III. Legitimacy of Two-Tier Poison Pills as Defensive Mechanisms

A. Introduction

A poison pill, or shareholder rights plan, is a defensive mechanism used by corporate boards to defend against hostile takeover.1 While variations exist, the typical flip-in rights plan gives shareholders, other than the unwelcome acquiror, the right to purchase securities at a discounted price.2 This right, when triggered, has the effect of diluting the value of the acquiror’s shares and increasing the cost of the acquisition.3 Poison pills are generally not triggered and do not prevent an acquisition, but encourage negotiation between the acquiror and the target company’s board of directors.4

On May 2, 2014, the Court of Chancery of Delaware declined to grant a motion for preliminary injunction to Third Point LLC (“Third Point”), an activist hedge fund and stockholder of Sotheby’s.5 The court signaled that the fund did not have a “reasonable probability of success” on its claims that the Sotheby’s board of directors misused a two-tier shareholder rights plan, or two-tier poison pill, in an attempt to maintain board control during an attempted hostile acquisition.6 The outcome of Third Point is significant because it establishes that the rule set forth in Unocal Corp. v. Mesa Petroleum Co.7 is the appropriate rule of review in cases involving previously unlitigated two-tier shareholder rights plans, even when such a plan may have the effect of interfering with a proxy contest.8 Although the court in Third Point suggested that

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2 Id.
3 Id. at 24.
4 See id. at 23 (stating that shareholder rights plans allow boards to buy time to negotiate rather than simply stopping hostile takeovers).
6 Id.
7 493 A.2d 946 (Del. 1985) (setting forth the two-part test for determining whether the standard business judgment rule applies to the defensive mechanism).
8 Third Point, 2014 WL 1922029, at *15–16 (finding that although the two-tier plan would affect the results of a proxy contest, a proxy contest was still possible).
two-tier plans may be unreasonable due to their discrimination between active and passive stockholders, and the resulting implications for a proxy contest, courts will continue to uphold the legitimacy of two-tier plans under the *Unocal* rule.9

This Article will examine the legitimacy of shareholder rights plans, historically and as applied to modern developments, and argue that Delaware courts will continue their deferential treatment of two-tier shareholder rights plans, while emphasizing the important function of the court as a balancing agent between directorial and shareholder rights and powers. Part B discusses the foundational approach to the legitimacy of shareholder rights plans, outlined by the two-prong test established in *Unocal* and reaffirmed in *Moran v. Household International, Inc.*10 Next, Part C discusses the limitations of the test, including the invalidation of “dead hand” and “no hand” shareholder rights plans under Delaware law and the “compelling justification” rule of *Blasius Industries, Inc. v. Atlas Corp.*11 Finally, Part D discusses the legitimacy of two-tier poison pills, and whether Delaware courts will continue to uphold two-tier pills as defensive mechanisms against hostile takeovers.

### B. *Unocal, Moran, and the Application of the Enhanced Business Judgment Rule to the Use of Defensive Mechanisms*

The 1980s began an era of enhanced scrutiny for defensive mechanisms in acquisitions.12 In 1985, the Supreme Court of Delaware upheld selective defensive mechanisms in the form of exclusionary self-tender offers as long as those mechanisms are enacted in good faith, after “reasonable investigation,” in order to protect the corporate enterprise, and when such mechanism is proportional in relation to the threat an enterprise is facing from a raider.13 The *Unocal* standard sets

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9 See id. at *15–*16, *20.
10 500 A.2d 1346, 1350 (Del. 1985) (applying *Unocal* in the context of poison pills).
11 564 A.2d 651, 661–63 (Del. Ch. 1988) (requiring “compelling justification” when a board acts “for the sole or primary purpose of thwarting a shareholder vote.”).
12 See *Unocal*, 493 A.2d at 954 (ruling definitively, in 1985, on defensive mechanisms in acquisitions); *Moran*, 500 A.2d at 1350 (deciding, in 1985, on the application of *Unocal* to shareholder rights plans).
13 *Unocal*, 493 A.2d at 958.
the bar for boards of directors higher than the standard business judgment rule, which presumes that boards of directors are acting “on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” This presumption protects boards of directors from liability in corporate transactions. The *Unocal* standard obviates this protection from liability unless boards of directors go beyond passively receiving information to actively investigating the threat. *Unocal* also directs courts to look to the board’s specific motives to protect the corporation, and requires an aspect of proportionality in the directors’ response to threats. The court in *Unocal* determined that this enhanced test was appropriate, as opposed to a standard business judgment rule, because it is necessary to apply an enhanced rule when, during a hostile takeover, “a board may be primarily acting its own interests.”

