IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

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JOHN A. MORAN and THE DYSON-KISSNER-MORAN CORPORATION, :

Plaintiffs, : Civil Action No. 7730

v. :

HOUSEHOLD INTERNATIONAL, INC., a Delaware corporation, DONALD C. CLARK, THOMAS D. FLYNN, MARY JOHNSTON EVANS, WILLIAM D. HENDRY, JOSEPH W. JAMES, MITCHELL P. KARTALIA, GORDON P. OSLER, ARTHUR E. RASMUSSEN, GEORGE W. RAUCH, JAMES M. TAIT, MILLER UPTON, BERNARD F. BRENNAN and GARY G. DILLON, :

Defendants.

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HOUSEHOLD INTERNATIONAL, INC., :

Counterclaim-Plaintiff, :

v. :

JOHN A. MORAN, CHARLES H. DYSON and THE DYSON-KISSNER-MORAN CORPORATION, :

Counterclaim-Defendants. :

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PLAINTIFFS' POST-TRIAL MEMORANDUM OF POINTS AND AUTHORITIES

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DATED: November 2, 1984

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I. INTRODUCTION AND SUMMARY OF ARGUMENT

1. The Household dividend rights plan (the "Plan") alters and abridges the fundamental stockholders' rights (1) to free alienation of their shares, (2) to buy shares in an open market, and (3) to engage in proxy contests. The full exercise of these rights is essential to the effective operation of the only mechanisms which can effect changes in corporate control without management's consent -- tender offers and proxy contests. It is only through the ability to change corporate control that stockholders can maintain a check on inefficient management and have access to the substantial premiums paid in takeovers.

2. The severity of the Plan's impact is uncontested. Not only did the plaintiffs' witnesses so testify, but much of the most telling testimony on the practical damages the Plan inflicts on stockholders' rights came from the very witnesses Household tendered to defend it.

3. The Plan is illegal because it deprives stockholders "without [their] consent" of rights which "might be of significant economic consequence." Joseph E. Seagram & Sons, Inc. v. Conoco, Inc. (below pp.20-28). The rights dividend was "sham" because the Household board misused devices, authorized by law for purposes of corporate finance, solely to alter and abridge Household's stockholders' fundamental property rights. Telvest, Inc. v. Olson (below pp.28-36). As a result, the Plan must be declared null and void.

4. Notwithstanding the admittedly severe impact on stockholder rights and the sham use of financing devices for the sole purpose of altering control relationships within Household, the

defendants say that the Plan should be sustained because it was adopted in the exercise of business judgment. But:

(a) The business judgment rule is not an independent source of power and does not supply authority to deprive stockholders of substantial rights. Zapata Corp. v. Maldonado (below pp.36-37).

(b) The business judgment rule applies only to exercises of "managerial prerogatives" relating to the business and affairs of the corporation and does not apply to actions taken to make structural changes in the relationships between the stockholders and the board. Aronson v. Lewis; Zapata Corp. v. Maldonado; DGCL § 141 (below pp.36-37).

(c) By the Plan the directors wrested corporate power from the hands of stockholders and, thus, even if its adoption were legally authorized, Household would bear the burden to establish that the Plan is fair and reasonable to the stockholders. Norlin Corp. v. Rooney, Pace, Inc. (below p.46); Good v. Texaco, Inc. (below pp.45-46). The Plan, under the "careful scrutiny" test applied in Thompson v. Enstar Corp. (below pp.44-45), is neither fair nor reasonable to the Household stockholders because it deprives them of valuable rights.

(d) A board's "good faith" belief that it is better able than stockholders to judge the adequacy of a tender offer does not grant it the power to deprive stockholders of their long-recognized right to decide such questions for themselves. Conoco Inc. v. The Seagram Co. Ltd.; Norlin Corp. v. Rooney, Pace, Inc. (below p.38).

(e) No business judgment precedent validates the far-reaching deterrent effects the Plan admittedly will have on all unidentified future transactions directed to changes of control. Each of the precedents relied on by Household dealt with an exercise of managerial power (i) required by and responding to a specific takeover attempt and (ii) involving a corporate act of independent economic substance.

(f) The Plan, in material and central respects, has effects which the board did not understand and did not intend. The Plan has enormous and intentional complexities and was incompletely and inaccurately presented to the board. A court of equity will not approve a measure adopted by a board in reliance on erroneous and incomplete information simply because the board listened to the advice of experts.

No board of a Delaware corporation has heretofore been permitted to transfer to itself power to control the corporation's ultimate destiny without consent of the stockholders. The Plan is illegal and must be voided.

II. THE IMPACT OF THE PLAN ON FUNDAMENTAL RIGHTS OF STOCKHOLDERS

A. The Stockholder Rights Involved Are Valuable

No rights are more important to stockholders than the right to free alienability of their shares, the right to buy shares in an open market and the right to join with other stockholders in their own economic self-interest to change management. These rights are essential to stockholder participation in the only two mechanisms which either act as a check on inefficient management or which can effect changes in corporate control without management's consent -- a tender offer or proxy contest. Equally important, they provide stockholders the opportunity to receive the significant economic benefits attendant to changes in corporate control.

The right to sell shares in a tender offer has enormous economic value for stockholders and is a valuable incident of stock ownership. The plaintiffs' expert and documentary evidence established the value of the right and the defendants, having furnished no contrary evidence, have conceded the point. Professor Jensen described the right as "the right to transfer control of corporate resources by participating in a tender offer that has not received prior approval of the Household board." (Jensen IV 133)* He further testified:

> [T]his right has two components of value. One of them is the value of the premiums that are generally paid in takeovers, and the second is the value of the external control process as reflected in the increased efficiency of the corporation, and that being reflected in the value of the shares.

(Jensen IV 135) Jensen's opinion is confirmed by defendants' documents and unimpeachable public sources such as the Securities and Exchange Commission ("SEC"). The Goldman Sachs study of tender offer premiums (DX 12) shows that the average premium paid to target

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* Trial testimony will be cited by the witness' last name followed by the volume number and a page number. For example, "Higgins VII ___." Trial exhibits will be cited by either "PX __" or "DX __" depending on whether the exhibit was introduced by plaintiffs or defendants. Deposition testimony will be cited by the deponent's last name followed by the word "Dep." and the page number. For example, "Clark Dep. __."

company shareholders in 79 completed unsolicited tender offers was 78.8% over the pre-tender market. (PX 329, 331; Jensen IV 142) This June the Office of the Chief Economist of the SEC published a study of 148 tender offers made between 1981 and 1983 which established that average premiums for any-and-all tender offers had been 63.4%, blended premiums for two-tier offers had been 55.1% and blended premiums for pure partial offers had been 31.3%.* (PX 333; Jensen IV 161-68) Tender offers represent

> billions and billions of dollars in increased wealth that is being granted to target firm shareholders through this process of the takeover market. . . .

(Jensen IV 166)

The second component of value identified by Jensen -- that access to the takeover market provides stockholders with important "external controls" over their investment -- also stands unchallenged. Tender offers provide an incentive for boards and managements to perform well because it is through a tender offer that alternative management teams compete for the right to manage the corporation. (Jensen IV 173-78) Defendants' expert Troubh confirmed Jensen's view:

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* Any-and-all offers refer to offers for 100% of the stock not already owned by the offeror. Partial offers refer to offers for only a portion of the stock, ordinarily enough (with the stock otherwise owned by the purchaser, if any) to give the purchaser the ability to exercise control.

A two-tier offer is a tender offer in which the offeror announces a tender offer for control to be followed by a second-step merger which will, upon completion, provide the offeror with 100% ownership. Stockholders usually receive debt or equity securities in the second-step merger unless DGCL § 262 gives them an appraisal remedy that they exercise and thus receive cash. A two-tier offer is "front end loaded" if the consideration offered in the tender offer is greater than that which is to follow in the merger.

> I think tender offers are probably generally a pretty good thing. I think that they permit sometimes more efficient managers to take control of assets which they might otherwise not be permitted to do.

(Troubh VIII 105)

The right of stockholders to buy shares without restriction is equally valuable. First, it is a necessary corollary of free alienability -- if the right to accumulate shares without restriction did not exist, then the right to sell shares freely in circumstances where a control premium could be realized without management's consent would be illusory. Second, the freedom to buy shares permits stockholders to protect the value of their investment by accumulating sufficient shares so that singly or with others they can exercise an effective voice in opposition to incumbent management.

The right to vote, and to organize stockholders for the purpose of voting, are essential to the effective operation of the proxy fight internal control mechanism -- and thus are basic to the stockholder's protection of his investment. Manuel F. Cohen, the former Chairman of the Securities and Exchange Commission, has emphasized that an essential element

> in a healthy system of corporate government . . . [is] a method by which corporate managers may be required to account for the results of their stewardship.

Aranow & Einhorn, <u>Proxy Contests for Corporate Control</u> (Columbia University Press 1968) (2d Ed.) (p. xiii). A proxy contest provides a check on management comparable to a tender offer. (Jensen IV 177-78) A stockholder's right to choose the managers of his corporation is inherent in his ownership of stock and is fundamental to the concept of corporate democracy.

B. How The Plan Materially Alters Stockholder Rights

The Rights Plan substantially restricts the right of free alienation of shares, the right to buy shares in an open market and the right effectively to vote shares and to organize the voting of shares in furtherance of the economic interest of stockholders. Defendants' witnesses confirmed the testimony of plaintiffs' experts that the Plan radically weakens the stockholder's role in corporate change of control mechanisms.

1. The Impact On Tender Offers

(a) The Plan Makes Two-Tier Offers Economically Impossible

Defendants' witnesses established that no prudent offeror will make a hostile two-tier tender offer for Household stock. Whitehead said the plan "absolutely stops" two-tier offers. (Whitehead VI 67) Higgins, the principal defense expert, went so far as to state that only an irrational person would use the traditional structure of a two-tier tender offer for Household in which cash was offered for 60 percent of Household's stock and stock was offered for the other 40 percent. Higgins said such an offer would never be done because it would cause massive dilution to the offeror's stock. (Higgins VII 140-41; *see also* Higgins VII 152-53)

The effective elimination of two-tier offers causes severe prejudice to Household's stockholders. Two-tier offers are a frequent means of acquisition (Higgins VII 138-39) and defendants' witnesses testified they frequently provide significant economic benefits to stockholders. Tower testified that, as a member of the board of Marathon Oil Co., he considered the two-tier, highly front end loaded offer -- $125 cash in first step, $80 value of notes in second step -- by U.S. Steel to be fair to Marathon's stockholders. (Tower X 75-80)* Higgins' firm, Salomon Brothers, and Whitehead's firm, Goldman Sachs, have each opined that front end loaded offers are fair to a target's stockholders. (Higgins VII 143-44; PX 348 at 12-13 and App. III) A now classic example of such a two-tier offer was Du Pont's offer for Conoco in which the consideration was $95 cash in the first step and $80 in securities in the second step. (PX 345 at 1, 33) Higgins conceded that the Conoco stockholders received a "significant premium" from this front end loaded offer. (Higgins VII 141-42) The evidence furnished by both sides as to the financial benefits from two-tier offers is confirmed by the SEC's study of all tender offers made during 1981-1983, which revealed an average 55.1% blended premium for two-tier offers. (PX 333) There is no contrary evidence in the record.

Two-tier offers are not only beneficial to target stockholders, but are made because there are legitimate business reasons for them. (Higgins VII 139) An acquiror may wish to issue stock to the target's stockholders to avoid increasing the debt on its own balance sheet. (_Id._) A stockholder may benefit because the second-

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* Notwithstanding that certain U.S. Steel stockholders did not participate in the first step, the Marathon board, along with its investment banker, First Boston Corporation, strongly recommended the merger since they viewed the two steps as a "unitary transaction" which, taken together, gave a substantial premium to stockholders. (Tower X 79-80) Tower's testimony directly impeached his counsel's assertions as to the inherent unfairness of front end loaded offers. (V 146-47)

step merger may be tax-free. (Id.)* Household, of course, acquired plaintiffs' company, Wallace Murray, in a two-tier offer. (Moran II 104)

(b) A Hostile Any-And-All Offer For Household Stock Is Impractical

The defendants claim the Plan encourages cash offers for 100 percent of Household's stock -- so called any-and-all offers. (Clark VI 78, 171; PX 203 at 7) In fact, the Plan imposes unacceptable financial risks on an offeror seeking to acquire 100% of Household's stock by means of an any-and-all offer, unless the offer is conditioned on the tender of a high minimum percentage of shares and Rights. However, any-and-all offers with high minimum conditions are, in Higgins' words, "self-defeating" (Higgins VII 185) and thus effectively unworkable.

