“Dead-hands” No Longer Alive in Delaware

The Delaware Supreme Court recently handed down a landmark decision that will affect many companies incorporated in Delaware. In Quickturn Design Systems, Inc. v. Shapiro, Del. Supr., No. 511, 1998, Holland J. (Dec. 31, 1998) the Delaware Supreme Court held that so-called “dead-hand” redemption provisions in stockholder rights plans are invalid defensive measures as a matter of Delaware statutory law. Five months earlier, in Carmody v. Toll Brothers Inc., Del. Ch. C.A. No. 15983 (July 24, 1998), the Delaware Chancery Court found that a dead-hand redemption provision of unlimited duration could be coercive to stockholders. In Quickturn, the Delaware Supreme Court not only explicitly reinforced the lower court’s Toll Brothers ruling, but went a step further to declare that even a deferred redemption provision of limited duration could be coercive to stockholders. In Quickturn, the Delaware Supreme Court not only explicitly reinforced the lower court’s Toll Brothers ruling, but went a step further to declare that even a deferred redemption provision of limited duration — in Quickturn’s case, 180 days — was invalid under Delaware law. Latham & Watkins represented Mentor Graphics Corp., the bidder, in the litigation with Quickturn, the target.

Dead-Hand Poison Pills

Stockholder rights plans, commonly known as "poison pills," are defensive measures adopted by companies to delay a hostile acquisition. When a hostile bidder acquires a designated amount of the target company’s shares (typically 10% to 20%), rights automatically issue which allow all stockholders other than the acquiror to buy newly issued shares at reduced prices, triggering a massive dilution of the value of the acquiror’s holdings. To overcome this defense, a hostile bidder typically must either seek judicial relief invalidating the pill (or requiring the target board to redeem it), or launch a proxy contest to elect a slate of directors who might redeem the poison pill. To block this second tactic, many companies adopted so-called “dead-hand” or “no hand” redemption provisions in their stockholder rights plans. These provisions barred anyone but the directors who adopted the dead-hand feature from redeeming the pills. This defensive measure would allow continuing directors to prevent the acceptance of an unsolicited offer, regardless of stockholder wishes or the views of newly elected directors.

Toll Brothers Calls into Question Pills of Unlimited Duration

On July 24, 1998, Vice Chancellor Jacobs ruled in Toll Brothers that dead-hand redemption provisions, which could only be re-
deemed by continuing directors, interfered with stockholders' rights by essentially presenting them with a Hobson's choice. If they elect a new board, the pill cannot be redeemed. The stockholders are therefore forced to vote for the incumbent board if they wish to redeem the pill, even though the board had already decided not to redeem the pill. In *Toll Brothers*, the court found this scenario could be coercive and is, therefore, contrary to Delaware law. Vice Chancellor Jacobs' decision left open the possibility that adoption of deferred redemption provisions of limited duration could be valid under Delaware law.

The Quickturn Case
On August 12, 1998, Mentor Graphics launched a premium cash tender offer for all of Quickturn's shares. In response, the Quickturn Board of Directors adopted two defensive measures designed to prevent Mentor Graphics from completing its hostile takeover. The first was an amendment to Quickturn's bylaws which allowed the Board to delay a special meeting of stockholders called at the request of a stockholder by 90 to 100 days. The second defensive measure was an amendment to Quickturn's shareholder rights plan, which eliminated a dead-hand feature and replaced it with a deferred redemption provision of limited duration. As amended, the stockholder rights plan prohibited a newly elected board from redeeming the pill for 180 days to facilitate a merger with, consolidation or sale of assets, or acquisition by any "Interested Party" — that is, a party that directly or indirectly supported the election of the new board — in this case, Mentor Graphics.

While simultaneously pursuing its tender offer and proxy contest, Mentor Graphics sued in Delaware Chancery Court to invalidate the bylaw amendment and the deferred redemption provision. Vice Chancellor Jacobs was thus given an opportunity to answer the question left unanswered in his *Toll Brothers* decision — whether a deferred redemption provision of limited duration would be a valid exercise of Delaware law.

In *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*, C.A. Nos. 16584 and 16588, Del. Ch. (Dec. 2, 1998), the Chancery Court upheld the bylaw amendment as a reasonable response to the threat of a hostile takeover on the ground that it provided stockholders with adequate time to become informed about the tender offer's terms and implications. Vice Chancellor Jacobs cautioned, however, that the court's "conclusion should not be regarded as a pronouncement that a bylaw mandated 90 to 100 [day] delay interval between the request for and the holding of a shareholder-initiated special meeting is invariably reasonable as a matter of law." *Mentor Graphics*, slip op. at 42-43. In noting that this portion of the Chancery Court's decision was not appealed and thus became final, the Delaware Supreme Court quoted Vice Chancellor Jacobs' cautionary language in a footnote, from which an inference could be drawn that the Supreme Court did not necessarily agree with the lower court's decision to uphold the bylaw amendment.

