IN THE

SUPREME COURT OF THE STATE OF DELAWARE

JOHN A. MORAN and THE DYSON-KISSNER-MORAN CORPORATION,	)	
Plaintiffs Below-Appellants,	)	
and	)	No. 37, 1985
GRETL GOLTER,	)	
Plaintiff Intervenor Below-Appellant,	)	
v.	)	Appeal from Judgment of the Court of Chancery in and for New Castle County in C.A. No. 7730
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 Below-Appellees.	)	

OPENING BRIEF OF APPELLANTS JOHN A. MORAN AND THE DYSON-KISSNER-MORAN CORPORATION

SKADDEN, ARPS, SLATE, MEAGHER & FLOM
One Rodney Square
P.O. Box 636
Wilmington, Delaware 19899
(302) 429-9200
Attorneys for Plaintiffs Below-Appellants

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STATEMENT OF THE NATURE OF THE PROCEEDING AND THE JUDGMENT APPEALED FROM

On August 17, 1984, plaintiffs John A. Moran ("Moran"), a Household International, Inc. ("Household") director of long standing, and The Dyson-Kissner-Moran Corporation ("DKM"), Household's largest stockholder with an investment of over $150 million in Household, filed this action to invalidate the Preferred Share Purchase Rights Plan (the "Rights Plan" or the "Plan").

Trial was held over ten days from September 24, 1984 to October 12, 1984. The court below filed an opinion on January 29, 1985 (the "Opinion" or "Op."). This appeal is taken by plaintiffs Moran and DKM from a judgment entered by the court in favor of the defendants. Plaintiff-intervenor Gretl Golter has also taken an appeal from that judgment.

This is the opening brief on appeal of plaintiffs below-appellants Moran and DKM.

INTRODUCTION

This Court's review of the Household Rights Plan is critical to the preservation of fundamental rights of the stockholders of every Delaware corporation and the continued existence of Delaware corporations as instruments of the corporate democratic process. In adopting the Plan, Household's board has unilaterally arrogated to itself the power to determine whether, when and by whom Household can ever be acquired. If upheld, the Plan will severely restrict stockholders' ability to exercise their traditional franchise rights to affect corporate policies and choose management by joining together or acquiring and voting as many shares as they wish.

The court below explicitly recognized the signal importance and broad significance of the case before it, noting that the "case presents a clash of fundamental interests within the corporate structure. . . ." (Op. at 30, A 319)[1] The trial court also explicitly found that the Plan is "calculated to alter the structure of the corporation" and "results in a fundamental transfer of a power from one constituency (shareholders) to another (the directors)" — all without the consent of the shareholder constituency whose power is thereby confiscated. (Op. at 36, A 325)

The trial court's findings of fact confirm the far-reaching legal and policy impact of the Plan. In order to focus on this unique arrogation of power by the directors through their adoption of the Plan, it is useful to bring the crucial findings of fact together. Specifically, the evidence showed and the court found:

(a) That a company as large as Household can only be acquired, as a practical matter, in a 100 percent ac-

1. References to the plaintiffs below-appellants' Appendix are cited as "A——." Plaintiffs' trial exhibits will be cited herein as "PX——;" defendants' trial exhibits will be cited as "DX——." The trial transcript will be cited by reference to the witness, transcript volume and page. References to depositions in the case are cited by reference to the name of the witness and transcript page.

quisition. (Op. at 41, A 330) Without board approval, such an acquisition can be accomplished only in a two-step transaction — that is, a tender offer for control followed by a second-step merger.

(b) That the Plan stops two-step offers (and hence, as a practical matter, all offers not approved by the board), because operation of the flip-over provision of the rights ("Rights") issued under the Plan — the so-called "poison pill" — will result in "devastating" dilution of the acquiror's capital in the necessary second-step merger. (Op. at 40, 8, A 329, 297)

(c) That an offeror can avoid this "devastating" dilution only by having the Rights redeemed — and only the Household board can redeem the Rights. (Op. at 8, 9, A 297, 298) Thus, under the Plan, the Household board holds all the cards and the stockholders hold none. If the board favors a takeover proposal, it (and it alone) can make the acquisition economically feasible by redeeming the Rights. If the board opposes a proposal, it can stop it in its tracks by leaving the Rights in place. The threat of "devastating" dilution will drive the potential offeror away.