Tender offers for multi-billion dollar companies like Household inevitably are followed by a second-step merger. (Higgins VII 159-60, 195, 216-17) One hundred percent ownership eliminates potential minority stockholder conflicts, gives access to target company cash flow to help repay debt incurred in the takeover and permits both companies' assets to be employed in the most efficient manner. (Higgins VII 153; Troubh VIII 130) Higgins could not recall any transaction in excess of $1 billion where the offeror did not follow its tender offer with a second-step merger. (Higgins VII 159-60, 195, 216-17)

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* Of course, the stockholder can sell the debt or equity securities he receives in the second-step because such securities are salable. (Moran II 103)

The Rights, however, add so much cost to the second-step merger that they make any-and-all offers unworkable. If, as is not uncommon, 10 percent of the shares and Rights remained outstanding after the first-step tender offer (Higgins VII 190-91), an offeror would have to pay an additional $600 million to acquire 100 percent of Household's stock. If 80 percent of the Rights are tendered and there is a second-step involving 20 percent of the Rights, the acquisition will cost $1.2 billion more than originally intended. (Troubh VIII 55-57; PX 183 at 1) Troubh concluded that no rational offeror would be willing to accept that amount of dilution. (Troubh VIII 57-58)* Abbott and Greenberg confirmed Troubh's view. (Abbott III 91-94; Greenberg IV 75) Thus, because the possible dilution in a second-step merger is so great, no prudent company could be expected to make a tender offer for 100 percent of Household stock without conditioning the offer on the tender of a very high percentage of Household's Rights.

Such a high minimum hostile tender offer has never been done before -- and with good reason. It would fail. The defendants' experts conceded the point and their testimony was confirmed by the plaintiffs' experts. Higgins was especially blunt about high minimum offers: "[y]ou would be advised not to do it because it would be self-defeating." (Higgins VII 185)

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* The further suggestion in the minutes that the offeror would compensate for the dilution by reducing the premium offered on the first step (PX 203 at 9) was even too far-fetched for defendants' experts. After plaintiffs' experts demonstrated the impossibility of such an offer succeeding (Greenberg IV 74-75; Abbott III 80-87; Jensen IV 180-92, V 49-52) because of the gross disparity between the consideration offered in the two steps, no defense witness was heard to challenge this testimony.

Arbitrageurs would not participate in such an offer. Household's expert conceded that arbitrageurs, like Alan Greenberg, hold the key to the success of a tender offer. (Wilcox IX 91) They buy shares in the open market after a tender offer is announced in the hope that they can sell the shares to the offeror at a slightly higher price. (Greenberg IV 65-68) If the offer succeeds, the arbitrageur profits; if the offer fails and the stock price recedes to its original level, arbitrageurs take a "bath." (Greenberg IV 68) Thus, an arbitrageur will not buy if the tender offer's chance of success is slim. Higgins' testimony on this point is unequivocal:

> Q. High minimums are self-defeating?
>
> A. Are weak tenders generally. . . .
> The reason is when you make a tender offer, one of the most important elements for the shareholders to consider when they decide whether or not they are either going to tender their shares or they are going to go out in the marketplace and buy shares is the confidence they have that they are going to get the money that's represented by the tender offer. And it's somewhat circular logic, but we advise clients all the time, and they say well, you know, I really want -- I don't want 50 percent. I want 70 or 80 percent. So I'm going to have a minimum of 70 to 80 percent in the tender. We say great. Let's accept that as a premise, and then allow us to contribute our experience, and that is if you have that minimum, you will create more uncertainty in the minds of shareholders about whether or not you would get it. You will get less shares than you will if you have no minimum, or a very, very low minimum. <u>Our experience has, you know, proven that to be the case</u>.
>
> Q. <u>They don't succeed, isn't that true, with a high minimum?</u>
>
> A. <u>They are not made</u>.
>
> (Higgins VII 185-87, emphasis supplied)

Other witnesses agreed with Higgins' concession about high minimum offers. Greenberg, whom Wilcox conceded is one of the shrewdest traders and arbitrageurs on Wall Street (Wilcox IX 91), testified that such an offer was "totally hopeless" based on his twenty years experience. (Greenberg IV 73)

There are reasons besides the reaction of the arbitrage community that offers conditioned on tender of a high minimum percentage of shares will fail. Greenberg testified: "A certain number of shareholders are out of the country. A certain number of shareholders have lost their certificate. A certain number of shareholders wouldn't tender to anybody for any price. They think they can get more." (Greenberg IV 73-74) Abbott agreed and stated, in addition, that certain stockholders would try to preserve appraisal rights. (Abbott III 79)

The amount of stock held by directors, officers and benefit plans is also "extremely relevant" in determining the likelihood that an offer conditioned on a high minimum number of shares would be successful. (Higgins VII 198) Wilcox testified that "in general employees would not vote against management" (Wilcox IX 95) and experience has shown employee loyalty with respect to tender offers that management is opposing.* (Wilcox IX 93-94) In Household's case the stock held by officers, directors and pension funds is an additional factor why a high minimum in a hostile offer is beyond attainment. Household directors and officers control 2.3 percent

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* Wilcox testified that when the employee benefit plans provide for pass-through tendering, the employees tend to tender in accordance with management's wishes. (Wilcox IX 93-94) Significantly, the day the board was told an offer with a high minimum condition could work, the board passed a resolution requiring pass-through tendering. (PX 203 at 6)

and the employee benefit plan controls an additional 4.6 percent. In addition, defendant director Rauch testified that he, his "friends" and his clients control in the aggregate approximately 7.5% of the Household stock. (PX 5 at 12; PX 41 at 3; Wilcox IX 93; Rauch Dep. 39-40)

Given all these factors, it is not surprising that hostile offers with high minimum conditions have never been done. Higgins, the head of Salomon Brothers' mergers and acquisitions department, could not recall a tender offer with a minimum condition of 80 or 90 percent, much less 95 percent. (Higgins VII 184-85) Wilcox, who rendered services on approximately 250 tender offers (Wilcox IX 15), could not remember one in which he recommended anything approaching such a condition. (Wilcox IX 92)*

Higgins conceded in his testimony that most potential offerors would be deterred by the Rights Plan from making a 95 percent minimum offer. (Higgins VII 62, 124-25, 129, 183) According to this defense expert, there is a "tremendous downside risk" for a potential acquiror to even launch such an offer. (Higgins VII 190) Reputations and millions of dollars spent preparing an offer are at

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* Jensen also testified that a tender offer for Household at $45 per share conditioned upon the tender of 95 percent of the shares and Rights, would lead a rational investor holding less than 5 percent of the stock not to tender but to await the enormously higher price available from the second step merger. As a result the offer would fail. (Jensen IV 180-92 and V 49-52) Professor Bradley and Abbott and Greenberg concurred with Jensen's analysis that an offer conditioned on tender of 95 percent of the Rights and shares could never succeed because it would be back end loaded. (Bradley V 98-105; Abbott III 80-88; Greenberg IV 73-74) Higgins' testimony to the contrary (Higgins VII 56-59) was unpersuasive.

stake. (Higgins VII 130) Nonetheless, Higgins claimed that he "might" recommend a 95 percent minimum because maybe "something will happen . . . I don't know exactly what" and that, in any event, his client could always pull out of the offer. (Higgins VII 187-90)

The offer is "self-defeating" because arbitrageurs will recognize that the offer's extreme condition will cause it to fail leaving them with a substantial loss on their shares. Even if one were to accept Higgins' view that some potential offeror might be willing to attempt the "minefield" (Higgins VII 60) of the Rights Plan, that provides no legal comfort to defendants. As is demonstrated <u>infra</u> at pp. 20 to 24, evidence of elimination of all hostile offerors is not necessary to prove the Plan invalid.

Because, as has been shown, market forces will not permit a tender offer by itself to evade the dilutive effects of the Rights Plan, defendants were driven to create an additional approach. They posit the making of an any-and-all tender offer in conjunction with a consent solicitation to replace the board. If the solicitation were successful, a new board could then redeem the Rights before the offeror purchased the tendered shares.*

However, the testimony points to only one conclusion -- this is an impractical and unworkable alternative. Greenberg called the consent solicitation process a "totally unrealistic" means of

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* In fact, this suggested course of action is precluded by the terms of the Rights Agreement. Once the offeror has the right to acquire 20% or more of Household's shares, the Rights become non-redeemable. A tender offer is a contract, arrangement or understanding pursuant to whose terms an offeror has the right to acquire the shares. (PX 204; Troubh VIII 50) <u>See</u> <u>Lowenschuss v. Kane</u>, 520 F.2d 255, 264-67 (2d Cir. 1975).

obtaining control. (Greenberg IV 77) Higgins testified that the consent procedure would be equivalent to "eight balls in the air at one time":

> Well, it has never happened. Could it be done? I would have to talk with counsel myself. The consent procedure itself is pretty complicated, as I understand it. I don't know whether it could be done. I think it would be eight balls in the air at one time. I think it is much more likely that he would just -- well, I don't know, sir.

(Higgins VII 224) Against this background of testimony, Household's failure to ask its proxy expert, Wilcox, his opinion of the consent procedure demonstrates that it, too, had concluded the procedure was a non-starter. In the end, the defendants were unable to identify any practical way around the Plan.

2. The Plan Effectively Bars Ownership Of 20 Percent Of Household Shares By An Individual Or Group

Before Household's board issued the Rights, Household stockholders -- like stockholders of any other United States publicly-held company* -- could freely purchase as many Household shares as their financial resources permitted. Because of the Plan, a rational investor, seeking to acquire Household or to exercise significant influence but retain the potential for a control premium on the sale of the company, would effectively be precluded from acquiring 20 percent or more of Household's shares.

Clark made this plain in his testimony:

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* The only exceptions are companies in regulated industries where federal and state law may prohibit ownership in excess of designated percentages of the company's stock and companies whose stockholders have consented to such a restriction. See DGCL § 202(b).

Q. Now, you will agree with me, won't you, that however irrational it is for anyone to acquire 20 percent, that this most important feature of the plan [the power of redemption] utterly disappears once the rights are triggerred by a 20-percent acquisition?

A. I will agree with you that if you have an irrational person who is willing to put $400 million into a situation that he would deem to be harmful to him and other shareholders -- yes, it could happen. But I would suggest to you that -- I would agree with you it is a possibility, but I would very strongly suggest to you the probability is zero.

* * *

[Y]ou are bringing up a hypothetical that I suggest doesn't even fit on the scale of probability.

(Clark VI 215-16) Whitehead adopted Clark's view that a 20 percent Household stock acquisition, which thereby made the Rights non-redeemable, would indeed be harmful to the interest of all stockholders: "I believe that if the rights were to become non-redeemable today, that would be harmful to the interests of the stockholders." (Whitehead VI 55)

The harm which both Clark and Whitehead acknowledged is obvious: once the Rights become non-redeemable, thus making irretrievable the massive dilution attendant to the Rights, Household stockholders will be denied the substantial economic benefits of a 100 percent acquisition of their company. Higgins testified that "no one is going to come after this company on a hostile basis once those rights become non-redeemable." (Higgins VII 146) Non-redemption of the Rights would as well seriously restrict Household's ability to effect a negotiated transaction, including a "White Knight" transaction (PX 183 at 3), since the dilutive effects of the Rights will apply with equal devastation to such an offeror.

In view of this concession as to the Plan's practical impact on 20 percent investments, Household relegated itself to the curious, short-lived defense that an investor would not acquire 20 percent of the stock of Household even if there were no Rights. Once again, Higgins could offer Household no comfort:

> Q. Have you ever heard of somebody coming in off the street . . . and making a $350-million stock acquisition [20% of Household] in a major public company?
>
> A. Yes.
>
> * * *
>
> Q. Have they ever done it in a company that had a rights plan?
>
> A. No. I am sorry. I didn't know that you qualified it by companies that had rights plans.

