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The Delaware Court of Chancery Reaffirms the Vitality of the Poison Pill in *Airgas*

The Delaware Chancery Court's decision in Air Products and Chemicals, Inc. v. Airgas, Inc., *reaffirms the vitality of the shareholder rights plan or "poison pill" as a defense against unsolicited and inadequately priced tender offers. The Court traces Delaware precedent over the past 25 years and concludes that the power to decide to sell the company, while not without limit, resides with the board.*

By Donald J. Wolfe, Jr., John F. Grossbauer, Kevin R. Shannon, and Berton W. Ashman, Jr.

On February 15, 2011, Chancellor Chandler of the Delaware Court of Chancery brought to a close one of the most closely watched takeover contests in recent years—the year-long battle for control of Airgas, Inc., an industrial gases company headquartered in Radnor, Pennsylvania—with his decision in *Air Products and Chemicals, Inc. v. Airgas, Inc.*[1] In so doing, the Chancellor reaffirmed—in a reluctant but nonetheless definitive manner—the vitality of the shareholder rights plan or "poison pill" as a defense against unsolicited and inadequately priced tender offers.

The 153-page facts-laden opinion, issued following both trial and a supplemental evidentiary hearing, addresses, in the court's words, "one of the most basic questions animating all of corporate law": whether the decision to sell the company, and when, falls within the managerial authority of the board or the ownership prerogatives of its shareholders. Tracing applicable Delaware legal precedent over the past 25 years, the court concluded that such power, while not without limit, resides with the board.

Background

The battle for Airgas began in mid-October 2009 when Air Products, an Airgas competitor located just down the road in Allentown, Pa., approached the company to propose a potential acquisition at $60 per share. At the time, Airgas shares were trading in or around the high $40's, following a period of depressed performance precipitated by the 2008 economic crisis. Airgas rejected Air Products' approach.

On February 4, 2010, Air Products sent the Airgas board a public letter threatening to take its bid directly to the shareholders. One week later, Air Products launched an all-cash, fully financed tender offer for all outstanding Airgas shares at $60 per share, conditioned on the tender of a majority of outstanding shares. Upon review of the offer and relying upon the advice of its investment bankers, Goldman Sachs and Bank of America Merrill Lynch, the Airgas board rejected the offer as "grossly inadequate" and recommended that its shareholders refrain from tendering.

At the same time it made its offer public, Air Products, which previously had purchased

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approximately 1.5 million or two percent of Airgas's outstanding shares, filed suit in the Court of Chancery alleging that the Airgas board was breaching its fiduciary duties by failing to redeem or render inapplicable the company's pre-existing anti-takeover protections in response to Air Products' offer, and requesting that the court order the board to do so. Class action litigation filed on behalf of Airgas shareholders, seeking similar relief, followed. The actions were coordinated and set for trial in early October 2010, following the company's annual shareholders meeting scheduled for September.

The defensive measures Air Products and the class plaintiffs sought to defuse included, among others, a rights plan that was triggered upon an interested party's acquisition of 15 percent or more of Airgas stock. In addition, at the time Air Products launched its offer, Airgas had a staggered board comprised of nine-members and three classes, with one such class eligible for election each year. As part of its acquisition strategy, Air Products nominated three independent nominees to the Airgas board for election at the September 2010 annual meeting.

In addition to proposing a slate of three new directors, Air Products proposed for adoption at the September 2010 annual meeting a series of bylaw amendments, the most critical of which required in the event of its adoption that Airgas hold its future annual meetings, including its 2011 meeting, in January of each year. The practical and proximate effect of this proposed bylaw, if approved, was to force the election of the next class of directors on Airgas's staggered board only four months after the September 2010 meeting. It thereby providing Air Products with the opportunity to overcome the delay that typically inheres in a staggered board regime by nominating a second slate and potentially gaining outright majority representation on the board in a matter of several months. Alleging that such a result was prohibited by Delaware law, Airgas declared its intention to challenge the provision in the event that it was approved at the September meeting.