(d) That the Plan severely restricts any effort by an offeror to conduct a proxy contest to replace the board (and thereby enable the offeror to redeem the Rights itself). (Op. at 45, 46, 48, 49, A 334, 335, 337, 338) Stockholders acting alone or together with a group who acquire 20 percent or more of Household stock automatically trigger the Rights and make them non-redeemable — even by the board. Once the Rights are non-redeemable, *all* 100 percent acquisitions of Household, even those approved by the board, are as a practical matter eliminated. No acquiror can afford the dilution of

its own capital structure resulting from an exercise of the Rights.[2]

(e) That the Plan restricts all efforts by Household stockholders to exercise their fundamental franchise rights to band together to change corporate policies or management by imposing disastrous economic consequences on all stockholders if any reach the 20 percent ownership level, alone or in a group. Thus, the Plan restricts even traditional stockholder means of influencing management whether or not a tender offer has been made or proposed. (Op. at 48-49, A 337-38)

By adopting the Plan, the Household board has stopped all acquisitions of Household which it does not favor. The board unilaterally has conferred on itself a veto over tender offers equivalent to the veto right which the Delaware General Assembly has given the boards of Delaware corporations as to mergers, dissolutions, and certain asset sales. In so doing, the Household board has taken from Household stockholders the right to accept the enormous economic benefits of tender offers, and has freed itself and Household's management from the discipline resulting from the potential that such tender offers or proxy contests may occur.

Having made these factual findings, with their revolutionary impact on the internal corporate governance of Delaware corporations, the trial court failed to appreciate the legal and policy significance of its own conclusions. With deference to the Vice Chancellor, the Opinion below does not focus clearly on the legal and policy issues raised by the "poison pill" device adopted by the Household board. This case illustrates the unique value of the appellate process, in which a Supreme Court, not burdened by the time pressures of an

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2. Household's market value is approximately $2 billion. The exercise of all the Rights would cost any acquiror $6 billion in dilution in addition to the purchase price of Household stock.

expedited trial, can take a detached second look at the broader legal and policy implications of a major corporate case.

A standard appellate test for reviewing findings of fact is whether they "are the product of an orderly and logical deductive process." *Application of Delaware Racing Ass'n*, Del. Supr., 213 A.2d 203, 207 (1965). The demands of order and logic are even more compelling where, as in this case, there are present both specific questions of the legal authority for a corporate action and overriding considerations of public corporate policy. It is part of the appellate process to ensure a consistent and principled application of fiduciary obligations under Delaware corporate law. *Compare Morse v. Stanley*, 732 F.2d 1139, 1143 (2d Cir. 1984). This case presents ideal issues for a complete *de novo* review by the State's highest court. *Compare* Supreme Court Rule 41, Certification of Questions of Law.

In particular, the Opinion below is not the product of an orderly and logical deductive process for several specific reasons.

First, although Household claims the Plan is authorized by section 157 of the Delaware General Corporation Law (the "DGCL"), the Opinion discusses this statute only in the context of expressing the defendants' contentions. The question of whether section 157 authorized the Household board to adopt the Plan is simply never discussed.

Second, the court below did not examine the impact of its own extraordinary factual findings. Nor did it ask the overriding policy question of whether the basic change wrought by the Plan in the structure of internal corporate governance — with directors arrogating to themselves powers which heretofore were the exclusive province of stockholders — is consistent with the policy of the DGCL and the fiduciary duties of directors of Delaware corporations. The Opinion simply does not address this most fundamental policy question.

Third, the court, after noting "a clash of fundamental interests within the corporate structure" (Op. at 30, A 319),

proceeds, as the *initial* point of discussion on the merits of that clash, not to the question of legal authority or public corporate policy, but rather to a discussion of burden of proof as implicated in the business judgment rule. (Op. at 30-37, A 319-26)

