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Practical Lessons to Be Learned Concerning Poison Pills In the Chancery Court's Decision in 'Air Products v. Airgas'

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The Delaware Supreme Court first upheld the legality of a shareholder rights plan, or ''poison pill,'' as a takeover defense in its 1985 decision in *Moran v. Household International Inc.* While also finding that the target board would remain subject to enhanced judicial scrutiny in determining whether and when to redeem the rights and withdraw the defense when confronted with a hostile acquisition bid, the contours of that constraint were left largely undefined. As a result, corporate law practitioners and scholars have hotly debated the topic over the course of the ensuing 25 years. During that same time, there has been no lack of challenges to the use of the pill, but the critical question has remained unresolved: how long can a board maintain a pill in the face of a structurally noncoercive offer that it deems inadequately priced?

That question was squarely presented and answered by the Delaware Court of Chancery in a sweeping post-trial opinion issued last month in *Air Products and Chemicals, Inc. v. Airgas, Inc.* (Del. Ch., C.A. No. 5249-CC, 2/15/11). In that decision, Chancellor William Chandler held that a board, having determined in good faith and after reasonable investigation that a tender offer is inadequate, may refuse to redeem the pill even if: (i) the only identified threat is attributable to the perceived inadequacy of price; (ii) the shareholders have been fully informed of the board's views in that regard; (iii) more than a full year has gone by; (iv) the bidder has declared its offer to be ''best and final''; and (v) a majority of the shareholders are likely to accept the offer if the pill is redeemed.

Thus, the Court of Chancery has now definitively declared that an independent board of a Delaware corporation, unquestionably free of entrenchment motives, may maintain the pill indefinitely so as to prevent shareholders from accepting a hostile offer, provided the board can demonstrate it has a reasonable basis for its determination that the offer is inadequate.

Despite the overarching implication of the court's decision and its seemingly broad empowerment of independent target boards, the ruling makes clear that a board's ability to maintain the pill ''is not absolute,'' and the determination of the board will be upheld only if it can withstand ''exacting judicial scrutiny of a judge who will evaluate the actions taken by, and motives of, the board.''

Indeed, the court's decision was itself based on an evaluation of the detailed factual record relating to the conduct and analysis of the Airgas board, which was the subject of two separate trials over the course of the protracted takeover battle. The opinion thus provides substantial guidance to directors (and their advisors) as to the type of conduct that will—or will not—withstand judicial scrutiny. Set forth below is a short summary of the case and some of the important points that directors and corporate practitioners should consider when evaluating how long a board can maintain a pill in response to a hostile offer

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The Court's Decision

The court's decision, summarized in the February 23, 2011 issue of *Corporate Counsel Weekly* (26 CCW 57, 2/23/11), has been widely reported. We thus offer only a brief description of the background facts and court's analysis to place in context the analysis that follows.

Air Products first approached Airgas to propose a combination of the companies in October 2009. Airgas rebuffed the offer as ill-timed and inadequate and, in the months that followed, remained unreceptive to Air Products' ensuing approaches. In February 2010, Air Products took its bid public, offering shareholders $60 per share in cash in a fully financed, all-shares tender offer conditioned on a majority tender. The Airgas board, armed with a preexisting shareholder rights plan, declared the offer ''grossly inadequate'' and advised its shareholders not to tender.

Air Products and certain other Airgas shareholders immediately brought suit against Airgas and its board, alleging that the Airgas directors were in breach of their fiduciary duties to the company's shareholders in maintaining the company's takeover defenses in the face of Air Products' offer. The plaintiffs sought injunctive relief to nullify the effect of those defenses, most particularly the Airgas rights plan.

The case progressed to trial in October 2010, by which time Air Products had raised its offer to $65.50. Two months after the conclusion of trial (but before the court had issued its decision), Air Products raised its offer again, this time to $70 per share, and declared the bid its ''best and final.'' Airgas again rejected the offer as inadequate and, in January 2011,

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the case returned to trial to assess the board's rejection of Air Products' new price. The following month, the court issued its opinion upholding the actions of the Airgas board. Immediately after issuance of the opinion, Air Products announced it was abandoning its acquisition effort and would not appeal.

The several factual elements critical to the court's decision rejecting Air Products' and the shareholder plaintiffs' claims included the uncontested independence of the Airgas board and the board's reliance on outside independent advisors. Perhaps most influential to the court's assessment of the independence and good faith of the Airgas Board was the fact Air Products had successfully placed three nominees on Airgas's board by way of a proxy contest conducted in the midst of its takeover attempt. Upon joining the board, the three new directors sought and secured the advice of yet another financial advisor and, having received that advice, sided with the remaining, incumbent directors in determining that Air Products' ''best and final'' $70 bid was ''clearly inadequate'' and should be resisted.