Later that year, the Supreme Court of Delaware made its first ruling as to the legitimacy of shareholder rights plans in *Moran*, and applied the two-prong test set forth in *Unocal*. The court held that the enhanced business judgment rule applies to shareholder rights plans when a board of directors can show, after reasonable investigation, that they have reasonable grounds to believe that the corporate enterprise is in danger (reasonableness test), and when rights plans are proportional in relation to said threat (proportionality test). In *Moran*, the court upheld the shareholder rights plan based on two foundational findings: first, that fundamental shareholder rights were not impeded because the board did not have unlimited discretion to use the poison pill pursuant to the rule set by *Unocal*; and second, that shareholders could engage in a proxy contest if needed and remove the board.

Although application of the enhanced business judgment rule may theoretically balance the rights of boards and shareholders, some

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14 *Id.* at 954 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)); BLACK’S LAW DICTIONARY 240 (10th ed. 2014).
15 BLACK’S LAW DICTIONARY 240 (10th ed. 2014).
16 *Unocal*, 493 A.2d at 958.
17 *Id.*
18 *Id.* at 954.
20 *Id.*
21 See *id.* at 1353–55 (responding to Appellant’s two central concerns involving shareholder rights plans: influence on shareholder rights and the ability to wage a successful proxy contest).
scholars argue this is illusory in application. Directors have, after all, experienced a high rate of success even under the enhanced scrutiny of the Unocal rule. There are cases, however, in which Delaware courts have found that shareholder rights plans do not meet the standard set by the Unocal rule, based on the foundational findings made in Moran. Further, there are other considerations, such as the growth of institutional investment, the effects of proxy contests, and the inability of legislation to keep up with innovations in acquisition tactics, which may tip the balance in favor of activist shareholders.


Shareholder rights plans have continued to evolve and corporate lawyers have developed a number of provisions to give boards of directors greater defensive prowess against raiders. In 1998,
Delaware courts examined the legitimacy of “dead hand” and “no hand” pill provisions. Dead hand provisions modify shareholder rights plans into ones that “cannot be redeemed except by the incumbent directors who adopted the plan or their designated successors.” In *Carmody*, the court held that dead hand provisions violated the directors’ fiduciary duties to shareholders under *Unocal* because the defensive maneuver made “[A] bidder’s ability to wage a successful proxy contest and gain control either ‘mathematically impossible’ or ‘realistically unattainable.’” Thus, the court found that, as stated in *Moran*, dead hand provisions could not meet the *Unocal* standard because they made the ability to engage in proxy contests so hard that they were “disproportionate and unreasonable . . . .” In *Quickturn*, the court ruled on “no hand” provisions, which prevent members of a newly elected board from redeeming a shareholder rights plan for a certain period of time after being elected, thus effectively freezing the acquisition process, even after winning a proxy contest. The court found that the provision violated the fiduciary duties of the board to the shareholders, because each director was unable to exercise his best judgment when making decisions about the business.

In line with issues of directorial power and limitation of proxy contests surrounding dead hand and no hand provisions, *Blasius* speaks directly to the issue of proxy contests in battles for corporate control. Proxy contests are relevant to corporate control contests, as they have long been used by raiders to gain control over boards, and because proxy contests are essential to an understanding of *Third Point*. A proxy contest is an offensive maneuver whereby challengers try to gain enough shareholder votes to elect a new board of directors, thereby bypassing shareholder rights plans by electing a board which will

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Ruprecht, No. 9469-VCP, 2014 WL 1922029, at *20 (Del. Ch. May 2, 2014) (regarding new developments in shareholder rights plans in the form of two-tier provisions); *Carmody*, 723 A.2d at 1182 (regarding new developments in shareholder rights plans in the form of dead hand provisions).  
27 *Quickturn*, 721 A.2d at 1283; *Carmody*, 723 A.2d at 1182.  
28 *Carmody*, 723 A.2d at 1182.  
29 Id. at 1195.  
30 Id.  
31 *Quickturn*, 721 A.2d at 1289.  
32 Id. at 1292.  
33 See *Blasius Indus., Inc. v. Atlas Corp.* 564 A.2d 651, 659 (Del. Ch. 1988) (finding that where a shareholder rights plan impermissibly interferes with the stockholder vote, it is not a legitimate defensive tactic).  
34 Katz & McIntosh, *supra* note 25, at 5.
redeem the poison pill and allow the challenger to take over. In recent years, some hedge funds have engaged in proxy contests not to redeem the pill and allow the acquisition of the target, but “in order to exercise direct influence or control over the board’s decision-making.”

In Blasius, the court found that the Unocal rule was not applicable when a board acts for the “primary purpose of interfering with the effectiveness of a stockholder vote.” The court held that in these cases a higher standard is necessary—that boards must demonstrate a “compelling justification” for their actions. In Blasius, a key factor Delaware courts emphasize emerged again—that proxy contests may not be unduly impeded by directors acting with unlimited discretion. Thus, there are situations in which the judicial deference seen in evaluating shareholder rights plans balances directorial rights with shareholder rights and the outcome is in the favor of shareholders. Courts will rule in favor of shareholders when poison pills cannot meet the standard set by the Unocal rule because fiduciary duties are violated by board members acting with unlimited discretion, or when it becomes impossible for an acquiror to gain control via a proxy contest.