Fourth, while the court below recognized that the "business judgment rule is *primarily* a tool of judicial review" (Op. at 35, A 324; emphasis added), the Opinion repeatedly suggests that the defensive shield of the rule somehow constitutes independent authority for the Household board's arrogation to itself of powers historically reserved to stockholders alone. Thus, the court below noted: "Household's defense of the adoption of the Rights Plan is bottomed on the application of the business judgment rule" (Op. at 14, A 303); "[t]he directors were advised that the adoption of the Rights Plan . . . was considered by the Wachtell, Lipton firm and by Richards, Layton and Finger, as a matter of directorial judgment under the business judgment rule" (Op. at 15, A 304); "[a]t the time the Rights Plan was adopted by Household's Board at the August 14, meeting it explicitly invoked the business judgment rule, upon the advice of counsel, as authority for its action" (Op. at 31, A 320); and "actions by a target board, if taken to protect all corporate constituencies and not simply to retain control, have been consistently approved under the business judgment rule." (Op. at 44, A 333) These statements evidence that the court failed to recognize that the business judgment rule "does not create authority" and "is not relevant in corporate decision making until after a decision is made." *Zapata Corp. v. Maldonado*, Del. Supr., 430 A.2d 779, 782 (1981). The Opinion below appears to rest on the erroneous proposition that the business judgment rule can constitute independent authority for the poison pill device adopted by the Household board.

Fifth, the Opinion below discusses the stockholders' right to join freely in proxy contests for corporate control (Op. at 45-49, A 334-38), and the stockholders' right to free alienability of their stock (Op. at 40-45, A 329-34), only as bal-

ancing factors on the factual issue of whether the Household board was justified in the exercise of its business judgment in adopting the anti-takeover device of the Plan. These factors and others are never considered in the context of the fundamental questions of stockholder constituent power and the democratic process of internal corporate governance long recognized under Delaware corporate and federal law.

Sixth, in considering the business judgment rule itself, no policy consideration is given to the fact that the power derived by the Household board from the Plan — which the trial court found was of itself enough to require a threshold showing of proper motive by the board — is achieved at the expense of Household's stockholders. The Opinion failed to recognize that this type of director "interest," involving the arrogation of power from stockholders, requires the directors to bear the burden of proving fairness regardless of motive or intent.

At bottom, the Opinion stands unalterably for the proposition that the directors of a Delaware corporation can effect a fundamental shift in the internal structure of their company by transferring power from their stockholders to themselves, so long as they can demonstrate a "reasonable purpose" for their action. Such a holding is clear error.

Such a fundamental transfer of power requires, at a minimum, the approval of the stockholder body whose rights are diminished by the transfer. The Household Rights Plan violates the basic compact between directors and stockholders under Delaware law, and must be struck down. It is neither reasonable nor fair to stockholders for directors to alter unilaterally the basic structure of the corporation. No provision of the DGCL authorizes such a unilateral act by the board. If such a provision were to be passed — or if an existing provision were to be so interpreted — it would violate stockholder rights guaranteed by Delaware law in provisions congruent with, and required by, federal statutes and the Commerce and Supremacy Clauses of the United States Constitution.

This is more than a fact case. We respectfully submit that this Court, in viewing the legal and policy issues involved in this appeal, should, as the final authority on Delaware state law, take a fresh look at this defensive device and draw its own independent conclusions as to the law and public policy. We urge that such a review can lead to only one conclusion: the Plan should be struck down.

SUMMARY OF ARGUMENT

1. Neither section 157 nor any other provision of the DGCL confers authority on the Household board to adopt the Rights Plan.

2. If it did authorize adoption by the Household board of the Plan, section 157 of the DGCL would contravene federal laws and the United States Constitution.

3. The business judgment rule is not a source of power for acts of a board of directors.

4. The Household board is unauthorized to usurp the stockholders' power to receive and accept a hostile tender offer by changing Household's fundamental structure.

5. The Household board is unauthorized to restrict substantially and illegally fair corporate suffrage.

6. Even if the Household board were found to have acted within its statutory authority, the presumption of propriety afforded by the business judgment rule is wholly inapplicable to the defendants' unauthorized and unfair alteration of Household's fundamental corporate structure because:

   (a) The interest of the directors requires them, at a minimum, to demonstrate the fairness of the Plan.

   (b) The Plan is unfair.

   (c) The Household board did not exercise informed business judgment in adopting the Plan.