In the months leading up to the September annual meeting, Air Products increased its offer price twice, first to $63.50 and, on the eve of the meeting, to $65.50. These price bumps furthered Air Products' strategy to encourage the movement of Airgas shares into the hands of risk arbitrageurs, viewed by Air Products as more likely to support its acquisition attempt and, thus, its attempt to seat three new directors on the Airgas board. That effort proved successful. At the time of the September meeting, arbs held approximately half of the company's outstanding shares. Having

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purchased their shares after announcement of the offer, most such holders were strongly incented to encourage a deal between the two companies at or above the offered price.

At the September meeting, Air Products' nominees were elected to the Airgas board, an outcome that resulted in the ouster of Airgas CEO and founder, Peter McCausland. Shortly after the meeting, the board unanimously voted to expand its membership to 10 and designated McCausland to fill the resulting vacancy. The new board thus included nine outside, independent directors and McCausland. In addition, the bylaw amendments, including most importantly that relating to the date of the next annual meeting, were approved by majority shareholder vote.

Rejecting Airgas's ensuing challenge to its legality, the Court of Chancery upheld the bylaw requiring Airgas's next annual meeting to be held in January 2011. In a November 23, 2010, opinion overturning the Chancery Court's decision following an expedited appeal, the Supreme Court invalidated the amendment. The Court held that it constituted an improper attempt to foreshorten the delay between elections of directors explicitly intended by staggered board provisions and permitted the improper removal of Airgas directors in the class of 2011 without cause and prior to the expiration of their terms—a result that otherwise would have required a supermajority vote of directors under the provisions of Airgas's charter.[2]

The case challenging the board's ability to maintain the rights plan, meanwhile, progressed to trial in October 2010. Those proceedings focused mainly on the reasonableness of the board's determination that Air Products' offer was inadequate from a financial point of view. Importantly, Air Products conceded at trial that $65.50 did not represent its best and final offer price.

On December 2, 2010, shortly after the Supreme Court issued its decision striking down the bylaw amendment, the Court of Chancery requested supplemental briefing from the parties to address the effect of that decision, if any, on the legal issues pending before it in the pill case. The court also asked, among other things, whether $65.50—a price Air Products conceded was not its best and final offer—was nonetheless the price at which Air Products wished the court to evaluate the Airgas board's determination that the offer constituted a sufficient threat to warrant continued reliance on the company's defensive measures. On December 9, Air Products raised its offer to $70 per share, explicitly labeling it its "best and final." On December 21, the Airgas board, now including Air Products' three nominees, and having hired at the nominees' insistence a third investment banker, Credit Suisse, to provide a "fresh look," met and reviewed the revised offer. The board, acting unanimously, rejected the offer as "clearly inadequate" and asserted that the value of the company in any sale transaction was at least $78 per share.

Against this factual backdrop, the Chancellor ordered supplemental trial proceedings in January to allow expansion of the existing record to include the more recent facts relating to the $70 offer and the basis for the response of the Airgas board.

The Court Confirms the Application of *Unocal*

The matter was submitted to the Chancellor's decision more than two decades after the Delaware Supreme Court's seminal determination in *Moran v. Household International, Inc.*,[3] that the poison pill was a valid takeover defense under Delaware law. Now, for the first time since the issuance of *Moran*, the court appeared poised to determine definitively whether a target board, in maintaining such a defensive measure in the face of a hostile offer it deemed inadequate, could validly determine to leave the defense in place indefinitely or for so long as it continued to deem the offer inadequate, in this instance for more than a year, or whether it was obligated as a fiduciary matter to redeem the rights and allow individual shareholders the opportunity to accept or reject the offer as they might see fit, once it appeared that the leverage supplied by the defense had been exhausted.

The board must show that its actions in response to the threat were neither preclusive nor coercive.

As an initial matter, the Court of Chancery declined to find that the heightened standard of review under *Unocal* did not apply to the formulation of an answer to that question.[4] Airgas had argued that in a case such as this, in which the board was almost entirely independent and indeed included individuals nominated by the bidder who nonetheless had joined in the determination to maintain the pill in the face of the offer, the omnipresent "specter of disloyalty" justifying the more exacting standard of review under *Unocal* has vanished and, therefore, the enhanced standard of review should not apply.[5] The Court held instead that *Unocal* supplied the appropriate contextual framework for the analysis.

