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DELAWARE COURT OF CHANCERY REFUSES TO ORDER AIRGAS BOARD'S REDEMPTION OF POISON PILL AND REAFFIRMS DIRECTORS' DECISION-MAKING AUTHORITY IN HOSTILE TAKEOVER BID CONTEXT

On February 15, 2011, Chancellor Chandler issued an important decision concerning the use of stockholder rights plans (or "poison pills") in defense against hostile takeover bids. In *Air Products & Chemicals, Inc. v. Airgas, Inc.*, C.A. No. 5249-CC (Del. Ch. 2011), the Chancellor approved the Airgas Board of Directors' use of the poison pill as a defensive tactic to ward off a "best and final" $5.9 billion ($70 per share) unsolicited takeover bid by Air Products. The Court found that the Airgas Board had exercised its fiduciary duties in good faith and had reasonably found Air Products' "best and final" offer, which represented a 61% premium to the undisturbed market price of Airgas stock, to be inadequate. Within hours of the ruling, Air Products withdrew its bid and declined to appeal the decision to the Delaware Supreme Court.

The Court's decision represented the culmination of a sixteen-month takeover battle between Airgas and Air Products, which included several price increases and offer extensions, advice to the Airgas Board from three independent financial advisors and two independent legal advisors, one successful proxy fight by Air Products to replace three Airgas directors, and an unsuccessful attempt by Air Products to advance the Airgas 2011 annual meeting of stockholders by eight months. Even more dramatic was the decision of the Air Products nominees, elected last September following the removal of certain (some incumbents remained after the election) incumbent directors at the Airgas 2010 annual meeting, to oppose Air Products' $70 per share bid as inadequate and support the decision of the incumbent Airgas Board members to maintain the poison pill defense.

The Court's opinion addresses one of the most fundamental questions of corporate law, namely, "the [proper] allocation of power between directors and stockholders." Specifically, in the circumstances of a board of directors' use of a poison pill to prevent stockholders from accepting a takeover bid which the target board has found to be inadequate: "who gets to decide when and if the corporation is for sale?" Over the last 25 years since the Delaware Supreme Court first approved a stockholder rights plan in *Moran v. Household International, Inc.*, this question has been vigorously debated and, to some extent, litigated, but all without an on-point conclusion until the Delaware Chancellor found in the Airgas case that, under Delaware takeover jurisprudence, "the power to defeat an inadequate hostile tender offer ultimately lies with the [target] board of directors."

Importantly, the Court was quick to note that this power is not absolute, and that the Court's decision is not an endorsement of a board of directors' attitude of "just say never". Prior to implementing defensive tactics in response to a takeover bid, a Delaware corporation's board of directors always must satisfy the exacting judicial scrutiny required under *Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985) and *Unitrin, Inc. v. American General Corp.* (Del. 1995). Only when a board is found to have acted in good faith, without conflicting interests, and having relied on outside independent advisors to

articulate a legally cognizable threat, may the board utilize a poison pill defense to block an unsolicited tender offer and force the bidder to the ballot box to elect a board majority that supports its bid and is willing to disarm the pill. It is in precisely such circumstances, as Chancellor Chandler confirms in his opinion, that it is not for the Court to substitute its business judgment for that of the board of directors.

Chancellor Chandler begins his analysis of the "longest litigated poison pill in Delaware history" by reiterating that enhanced judicial scrutiny under *Unocal*—and not the deferential business judgment rule—is the appropriate standard of review when a poison pill is maintained as a defensive measure to thwart an unsolicited tender offer and the board of directors is charged with the decision of whether to redeem the pill. Even though the Airgas Board was independent, received advice from three independent outside advisors, and the Air Products' nominees "changed teams" after election to the Airgas Board, the fact still remained that the Airgas Board was "taking defensive action in response to a pending takeover bid."