7. The Plan illegally restrains the alienation of Household stock.

STATEMENT OF FACTS

I. THE HOUSEHOLD RIGHTS PLAN

On August 14, 1984, the Household board voted 14-2 to adopt the so-called Preferred Share Purchase Rights Plan that was the creation of its recently retained special counsel.[3] Only one other company, also represented by the same counsel, had at that time adopted such a plan. The Plan is designed to give the board a uniquely effective weapon against hostile takeovers and to counter the recent trend in the courts and legislatures giving stockholders the decisive voice as to whether particular takeover offers succeed. (PX 203 at 3-4, 7, A 792-93, 796)

Pursuant to the terms of the Plan (PX 204, A 819-81), Household common stockholders of record on August 28, 1984 (and thereafter) are entitled to the issuance of one Right per common share under certain triggering conditions. Until these conditions are fulfilled, no Rights are issued and the Rights may not be traded separately from the common shares. The Rights may be cancelled by the board for $.50 per Right. At this writing, the Rights remain entirely inchoate.

There are two triggering events which activate the Rights: the announcement of a tender offer for 30 percent of Household's shares (the "30% Trigger") or the acquisition of 20 percent (or the right to acquire or vote 20 percent) of Household's shares by any single entity or group acting together (the "20% Trigger").

If the 30% Trigger occurs, the Rights certificates are issued, are separately tradeable, are immediately exercisable to purchase 1/100 share of a new out-of-the-money preferred

3. On the recommendation of special counsel, the board also adopted a series of anti-takeover by-law amendments, including an anti-consent solicitation amendment identical to the one enjoined in *Plaza Securities Co. v. Datapoint Corp.*, Del. Ch., C.A. No. 7932, Brown, C. (Mar. 5, 1985) (Ex. A), *aff'd*, Del. Supr., No. 79, 1985 (Mar. 8, 1985). (PX 191, A 715-22)

stock[4] for $100 and remain redeemable by the board.

If the 20% Trigger occurs, the Rights certificates are issued and *become non-redeemable*, are separately tradeable and are exercisable to purchase 1/100 of a share of the out-of-the-money preferred.

Thereafter, if Household merges or consolidates with *any* other entity, the Rights holders can exercise each Right to purchase $200 of the common stock of the merger partner for $100. This is the "flip-over" provision (or "poison pill") which the trial court found causes "dilution of the acquiror's capital [which] is immediate and devastating." (Op. at 8, A 297) The flip-over is only contained in the Right and is not available as an anti-takeover device if the Rights are exercised to purchase Household preferred shares. That is why the preferred was intentionally priced so far out-of-the-money.

The Rights have a ten-year term. The Rights may be amended at any time by the board with the acquiescence of the Rights agent (a bank chosen by Household) to improve their terms. For example, the board could extend their life or increase the flip-over multiplier so that each Right could buy, instead of $200, $1,000 or any other amount of the acquiror's common stock for $100. This virtually unlimited flexibility is intended to ensure that if any defense to the poison pill is discovered, the Rights can always be amended to counter it. The Rights Plan gives the board a veto on all hostile tender offers and is practically limitless in its restriction of the stockholders' ability to participate in tender offers and to engage effectively in proxy contests.

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4. The preferred is out-of-the-money because each 1/100 of a share will be issued for $100, yet would carry the same dividend as Household's common stock, which has not traded above $40 during the past 15 years. (Clark VI 149, A 533) The Household board was told that the 1/100 share of preferred should "approximate the value of one share of common stock." (PX 191, A 727) Moran thought it would be worth far less than the common if ever issued. (Moran I 147-48, A 439-40)

II. TAKEOVERS AND THE ECONOMIC CLIMATE IN WHICH THEY OPERATE

Household's witnesses conceded at trial, and the court below specifically found, that the Plan is a "drastic but highly effective deterrent device" (Op. at 2, A 291) that prevents virtually all hostile takeovers. A full understanding of the severity of this deterrent is aided by a review of the characteristics and effects of the most common types of tender offers and proxy contests, the climate in which they occur and relevant factors which may affect their practical desirability and chances of success.