Relying on the Supreme Court's stated rationale in *Unocal*, the Chancellor maintained that the threat of disloyalty *always* exists when a board resists a takeover. Whether those directors are insiders or outsiders, "[t]he idea that boards may be acting in their own self-interest to perpetuate themselves in office is, in and of itself, the 'omnipresent specter.'"[6] The Chancellor thus concluded that the burden of proof must therefore remain on the defendant board to justify its actions and that, in order to meet that burden, *Unocal* required that the target board show: "(1) that it had 'reasonable grounds for believing a danger to corporate policy and effectiveness existed" (*i.e.*, the board must articulate a legally cognizable threat); and (2) that any board action taken in response to that threat is 'reasonable in relation to the threat posed.'"[7] Under the first prong of *Unocal*, the board must prove that it had engaged in a good faith, reasonable investigation to determine whether the offer posed a cognizable threat. The proof of the board's compliance with its duties under this initial part of the test is "materially enhanced" when the board is shown to be composed of a majority of independent directors. Under the second prong, the board must show that its actions in response to the threat were neither preclusive nor coercive (*i.e.*, not "draconian") and "within a range of reasonable responses to the threat posed."[8]

A Legally Cognizable Threat

Addressing the facts at hand, the court held that the Airgas board easily satisfied the requirement of having undertaken a good faith, reasonable investigation in response to Air Products' offer. The Chancellor noted in this regard that the board was composed of a majority of independent directors, including Air Products' three nominees, and relied upon the advice of "not one, not two, but three" independent financial advisors to conclude, unanimously, that the offer was "clearly inadequate."[9]

The court confronted a thornier question, however, in considering whether the conclusion reached by the board as a result of that good faith investigation gave it valid grounds to conclude that the offer posed a legally cognizable threat. Reviewing in detail the precedent that had followed *Moran*, the court identified three varieties of threat in the takeover context that had found favor in the common law as a justification for implementing or maintaining defensive actions: (1) a structurally coercive offer, like the two-tiered, front-end-loaded offer addressed in *Moran*; (2) a potential loss of opportunity, generally in the form of an alternative, superior offer the board might realize if given additional time; and finally (3) "substantive coercion."[10] Setting aside the first two as inapplicable to the facts at hand,[11] the court focused on substantive coercion.

Citing the Supreme Court's decision in *Unitrin, Inc. v. American General Corp.*, the Chancellor observed that substantive coercion has been defined as the risk that shareholders will accept an inadequate offer despite the target board's recommendation to reject it in favor of following through on the company's long-term plan, either because of confusion, ignorance, or the mistaken belief that the board's assessment of long-term company value is wrong.[12] In statements that appeared specifically designed to invite the Supreme Court's reexamination of this question in the event of an ensuing appeal, the Chancellor noted his misgivings regarding the continuing viability of this concept as a legally cognizable threat for purposes of *Unocal* and, more to the point, in finding that an inadequate offer, even if fully-financed, all cash, and accompanied by the promise to acquire non-tendering shares at the same price, could be deemed to constitute such a threat.[13] Nevertheless, explicitly noting the constraints imposed by precedent, the Chancellor opined that the risk Airgas confronted was not only that Air Products' offer undervalued the company but also that a majority of shareholders might nevertheless choose to accept it, a risk not attributable in this case to confusion or mistake, or even to a belief that the Airgas board was wrong regarding value, but rather to the fact that a large percentage of Airgas shareholders (nearly half) were risk arbitrageurs. Having bought their shares following announcement of Air Products' offer, such investors, the Chancellor observed, 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.[14] Finding sufficient evidence in the record to support the reasonableness of this fear on the part of the Airgas board, the Chancellor held that the board had identified a legally cognizable threat.[15]