D. Third Point, Statutory Relevance, and the Legitimacy of Two-Tier Shareholder Rights Plans

Third Point involves litigation of yet another modern evolution of shareholder rights plans—the division of acquirors into two tiers of passive and active investors. Under the terms of the Sotheby’s shareholder rights plan, there is a distinction between Schedule 13G filers and Schedule 13D filers. The Securities Exchange Act of 1934

36 Katz & McIntosh, supra note 25, at 5.
37 Blasius, 564 A.2d at 659.
38 Id. at 661.
39 Id. at 659.
40 Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281, 1292 (Del. 1998); Blasius 564 A.2d at 659; Carmody v. Toll Bros., Inc., 723 A.2d 1180, 1195 (Del. Ch. 1998).
41 Quickturn, 721 A.2d at 1292; Blasius, 564 A.2d at 659; Carmody, 723 A.2d at 1195.
43 Id. at *10.
(“Exchange Act”) provides reporting standards for acquirors of more than 5% of certain classes of securities, including requiring information as to whether securities are being purchased for the purpose of acquiring control of a business.\(^44\) Pursuant to the Exchange Act, the Securities and Exchange Commission (“SEC”) has promulgated rules distinguishing between how much information must be reported.\(^45\) Those acquirors who aim to exercise control over a company must report, via the Schedule 13D form, in more detail than those acquirors who “ha[ve] acquired such securities in the ordinary course of his business and not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect . . . .”\(^46\)

Thus, the rights plan in Third Point utilizes the structure provided by the SEC in order to distinguish between acquirors who are Schedule 13G filers, and thus passive investors, and Schedule 13D filers, acquirors who are potential raiders.\(^47\) The discriminatory nature of the plan stipulates that Schedule 13G filers may acquire up to a 20% interest in Sotheby’s, while a 13D filer may only acquire up to a 10% interest in the company before the rights plan is triggered.\(^48\)

The court in Third Point declined to grant a motion for preliminary injunction under Unocal.\(^49\) The court found that the board of directors in this instance “conducted a good faith and reasonable investigation into the threat posed by Third Point.”\(^50\) The court found that the directors came to a reasonable conclusion based on said investigation that Third Point presented a legally cognizable threat.\(^51\) Thus, the court found that Third Point was unlikely to be able to prove

\(^{45}\) 17 C.F.R. § 240.13d–1 (2014).
\(^{46}\) Id.
\(^{47}\) Third Point, 2014 WL 1922029, at *10 (“Under the Rights Plan’s definition of ‘Acquiring Person,’ those who report their ownership in the Company pursuant to Schedule 13G may acquire up to a 20% interest in Sotheby’s . . . . All other stockholders, including those who report their ownership pursuant to Schedule 13D, such as Third Point and Marcato, are limited to a 10% stake in the Company before triggering the Rights Plan . . . .”).
\(^{48}\) Id.
\(^{49}\) Id. at *1.
\(^{50}\) Id. at *17.
\(^{51}\) Id. (describing the threat faced by Sotheby’s as several activist hedge funds accumulating small amounts of stock simultaneously, allowing a large block of stock to be acquired without any one acquiror having to pay a control premium).
that the Sotheby’s board failed to satisfy the “reasonableness” prong of the *Unocal* test. The court found that Third Point also was unlikely to prove that the shareholder rights plan was a disproportionate response, in line with the “proportionality” prong of the *Unocal* test. Although Third Point’s ownership level at the time of the suit was below 10%, Third Point was still the largest stockholder of Sotheby’s, legitimizing the very real nature of the threat to the corporation even at low ownership levels of stock. Further, the court noted that because the rights plan distinguished between active and passive investors, the plan was actually a *more* proportionate and closely tailored reaction to potential raiders. The court did discuss that the discriminatory provision could possibly be problematic if it incentivized 13G filers to side with the directors in a proxy contest, but noted that the structure of the pill would not preclude 13G filers from voting against the directors in such a contest.