A. The Undisputed Benefits Of Tender Offers And Proxy Contests

The benefits to stockholders which result from tender offers are well-established.[5] As Justice White wrote in *Edgar v. MITE Corp.*, 457 U.S. 624, 642, 102 S. Ct. 2629, 2642 (1982):

> The effects of allowing the Illinois Secretary of State to block a nationwide tender offer are substantial. Shareholders are deprived of the opportunity to sell their shares at a premium. The reallocation of economic resources to their highest-valued use, a process which can improve efficiency and competition, is hindered. The incentive the tender offer mechanism provides incumbent management to perform well so that stock prices remain high is reduced.

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5. *See* Economic Report of the President (transmitted to the Congress, February, 1985, (the "President's Report") (Ex. B) at 187 *et seq.* (*See also* Securities Exchange Act Release No. 21079 (June 21, 1984), Fed. Sec. L. Rep. (CCH) ¶83,637 (the "SEC Study") (PX 333, A 898-926))

The evidence below supported the Supreme Court's analysis in *Edgar* and was uncontradicted. A study by Household's own expert, Goldman, Sachs & Co. ("Goldman, Sachs"), shows that the average price paid to target stockholders in 79 completed unsolicited tender offers was 78.8 percent over the pre-tender market price. (DX 12, A 934-1062; PX 329-31, A 895-97; Jensen IV 142, A 471) A study completed in June of 1984 by the Chief Economist of the Securities and Exchange Commission (the "SEC") of 148 tender offers made between 1981 and 1983 established that the average premium for "any-or-all" tender offers had been 63.4 percent, the average blended premium[6] for two-tier offers had been 55.1 percent, and the average blended premium for pure partial offers had been 31.3 percent. (SEC Study at 86,916, A 900; Jensen IV 161-68, A 473-80) 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, A 478)

In addition to the purely economic benefits of market premiums paid, defendants' and plaintiffs' witnesses alike testified that tender offers provide stockholders with important "external controls" over their investments. Professor Michael Jensen ("Jensen"), visiting professor at the Harvard Business School, testified that tender offers provide an incentive for boards and managements to perform well because the tender offer mechanism permits alternative management teams to compete for the right to manage the corporation. (Jensen IV 173-78, A 482-87) Defendants' expert Raymond Troubh ("Troubh") confirmed that view:

> I think tender offers are probably generally a pretty good thing. I think that they

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6. The blended premium is obtained by combining the premiums in the first and second steps of a two-step acquisition. In a transaction with no second step, the premium in the first step is averaged with the market price for the shares after the offer.

> permit sometimes more efficient managers to take control of assets which they might otherwise might not be permitted to do.

(Troubh VIII 105, A 601)

Proxy contests also provide an important — indeed, the only — alternative mechanism which can act as a check on inefficient management, effect changes in corporate control without management's consent, and provide stockholders the opportunity to receive the significant economic benefits that flow from actual and potential changes in corporate control. (Jensen IV 177-78, A 486-87) Manuel F. Cohen, the former Chairman of the SEC, has emphasized that proxy contests are an essential element "in a healthy system of corporate government . . . [providing] a method by which corporate managers may be required to account for the results of their stewardship." Aranow & Einhorn, *Proxy Contests for Corporate Control*, at xiii (Columbia University Press, 2d ed. 1968); *see Aronson v. Lewis*, Del. Supr., 473 A.2d 805, 811 (1984).

The benefits denied Household stockholders by the Plan flow not only from actual tender offers received or proxy contests joined, but also from the potential for tender offers and proxy contests. The potential that such a challenge to management control may be mounted provides a strong incentive for responsible corporate management. President's Report at 188-89, 198-99 (Ex. B); *Edgar v. MITE Corp., supra*, 457 U.S. at 643, 102 S. Ct. at 2642.

B. The Tender Offer Process

A tender offer is an offer made directly to the stockholders of the target corporation to purchase their shares of stock for a specified consideration. For purposes of this appeal, tender offers may be divided into three basic groups: any-or-all, pure partial, and two-step or two-tier offers. (SEC Study at 86,922, A 906).

1. *Any-or-all offers* are offers to purchase any shares tendered up to 100 percent of the target company stock not already owned by the offeror. (*Id.*) Since no offer has ever gained 100 percent acceptance, the offeror ordinarily will seek to acquire the remaining stock by a merger. Thus, an "any-or-all" offer may comprise the first step in a two-step or two-tier offer (described below).