With regard to Quickturn's poison pill, Vice Chancellor Jacobs held that the deferred redemption provision enacted by Quickturn — which discriminated against a Mentor bid, but not a bid from another company — was not within the range of reasonableness and proportionality required by Delaware law. In reaching this conclusion, Vice Chancellor Jacobs found that Quickturn's directors believed they were adopting a non-discriminatory dead-hand provision that would apply to all prospective bidders, and not just the bidder who sponsored the newly elected board. In fact, however, the Quickturn Board adopted a provision that discriminated only against the bidder — Mentor Graphics — that sponsored the new board candidates. Because the Board did not understand the provision it had adopted, Vice Chancellor Jacobs held that the Quickturn Board had breached its fiduciary duties in adopting the discriminatory deferred redemption provision. This ruling underscores the need to ensure that counsel accurately explains the effect of any proposed defensive measure and that the board members indi-
vidually and collectively understand the explanation. Once again, however, Vice Chancellor Jacobs declined to rule on whether the deferred redemption provision was *per se* invalid under Delaware law.

In a little noticed aspect of the case, Vice Chancellor Jacobs issued a pre-trial ruling that precluded Quickturn from introducing evidence relating to the legal advice the Quickturn Board considered in its deliberations in response to Mentor Graphics’ tender offer. Because Quickturn had refused during discovery to allow inquiry into the Board’s collective deliberations or discussions on the ground that they involved the advice of legal counsel, Vice Chancellor Jacobs precluded Quickturn from referring to or introducing evidence of the specific content of those discussions or any of the substantive legal advice the Board received. It should be a rare case where a company asserts the privilege with respect to the board’s consideration of legal advice in response to a bid, because doing so may well result in a similar preclusion order. In the absence of evidence regarding counsel’s advice, it may be difficult for the board to demonstrate that it had a reasonable basis for adopting the defensive measures. Because the privilege will usually be voluntarily waived in this context, it is obviously important that the board ensures that it receives advice from counsel experienced in contests for corporate control.

The Delaware Supreme Court Invalidates “Dead-Hand” Provisions

On December 31, 1998, the Delaware Supreme Court answered the question that Vice Chancellor Jacobs had left unanswered in both *Toll Brothers* and *Mentor Graphics*. The Court held that deferred redemption provisions — even those of limited duration — are invalid under Section 141(a) of the Delaware General Corporation Law because they prevent a newly elected board from “completely discharging its fundamental management duties to the corporation and its stockholders ....” *Quickturn* at 29 (emphasis in original). Accordingly, the Supreme Court found the deferred redemption provision violates fundamental Delaware law in all cases.


Possible Implications of the *Quickturn* Decision

The Delaware Supreme Court’s ruling raises questions with respect to other conduct which purports to bind future boards. In invalidating Quickturn’s deferred redemption provision, the court emphasized that “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.” *Quickturn* at 30-31. Perhaps a subsequent line of cases under Section 141(a) will test the validity of ordinary contracts which restrict a board’s range of action, such as standstill agreements, because they “tend... to limit in a substantial way the freedom of... directors’ decisions on matters of management policy.” *Quickturn* at 31. Although the Delaware Supreme Court has previously stated that “business decisions are not an abdication of directorial authority merely because they tend to limit a board’s freedom of future action,” *Grimes v. Donald*, Del. Supr., 673 A.2d 1207, 1214 (1996), the *Quickturn* decision may signal a retreat from this view. Arguably, a standstill agreement can substantially limit a newly elected board’s freedom in making important decisions on matters of management policy — such as whether to pursue an acquisition of a competitor — thus limiting the board’s exercise of its fiduciary duties. Such an agreement is arguably vulnerable to the Supreme Court’s reasoning in *Quickturn*.

A second collateral effect of the *Quickturn* decision could be to limit stockholders’ efforts to control a
board’s response to future takeover offers. By its logic, the Supreme Court’s ruling may undercut current efforts to use stockholder votes to force boards to redeem pills. For example, certain institutional stockholder groups have recently sponsored proposals that would exempt from the poison pill any fully financed offer that is made at a price that is more than 50% above market. The Quickturn decision could have the effect of limiting stockholders’ rights to implement such provisions on the ground that they interfere with the board of directors’ “full power to manage and direct the business and affairs of a Delaware corporation.” For an interesting discussion of how the Oklahoma Supreme Court has addressed a related issue in the context of Oklahoma’s corporate statutes, which are similar to Delaware’s in several respects, see International Brotherhood of Teamsters General Fund v. Fleming Companies, Inc., 1999 OK 3, 1999 Okla. LEXIS 3 (January 26, 1999).

What Does the Quickturn Decision Mean for Other Corporations?

To comply with Section 141(a) of the Delaware corporations law, Delaware companies that have adopted so-called “dead-hand” or “no hand” redemption provisions should amend their stockholder rights plans to eliminate the offending provisions. They should also reevaluate their bylaws as they relate to special meetings called by stockholders. Given the influential role of Delaware law in other states’ analyses of corporate law issues, companies should consult with counsel regarding the need to amend their poison pills and/or bylaws to conform to the Quickturn decision, whether or not they are incorporated in Delaware.

For legal advice concerning adopting and amending stockholder rights plans or other takeover defenses and strategies, please call any member of the Firm’s Litigation or Corporate Departments, or one of the attorneys listed below.

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