Under *Unocal*, the Delaware courts have placed the initial burden on directors to demonstrate that their actions were reasonable. In order to satisfy this initial burden, the Delaware courts have said that directors must show that in adopting defensive measures they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and the defensive measures adopted were reasonable in relation to the threat posed. The first part of this test is, in the words of one Delaware court decision, "essentially an inquiry into whether the board used a reasonable process to identity a legitimate threat to the corporation." (*In Re Gaylord Container Corporation Shareholders Litigation* (Del. Ch. 2000)). As to the reasonableness of a defensive response, the Delaware courts have held that the defensive measure must be neither preclusive nor coercive and, in any event, the measure must be within a range of reasonable responses to the threat posed. Upon such a showing, which is materially enhanced by the presence of a majority of outside independent directors, the presumption of the business judgment rule then will apply and the burden of proof will shift back to the plaintiff, who has the ultimate burden to demonstrate by a preponderance of the evidence that the directors breached their fiduciary duties.

In applying the first prong of *Unocal* in the *Airgas* decision, Chancellor Chandler confronted squarely the long-debated issue of whether an inadequate, all-cash, all-shares tender offer reasonably could be perceived by a target board of directors as a legally cognizable threat. Airgas asserted that its stockholders, a near majority of which were comprised of merger arbitrageurs and hedge funds with a short-term, deal-driven investment focus, might tender into an inadequately priced offer despite the Airgas Board's recommendation to the contrary and thereby substantively coerce the other stockholders also to tender into this offer. The Court acknowledged that prior precedent of the Delaware Supreme Court supported the notion that substantive coercion of this kind, and the resulting risk that stockholders might mistakenly sell their shares for an inadequate price, constitutes a legitimate threat for purposes of applying the *Unocal* analysis.

The Court then found that the Airgas Board's good faith and reasonable investigation, which included reliance on valuation analyses of three separate financial advisors, provided grounds sufficient to conclude that the Air Products' offer was inadequate. Because of the high composition of "merger arbs" in Airgas' stockholder base, the risk was real that a majority of stockholders might tender "regardless of whether the price is inadequate or not." Although the Chancellor voiced his skepticism as to whether a structurally non-coercive, all-cash, all-shares tender offer such as Air Products' ought to be recognized as a threat under *Unocal*, he concluded that existing Delaware law states that it is, and he therefore found that a legally cognizable threat to the corporate enterprise was reasonably perceived by the Airgas Board.

Turning to the second prong of *Unocal*, the Court examined whether the Airgas Board's continued maintenance of the poison pill and staggered board was proportionate to the threat posed. The Chancellor noted that to satisfy this test, defendants must first establish that the relevant defenses "are not preclusive or coercive," and concluded that since Airgas was not seeking "to cram down a management sponsored alternative, but . . . simply wants to maintain the status quo," Airgas' defenses were not coercive. In addressing the issue of whether the Airgas defenses were "preclusive", the Chancellor explained that Delaware courts had found that these defensive measures were not preclusive because although

they delayed a bidder's assumption of control through the ballot—by as long as two years[1]— they did not preclude the hostile party from electing its nominees to a majority of the target board's seats as long as gaining control of the board remained realistically attainable "at some point in the future." Although the Court found that Air Products' chances of obtaining control through a special meeting of stockholders (which required a supermajority vote in order to remove and replace the entire Airgas Board) were "realistically unattainable" due to the number of shares held by Airgas management, the Court found the opposite with regard to the next (2011) annual meeting of stockholders, stating it "is very realistically attainable" that Air Products could likely obtain a simple majority at the next annual meeting and thus, when combined with Air Products' first successful slate of insurgent directors, obtain control of the Airgas Board.[2]

Interestingly, Chancellor Chandler called out the following practical outcome of his decision:

But what seems clear to me, quite honestly, is that a poison pill is assuredly preclusive in the everyday common sense meaning of the word; indeed, its *raison d'être* is preclusion—to stop a bid (or *this* bid) from progressing.