2. *Pure partial offers* are offers in which the bidder states a maximum number less than 100 percent of shares to be purchased, and neither announces a second-step merger during the tender offer nor effects such a merger closely following consummation of the offer. (*Id.*) In many cases, partial offers are made for just enough stock to give the offeror the ability to exercise control of the target. (*Id.*)

3. *Two-step or two-tier offers* include any proposal for acquisition which is to be accomplished by a tender offer for control followed by a second-step merger. (Op. at 11 n.2, A 300; SEC Study at 86,922, A 906)

Generally, in a two-step offer, the offeror seeks to acquire enough shares in the first-step tender offer to establish a control position and, to that end, offers to purchase shares at a substantial premium over market. The terms of the second-step merger may or may not be explicitly stated at the time of the tender offer. (Op. at 11 n.2, A 300) Stockholders usually receive debt or equity securities of the offeror in the second-step merger (*id.*; SEC Study at 86,922, A 906), unless DGCL §262 permits them to seek a cash appraisal.[7] *See* President's Report at 204-05 (Ex. B).

If the kind or amount of consideration paid in the second step is different from that paid in the first step, the offer is considered to be of the two-tier variety. The trial court found that two-tier offers are typically "front-end loaded" because

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7. With this Court's emphasis on the newly expanded appraisal remedy in *Weinberger v. UOP, Inc.*, Del. Supr., 457 A.2d 701 (1983), the possibility of receiving cash in lieu of securities designated as consideration in a second-step merger is very real.

the consideration offered in the tender offer is greater than that which is to follow in the merger.[8]

4. *Minimums.* Any of the above-described offers can be conditioned on a minimum number of shares being tendered.[9] Minimums are generally imposed in order to assure that the offeror will not spend material sums without obtaining its objective (*e.g.*, a sufficient stake in the company to permit equity accounting or to give the offeror working control). (SEC Study at 86,922, A 906)

C. Hostile Takeovers Of Public Companies As Large As Household Can Only Be Accomplished By A Two-Step Or Two-Tier Offer

1. *Potential acquirors of Household must obtain 100 percent ownership*

The evidence showed, and the court below expressly recognized, that potential acquirors of large companies such as Household need to acquire 100 percent ownership. The court found that "the primary goal of a potential acquiror is to achieve 100% ownership" (Op. at 41, A 330), because, as defendants' own experts conceded, 100 percent ownership eliminates potential minority stockholder conflicts, gives access to target company cash flow to help repay any debt incurred in the offer, and permits the combined companies' as-

8. (Op. at 11, A 300). Such is not always the case, however. Where, for example, the target has in place a "fair price" charter amendment (which generally requires that the merger consideration be equal to the tender offer price), acquirors have continued to employ the two-step structure, for some or all of the reasons set forth, *infra*, at page 19.

Because stockholders must approve "fair price" amendments, they represent an example of stockholders making the judgment to accept whatever disadvantages, as well as advantages, may result from their enactment. *See* President's Report at 208-09 (Ex. B). Unlike the Rights Plan, "fair price" provisions do not give directors a veto over tender offers. The decision is left with the stockholders, where it belongs.

9. If an any-or-all offer has a minimum condition, it is more precisely characterized as a 100 percent offer with a minimum.

sets to be employed in the most efficient manner. (Op. at 41, A 330; Higgins VII 153, A 564; Troubh VIII 130, A 604A) Such post-acquisition benefits allow the acquiror to pay a higher price to the acquired company's stockholders; without them (as in a partial offer), an acquiror may not be able to afford any market premium at all.

Household's principal expert, Jay Higgins ("Higgins") of Salomon Brothers Inc ("Salomon Brothers"), admitted that no partial offer had ever been made for a company as large as Household, and characterized such an offer as "totally theoretical." (Higgins VII 159-60, 195-96, 216-17, A 569-70, 582-83, 587-88) Higgins could not recall a single completed transaction of $1 billion or more in which the acquiror did not obtain 100 percent of the target. (Higgins VII 159-60, A 569-70)

Plaintiffs' expert Alan Greenberg ("Greenberg"), the chief executive of Bear, Stearns & Co. ("Bear Stearns") — whom defendants' expert John Wilcox ("Wilcox") characterized as one of the best-known traders and arbitrageurs on Wall Street (Wilcox IX 91, A 612) — agreed. Greenberg testified that making a pure partial offer for Household would be "ridiculous. Nobody is going to do that, or pay a premium and do that." (Greenberg IV 76, A 469)