(Higgins VII 222-23)

For the same reasons that Clark believed no rational investor would purchase 20 percent,* no prudent company would make a partial tender offer, especially at a control premium, and give up for ten years -- because of the massive dilutive effects of the Rights -- the ability to acquire 100% of Household. Higgins admitted that no partial offer had ever been made for a company the size of Household, and characterized such an offer as "totally theoretical." (Higgins VII 159-60, 195-96, 216-17) Greenberg said of the partial offer, wait ten years to merge, alternative: "Nobody is going to do that, or pay a premium and do that." (Greenberg IV 76)

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* Clark characterized such a possibility as "improbable to the nth degree." (Clark VI 219)

3. <u>Proxy Fights Are Restricted, Inhibited And Made More Expensive By The Rights</u>

Contrary to the assurances given at the August 14 Household board meeting, the Plan "restricts, inhibits [and] makes more expensive" proxy contests. (PX 203 at 8) By imposing an unacceptable economic penalty if a person, entity or group acquires 20 percent of Household's stock, the Rights significantly inhibit and restrict potential insurgents in waging a fair contest.

Household now concedes that the Plan was intended to create a barrier to an insurgent group's efforts to mount an effective proxy contest. In their pre-trial memorandum, defendants make the following remarkable concession:

> there is no merit to plaintiffs' contention that the Rights Plan supposedly deters proxy fights because if a "group" owning more than 20% of Household shares conducts a proxy contest, the Rights become exercisable and non-redeemable. The short answer to this contention is that <u>the Board could reasonably conclude that it is precisely a "group" formed for the purpose of taking control of Household in a coercive transaction that might be so "deterred," and that is one of the objectives of the Plan</u>. (Defendants' Pre-Trial Memorandum at 51) (emphasis supplied)

The only defense offered by Household for its restriction on stockholders' proxy contest rights was the claim that some proxy contests are won by stockholders owning less than 20 percent. This is a classic <u>non sequitur</u>. The proof offered by Household's own witnesses demonstrated that insurgents owning more than 20 percent had a better chance of winning than if their holdings were less than that amount -- an obvious fact in any case. Each of these witnesses conceded that it is a "truism" that the more shares insurgents own the better are their chances in a contest. (Wilcox IX 72; Troubh VIII 115; Higgins VII 171-72)

Household also introduced an exhibit (DX 39) that purported to demonstrate that the 20 percent limitation on ownership does not inhibit proxy fights. In fact, the exhibit demonstrates the exact opposite. First, it demonstrates that a substantial number of proxy fights are waged in which the dissidents hold in excess of 20 percent: about 22 percent of the proxy fights between January 1, 1981 and September 28, 1984 were waged by dissidents holding more than 20 percent of the stock. Second, the exhibit demonstrates that dissidents fare substantially better when they have more than 20 percent. In this case, Wilcox, after he looked more closely at his chart, conceded the point:

> Q. And based on the fact that your study shows that management wins 35 percent when dissidents have less than 20 percent and management wins only about 18 or 17 percent when dissidents have more than 20 percent, you draw the conclusion that the dissidents owning more stock makes no difference to the outcome of the contest?
>
> A. I don't think I ever said it didn't make any difference.

(Wilcox IX 90)

There are other reasons why the 20 percent limitation inhibits proxy contests. Aranow & Einhorn, in their seminal work on proxy contests, note that one method by which insurgents traditionally deal with the need for large stockholdings is by forming a stockholders committee. "By so doing, important stockholders or their representatives can be brought into the group." Aranow & Einhorn, Proxy Contests for Corporate Control, at 17. They explain that

> In this connection, one of the most effective, and sometimes dramatic, means of increasing the insurgents' strength is to buy a large block of stock from someone formerly aligned with the management. The purchase of stock on which the management relies is equivalent to purchasing twice as many shares from uncommitted stockholders.

Id. at 21. In the case of Household, however, the Plan creates an artificial 20 percent ceiling on stockholder group's purchases. Moreover, one management response to a proxy contest may be to issue a large block of shares into friendly hands, thus diluting the voting strength of the insurgent. (Higgins VII 52) If the insurgents are free to buy shares without limitation, they can minimize the dilution and therefore the negative impact of management's actions. The larger the number of shares held by the insurgents to begin with, particularly if more than 20 percent, the more difficult it will be for management to successfully use this "friendly issuance" device to dilute them. (Wilcox IX 73-74)

The Rights impose a critical inhibition on proxy contests. The defendants advanced proxy contests as an effective alternative means to tender offers to replace the board of Household. (PX 203 at 8) Certain directors stressed at their depositions that the lack of inhibition on such contests was an important factor in their decisions to adopt the Plan. (Clark Dep. 91-92; Hendry Dep. 58-59, 61-62) One Household defense expert, Mr. Troubh, testified that he did not believe that a board "should be permitted to prevent the forming of groups." (Troubh VIII 123) The Plan seriously impacts stockholder rights by materially restricting and inhibiting the formation of an effective group.

III. THE RIGHTS PLAN IMPERMISSIBLY RESTRICTS THE RIGHT TO FREE ALIENATION OF STOCK AND TO FAIR CORPORATE SUFFRAGE

A. The Right To Free Alienation Of Stock

The Rights Plan impermissibly interferes with stockholder rights to alienate their shares as guaranteed by the common law and implemented by Sections 159 and 202(b) of the DGCL. Such interference has been more than proven. Household's witnesses conceded that the Plan eliminates all hostile two-tier offers. Household's experts also established that the Plan presents a virtually insurmountable barrier to a hostile bidder seeking 100 percent of Household even through an any-and-all hostile tender offer. The testimony makes it evident as well that the Rights Plan is a major deterrent to a purchaser of Household shares accumulating more than 20 percent; indeed, Household's Chairman testified it would be irrational to do so. These effects are unique and unprecedented. No previous board of a Delaware corporation has been permitted unilaterally to so limit ownership of its shares, circumscribe so severely an economically significant market for its shares or to penalize all stockholders if a given level of ownership is exceeded.

Shares of Delaware corporations are personal property. DGCL § 159. Delaware courts have long recognized that "an important incident of the ownership of property is its transferability. . . ." Tracey v. Franklin, Del. Supr. 67 A.2d 56, 58 (1949). At common law the issue was whether restraints on alienation voluntarily entered into by shareholders were against public policy. Id. at 59

With the amendment of DGCL Section 202, the Delaware General Assembly validated certain kinds of restraints on alienation of stock but retained the common law requirement that any such restraint must be consented to by the owner of each share so restrained. DGCL § 202(b):

> No restriction so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction.

In the leading case interpreting § 202(b), Joseph E. Seagram & Sons, Inc. v. Conoco, Inc., 519 F. Supp. 506 (D. Del. 1981), Chief Judge Latchum held that a by-law which limited ownership of Conoco's shares by "aliens" to 20 percent constituted an unlawful restriction on alienation. The by-law would have eliminated Seagram as one of three competing tender offerors for Conoco. The court held that by so restricting the class of purchasers, Conoco's board had interfered with free alienation of Conoco shares and thus, "the actual exercise of ownership rights vested in the shareholder. . . ." Id. at 513.

The court further found that such a restriction need not be an absolute bar on all transfers to be illegal. Rather Judge Latchum struck down the Conoco by-law because it

> would produce the incongruous result of allowing the Board of Directors unilaterally to impose stock transfer restrictions, which might be of significant economic consequence, on existing shares without the consent of the corporation's shareholders.

Id. (emphasis added) The court found these to be

> restrictions which could involve serious limitations on the free alienation of stock and could severely circumscribe an existing shareholder's market for selling Conoco stock [which] would be imposed without the consent of the shareholder.

Id. (emphasis added)

The Plan imposes restrictions on alienation which go far beyond the restrictions invalidated in Seagram. Only alien buyers were restricted by the Conoco by-laws. The Household Plan is conceded by Household's witnesses to eliminate all hostile two-tier offerors and is aimed at and, according to the defendants' witnesses, presents an extraordinary barrier against all twenty percent investors and hostile any-and-all offerors. These conceded restrictions alone "involve serious limitations on the free alienation of stock" and have been proved without contest to be "of significant economic consequence" to the Household stockholders.

The First Circuit recently followed Seagram in San Francisco Real Estate Investors v. Real Estate Investment Trust of America, 701 F.2d 1000 (1st Cir. 1983). The defendant's board adopted a by-law which penalized ownership exceeding 9.8% of the trust's shares by any one holder or his affiliates. The penalty for exceeding the limit was loss of voting, dividend and distribution rights for, and possible redemption of, any shares held in excess of 9.8%. The ostensible reason for the by-law was the fear that concentrated share ownership could cost the trust its REIT tax benefits and thus harm all stockholders.

The First Circuit rejected the argument that such a restriction was necessary to protect tax status, noting that there was a provision in the trust's declaration (the equivalent of a corporate charter) which dealt with that problem by permitting redemption of shares to the extent necessary to protect tax status. (DGCL § 151(b) similarly permits such a redemption provision, to the extent necessary to protect a license, franchise or membership, but only if consented to by the stockholders.)

The First Circuit in enjoining the by-law stated that the

> assertions that in some instances Massachusetts law permits restrictions on transfer and that "a discouragement to some few hypothetical buyers" poses no conflict with Section 4.2 [of the trust declaration]* ring hollow to us, as does [the] attempt to distinguish Joseph E. Seagram & Sons v. Conoco, Inc., 519 F. Supp. 506 (D. Del. 1981).

San Francisco Real Estate Investors v. Real Estate Investment Trust of America, 701 F.2d at 1005 (emphasis added; footnote omitted). The court's opinion in San Francisco makes a fundamental point which applies here with equal force -- the elimination of a class of potential buyers, whether identified or only hypothetical, by board action alone is not permissible. Because the Rights Plan embodies this precise effect, it is illegal.

The Household Rights Plan impermissibly interferes with the right of free alienation of shares guaranteed by DGCL §§ 159 and 202(b). For that reason it must be struck down.

B. The Right To Fair Corporate Suffrage

The Rights Plan not only effectively bars any person from acquiring twenty percent of Household's shares, it also imposes a punishing financial penalty on all stockholders if stockholders owning 20 percent or more form a group to run a proxy contest. The

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* Section 4.2 of the trust declaration provided that a shareholder is entitled to a certificate which "shall be treated as negotiable and title thereto . . . 'shall be transferred by delivery thereof to the same extent . . . as a stock certificate.'" Id. at 1004. Similarly, DGCL Section 159 provides that the shares of stock of every corporation shall be deemed personal property and transferable.

defendants have offered no justification for this extraordinary imposition on the right of fair corporate suffrage which is universally recognized as "an important right that should attach to every equity security". J.I. Case Co. v. Borak, 377 U.S. 426, 431, 84 S.Ct. 1555, 1559 (1964).

The defendants will not be heard to argue that the Household board could have adopted a by-law limiting to less than 20 percent the share ownership of any individual or group intending to run a proxy contest. Courts have repeatedly struck down board attempts in the form of by-laws to insulate themselves from effective proxy challenge. See, e.g., Schnell v. Chris-Craft Industries, Inc., Del. Supr., 285 A.2d 437 (1971) (by-law advancing annual meeting date which interfered with insurgent proxy effort struck down); Lerman v. Diagnostic Data, Inc., Del. Ch., 421 A.2d 906 (1980) (by-law infringing nomination rights of insurgent director nominees struck down); Holly Sugar Corp. v. Buchsbaum [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,366 at 92,333 (D. Col. 1981) (by-law barring calling of a special meeting by, among others, insurgent groups previously enjoined for proxy violations struck down).

Courts do not countenance management restrictions on stockholder suffrage rights because these rights are of fundamental importance. The separation of ownership from management in modern corporations limits stockholder ability to control their investments. Their only recourse is to replace management by voting them out if their performance is unsatisfactory. As the court noted in

Lincoln American Corp. v. Victory Life Insurance Co., 375 F. Supp. 112 (D. Kan. 1974):

> The solicitation of proxies by a corporation's stockholders is an inherent and fundamental right attending the ownership of stock; it affords an effective means of voicing opinions and obtaining representation; it enables stockholders to do collectively that which they could not do individually; and it insures the stockholders' right to know the truth. The right to solicit proxies represents more than merely an opportunity to prevent corporate mismanagement - it permits the stockholders to effect a change in corporate policy, to bring in new and more effective leadership, and to strengthen corporate responsibility. Far from being inimical to the interests of a corporation, whether private or public, the right to solicit proxies insures a means of protecting those interests.