In its evaluation of this compelling fact, the court observed that Air Products ''got what it wanted.'' Air Products chose to replace a class of the Airgas board with three independent directors, promising shareholders that their election would offer ''a fresh look'' untainted by the potential biases of the incumbents. Upon election, the three nominees questioned the incumbent directors about their assumptions, sought and obtained the advice of another outside financial advisor (as well as additional outside legal counsel), and ultimately reached the same conclusion, that Air Products' offer was inadequate and Airgas's defenses to that offer should be maintained.

Against this factual background, the court reviewed the Airgas board's actions under the standard of enhanced scrutiny set forth in the Delaware Supreme Court's 1985 decision in *Unocal Corp. v. Mesa Petroleum Co.*, the proportionality standard of judicial review applicable (the court noted) whenever a board chooses to maintain defensive measures in the face of a hostile acquisition bid. It thus analyzed the decisions of the Airgas board pursuant to the tests articulated in *Unocal*, placing the burden of proof on the target board to demonstrate *both* that it had reasonable grounds to believe the offer presented a threat to corporate policy and effectiveness *and* that the actions it took in response to that offer were reasonable in relation to the threat posed—*i.e.*, that the actions were neither preclusive nor coercive.

Relying upon Delaware Supreme Court precedent, the court held that the board reasonably perceived the inadequate price of the offer as a threat within the meaning of *Unocal*, a conclusion buttressed by the fact established at trial that approximately half of Airgas's shares had, through the course of the takeover battle, moved into the hands of risk arbitrageurs (''arbs''). As described in greater detail below, the court also held that the board's continued reliance on the pill and other defenses in response to Air Products' ''best and final'' offer was a proportionate and, thus, permissible response.

Guidance From the Opinion

1. Proper Uses of the Pill Prior to the ''End Stage.'' In approving the board's reliance on the pill, the court expressly recognized that poison pills serve certain legitimate corporate purposes and remain ''a powerful tool'' to aid directors in responding to hostile offers. The court observed that the pill provides the board with the ''negotiating leverage'' necessary to obtain the best price for shareholders, whether by way of a sale to the hostile bidder or in connection with an alternative transaction.

There can be little doubt that the board is in a far better position to pursue these ends on behalf of all shareholders than are the individual shareholders since, for a variety of reasons, individual holders are unlikely to function effectively as a group, particularly given their discrete and often conflicting economic interests. The leverage afforded the board through use of the pill, forcing the offeror to negotiate with it, would have little purpose if the offeror were free to avoid the effects of the pill by simply waiting it out, as Air Products had attempted. As the court stated, ''[I]n order to have any effectiveness, pills do not—and cannot—have a set expiration date.''

The court also observed that, as a general matter, a board's need to secure time to inform shareholders fully as to the basis for its opposition to an offer is a legitimate purpose for reliance on the pill and that, at a minimum, a board can maintain a pill while it evaluates the company's options and acts to disclose sufficient information for shareholders to make an informed decision regarding the offer. Here, the pill afforded the Airgas board time to inform shareholders of ''its view of Airgas's intrinsic value and Airgas's value in a sale transaction.''

One may also assume it highly unlikely that the court would have ordered the pill be redeemed after the first trial, given Air Products' concession that the pending $65.50 offer was not its ''best and final'' offer, suggesting that the additional legitimate use of the pill, to extract the highest price possible, had not yet been exhausted. Only after Air Products raised its offer to $70 per share and declared the offer final did the Chancellor, following the second trial, offer his personal observation that, because the price would not increase and the Airgas board had sufficiently informed the stockholders as to the basis for its view that the offer was inadequate, the pill had ''served its legitimate purpose.'' The Chancellor conceded, however, that this view was not in keeping with existing precedent, which permits the board to continue to maintain the pill in defense of an inadequately priced offer.

At a minimum, the court's decision suggests that an independent, fully informed target board can support its continued use of the pill if it can demonstrate that the takeover battle has not reached the ''end stage.'' While it would seem easy for the offeror to blunt this purpose by declaring its pending offer ''best and final,'' this approach, as the Chancellor noted, presents risks to the would-be acquiror, both as to flexibility, credibility, and access to judicial intervention: ''Having publicly announced that its $70 offer is its 'final' offer . . . Air Products has now effectively and irrevocably represented to this court that there will be no further requests for judicial relief with respect to any other offer (should there ever be one).''

2. Proper Purposes for Maintaining the Pill in the Face of a Final Offer. The next logical question is what showing is required to permit a target board to maintain the pill after the takeover battle has reached the end stage. Although the Airgas board offered numerous grounds to support its continued use of the pill, the court focused primarily on the board's assertion that the offer was inadequate. The court questioned whether inadequate value alone posed a threat, but concluded it was constrained by existing precedent that recognized inadequate value as a cognizable threat for purposes of *Unocal*, noting that Delaware law had identified inadequate price, and the related fear that shareholders will accept (and by their action require non-assenting shareholders to accept) a lesser price than that to which they would otherwise be entitled, as a form of ''substantive coercion.''