A Reasonable Response to the Threat Posed

Turning to the second prong of *Unocal*, the court again declared itself bound by "clear precedent to proceed on the assumption that Airgas's defensive measures are not preclusive if they [only] delay Air Products from obtaining control of the Airgas board (even if that delay is significant) *so long as obtaining control at some point in the future is realistically attainable*."[16] The court noted that the recent Supreme Court decision in *Versata Enterprises, Inc. v. Selectica, Inc.*,[17] had held that the combination of a staggered board and rights plan (which together, if effectively employed, could delay an acquiror's ability to gain control of the target for at least two election cycles) does not constitute a preclusive defensive measure under Delaware law.[18] Given the current composition of Airgas shareholders, including a majority that would likely choose to tender into Air Products' offer if the pill were redeemed without regard to the question of adequacy of price, the court found that Air Products could "very realistically" obtain control of the Airgas board at the company's next annual meeting, another eight months away, should it choose to do so.[19]

The combination of a staggered board and rights plan does not constitute a preclusive defensive measure under Delaware law.

Having thus found the board's response neither preclusive nor coercive,[20] the court likewise held it to be reasonable in relation to the threat posed by Air Products' offer. It found that the evidentiary record after trial and the supplemental hearing demonstrated that the Airgas board had concluded in good faith, and with numerous outside advisors, that the offer "clearly undervalue[d] Airgas in a sale transaction," even though it represented a premium to the trading price of the company's shares at the time Air Products launched its offer.[21] Reciting the "powerful dictum" found in *Paramount Communications*, the court reaffirmed that "[d]irectors 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."[22] In the present circumstance, in which even Air Products' three nominees joined in the board's determination that the offer undervalued Airgas and failed to account for the value Airgas could obtain as a standalone company, the court stated it could not conclude that the board "clearly" lacked a basis to believe in the value and sustainability of its long-term plan.[23] As such, the court concluded, the board's actions in defense against the offer ensured protection of the company's long-term value by preventing a change of control from occurring at an inadequate price. The Chancellor stated that, if Air Products (or any other bidder) should seek to obtain control of the company, it was not "forever" precluded from doing so. But it would either have to change the price of its offer or seek to further (and perhaps more carefully) change the board. Meanwhile, the court found, the Airgas board was employing the pill to maintain the status quo and run the company for the long-term.[24] Because it was not seeking to cram down a management-sponsored alternative "or any company-changing alternative," the board's continued reliance on the pill was reasonable and proportionate.[25]

The Vitality of the Pill—"No Set Expiration Date"

In reaching his decision in favor of Airgas, Chancellor Chandler expressed his own reluctance in upholding a board's continued defense to a tender offer that suffers only from inadequacy and his own view that inadequacy alone seems a meager justification to deprive shareholders of the choice to accept the offer. But the Chancellor noted his constraint under a steady path of precedents since *Moran* compelling his conclusion in favor of Airgas—most notably, *Paramount Communications*, *Unitrin*, and, more recently, *Selectica*. Each of these decisions affirms and protects the managerial prerogative of a board that, acting in good faith, confronts a takeover attempt it deems not in the best interests of the shareholders. As the Chancellor stated at the outset of his opinion, "the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."[26] The pill remains a powerful tool in aid of those directors. And, the Chancellor concluded, for the pill to have any real effectiveness, it need not, and indeed cannot, have "a set expiration date," regardless whether that date is triggered by an election cycle or the bidder's declaration that its offer is best and final.

> ***Chancellor Chandler expressed his own reluctance in upholding a board's continued defense to a tender offer that suffers only from inadequacy.***

Thus, if a hostile bidder wishes to succeed in its offer in the face of a pill maintained by a board acting in good faith, it must do more than deem the offer final and run to court. The bidder should either seek to elect a board majority that supports it, or increase its bid to a price the board must reasonably deem adequate.