Id. at 119-20. Moreover,

> small shareholders in large publicly held companies have an insufficient incentive adequately to monitor the management of the firm. Nevertheless, these shareholders are not bereft of all relief from improper or inefficient management. Large shareholders, or outsiders who may challenge incumbent management, help protect the small shareholders' interest in monitoring -- by possibly challenging -- incumbent management. The more obstacles that are placed in the path of those who would acquire large holdings, and the more expensive and time consuming the takeover process becomes, the less protection for the small shareholder.

Liberty National Insurance Holding Co. v. The Charter Co., 734 F.2d 545, 566 (11th Cir. 1984).

The General Assembly and the courts have emphasized the importance of stockholders' rights to a free and informed vote. As the court in Studebaker Corp. v. Allied Products Corp., stated:

> Only at the annual or specially called meeting of the shareholders can the individual shareholders exercise their right of suffrage.

256 F. Supp. 173, 189 (W.D. Mich. 1966). Any substantial interference with those suffrage rights materially impairs stockholders'

abilities to control their company's destiny. <u>See</u> DGCL § 211(b); <u>Coaxial Communications, Inc. v. CNA Financial Corp.</u>, Del. Supr., 367 A.2d 994 (1976); <u>Holly Sugar Corp. v. Buchsbaum</u>, <u>supra</u>.

The aggregation of shares is the only effective means available to stockholders to gain a meaningful voice in the selection of corporate managers. Such an aggregation may be accomplished in three ways: (1) through purchases of large blocks; (2) through concerted action by the holders of a high percentage of the shares; and (3) through proxy solicitations. The first two methods are the most certain road to success. A share bought is a vote owned. Proxies, on the other hand, are subject to revocation up to the time of the vote. These three methods are most effective when used in tandem. Aranow & Einhorn at 14-21.

The Rights Plan directly limits the first two of these methods and, thereby, imposes prejudicial restrictions on effective proxy solicitations. Household's counsel were aware that any such interference would be unlawful. They explicitly advised the board that the Rights Plan would "in no way" restrict, inhibit or make more expensive proxy fights. (PX 203 at 8)

At trial Household's only defense in the face of the obvious detrimental impact on insurgents caused by the Plan's share ownership limitations was that some proxy contests had been won by holders of less than 20 percent. Apparently, it believes that only restrictions which produce the extreme result of eliminating all possibility of an insurgent victory are illegal. As the courts have time after time determined, that is simply not the law. <u>See</u> <u>Schnell v. Chris-Craft Industries, Inc.</u>, Del. Supr., 285 A.2d 437, 439

(1971); Coalition to Advocate Public Utility Responsibility, Inc. v. Engels, 364 F. Supp. 1202, 1204 (D. Minn. 1973); National City Lines, Inc., v. LLC Corp., [1981-82 Transfer Binder] Fed. Sec. L.Rep. (CCH) ¶ 98,374 at 92,261 (W.D. Mo. 1981); NUI Corp. v. Kimmelman, [Current] Fed. Sec. L. Rep. (CCH) ¶ 91,664 at 99,356-57 (D.N.J. 1984).

IV. THE PLAN IS VOID UNDER TELVEST V. OLSON BECAUSE IT USES SHAM SECURITIES TO ALTER FUNDAMENTAL STOCKHOLDER RIGHTS

Household will not contend that its board could adopt resolutions (1) restricting ownership of its stock to less than 20 percent, (2) requiring board approval for all two-tier or hostile tender offers or (3) restricting those opposing management in a proxy contest to ownership of less than 20 percent of the stock. Such contentions would fall of their own weight. Household's witness Troubh so testified:

> Q: Would you not agree with me, Mr. Troubh, that it would be desirable for the board to adopt a proposal that would eliminate the possibility of this kind of disruption through hostile takeover efforts?
>
> A: I don't quite see how that would be done. That sounds to me like legislation which no board has in its power to do.

(Troubh VIII 61)

Since outright prohibition is illegal, Household has created a device which achieves the same result by making the exercise of these fundamental rights inflict severe damage on the corporation and its stockholders. This circumvention of the law was accomplished by the distortion of financing techniques -- dividends, rights and preferred stock -- to serve as mechanics intended solely to alter the power relationships between the stockholders and the directors. The Plan is a classic effort to do indirectly that which could not legally be done directly.*

In Telvest, Inc. v. Olson, Del. Ch., C.A. No. 5798, Brown, V.C. (March 8, 1979) (App. Ex. A) Chancellor (then Vice Chancellor) Brown held that a board of directors may not alter existing voting rights of common stockholders without their consent by issuing to all common stockholders a sham security in the form of a dividend. The security in that case was called a piggyback preferred stock. Its key characteristic was supermajority voting rights. The security transformed the vote necessary to approve a merger with a party owning 20 percent or more of the company's stock from a majority to 80 percent.

The Court found that the preferred was a sham security because its supposed preferences were "illusory at best." The Court found further that "if any preference is created, it would seem to lie almost entirely in the voting rights." Chancellor Brown invalidated the piggyback preferred stock dividend, stating:

> I am aware of no policy evident in the Delaware Corporation Law, and I have been referred to none, which would empower a board of directors to alter existing voting rights of shareholders for the supposed good of the shareholders without permitting the shareholders to be heard on the matter.

Four years later, in National Education Corporation v. Bell & Howell Co., Del. Ch., C.A. No. 7278, Brown, C. (August 25,

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* "Equity will not permit one to evade the law by dressing what is prohibited in substance in the form of that which is permissible." Kelley v. Dover, Del. Ch., 300 A.2d 31, 38 (1972) (Duffy, C.).

1983), (App. Ex. B) Chancellor Brown was faced with the question whether a preferred stock, which Bell & Howell characterized as a "true preferred stock in every sense of the term," (Bell & Howell Preliminary Injunction Brief dated August 22, 1983 at 14-19 (App. Ex. C at 14-19)) could be lawfully issued as a dividend if it imposed a new 80 percent voting requirement applicable only in the unlikely event of a merger with a non-public company. Bell & Howell stressed that the dividend was lawful, even though it changed stockholders' voting rights, because the stock:

1. carried an annual dividend with a fixed minimum of $12 per share which was higher than the dividend on the common;
2. had a liquidation preference of $300 per share;
3. was subject to redemption at Bell & Howell's option after September 1, 1998 for $300 per share;
4. was convertible by the holder into 120 shares of Bell & Howell common; and
5. granted its holders special voting rights designed solely to protect their rights as preferred stockholders, namely the right to elect two directors if dividends were in arrears for six quarters and an 80 percent majority vote as a class on any amendment to the charter that materially altered the preferred's rights or preferences.*

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* The preferred stock also provided that its holders could force the company to redeem their stock for cash if someone acquired 40 percent or more of Bell & Howell voting stock and did not within 30 days announce a transaction to acquire all of the remaining Bell & Howell shares and within 120 days thereafter (Footnote continued)

App. Ex. C at 14-19

Based on these arguments, the Court found that, unlike in Telvest, "in this case the new preferred stock does have rights in addition to those relating to voting power. It is said that the new preferred will have independent trading value." Bell & Howell, Slip op. at 10. Despite these findings, the Court was unable to determine that Bell & Howell had shown that its dividend was legal. Id. at 11.

Not only are the Household Rights sham securities, but their impact on fundamental stockholder rights is far more severe than the dividends issued in Telvest and Bell & Howell. In those cases, there was no two-for-one dilution feature, as here, whose disastrous financial consequences directly impede the making of a hostile tender offer. In Telvest the acquisition of 20 percent of the stock did not effectively bar all merger transactions as the Rights do; it just increased the required vote. In Bell & Howell, the 40 percent trigger made the inhibition on proxy contests far less severe than here. Moreover, the "put" provision of the Bell & Howell preferred could be avoided by an offer for all the stock within a stipulated period of time. Once the Household Rights are

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(Footnote * continued from previous page)
consummate such a transaction at the highest price paid to acquire the initial 40 percent block. Bell & Howell argued that "[t]he purpose of this provision is to remove the ability of a raider making a front-end-loaded offer to stampede stockholders into tendering their shares in order to protect themselves against loss of the tender offer premium or being locked into a minority position." The preferred, in a merger, was also guaranteed the right to receive "substitute preferred stock of comparable value, convertible into common stock of the surviving entity." (App. Ex. C at 15-17).

triggered and become non-redeemable, their disastrous consequences cannot be eliminated. The Rights here are amendable at the will of the board. Thus, a prospective hostile offeror must be willing to face not only the existing "minefield" but also any new obstacles the board may place in his path by amending the Rights Plan.

In Telvest the directors argued that the filing of the certificate of designation constituted a charter amendment and thus was sufficient to alter rights guaranteed by the charter. Shortly before Bell & Howell was decided, the General Assembly amended DGCL §151(g), making it explicit that a charter amendment could be effected by the board in a resolution fixing the terms of a legitimate preferred security. In Bell & Howell, the directors similarly sought to follow the required statutory course to amend the charter by issuing a preferred stock dividend. Despite the amendment to DGCL §151(g) and a finding that the Bell & Howell preferred was arguably a real preferred security, the Court was unable to find that the dividend was lawful.

An issue in each of those cases was whether rights, which can not be altered without a charter amendment, could be altered by such an amendment adopted solely by the board. The Household board altered more significant rights without even the formality of an attempted charter amendment. Household altered and abridged these rights by the issuance of sham securities.

As the Chancellor reaffirmed in Bell & Howell:

> The piggyback preferred stock that was to be issued [in Telvest] as a stock dividend to the common shareholders

> was clearly a sham insofar as it purported to be preferred stock. It carried no real preferences whatever other than a grant of increased voting power. So viewed, it was nothing more than an attempt by a board of directors, by resolution, to change the existing voting rights of the common shareholders without their consent so as to make a hostile acquisition of the corporation more difficult to achieve. (Slip op. at 9-10)

The Household Rights are sham. They are not rights in any sense previously known.* The Rights carry with them the ability to buy one hundreth of a share of a participating preferred stock for $100. However, the Rights, as Whitehead testified, have "little or no value". (Whitehead Dep. 28) The preferred was designed to be grossly "out-of-the-money." It was conceded that this was intentional. (PX 183 at 2)** Moran testified that he believes that if the preferred were to be issued, it would be worth no more than $17.50 per 1/100 of a share. (Moran I 148) Defendants offered no testimony to show a value anywhere near the $100 exercise price. Only if the value of the preferred were to exceed the exercise price would stockholders have an incentive to exercise the Rights to buy the preferred. Under those highly unlikely circumstances, the anti-takeover characteristics of the dividend and, thus, its sole purpose would disappear.***

These facts are all conceded. The only effort made by the defendants to show that the Household Rights were not sham securi-

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* Flynn Dep. 85-86. <u>See</u> 2 Dewing, <u>The Financial Policy of Corporations</u> 1141 (5th ed. 1953)

** This point was conceded in the Household board presentation which informed the board that the preferred is "out of the money," and would not dilute earnings per share. (PX 183 at 2)

*** Household common stock traded in the range of about $10 per share to $33 per share from 1974 to date (PX 318).

ties was the argument in the defendants' pre-trial memorandum (pages 83-89) that the flip-over provision in the Rights is analogous to anti-destruction clauses in certain legitimate securities. This argument is demonstrably wrong. There was no evidence introduced at trial of any other security which gave its holder the right to buy another company's common stock for half price in the event of a merger. Anti-destruction clauses may preserve but they do not create value.

Anti-destruction clauses were developed to protect the value of the security in which they appear should the issuer merge or sell its assets. Broad v. Rockwell International Corp., 642 F.2d 929, 945 (5th Cir.), cert. denied, 454 U.S. 965, 102 S.Ct. 506 (1981). Such clauses provide that in the event of a merger, the existing conversion or exercise rights of a security will be preserved -- not that the value in the security, itself, will be created. An anti-destruction clause guarantees that the substance of the holder's right to acquire the issuer's preferred stock does not disappear when the issuer's preferred, itself, disappears in the merger. Instead, the merger partner must provide either (a) an equivalent new preferred for which the rights may be exchanged or (b) an opportunity to exchange the rights, upon payment of the exercise price, for the same consideration as the issuer's preferred receives in the merger.

