority shareholders, otherwise it defies clear standards and potentially creates uncertainty. In contrast, a "bad" pill "effectively preclude(s) bid-

[24] e.g. The American Law Institute, p.220.

[25] National Companies and Securities Commission, *Defensive Schemes and the Duties of Directors* (Discussion Paper, 1986), p.25.

[26] "To buy (the target), you must buy out its management": *Dynamics Corporation of America* v. *CTS Corporation,* V, p.93,762 per Posner J.

ders from competing with the optionee bidder",[27] and comes back for validity to the abovementioned overriding common law and statutory duties of corporate management. However, this distinction between "good" and "bad" is arguably tenuous, as any device which induces competition among bidders by definition precludes potential competitors. Hence, in the words of the American Law Institute, rigorous judicial review of directors' actions in approving defensive pills is likely to be fact-specific. As recognised by the N.C.S.C., assessment of directors' motives or objectives is very difficult in the absence of objective criteria: "For as long as the law focusses on motive, it will be very rarely that a private litigant can feel any confidence of success in challenging the propriety of a board room decision before the courts.".[28]

Consistent with the duties of company directors found in the common law and s.229 of the *Companies Act* 1981 (Cth.) and Codes to act bona fide and for the benefit of the company as a whole, the law expects decisions by directors and other corporate management to be informed with respect to the exercise of business judgment. The American standard is expressed as the "business judgment rule", whereby the courts will not review the decision of directors which are presumed to be based on sound business judgment, a presumption which can be rebutted with evidence of conflict of interest, fraud, bad faith or gross overreaction. This is expressed more formally in the words of the American Law Institute's Corporate Governance project:[29]

> ANALYSIS AND RECOMMENDATION
> ss. 4.01 Duty of Care of Directors and Officers; the Business Judgment Rule
>
> (a) A director or officer has a duty to his corporation to perform his functions in good faith, in a manner that he reasonably believes to be in the best interests of the corporation, and with the care that an ordinarily prudent person would reasonably be expected to exercise in a like position and under similar circumstances. . . .
>
> (c) A director or officer who makes a business judgment in good faith fulfils his duty under this Section if:
>
> (1) he is not interested . . . in the subject of his business judgment;
>
> (2) he is informed with respect to the subject of his business judgment to the extent he reasonably believes to be appropriate under the circumstances; and

[27] *Hanson Trust PLC, et. al* v. *ML SCM Acquisition Inc., et. al.* 781 F. 2d 264 (2nd Cir. 1986) at p.274, cited by the American Law Institute, p.220.

[28] N.C.S.C., Report of the cross investments between The Broken Hill Proprietary Company Limited and Elders IXL Limited, A.G.P.S., 1986, Part IV, Chapter 8, 2.6.3.

[29] The American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* (Tentative Draft No. 4) Philadelphia, (April 12, 1985), Section 4.01, Duty of Care of Directors and Officers; The Business Judgment Rule, pp.6-7; see generally *Smith* v. *Van Gorkom* 488 A. 2d. 858 (Del. Supr. 1985) at pp. 872-873; A.H. Frey, J.H. Choper, N.E. Leech and C.R. Morris Jr., *Cases and Materials on Corporations* (Boston, Little, Brown and Company, 2nd ed., 1977) pp. 148-167 and references therein. An earlier edition of this standard was considered by the N.C.S.C. to be "worthwhile", and a matter that may properly be the subject of a review by the Companies and Securities Law Review Committee: N.C.S.C., op. cit., Part IV Chapter 8, 2.6.5.

(3) he rationally believes that his business judgment is in the best interests of the corporation.

In line with these corporate governance principles, and the American Law Institute's exhortation of the ingredients of a "good" pill, and as affirmed by the U.S. Court of Appeals, Seventh Circuit,[30] District Court Judge Susan Getzendanner laid down three routes by which, in Her Honour's opinion, the bidder would prevail on the merits at trial:

(1) Entrenchment purpose

A poison pill designed to defeat a bid "at all costs" interferes with the free market for corporate control and would be enjoined by the American courts. To uphold a pill, the courts look for reasonableness of response. Where the Board is independent, its actions are entitled to a presumption of validity,[31] so long as "reasonable grounds" characterise the directors' motives in belief of danger to corporate policy.

Evidence of entrenchment purpose can be rebutted by the conscientiousness of the Board's response to the bid. The length and depth of discussion of strategy, the independence, scope and use made of outside counsel and experts and the thoroughness of discussion are all factors indicating the validity of the Board's response and that it is more than "a single-minded continued effort at stopping"[32] the competition.

Evidence of entrenchment can be obvious. In this case, the offeror argued that entrenchment, or other self-interested reasons, were evident and were evidenced by two factors. Firstly, it was submitted that the design of the first pill was primarily to win the forthcoming proxy contest. It argued that because of the $US50 pill, current management would be supported in the forthcoming contest. The pill's white knight strategy — that shareholders who were interested in selling would probably vote for current management in the forthcoming proxy contest — could not entrench management as the auction process was underway, facilitated by the pill, with no evidence that the pill was a device for re-election.