NOTES

1. *Air Prods. and Chems., Inc. v. Airgas, Inc.*, C.A. No. 5249-CC, *In re Airgas Inc. S'holder Litig.*, C.A. No. 5256-CC, 2011 WL 419735 (Del. Ch. Feb. 15, 2011).
2. *Airgas, Inc. v. Air Prods. and Chems., Inc.*, 8 A.3d 1182 (Del. 2010).
3. 500 A.2d 1346 (Del. 1985). The Delaware Supreme Court held in *Moran* that structurally coercive acquisition techniques, such as the two-tiered front-end-loaded hostile tender offer at issue in that case, were legally cognizable threats, and that the use of a poison pill in defense against such a threat was reasonable. *Id.* at 1354. The Court made clear, however, that the right to use poison pills as defensive measures was

"not absolute" and that boards would not have "unfettered discretion" in refusing to redeem them. *Id.* Thus, the question remained: when *must* a board redeem the pill?

4. *See Airgas, Inc.*, 2011 WL 419735, at *25 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985)).

5. *Id.* at *26.

6. *Id.* at *27 (quoting *Unocal*, 493 A.2d at 955).

7. *Id.* at *25 (quoting *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del 1995)).

8. *Id.* at *26.

9. *Id.* at *35.

10. *Id.* at *36-37.

11. The offer was all-cash, for all-shares, fully financed, with the promise of acquiring any non-tendered shares at the same price as soon as legally practicable, and thus not structurally coercive, and the Airgas board conceded it only wished to maintain its long-term plan, not seek out alternative opportunities for a sale.

12. *Id.* at *32, *37 (citing *Unitrin*, 651 A.2d at 1385).

13. The Chancellor quoted similar concerns voiced by Vice Chancellor Leo E. Strine, Jr. in *Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000), regarding the recognition of "substantive coercion," as defined in *Unitrin*, as a legally cognizable threat. The Vice Chancellor warned against giving too much credence to the concept of substantive coercion and stated that, once shareholders are presumed adequately informed on a given action, Delaware law should refrain from "ascrib[ing] rube-like qualities" to them as to assume they would be confused or mistaken in making a decision regarding their own shares. *Chesapeake Corp.*, 771 A.2d at 328. *See Airgas, Inc.*, 2011 WL 419735, at *32.

14. *Airgas, Inc.*, 2011 WL 419735,at *38-39.

15. *Id.* at *39.

16. *Id.* at *42 (emphasis added).

17. 5 A.3d 586 (Del. 2010).

18. *Airgas, Inc.*, 2011 WL 419735, at *41.

19. *Id.* at *46. The court found there was "no question" Air Products would "control" the Airgas board after a second successful election, notwithstanding that Air Products initial slate of nominees had "switched teams" and agreed with the remaining incumbents to keep the rights plan in place. *Id.* at *46 n.479.

20. Because Airgas was not trying to "cram down a management sponsored alternative" to Air Products' offer but rather attempting only to "maintain the status quo and manage the company for the long term," its defensive response to the offer was not coercive. *Id.* at *40 (citing *Selectica*, 5 A.2d at 601).

21. *Airgas, Inc.*, 2011 WL 419735, at *46.

22. *Id.* at *47 (quoting *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1154 (Del. 1990)).

23. *Id.* at *47.

24. *Id.* at *48.

25. *Id.* Harkening back to the pronouncement in *Moran* that a board's authority to rely upon the pill is not absolute, the court left open the possibility that, under certain other circumstances, it may still be appropriate to order the pill's redemption. In *Yucaipa American Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310, 351 n.29 (Del. Ch. 2010), Vice Chancellor Strine described a scenario in which the bidder has made a structurally non-coercive all-shares offer and has won a proxy context for a third of the board, but the incumbent board majority refuses to redeem the pill. Under those circumstances, Vice Chancellor Strine suggested (and the Chancellor allowed), the pill might be deemed preclusive. *Airgas, Inc.*, 2010 WL 519735, at *49-50. Here, however, upon joining the board, the bidder's slate agreed with the decision to maintain the pill. Moreover, as the Chancellor noted, Airgas's charter includes a provision that allows 33% of the shareholders to call a special meeting and remove the board by a 67% vote of the outstanding shares, providing Air Products (or any other bidder) an additional avenue to unseating the incumbent board, and arguably further demonstrating the non-preclusive nature of the board's defensive position. *Id.* at *50.

26. *Id.* at *1.