The two-for-one flip-over provision in the Household Rights in the event of a merger does not preserve the holder's right to convert into Household's preferred or its equivalent; rather, it creates an entirely new right to buy stock at half-price from the merger partner. The purpose of this new right is not preservation of value in the merger. Its purpose is to prevent the merger.*

Household's citation of the anti-destruction clause illustrates the defects that infect the Plan as a whole. Anti-destruction clauses have no life apart from their incidental purpose to protect the bargained for value of the security (and the rights of its holder) from loss in a merger or other fundamental corporate change. Such clauses force the issuer and the acquiror to honor the original bargain that created the security. Household seized this mechanic and would use it out of context to force the acquiror to alter the rights of the parties and create an entirely new bargain, unsupported by consideration. Household's purpose is not to preserve pre-existing property, but to threaten the creation of exorbitant artificial value at the expense of the acquiror and, thereby, to prevent

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* The American Bar Foundation's Commentaries on Indentures, cited by the defendants and Professor Cary's text [W. Cary & M. Eisenberg, Cases and Materials on Corporations 1155 (5th ed. unabr. 1980)] both make the point that normal anti-destruction clauses provide:

> that the holder of the convertible security shall have the right thereafter to convert it 'into the kind and amount of shares of stock and other securities and property receivable . . . by a holder of the number of shares of capital stock into which such, [convertible security] might have been converted. . ..

The cases cited by the plaintiffs at pages 86-88 of their Pretrial Memorandum are to the same effect: both Wood v. Coastal States Gas Corp., Del. Supr., 401 A.2d 932 (1979), and B.S.F. Co. v. Philadelphia National Bank, Del. Supr., 204 A.2d 746 (1964) (applying Pennsylvania law), involved a conversion privilege where convertible securities were convertible into stock of the acquiring company in the same ratio as the convertible stock would have been convertible into stock of the acquired company if there had been no merger.

unwanted corporate change. The sole purpose of the two-for-one value multiplier in the flip-over provision, then, is to prevent the right from flipping over in the first place. The Household flip-over was prepared and issued with the clear recognition that no one in his right mind would dilute his company by selling his stock to others at half its market value. The device was conceived with the intent, and the assurance, that it would stop takeovers and, therefore, never be exercised.

Because the Household Rights are sham securities whose sole purpose is to alter fundamental rights of stockholders without their consent, the Rights Plan must be voided under Telvest.

V. THE HOUSEHOLD RIGHTS PLAN CANNOT BE JUSTIFIED UNDER ANY LEGAL STANDARD FOR BOARD ACTION

Board action, which has as its sole or primary purpose the altering of fundamental stockholder rights so as to vest a new power in the directors to decide whether a tender offer can succeed, may not be sustained under the business judgment or any other rule or doctrine of Delaware law.

A. The Business Judgment Rule Does Not Justify The Rights Plan

As has been shown, the DGCL and the common law guarantee Household stockholders fundamental ownership rights of alienability and fair corporate suffrage. The board does not have the power to abridge or alter these rights without stockholder consent. Since the Rights Plan does that, it is illegal and must be voided.

The business judgment rule provides no independent source of power for the Household board's action. That doctrine is a defensive measure invoked by directors who are being sued for exercising an existing power:

> The "business judgment" rule is a judicial creation that presumes propriety, under certain circumstances, in a board's decision. Viewed defensively, it does not create authority.

Zapata Corp. v. Maldonado, Del. Supr., 430 A.2d 779, 782 (Del. 1981); DMG, Inc. v. Aegis Corp., Del. Ch., C.A. No. 7619, Brown, C. (June 29, 1984) slip. op. at 9 (App. Ex. D). As Justice Quillen emphasized in Zapata: "the 'business judgment' rule evolved to give recognition and deference to directors' business expertise when expressing their managerial power under § 141(a)." 430 A.2d at 782. See also Aronson v. Lewis, Del. Supr., 473 A.2d 805, 813 (1984). No statutory provision authorizes a board to achieve the same effect as a charter amendment by altering the fundamental power relationships between the board and the stockholders and seizing for the directors control over the destiny of the corporation. No business judgment case holds otherwise. See Norlin Corp. v. Rooney, Pace, Inc. [Current] Fed. Sec. L. Rep. (CCH) ¶ 91,564 at 98,862 (2d Cir. 1984); Holly Sugar Corp. v. Buchsbaum [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,366 at 92,238 (D. Col. 1981); Pacific Realty Trust v. APC Investments, Inc., 651 P.2d 163, 166-67 (Ore. 1982). See Telvest, Inc. v. Olson, supra.

Household would have the Court find that its directors' "good faith" in adopting the Plan is by itself sufficient to make the board's action valid. Whitehead testified that the board believed in good faith that it was better able than the stockholders to decide whether they should accept a tender offer. (Whitehead VI

63) That belief, even in good faith, does not give the board the right to arrogate fundamental stockholder decisions to itself.

The law guarantees stockholders the right to make their own decisions. As Judge Weinfeld put it in Conoco, Inc. v. The Seagram Company Ltd.:

> To be sure, the Board of Directors are under a duty to exercise their best business judgment with respect to any proposal pertaining to corporate affairs, including tender offers. They may be right; they may know what is best for the corporation, but their judgment is not conclusive upon the shareholders. What is sometimes lost sight of in these tender offer controversies is that the shareholders, not the directors, have the right of franchise with respect to the shares owned by them; "stockholders, once informed of the facts, have a right to make their own decisions in matters pertaining to their economic self-interest, whether consonant with or contrary to the advice of others, whether such advice is tendered by management or outsiders or those motivated by self-interest."

517 F.Supp. 1299, 1303 (S.D.N.Y. 1981) (emphasis added; footnote omitted). This overriding stockholder right was underscored by the Second Circuit in its landmark decision in Norlin:

> Our most important duty is to protect the fundamental structure of corporate governance. While the day-to-day affairs of a company are to be managed by its officers under the supervision of directors, decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures.

[Current] Fed. Sec. L. Rep. ¶91,564 at 98,862.* That is no longer the case at Household.

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* See also Indiana National Corp. v. Rich, 712 F.2d 1180, 1185 (7th Cir. 1983) (emphasis in original) ("[M]anagement does not represent the interest of shareholders in relation to who ultimately wins any potential struggle for control . . . ."); Buffalo Forge Co. v. Ogden Corp., 717 F.2d 757, 760 (2d Cir.), cert. denied, 104 S. Ct. 550 (1983) (it is for investors -- not management -- "to decide whether takeover offers were fair and equitable"); Kennecott Corp v. Smith, 637 F.2d 181, 187-88 (3d Cir. 1980) (the Williams Act allows shareholders to "exercise a knowledgeable and unfettered choice" concerning tender offers).

The Rights Plan was designed to make impossible the primary takeover technique feared by the Board, namely, a two-tier takeover made without board approval. (Whitehead VI 67) By making two-tier hostile transactions impossible, the board also effectively eliminated offerors who needed 100 percent ownership to help defray acquisition financing, including, but not limited to, the feared "bustup takeover specialists." Thus, the Board eliminated perfectly lawful takeover techniques. As Troubh put it when asked if it would be desirable to eliminate hostile takeovers:

> That sounds to me like legislation which no board has in its power to do.

(Troubh VIII 61)

Troubh is right. For the Household board's purposes, the only recourse was to Congress for legislation or to the stockholders for a charter amendment. See Conoco Inc. v. The Seagram Co. Ltd., 517 F. Supp. at 1304; Telvest, Inc. v. Olson, supra. Even accepting its good faith, the Household board did not have the power to stop takeovers. Congress, the General Assembly and the Household charter left that decision to the stockholders. In drafting DGCL § 203, Delaware's tender offer law, the Corporation Law Committee of the Delaware State Bar Association rejected regulations which would obstruct or preclude the making of such offers because:

> It was the opinion of the committee that regulation which would have the effect of discouraging tender offers would not be in the best interests of Delaware corporations or their shareholders, in light of the fact that, when a tender offer is made, it is shareholders in the offeree company who benefit most directly and immediately.

A. Berkowitz, Delaware Tender Offer Regulation, 2 Del. J. Corp. Law 373, 374 (1977). See S. Arsht, A History of Delaware Corporation

Law, 1 Del. J. Corp. Law 1, 20 (1976). As the court stated in enforcing Congress' policy and holding the Idaho anti-takeover statute unconstitutional:

> Idaho's statute is preempted, because the market approach to investor protection adopted by Congress and the fiduciary approach adopted by Idaho are incompatible. . . . Congress intended for the investor to evaluate a tender offer; Idaho asks the target company management to make that decision on behalf of the shareholders.

Great Western United Corp. v. Kidwell, 577 F.2d 1256, 1279 (5th Cir. 1978) (footnotes omitted), rev'd on venue grounds sub nom. Leroy v. Great Western United Corp., 443 U.S. 173, 99 S. Ct. 2710 (1979). See also Edgar v. MITE Corp., 457 U.S. 624, 102 S. Ct. 2629 (1982).

Upon analysis, Household's justifications for its Plan are readily seen as objections to legally guaranteed and beneficial transactions. The board was advised that there are newly developed takeover techniques, described as "front end loaded" two-tier "bust-up" takeovers and "junk bond" financing, that render Household more vulnerable to a takeover. (McMahon IX 182-208, 219-21; PX 203 at 2-3) The board was also told that "courts have shown an increasing reluctance to interfere in takeover situations . . . that the state takeover statutes . . . have been declared unconstitutional. . . . [and] that other state statutes, providing for regulatory agency approval of change of control . . . may be unconstitutional. . . ." In addition the board was told "that current legislative proposals at the federal level could strengthen the hand of a potential tender offeror by limiting the defensive options open to a Board of Directors." (PX 203 at 3)

Put succinctly, the board was advised that it should adopt the Rights Plan because Household was vulnerable to a takeover through entirely lawful takeover techniques, that it could not expect help from the courts in defeating legitimate takeover offers and that public policy as expressed by Congress might further limit a board's ability to defeat a takeover.* The fact that courts and legislatures have affirmed certain stockholder rights is a poor justification for their deprivation by unilateral board action.

As for the much maligned bust up takeover, there is no dispute as to its legality or benefits. Higgins put it aptly:

> I mean, the whole question of -- bust-up tender offers or proposals aren't illegitimate, you know, acts and highly financed takeover vehicles, you know; nothing in the world wrong with that. And if a deal is done at a fair price, the fact that the guy has got to sell the whole shop to pay for his debts and make a profit, there is nothing wrong with that.

(Higgins VII 218-19) Strikingly absent from defendants' proof is any evidence that any front end loaded two-tier or bust-up offer for any company was ever completed at an unfair price. To the contrary, it was the defense witnesses Higgins and Tower who testified to

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* Another alleged justification for the Rights Plan -- that it gives the board the ability to prevent "greenmail" -- is also spurious. The theoretical threat of "greenmail" hardly justifies the radical and sweeping deterrent effects of the Plan on all hostile offers and the consequent deprivation of economic benefits and rights of stockholders. A charter amendment prohibiting payment of greenmail would have solved this as yet hypothetical problem without eviscerating stockholders' rights. Cf. San Francisco Real Estate Investors v. Real Estate Investment Trust of America, 701 F.2d 1000, 1005-06 (1st Cir. 1983); Pacific Realty Trust v. APC Investments, Inc., 651 P.2d 163, 167 (Ore. 1982). Moreover, the most obvious way to cope with the hypothetical "greenmailer" is to not pay him off. Whitehead recognized this. (Whitehead VI 59) Given such an alternative, it is unconscionable to ask a court of equity to sanction the significant infringement of stockholder rights to prevent that which the board can prevent by simply saying "No." See Chock Full O'Nuts v. Finkelstein, 548 F. Supp. 212, 219 (S.D.N.Y. 1982).

their personal involvement in front end loaded or bust-up offers and who, along with Whitehead and Clark, conceded that the form of the offer is irrelevant as long as the "deal is done at a fair price." (Higgins VII 218, 179-80; Whitehead VI 67-68; Tower X 79-80; Clark VI 253)

The problem Household perceived was not that illegal or inadequate tender offers might be successfully made for the company. Rather, it was that these new techniques increased the number of prospective offerors for Household and made an offer more likely. (McMahon IX 196-201; Clark V 261-62) Household management's actions and the evidence presented show that management was dead set against offers.*

While the board might prefer to be the final arbiter on tender offers, institutional stockholders, who hold over 50% of Household shares, would, as Whitehead conceded, "prefer to make that decision themselves." (Whitehead VI 65; PX 41 at 3)** So would the rest of Household's stockholders. Higgins said the obvious: stockholders "are always interested in getting premiums for their shares. . . [P]eople buy stocks to make money. I mean, it is America." (Higgins VII 156; 84) Whitehead urged, however, that the Board was justified in taking the decision from all stockholders because there were "small stockholders . . . who are less equipped

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* PX 59 ("We have absolutely no interest in talking about an LBO or any other change in current ownership of HI."); Whitehead VI 43-44; Higgins VII 153-54; Fahey Dep. 148-49.