The court emphasized, however, that it will not blindly defer to the target board's determination that the offer is inadequate; rather, the board must offer evidence to support its determination. In this regard, it is also important to note the court will not make an independent determination as to whether the offer is inadequate and thereby substitute its judgment for that of the board. Rather, when the board is composed of an independent majority, the judicial inquiry will focus on whether the board possessed a reasonable basis for its inadequacy determination. Offering insights as to this inquiry, the *Airgas* court was influenced by the following factors:

- the Airgas board relied upon outside independent financial advisors in reaching its conclusion;
- the board's determination was supported by the company's view of value obtainable through its five-year strategic plan, which was prepared in the normal course;
- the company's actual performance was consistent with its plan; and
- the board, comprised of a majority of independent directors, including Air Products' three nominees, was unanimous in its determination that the offer was inadequate.

Based on the record, the court found the board ''acted in good faith and in the honest belief that the Air Products offer, at $70 per share, is inadequate.'' The court also rejected Air Products' suggestion that the offer was adequate simply because it exceeded the likely trading price of Airgas's stock absent an offer. As the court noted, the board is in the best position to value the company, given its experience and access to nonpublic company information. The stock trading price, which does not reflect the value of a company in a change of control transaction, will not trump the board's assessment.

3. The Significance of Shareholder Demographics. In conjunction with its claim that Air Products' offer was inadequately priced, Airgas asserted that arbs had acquired approximately half of the company's stock since the initiation of the battle for control, exacerbating the threat of substantive coercion and further supporting the continued use of the pill. Although the board conceded that directors owe fiduciary duties to all shareholders, whether short-term arbs or long-term holders, Airgas asserted that the arbs were buying the possibility of a transaction, not making an equity investment, and, having bought into the company after announcement of Air Products' initial bid, necessarily would be inclined to tender into an inadequate offer.

Because arbs comprised a constituency of sufficient size to likely guarantee satisfaction of the minimum tender condition of 50 percent, Airgas contended the remaining shareholders would be ''coerced into tendering into an inadequate offer'' to avoid being stranded as minority stockholders without guarantee of a promptly ensuing cash-out merger.

The court, addressing this argument, noted that the mere presence of arbs did not necessarily constitute an independent threat for *Unocal* purposes but rather, arguably enhances the threat otherwise attendant to an inadequate offer: ''the threat that merger arbs will tender into an inadequately priced offer is only a legitimate threat if the offer is indeed inadequate.''

Based on the record presented, the court concluded that the board reasonably feared that the arbs ''had no interest in the company's long-term prospects but, instead, sought only to secure an immediate gain above the price they had initially paid, through the consummation of a transaction, without regard to whether the transaction price clearly or even grossly undervalued Airgas.''

4. The Board is Not Required to Sell the Company. Seeking to turn the foregoing fact in its favor, Air Products contended that the pill should be removed for the very reason that a majority of the shareholders wanted to accept the offer. Having concluded that a majority of shareholders (primarily arbs that had bought in after announcement of the hostile offer) might be willing to tender regardless of whether the price was adequate, the court was required to confront the question of whether a board could continue with its existing long-term strategy and thereby preclude the shareholders from accepting a transaction, which would cede control of the company, notwithstanding that a majority favored it.

Based on Delaware precedent, the court ruled that the shareholders—even a majority—may not force the board to pursue a sale of the company. If this were not the case, a board could be forced into *Revlon* mode any time a hostile bidder made an offer at a premium to market value. Under Delaware law, ''directors are not obligated to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.''

Here, based on the record, including extensive testimony regarding Airgas's five-year plan and the company's recent performance, the court could not conclude that there was ''clearly no basis'' for the Airgas board's belief in the sustainability of its long-term plan. Thus, the court reaffirmed that a board is not required to pursue a sale of the company when confronted with a premium offer even if a majority of the shareholders desire a sale transaction.

5. The Board Did Not Cram Down an Alternate Transaction. A board has numerous options available when responding to a hostile transaction. In determining that Airgas's response was reasonable and proportionate, the court found it significant that the board was ''simply maintaining the status quo, running the company for the long-term, and consistently showing improved financial results each passing quarter.'' The board did not take actions designed to forever preclude Air Products or any bidder from acquiring Airgas; ''they simply prevented a change of control from occurring at an inadequate price.''

The court contrasted the conduct of the Airgas board to that presented in other cases in which a board responded to a hostile offer by proposing ''a management endorsed breakup transaction that, realistically viewed, constituted a functional alternative to the resisted sale.'' Such a response, the court reasoned, is fundamentally different than that posed by a board which ''just says no'' and maintains the status quo.

The court thus made clear a board that seeks to cram down a management-sponsored alternative ''or any company-changing alternative'' is much less likely to survive court scrutiny.

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