Indeed, evidence that the target's management was determined to stop the bid — and that it was hostile to the bidders — even if unreasonable — could not be equated with entrenchment if the market for corporate control had not been impeded.

(2) Good faith and reasonable investigation

Company law requires of corporate officers fiduciary standards in the exercise of their business judgment. Informed business judgment is the standard, and it is rebutted only by "gross negligence". The fact that the five of eight directors who were outsiders passively observed while the central

[30] *Dynamics Corporation of America* v. *CTS Corporation,* V.

[31] *John A. Moran, et. al.* v. *Household International, Inc., et. al.* 500 A. 2d 1346 (Del. Supr. 1985) at p.1356.

[32] *Dynamics Corporation of America* v. *CTS Corporation, et. al.,* III, p.93,619.

management team actively participated in determining the target's response was considered by District Court Judge Getzendanner to have been counterbalanced by the fact that the Board did not adopt the first pill until obtaining both legal and investment advice. Any finding of gross negligence was therefore rebutted.

The decision by management of the target to sell the corporation was argued by the offeror to be in breach of the Board's fiduciary duty as no more than a strategy designed to maintain control. Especially in view of the Board's earlier determination that now was not the time to sell the target company, the decision was argued not to be a reasonable response to the threat posed by the bid. District Court Judge Getzendanner upheld the view that the directors' standard of conscientious fairness[33] had been observed in the circumstances of the second poison pill, and found no real evidence of fraud, bad faith or self-dealing. Instead, Her Honour found the Board's action to be "an honest attempt to correct the inadequacies of their earlier responses"[34] and not a single-minded attempt to stop the contest at all costs.

Starting from the basis of scepticism about the arguments for take-over defensive measures such as poison pills, Posner J. raised several "doubts" going to the question of the corporate management's good faith in this take-over.[35] For example, although the merchant banker's "independence fee" (or bonus) for defeating the offer had been removed from the second pill, details of its second-round compensation package were not known to the court. The reasons for the Board's choice of a 28% trigger were unclear – why was it set below the level of 50% that would give a minority shareholder an actual legal right to block majority (i.e. 50%) decisions? And holding the trigger price of $US50 to be highly relevant to the issue of reasonableness and good faith – as if set too high it would prevent all bids – Posner J. remanded the case for further consideration of the offeror's request of a preliminary injunction.

(3) Defence as reasonable in relation to threat posed

A poison pill defence strategy must qualify as a reasonable response to the perceived threat posed by take-over. It need not be the most reasonable response as long as it is a reasonable response. An "appropriate" response is not one which kills the bid at all costs, as a pill must facilitate not block the auction process. It must be based on the target's true value and, if aimed at offers which are hostile and coercive, will fail if inconsistent with the overriding fiduciary duties of management.

Any pill must spur a bidding contest, and not deter bids and depress the market. There was no evidence of extremeness of the plan of the offeror such as the selling off of the target's assets to finance the acquisition after the take-over. The issuing of debt under the new plan was considered by Posner J. to be reasonable in view of the fact of the limited likelihood that

[33] E.g. references cited in fn. 4, supra.
[34] *Dynamics Corporation of America* v. *CTS Corporation, et. al.*, III, p.93,619.
[35] *Dynamics Corporation of America* v. *CTS Corporation, et. al.*, VIII, pp.94,865 - 94,869.

the full debt would ever issue. Any plan which aimed to ensure an orderly auction of the company was therefore confirmed by Posner J. to constitute a reasonable response to a take-over bid.

The Dynamics Cases provide an example of defensive measures, taking the form of defensive strategies, proving detrimental to shareholders by initially making the target take-over proof. The original offer price of $US43 for 18% of the target's shares (and market price then at $US35 for the remainder) was ultimately replaced by the settlement at a ceiling for twelve months at $US29.63. In other words, the defensive measures proved ultimately unsuccessful and ineffectual. Certainly the common law and statute law may require of directors the duty to offer defences at least at the outset but so as to facilitate the auction process in the interests of their shareholders, but fending off a bid without justification or for the wrong motives can cause losses, reduce the value of the bid and impose costs. Even where market forces are allowed to operate, poison pill take-over defences may impose costs and reduce returns.

CONCLUSIONS FOR AUSTRALIAN SECURITIES LAW

The lasting utility of this case for Australian securities law lies in its provision of a fully worked example at the highest judicial level of the N.C.S.C. Commentary on the responsibilities of directors of take-over target companies. In conducting the company's affairs for the benefit of members as a whole, directors are not authorised according to the common law, statute, or the American business judgment rule to ensure that the company remains independent at all costs. Entrenchment of management and other tactics designed to frustrate a bid may cause real losses to members and, as in the CTS Case, will be rejected by the courts. In exercise of their fiduciary duties, the courts expect of directors a take-over response characterised by good faith based on reasonable investigation without fraud, bad faith or self-dealing. Independent legal and investment advice could rebut findings of gross negligence or self dealing. So long as poison pills and other defensive measures facilitate shareholder wealth maximisation through an increase in price and/or other conditions of the bid, they can expect to be upheld by the courts as in the interests of the company as a whole.