** Wilcox testified that "[m]ost companies have a majority of their shares held by professional investors, and the individual holders represent a minority." (Wilcox IX 16) to determine whether a particular premium is fair or not in the long-term interests of the stockholders." (Whitehead VI 65)

Similar arguments have received short shrift from the courts:

> Counsel for Conoco. . . urged that in this frenetic period of billion dollar tender offers . . . there is need to protect the long-term investment shareholder and the "widows and orphans" who derive income from their holdings against the predatory speculators in the stock. If there are such evils in a free-trading stock market, the correction rests with the Congress and not with the judiciary.

Conoco v. The Seagram Co., Ltd., 517 F. Supp. at 1304.

The consequences to our system of corporate governance would be extraordinary if defendants' alleged good faith belief that they were acting in the interests of stockholders in adopting the Rights Plan were alone sufficient to validate it. If the mere belief of a board of directors that it can better exercise rights heretofore the exclusive property of stockholders furnishes sufficient basis for arrogating those rights and then shielding the decision from scrutiny under the claim of business judgment, it is difficult to imagine any stockholder right that would be secure or any entrenchment device that could not be so justified.

B. Even If The Board Were Found To Have Acted Within Its Powers, The Rights Plan Should Be Voided As Unreasonable And Unfair To Stockholders

The Rights Plan alters and abridges fundamental stockholder rights and it vests in the directors substantial new powers which strengthen and maintain their control of the company. As such, even if it were authorized by statute, the board's action would not be entitled to a presumption of validity under the business judgment rule. Rather, the burden was on the board to demonstrate that the Plan was fair and reasonable to stockholders. The board failed to carry that burden.

This Court, in a decision relied on by defendants,* recently held that where board action even partially infringes stockholder rights, the act is not presumptively valid but must be subjected to "careful scrutiny" to ensure that it was reasonable and fair to stockholders. Thompson v. Enstar Corp., Del. Ch., C.A. Nos. 7641, 7643, Hartnett, V.C. (July 5, 1984) revised (August 16, 1984) (App. Ex. E).

In Thompson v. Enstar, the Enstar board widely advertised that Enstar was for sale. It accepted the only firm offer, which was conditioned upon the creation of a voting trust lockup arrangement ceding the offeror voting control over Enstar's most valuable asset. In analyzing the legality of this arrangement, Vice Chancellor Hartnett held:

> Lock-up agreements have been justifiably criticized. They often prevent open bidding for assets which, of course, is usually in the best interests of the shareholders. They also often infringe on the voting rights of shareholders. They therefore must be given careful scrutiny by a court to see if under all the facts and circumstances existing in a particular case they are fair to the shareholders.

Id. at 11 (emphasis added).

Vice Chancellor Hartnett carefully scrutinized all the relevant facts before he concluded that, although it was a "close call," the lockup arrangement was fair to the stockholders and that the directors had acted reasonably. The Court found that the Enstar

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* Defendants' Pre-Trial Memorandum at 60, 63, 69.

board had only one bona fide offer; the offer was contingent upon the adoption of the lockup provisions; there was a deadline for accepting the offer; the offer was deemed fair by the Enstar investment bankers and was likely much higher than what could be obtained on liquidation; and, if the offer were rejected, the Enstar stock price might plummet. Id. at 12.

Here, unlike in Enstar, there is nothing speculative about the impact of the Rights Plan on fundamental stockholder property rights. The Plan prevents stockholders from receiving or accepting premium offers for their shares without board approval and it interferes with their ability to buy shares or join with others to oust management through a proxy fight. Moreover, unlike in Enstar, there has been no attempt to show that the deprivation of those rights is fair to stockholders. Here stockholders have not been provided with a takeover bid at a price found to be fair. Rather, the purpose of the Rights Plan is to ensure that the Household stockholders do not receive a hostile takeover bid. Here, unlike the independent directors in Enstar, the directors are not promoting a transaction which will put them out-of-office. Rather, they are substantially increasing their ability to maintain their control over the company in the face of strong stockholder opposition. (PX 251-54, 257, 260, 312; Hayden II 122, 129-30)

The Supreme Court has held that when directors use corporate powers to preserve their control, they become interested directors. Bennett v. Propp, Del. Supr., 187 A.2d 405, 408 (1962). In Good v. Texaco, Inc., Del. Ch., C.A. No. 7501, Brown, C. (May 14, 1984) (App. Ex. F), Chancellor Brown declined to dismiss a derivative action against Texaco's directors for failure to make a demand. The challenged transaction involved a repurchase by Texaco of 9.7% of its shares from the Bass group. The Court found that the transaction was structured so that the board of directors would be able to vote approximately half of the Bass Texaco shares (or 5%) for several years. Chancellor Brown held:

> Since this power to vote the shares of the Bass defendants hereafter is alleged to be a power acquired for the board of directors itself, it follows that all board members are necessarily interested personally in the transaction that they are alleged to have wrongfully approved. Under these circumstances it seems without question that the defendant directors have such an interest as would deprive them of the protection of the business judgment rule at this threshold stage of the proceedings.

Slip op. at 11 (emphasis added).

Similarly, in Norlin Corp. v. Rooney, Pace, Inc., supra, the Second Circuit applying New York law held that directors, who vested in themselves voting power over shares issued to an ESOP and a subsidiary, were interested. Id. at pp. 98,868-869. The court held that:

> Once a prima facie showing is made that directors have a self-interest in a particular corporate transaction, the burden shifts to them to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders.

Id. at p. 98,867. See Treadway Companies Inc. v. Care Corp., 638 F.2d 357, 380 (2d Cir. 1980) (emphasis added) (New Jersey law):

> In nearly all of the cases treating stock transactions intended to affect control, the directors who approved the transaction have had a real and obvious interest in it: their interest in retaining or strengthening their control of the corporation. It is this interest which causes the burden of proof to be shifted to the directors to demonstrate the propriety of the transactions. See Bennett v. Propp, 41 Del.Ch.14, 187 A.2d 405, 409 (1962) . . . . Petty v. Penntech Papers, Inc., 347 A.2d 140, 143 (Del. Ch. 1975).

The Rights Plan was adopted for the sole purpose of strengthening the directors' control over Household.* It was adopted by Household as part of concerted efforts by Household and its anti-raid advisory team. Its adoption was motivated by a fear that Household was vulnerable to a takeover by a large number of potential acquirors. (McMahon IX 196-201, 219-21) The board was reminded of the AVCO takeover attempt and told that Household was particularly vulnerable because it was in the same industry. (PX 203 at 3) Board members were told about the Bachenheimer approach and were advised, surreptitiously, about the leveraged buy out discussions between Clark and Moran. (Whitehead VI 7-9, 48-50; Clark V 249-51) The Board acted because it feared that a takeover was imminent.

> Q. And Mr. Clark told you, did he not, that Mr. Moran might be preparing an unfriendly tender offer for the company, and therefore he felt it was essential that the board not follow your advice, and that it was urgent that the action be taken that day, did he not?
>
> A. Yes.
>
> * * *
>
> Q. Other directors also told you that it was essential, or urgent, that this rights plan be adopted on August 14th because Mr. Moran was planning a hostile takeover bid for the company, did they not?
>
> A. They told me that they thought Mr. Moran might be preparing a hostile takeover bid. I'm sure that no one had knowledge that that was a fact. And they told me of other factors that caused the concern that led them to feel that action was urgent.

(Whitehead VI 48-50)

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* The defendants' own letter to stockholders seeking to justify the Plan admitted that it "should deter any attempt to acquire your company in a manner or on terms not approved by the Board." (PX 211, at 2)

As Clark emphasized, the Rights Plan was designed to give the directors the power to decide whether a tender offer could be made based on the directors' decision as to whether the offeror's terms were acceptable:

> Well, I think perhaps the most important feature of the plan to me -- and I believe other board members shared this opinion. I have discussed it with them -- is the ability of the board to redeem the rights in the event any offer, even if it were a two-tier offer. If the terms of it were acceptable to the board, this plan gives the board total flexibility to redeem those rights.

(Clark V 238) Far more than the directors in Good, the Household directors through their own acts have given themselves the ability to exercise extraordinary new powers affecting their control of the company. A decision by the board not to redeem the Rights will make impractical any hostile offer and the consequent change in control of Household. The Texaco directors' ability to vote 5 percent of the company's shares for a limited period had a much lesser impact on control.

The directors in Norlin found themselves in a much more difficult position than the Household directors. They faced an immediate takeover attempt. Like the Household board they took extreme steps to give themselves the power to stop takeovers, making themselves interested directors. They argued that, despite their interest, their actions were fair because the particular takeover they were seeking to avoid was, in their business judgment, unfair. The court rejected that defense:

> But even if Norlin's fears were legitimate, that would only help to justify the board's determination that an

anticipated takeover attempt should be opposed as not in the corporation's best interest. It has no relevance to our evaluation whether the actions taken by the board in response to that decision were fair and reasonable . . . . Again, this concern, however real it may be, does not help to establish the independent legitimacy of the actions taken by the board to counter a perceived threat.

Id. at 98,869 (emphasis added)

The Norlin directors also sought to justify their acts on the ground that "the board needed to consolidate control to 'buy' time to explore financial alternatives." Norlin asserted that the stockholders would be the beneficiaries. A remarkably similar argument was made in defendants' pre-trial memorandum at 41-42 and by Clark, Fahey and Troubh. (Clark Dep. 62; Troubh VIII 62-66; Fahey Dep. 54-57) The Norlin court disposed of that argument summarily in phrases echoing Judge Weinfeld in Conoco:

> This argument stands our prior cases on their heads . . . . We have never given the slightest indication that we would sanction a board decision to lock up voting power by any means, for as long as the directors deem necessary, prior to making the decisions that will determine a corporation's destiny. Were we to countenance that, we would in effect be approving a wholesale wresting of corporate power from the hands of the shareholders, to whom it is entrusted by statute, and into the hands of the officers and directors.

Id. (emphasis added)

The stockholder owners of the corporation are entitled to determine for themselves who should manage their company and whether their shares and their company should be sold. When they are dispossessed of the right to make those decisions, they are dispossessed of fundamental property rights. That is neither fair nor reasonable to stockholders and, for that reason, the Rights Plan must be voided.

C. There Is No Precedent For Application Of The Business Judgment Rule To Sham Actions That Defeat Fundamental Stockholder Rights

The Plan cannot be justified by reference to any business judgment case cited by the defendants. The discussion of defensive devices in those cases is irrelevant to this Court's analysis of the Plan, for three reasons.

First, in every case, the board made a necessary managerial response related to a specific takeover attempt. Each board was obliged to make and made an evaluation of the desirability and fairness of the specific offer and weighed the detriments of the contemplated defensive action against the benefits of an alternative course. The Household board did not reach a business judgment with respect to the merits of a particular takeover attempt. It made a sweeping judgment on the desirability as a matter of public policy of boards of directors passing on takeovers. The business judgment rule does not apply to such actions.