The decision in *Third Point* makes it unlikely that courts will find two-tier shareholder rights plans illegitimate in the future. On their face, two-tier plans seem to meet the standard set by the *Unocal* rule, and do not violate the foundational findings of *Moran*. Two-tier plans do not function like dead hand or no hand provisions, they do not appear to be examples of directors working with unlimited discretion, nor, importantly, do they preclude the ability for an activist shareholder to wage a successful proxy contest. Indeed, the court in *Third Point* addressed the possibility of an application of *Blasius*, but found *Blasius* unlikely to apply in practice for several reasons, most importantly

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52 Id.
53 Id. at *21.
54 Id. at *20–*21.
55 Id.
56 Id. at *16, *20.
57 See id. at *20 (finding that that while the discriminatory nature of the plan could be possibly be problematic, the discriminatory nature of the plan itself also makes the plan a more closely tailored response to activist threats).
58 See supra notes 51–56 and accompanying text (finding that in *Third Point*, the two-tier pill was a reasonable and proportional response to a legally cognizable threat in line with *Unocal* standard and did not preclude the possibility of a successful proxy contest).
59 See supra notes 29–32, 51–56 and accompanying text (stating that unlike two-tier pills, dead hand provisions impermissibly limit the ability of an acquiror to wage a successful proxy contest and no hand provisions limit the ability of directors to act in the best interest of the corporation, an impingement on shareholder rights, violating the *Unocal* standard).
because two-tier plans do not preclude a legitimate proxy vote. Indeed, Sotheby’s two-tier pill worked the way that it should work, as a defensive maneuver, not to bar the acquisition of a company, but to allow a board of directors to execute their fiduciary duties to shareholders by attempting to secure the best price possible for its shares and to maintain directorial power. In fact, after the court issued its opinion in *Third Point*, Sotheby’s and Third Point reached a settlement by which Third Point was able to acquire up to fifteen percent of Sotheby’s stock and gained three seats on the board of directors, while Sotheby’s was able to keep their CEO on the board as president and chairman. This result allowed Third Point to exercise some control over the board, but the preexisting board was also able to maintain some control over the corporation, a beneficial result for both parties.

Delaware courts seem to be performing a balancing act over the line of corporate governance. On one side, courts grant significant deference to directors employing defensive maneuvers against hostile takeovers, as long as those directors are acting in line with their fiduciary duties. On the other side, courts have made it clear that defensive mechanisms that preclude the ability of activist shareholders to engage in meaningful attempts to change corporate governance will not be tolerated. A decisive factor in upcoming years will likely be

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60 *Third Point*, 2014 WL 1922029, at *16.
61 See Lehot et al., supra note 1, at 23 (suggesting that the threat of the pill gives boards the opportunity to negotiate for the best possible deal).
63 See id. (suggesting that although Third Point was not able to gain complete control, they will be able to inject new ideas about how to run the corporation through their board members, while the CEO will be able to protect traditional practices within the corporation).
64 See supra notes 22–24 and accompanying text (recounting that courts often find in favor of boards of directors, but there are limits to the amount of restrictions on shareholder rights that they will accept).
65 See supra notes 22–24 and accompanying text (reporting a high success rate for target boards of directors in cases involving shareholder rights plans, but not in cases when shareholder rights are impermissibly violated).
66 See supra notes 22–24 and accompanying text (citing cases in which courts have ruled against shareholder rights plans).
how quickly regulatory mechanisms can catch up to the innovation of raiders. The 13D filing requirements set by the SEC allow a ten-day window between acquisition and disclosure. With today’s technology, it is possible to purchase less than a five percent interest in a company, thereby avoiding the 13D filing requirement, and then rapidly acquire a much larger interest than five percent within the ten-day disclosure window without drawing attention to the purchaser’s activities. With the realities of the corporate raider and constantly growing and changing acquisition tactics, boards likely need more advanced defensive maneuvers to maintain control of their organizations and fulfill their fiduciary duties to their stockholders.

E. Conclusion

As the court in Unocal stated in its opinion, “our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.” The role of the courts is crucial in this evolution. As legislation and regulation frequently move at a glacial pace, it is vital that courts are able to take an active position in drawing the line between permissible and impermissible activities in corporate law. The court’s decision in Third Point regarding the legitimacy of two-tier poison pills is exemplary of this need. As raiders devise more aggressive tactics to shift balances of powers and management within corporations, boards of directors must be able to employ inventive defensive mechanisms in response. While ultimately it is up to legislators to tip the scales in favor of one party or

67 Katz & McIntosh, supra note 25, at 5.
69 Katz & McIntosh, supra note 25, at 5.
70 See Maynard, supra note 25, at 560–61 (regarding the shifting of power from boards of directors to activist shareholders).
72 See supra note 25, 67 and accompanying text (suggesting that where legislation and regulatory mechanisms do not address new activist tactics, courts must be able to balance board and shareholder rights).
73 See supra notes 49–55, 69 and accompanying text (discussing that the court did not grant preliminary injunction, allowing Sotheby’s to maintain some leverage against Third Point, who could otherwise rapidly acquire a majority of their shares).
74 See supra notes 25, 69 and accompanying text (hypothesizing that where activist shareholders continue to gain power in the acquisition process, boards must also develop ways to maintain control in line with their fiduciary duties).
the other, Delaware’s courts are engaged in a delicate balancing act that protects the rights of activist shareholders and existing corporate structures.

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