He further observed that the Airgas poison pill served its purpose for over sixteen months, halting Air Products' bid and allowing management time to fully inform the stockholders of the Airgas Board's views as to the adequacy and timing of the Air Products' offer. Importantly, at this stage, "the only bypass of the pill is electing a new board." Thus, despite the recognition that the actual point of a stockholder rights plan is to halt or even thwart a hostile bid that the board of directors properly deems inadequate, the *Airgas* decision reiterates that controlling Delaware law is such that the poison pill, even coupled with a staggered board, is not *per se* "preclusive" under *Unocal* so as to render either or both disproportionate to the threat posed by an inadequate unsolicited takeover bid.

The last issue addressed by the Court in *Airgas* was whether the measures taken by the Airgas Board fall within a range of reasonableness. At this point, the Court appeared to have little difficulty in finding that the Airgas Board met this test: the Airgas Board was simply maintaining the status quo and its actions did not forever preclude Air Products from acquiring Airgas, sooner, *if the price is right*. Moreover, and perhaps most telling to the Chancellor, Air Products' *own* nominees (who were elected under the specific mandate of making their own informed, independent assessment of Air Products' bid and who insisted that Airgas retain a third independent financial advisor to review the Air Products' bid) could not in good faith support the bid once they questioned and understood for themselves the basis for the incumbent Airgas directors' position. In the Court's view, this circumstance is one where Delaware law expressly empowers a well-motivated, deliberate board of directors which acts in an informed way to protect the corporate enterprise and long-term value by preventing a change of control at an inadequate price. Indeed, the Court concluded in this regard that the "Airgas board serves as a quintessential example."

The Court expressly rejected the warnings of plaintiffs' counsel that upholding the Airgas pill would create a powerful poison-pill-staggered-board elixir that would foster "takeover proof" companies. We agree that such concerns are unfounded, and agree with the Court that the poison-pill-staggered-board combination merely buys the target board of directors more time. We are also skeptical that many future target boards deploying such a defense will have the benefit of

[1] If a hostile bidder is unable to obtain a court order invalidating a target board's use of a rights plan, the hostile bidder must wage a proxy contest to elect to the board its nominees who are committed to redeeming the outstanding poison pill rights. If the target has a staggered board of directors and if stockholders cannot take action between annual meetings, a hostile bidder cannot gain control of the board of directors with its nominees without going through two annual meeting proxy contests.

[2] One important fact about the *Airgas* case that is unusual is that the candidates nominated by Air Products and elected to the Airgas Board at the Airgas 2010 annual meeting wound up supporting the Airgas Board's decision to oppose the $70 per share offer made by Air Products. In the usual case, the hostile bidder selects a slate that it expects will support its bid. Although the hostile bidder's nominees, if elected to the target board, must be completely loyal to the stockholders of the target (as required by their fiduciary duties), there is room for this group to exercise its informed business judgment as to how to best respond to the hostile party's takeover bid in furtherance of the best interests of the target stockholders, including voting to redeem a poison pill and thereby allow the target stockholders to decide whether to accept the bid.

insurgent directors who "switch sides" and other powerful facts such as the truly extraordinary long-run financial performance of Airgas to bolster their resolve and persuade the court of the reasonableness of their conclusions about the inadequacy of the bids they are opposing.

Given that most Fortune 500 companies have spent years dismantling their takeover defenses in response to the corporate governance views of institutional investors, stockholder activists and proxy advisory firms such as ISS, the poison pill represents the last real meaningful takeover defense for many companies. Last year's decision by the Delaware Supreme Court in *Versata Enters., Inc. v. Selectica* (Del. 2010) upholding the use of an "NOL" poison pill with a low trigger threshold was very encouraging (especially since the Court—for the first time—validated the discriminatory aspect of the modern pill), but that decision is of less importance to profitable companies without meaningful NOLs. In contrast, the *Airgas* decision should encourage all boards of directors of Delaware corporations to carefully consider placing a stockholder rights plan "on-the-shelf" so that this defense can be deployed on short notice in the face of a takeover bid or threat. In addition, given the continued strong support by the Delaware courts of the poison pill takeover defense, Delaware corporations should not be hesitant about adopting stockholder rights plans to address takeover threats, especially where other meaningful takeover defenses have been dismantled or don't exist.

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