Second, in every case the board action had legal and economic significance wholly apart from any anti-takeover effect. Each case involved a transaction of economic substance.* In each case, the corporation exchanged something of material value (e.g., cash, authorized but unissued or treasury securities, or assets) for some-

* The sole exception -- the transaction attacked in Pogostin v. Rice, Del. Supr., No. 255, 1983, Moore, J. (June 21, 1984) (App. Ex. G) -- lacks economic substance only because all that was at issue in Pogostin was a statement by the board that an offer was unfair. Because the offeror had voluntarily conditioned its offer on board approval, no other act was required to deter the inadequate offer.

thing else, also of material value (e.g., cash, the company's own shares, securities of another corporation, or real assets). See Crouse-Hinds Co. v. InterNorth, Inc., 634 F.2d 690, 703 (2d Cir. 1980) (exchange offer between Crouse-Hinds and Belden Corp. in support of arms' length merger agreement negotiated prior to InterNorth hostile tender offer); Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. 623, 625 (D. Md. 1982) (counter-tender by Marietta for Bendix at a price conceded by Bendix to be advantageous to Marietta); Carter Hawley Hale Stores, Inc. v. The Limited, Inc., C.A. No. 84-2200-AWT (C.D. Cal. April 17, 1984) (App. Ex. H) and S.E.C. v. Carter Hawley Hale Stores, Inc., 587 F. Supp. 1248 (C.D. Cal. 1984) (repurchase of its shares by Carter Hawley in open market at market price; issuance of preferred stock in return for $300 million); Pogo Producing Co. v. Northwest Industries, Inc., No. H-83-2667 (S.D. Tex. May 24, 1983) slip op. at 2-3 (App. Ex. I) (self-tender by Pogo at same price as Northwest's hostile tender); Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.) cert. denied, 454 U.S. 1092, 102 S.Ct. 658 (1981) (purchase of six major stores by Marshall Field found by lower court not to be "unsound business ventures," 486 F. Supp. 1168, 1194 (1980)); Northwest Industries, Inc. v. B.F. Goodrich Co., 301 F. Supp. 706, 709 (N.D. Ill. 1969) (purchase by Goodrich of synthetic rubber venture resulting in substantially increased cash flow and material increase in earnings of Goodrich); GM Sub Corp. v. Liggett Group, Inc., Del. Ch., C.A. No. 6155, Brown, C. (April 25, 1980), slip op. at 4 (App. Ex. J) (Liggett's sale of "crown jewel" asset for twenty two times earnings compared with tender offer price of eight times earnings); Whittaker Corp. v.

Edgar, 535 F. Supp. 933, 938, 941-42 (N.D. Ill. 1982) aff'd, Nos. 82-1305, 82-1307 (7th Cir. Mar. 5, 1984) (in effect, sale by Brunswick Corp. of major asset, valued by hostile offeror Whittaker at $350 million, for approximately $420 million); Buffalo Forge Corp. v. Ogden Corp., 555 F. Supp. 892, 905 (W.D.N.Y.), aff'd, 717 F.2d 757 (2d Cir.), cert. denied, 104 St. 550 (1983) (Buffalo Forge's sale of treasury stock at price exceeding initial tender offer price to obtain a higher bid); Heit v. Baird, 567 F.2d 1157, 1161-62 (1st Cir. 1977) (Baird Atomic's issuance of block of new stock to three directors at market price "may have served any number of entirely proper corporate purposes"); Treadway Companies, Inc. v. Care Corp., 638 F.2d 357, 380-84 (2d Cir. 1980) (Treadway issued block of authorized but unissued common stock at market price); Gearhart Industries, Inc. v. Smith International, Inc., 741 F.2d 707, 722-24 (5th Cir. 1984) (Gearhart's issuance of warrants with sale of debentures for approximately $70 million as necessary part of financing package, terms of which were negotiated at arms' length).

Each transaction addressed purposes contemplated by the statute which gave it validity. For example, the issuance of treasury and authorized but unissued stock is validated by DGCL §§ 160 and 161 and similar statutes in other jurisdictions as a means of generating capital for the corporation. That purpose was directly served by the stock issues in Crouse-Hinds, Buffalo Forge, Treadway, Heit v. Baird and Gearhart. In each case, the corporation was found to have obtained significant consideration for the securities.

The power of the board to purchase or sell real and personal property conferred by DGCL § 122(4) and comparable statutes in other jurisdictions is intended to provide flexibility in asset reallocation for maximization of stockholder value. That purpose was handsomely served in the asset purchase and sale cases cited by defendants. In GM Sub, for example, a subsidiary was sold for 22 times its earnings in a transaction said to have enhanced Liggett's overall position. Slip op. at 4. Repurchase programs and self-tenders like those in Carter Hawley and Pogo are authorized by DGCL § 160 and comparable statutes, which recognize that purchase of a corporation's own shares can benefit the remaining stockholders.

In each case, the terms and conditions of the transaction were dictated in part by considerations outside the control of the board. In the case of asset sales and purchases, and stock issues, sales and exchanges, the terms were negotiated at arms' length with third parties. See, e.g., GM Sub, slip op. at 4; Buffalo Forge, 555 F. Supp. at 900; Crouse-Hinds, 634 F.2d at 692, 695; Gearhart Industries, Inc. v. Smith International, Inc. [current] Fed. Sec. L. Rep. (CCH) ¶ 91,852 at 98,977 (N.D. Tex.) aff'd in part rev'd in part, 741 F.2d 707 (5th Cir. 1984); Northwest Industries, 301 F. Supp. at 709; Treadway, 638 F.2d at 366. In the case of the Carter Hawley repurchase program, Pogo self-tender and Marietta counter tender, the terms were dictated by market forces.

In contrast, the Plan has no economic substance. It derives no authority from the statutes which purportedly give it validity. Its terms were conjured up unilaterally by the Household board. It is a sham device, within the Court's definition of the term in Telvest.

Third, none of the defensive devices in the cases cited by defendants had the far-reaching impact on fundamental stockholder rights of the Plan. In not a single case did the device block the hostile takeover to which it was specifically addressed.* In several of the cases cited by defendants the hostile offeror went on to acquire the target company.

In Buffalo Forge, the Ampco-Pittsburgh Corporation succeeded in acquiring Buffalo Forge, notwithstanding Buffalo Forge's sale of 425,000 treasury shares to white knight Ogden Corporation in response to Ampco's initial offer. 555 F. Supp. at 895, 906. The sale by Liggett of its purported crown jewel did not deter GM Sub from purchasing Liggett. Rothchild International Corp. v. Liggett Group, Inc., Del. Ch., C.A. No. 6239, Brown, V.C. (July 14, 1981), slip op. at 1. (App. Ex. K). Martin Marietta's counter-tender did

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* In Panter v. Marshall Field & Co., 486 F.Supp. 1168, 4184 (N.D. Ill. 1980), aff'd, 646 F.2d 271 (7th Cir.) cert denied, 454 U.S. 1092, 102 S.Ct. 658 (1981) the only case in which the putative acquiror abandoned its offer, the offeror Carter Hawley gave up the offer because of its "doubt about Marshall Field's earning potential," not any antitrust implication of Marshall Field's acquisitions. Moreover, the trial court found that there were independent reasons for the acquisitions. Marshall Field had been considering them for several years before it became aware of the Carter Hawley offer, id. at 1182, and believed that the Carter Hawley offer was illegal under the antitrust laws without the allegedly defensive acquisitions. Id. at 1180. Where there are no such independent grounds, courts have not hesitated to strike down acquisitions made purely for antitrust purposes. See, e.g., Royal Industries, Inc. v. Monogram Industries, Inc., (CCH) [76-77 Binder] Fed. Sec. L. Rep. ¶ 95,863 at 91,131 (C.D. Cal. 1976).

In Heit and Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980), cert. denied, 450 U.S. 999, 101 S.Ct. 1704 (1981) also cited by defendants, there was no outstanding offer to be abandoned. In Johnson, in fact, the board majority held voting control of the company; there could be no takeover without their consent.

not deter the Bendix Corporation from purchasing a majority interest in Marietta pursuant to its tender offer. Martin Marietta Corp. v. Bendix Corp., 549 F. Supp. at 625. See also DMG, Inc. v. Aegis Corp., Del. Ch., C.A. No. 7619, Brown, C. (June 29, 1984) (lock-up option granted to DMG to acquire Aegis subsidiary did not prevent Minstar, Inc. from acquiring Aegis by tender offer) (App. Ex. D).

Defendants argue that some of the defensive actions in their cases affected stockholder rights as drastically as the Plan because they fundamentally altered the corporation's asset structure and thereby reduced its value. As noted above, the cases cited by defendants are to the cortrary. Had the transactions caused an unfair impact on the target company or its stockholders, the transaction would have been enjoined. See Gimbel v. Signal Companies, Inc., Del. Ch., 316 A.2d 599, aff'd, Del. Supr. 316 A.2d 619 (1974). No such injunction was issued in any of the cases cited by defendants.

In addition to the cases cited above in which the hostile offeror completed its acquisition notwithstanding the target's defensive actions, other cases cited by defendants demonstrate that these defensive actions did not deter a continuation of the takeover effort. See, e.g., Pogo, slip op. at 3 (Pogo's self-tender did not deter Northwest and Sedco, Inc. from proceeding with their tender offer for Pogo; ultimate failure of offer was due to lack of tenders, not to abandonment of offer (App. Ex. L)); S.E.C. v. Carter Hawley Hale Stores, Inc., 587 F. Supp. 1248, 1251 (C.D. Cal. 1984) (The Limited continued its tender at a higher price after Carter Hawley commenced repurchase program; far from deterring the offer, the action had the effect of increasing the offering price); Crouse-Hinds, 634 F.2d at 690 (InterNorth consummated its offer after completion of Belden Crouse-Hinds merger). Particularly instructive is the court's comment on the effect of Buffalo Forge's defensive action:

> [N]either Ogden nor Buffalo Forge intended the sale of the treasury shares . . . to foreclose additional bidding, either by Ampco or third parties. And, in fact, the sale of the treasury shares did not foreclose competitive bidding, but rather stimulated it. 555 F. Supp. at 906.

Each of defendants' cases treats a board's exercise of managerial judgment with respect to a specific business problem. None of the actions taken in those cases was a sham within the meaning of Telvest. None of the actions approved in those cases imposed any structural deterrent to hostile takeovers or interfered with the stockholders' right of unrestricted alienability. Since the defensive actions in these cases did not have effects comparable to those of the Plan, they cannot serve as precedent for the application of the standards of the business judgment rule in this Court's review of the Plan.*

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* Equally puzzling were defendants' extended references during trial to the so-called "Poison Pill" preferred stock issues of Lenox, Enstar and Superior Oil, none of which had a two-for-one flip-over provision. Since none of those provisions has ever been approved by any court, they cannot provide a precedent for application of the business judgment rule to the Plan. In addition, the "Poison Pill" aspect of certain of those devices could be circumvented by announcing an offer to acquire the remainder of the stock within a specified period after acquisition of a triggering block. Thus, unlike the Plan, any deterrent effect on takeovers could be avoided by an acquiror without the need for board approval. In any case, defendants' justification of the Plan by reference to a device which their own expert called a "suicide" or "kamikaze device," (Troubh VIII 51) is less than compelling.

D. The Board Did Not Exercise An Informed Business Judgment

No court, under any standard of review, will uphold uninformed and misinformed decisions of a board of directors. Even if the business judgment doctrine were applicable here, therefore, it would not validate the adoption of the Plan. "[T]o invoke the rule's protection, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them." Aronson v. Lewis, Del. Supr., 473 A.2d 805, 812 (1984) (emphasis added); accord Gimbel v. Signal Companies, Inc., Del. Ch., 316 A.2d 599, aff'd, Del. Supr. 316 A.2d 619 (1974); Kaplan v. Centex Corp., Del. Ch., 284 A.2d 119 (1971); Lutz v. Boas, Del. Ch., 171 A.2d 381 (1961); Andresen v. Bucalo, Del. Ch., C.A. No. 6372, Hartnett, V.C. (March 14, 1984) (App. Ex. M) (board's business decision not protected under the business judgment rule because the board "did not exercise any independent or informed judgment as to the fairness of the agreements to the corporation." Slip op. at 8)

The board did not know what it adopted. The board was advised that the Plan would encourage offerors to channel their offers into cash offers for all of the shares. The evidence, much of it from the defendants' witnesses, establishes that such offers are imprudent and impractical. The board was advised that the Plan does not impede, restrict or make more expensive a proxy contest. The evidence established that proxy contests can henceforth only be waged on terms that seriously handicap potential insurgents. Acquisitions of minority positions which could threaten the board's control are effectively limited to less than 20 percent; yet the board was not so advised. These areas of misinformation go to the heart of what the board thought it was doing.

The Plan was designed to be intentionally confusing so that potential offerors, their counsel and investment bankers would be deterred by their inability to understand its ramifications and effects. (PX 183 at 1) The Household directors, who only had an incomplete three page summary of the Plan and, at most, a two hour oral presentation, could not have been expected to master it sufficiently to exercise an informed judgment. Hull, Household's general counsel, one of the "experts" who briefed the board, gave testimony which was materially inaccurate in describing one of its key aspects.*

1. The Board Was Given Inadequate And <u>Misleading Information About The Plan</u>

The board was given summary, inadequate and misleading information about the mechanics and effects of the Plan. As a result, the board members' knowledge of both the mechanics and effects of the Plan was inaccurate and incomplete.

Before the August 14 board meeting, the board received a three page memorandum (PX 183) describing the Plan. The last page purports to contain a summary of the principal features of the Rights. That summary omits key aspects of the Rights. For example, it describes the 20% acquisition trigger as an acquisition by a

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* Hull testified on deposition that the formation of a group holding more than 20 percent of Household's stock would not affect the board's ability to redeem the Rights. (Hull Dep. 34)

person or group of "20% or more of the Company's common stock." (PX 183 at 3) As a result, a number of directors only understood the 20% trigger to apply to actual share purchases. (Evans Dep. 40; Kartalia Dep. 68-69; Hendry Dep. 54-55; Tait Dep. 44-45; Osler Dep. 55; <u>see</u> <u>also</u> Hull Dep. 34) The board had not been told that the Rights Agreement defined a 20% acquisition to include:

> (i) the acquisition of any right to acquire or right to vote shares of the company's common stock pursuant to any agreement, arrangement or understanding, or
>
> (ii) the simple formation of a group of stockholders "for the purpose of acquiring, holding, voting or disposing of any securities of the Company."

(PX 204 at 2-3) These provisions impair the ability of Household stockholders to conduct a proxy contest for control. Knowledge of these provisions is essential to a proper understanding of the function of the Rights as an anti-takeover device. Defense expert Troubh testified that "one of the important questions" for a board adopting a "poison pill" would be the beneficial ownership definitions which trigger the device. (Troubh VIII 77)

Household says that it would have been unusual and unnecessary for the directors to have read the actual Rights Agreement. (<u>See</u>, <u>e.g.</u>, Clark Dep. 96) The board was left to rely, instead, on a cursory summary in the board book and on counsel's oral exposition at the meeting. Those sources of information were inadequate. When asked a question about the impact of the 20% trigger on the formation of a group, one director candidly admitted "I think I would have to read the rights agreement before I understood that." (Osler Dep. 55) A seven page summary of the Rights Agreement prepared at least three days in advance of the board meeting explained that a

20% acquisition -- the central event in the operation of the Plan -- included both (1) beneficial ownership of and (2) the right to acquire or vote 20% of Household's common stock. (PX 178 at 1) The summary was not furnished to the directors. (Clark Dep. 144-45) Since the oral presentations to the board added nothing to the three page memorandum's description of these mechanics, no information on the subject was available to the board.

The members of the board also were not accurately advised as to the practical effects of the Plan. Rauch testified that the Plan was "a very equitable plan in that it . . . left the field open for cash tender offers without limitation to all of the stockholders." (Rauch Dep. 59) Rauch, a lawyer, also said that the Plan does not discourage or deter anyone from submitting an all cash offer directly to stockholders. (Rauch Dep. 82; see also Brennan Dep. 86 and 139; Kartalia Dep. 97-99) Osler testified repeatedly that the Plan has absolutely no impact on an offer for 100 percent of the shares:

> A. What I am saying is that a hundred percent takeover, there is -- rights is no deterrent.
>
> Q. Has no effect at all; right?
>
> A. That's my belief.

(Osler Dep. 148, see also 35, 36 and 101)

The witnesses made these basic errors because they believed, as they had been told, that a cash offer for all the shares conditioned on the tender of a high minimum number of shares would succeed.

> [A]s we have been told by Goldman Sachs, historically, 95 to 98 percent of the stock is tendered generally in all-or-any type of a transaction.

(Brennan Dep. 92) Thus, Brennan and others took as fact that 95 to 98 percent of the Household common stock would be tendered to an any-or-all offer. (Upton Dep. 55; Kartalia Dep. 98-99) Based on the cited example, the directors concluded that the Plan does not deter 100 percent takeovers. (Osler Dep. 101-05; PX 203 at 9)*

The board members were told that the Plan "in no way restricts, inhibits or makes more expensive a proxy contest to elect a new Board of Directors." (PX 203 at 8) The directors believed this to be true. (Clark Dep. 91-92; Kartalia Dep. 89-90; Hendry Dep. 62-63; Tait Dep. 49-50; see also Hull Dep. 32-33) Rauch said that one of the most equitable features of the Plan is that "It does not disturb the shareholders' rights in any way," (Rauch 81) and that it does "not disturb the voting rights of the common shareholders." (Rauch 59)

Contrary to the explicit advice furnished to the board, the evidence adduced at trial established that the Plan:

- Makes 100% hostile acquisition attempts impractical and imprudent;
- Effectively limits stock ownership by individuals or groups to 19.9% of the common shares outstanding; and
- Inhibits stockholders from engaging in proxy contests.

These misrepresentations do not relate to trivial matters. Each one goes directly to the heart of what the board thought it was

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* The board was unaware that high minimum offers are "self defeating" (Higgins VII 185) or that no tender offer had ever been made with a 90 to 95 percent minimum. (Osler Dep. 104) Thus, they had no reason to question what they were told at the board meeting.

doing. Directors testified they would not have voted as they did had they known of the Plan's effects. (Hendry Dep. 62-63; Tait Dep. 50-51) Others said that the absence of such effects was a significant factor in their vote. (Clark Dep. 91-92; Rauch Dep. 81) Their action in approving the Plan, thus, was uninformed and voidable. Aronson v. Lewis, supra.

2. One-Sided Presentation

In addition to its clear errors of fact, the board presentation was one-sided and incomplete. The most significant omission was the information which demonstrated the financial benefits to shareholders resulting from hostile offers, including the two-tier or bust-up variety.

> Q. [Did you tell them] how much the premiums would be in these takeovers that were taking place that you were identifying, how much money they could get for their stockholders?
>
> A. (McMahon) Of course not. That was not the point of my presentation. (McMahon IX 224-25)

McMahon did not provide the board Goldman Sachs' view that two-tier offers and "bust ups" are often fair to stockholders.* Instead the presentation used emotion-charged epithets such as "bust up" and "bootstrap" and "junk bonds."** The board was not told of the positive aspects of these acquisition techniques or of the enormous benefits they bring to stockholders. McMahon had only one purpose

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* See PX 203; Fahey Dep. 91-92 (two-tier can be fair to stockholders); Fahey Dep. 96 ("bust-up" offer can be attractive).

** At one point some entire chronological period was referred to as "an era of bust-up takeovers." (PX 203 at 9) in addressing the board. He gave his "standard speech," his "anti-raid pitch," to convince the board that Household was vulnerable to a takeover. (McMahon IX 207, 219-21 and 223-24; Osler Dep. 32)

The board was told two-tier offers were bad for stockholders. (PX 203 at 3) They were not told that premiums in two-tier offers are comparable to those obtained in other offers (PX 333 at 2) or that many investment banking firms -- including Goldman Sachs -- have frequently given opinions that the blended premiums in two-tier offers are fair to stockholders. See, e.g., PX 346 at B-1-2; 348 at App. III, 349 at App. D-F; 350 at Exh. B.

The board was told that "bust-ups" tend "to disrupt a company and to weaken its financial stability. . . ." (PX 203 at 3) The Board was not told that

> the whole question of -- bust-up tender offers or proposals aren't illegitimate, you know, acts and highly financed takeover vehicles, you know; nothing in the world wrong with that. And if a deal is done at a fair price, the fact that the guy has got to sell the whole shop to pay for his debts and make a profit, there is nothing wrong with that. (Higgins VII 218-19)

The Board was also not told that "bust-ups" produce financial bonanzas for stockholders. As to two of the examples used by special counsel (PX 203 at 9) to illustrate the evils of "bust-ups" -- Gulf and Getty -- Higgins testified that the offers were very fair to stockholders. (Higgins VII 174-80; PX 203 at 9) Higgins' firm, Salomon Brothers, gave opinions to the Gulf board and to a major Getty shareholder that those offers were fair. He testified that, in rendering those opinions, his firm had not been "concerned in the slightest that those purchasers may sell major parts of the company." (Higgins VII 180)

Key features of the Plan were left unexplained. The board was not informed of and did not discuss the serious consequences to the corporation from a triggering of the Rights or the Board's loss of its power to redeem the Rights. (Clark VI 218-20; Evans Dep. 71; Upton Dep. 44-45) The directors also did not discuss the rationale for choosing 20 and 30 percent as the level for triggering events (McMahon IX 236; Tower X 87; Osler Dep. 51), or for including any tender offer trigger at all in the Plan. (Evans Dep. 83-84 and 88; Brennan Dep. 107-08) No one asked about or was told why the Rights diluted an acquiror by a factor of two to one. (Osler Dep. 18; Flynn Dep. 83-84) As Osler said "I obviously don't know the answer to that because I didn't make up the plan." (Osler Dep. 18) Even McMahon did not know the derivation of the 20 and 30 percent triggers. (McMahon IX 235-36)

Finally, special counsel told the members of the board that it was within their "business judgment" "and in no way constitutes management entrenchment" (PX 203 at 8) for them to adopt the Plan. Delaware counsel was affirmatively misrepresented to have rendered an opinion that adoption of the Plan was within the business judgment of the board. (PX 237, 238) The directors said that they relied on the opinion of Delaware counsel to that effect. (See, e.g., Upton 23 and 135; James 146-47; Clark 51-52; Brennan 125-26; Osler 8-9; Rasmussen 61-63)

In Gimbel v. Signal Companies, Inc., supra, the court set forth a number of factors that bear on the question of whether the board made an informed judgment or acted imprudently: a) whether the board knew and considered the effects of its action; b) whether it was necessary for the board to act as hastily as it did; and c) whether the board considered requests that the vote be delayed. Similar facts were considered by the court in Weinberger v. United Financial Corp., Del. Ch., C.A. No. 5915, Hartnett, V.C. (Oct. 13, 1983). (App. Ex. N) These factors compel the conclusion that even if the business judgment rule were available to validate this transaction, the board's actions are not entitled to its special protection. The board was hopelessly uninformed as to the mechanics and proven effects of the Plan. The board acted hastily where no need for haste existed and disregarded strong pleas from two of its members (Messrs. Whitehead and Moran) to delay consideration.*

The evidence establishes that the Plan actually passed by the board was very different from the Plan the Board intended to adopt. Far more seriously confused and rushed than the board in Gimbel, the Household board transferred fundamental rights from the stockholders to the board without stockholder consent in a two hour board session after receiving confusing, incomplete, misleading and emotionally charged advice. A proper regard for the integrity of the procedures of corporate governance requires that the result must not be allowed to stand.

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* The evidence shows that the reason the directors did not accept Whitehead's recommendation that consideration of the Plan be deferred was Clark's statements to the board on August 13 concerning "Mr. Moran's activities." (Osler Dep. 108-09) Nevertheless, although Moran was present at the board meeting and had not been invited to the meetings on August 13, no director asked Moran whether Clark's concern had any basis. (Evans Dep. 45; Whitehead VI 51) Whitehead conceded at trial that asking Moran about his intentions would have been a sensible way to determine whether there was a need for such haste. (Whitehead VI 51)

CONCLUSION

For all of the foregoing reasons, plaintiffs respectfully request that the Court enter judgment against defendants declaring the Rights Plan invalid and unlawful and granting such other and further relief as is just and proper under the circumstances.

DATED: November 2, 1984

Respectfully submitted,

SKADDEN, ARPS, SLATE, MEAGHER & FLOM

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