2. *Without board approval, a 100 percent acquisition can only be accomplished by a two-step or two-tier offer*

The evidence was undisputed that tender offers, and especially hostile tender offers for large companies like Household, never achieve a 100 percent acceptance. As a consequence, 100 percent ownership of a public company can only be accomplished through a statutory merger. Hostile tender offers for large companies such as Household inevitably are followed by a second-step merger. (Higgins VII 159-60, 195, 216-17, A 569-70, 582, 587-88)

3. *The clear evidence of the benefits to target stockholders of two-step and two-tier offers*

The trial court found that the "coercive nature" of two-tier tender offers allegedly resulting from "the risk that some shareholders will be 'frozen out' of any premium once control is achieved is well documented." (Op. at 43, A 332)

The trial court's conclusion is clearly erroneous. The trial court relied solely on a report of an advisory committee to the SEC. The SEC, in reviewing and declining to adopt the advisory committee's recommendations regarding two-tier offers, stated that it "is not satisifed that the case for the supposed coercion in a two-tier bid has been made with sufficient precision. In this regard, the Commission notes that any tender offer, and particularly any partial tender offer, involves an element of coercion or pressure." (SEC Study at 86,917, A 901) The SEC Study was based on a statistical study done by the SEC Chief Economist. The President's Report at 204-05 (Ex. B), similarly concluded:

> There is, however, no systematic evidence that two-tier offers have such a coercive effect, and there is substantial evidence that the market prevents such abuses from occurring. In particular, the market for takeovers is competitive and bidders who attempt to structure two-tier offers that result in a below-market price for the company's assets can expect to find themselves outbid by a superior offer with a premium closer to the target's actual market value.

The President's Report concluded, as had the SEC Study, that "no single-tier bid has ever lost to a two-tier bid with a lower blended premium, despite the allegedly coercive effect of the two-tier bid." *Id.* at 205. (SEC Study at 86,916 n.9, A 900)

There is no evidence in the record of any unfair, coercive two-tier offer succeeding. Each of the two-tier offers discussed in the record was acknowledged to have been fair to the target company's stockholders by defendants' witnesses. The evidence is undisputed that successful two-tier offers are enormously beneficial to the stockholders of the acquired company. *See* President's Report at 205 (Ex. B).

The SEC Study of 148 tender offers made between 1981 and 1983 established that the average blended premium for two-tier offers had been 55.1 percent over the pre-announcement market price. Such significant economic benefits for target stockholders from two-tier offers were confirmed by Household's own witnesses. Defense witnesses who had been personally involved in two-tier offers uniformly considered their "own" particular two-tier offers to have been fair. Household board member Raymond Tower ("Tower") testified that, as a member of the board of Marathon Oil Company, he considered the two-tier, highly front-end loaded offer — $125 in cash in the first-step tender offer, and notes valued at $80 in the second-step merger — by U.S. Steel to have been fair to Marathon's stockholders.[10] From the other side of a takeover transaction, as a director of FMC Corporation, Tower believed that FMC's front-end loaded two-tier offer for the R.P. Scherer Corporation offered a fair price to Scherer stockholders. (Tower X 80, A 636)

Defendants' expert Higgins' firm, Salomon Brothers, and defense witness John Whitehead's ("Whitehead") firm, Goldman, Sachs, have both rendered opinions that specific front-end loaded offers are fair to a target's stockholders. (Higgins VII 143-44, A 561-62; PX 348 at 12-13 and App. III, A 930-33) A classic example of such a two-tier offer was du Pont's

10. (Tower X 75-80, 88, A 631-36, 638) Notwithstanding that certain Marathon stockholders did not participate in the first step, the Marathon board, including Tower, along with its investment banker, First Boston Corporation, strongly recommended the second-step merger, since they viewed the two steps as a "unitary transaction" which gave a substantial premium to stockholders. (*Id.* at 79-80, A 635-36)

offer for Conoco, in which the consideration was $95 in cash in the first step, and $80 in securities in the second step. (PX 345 at 1, 33, A 927, 928) Higgins testified that the Conoco stockholders received a "significant premium" from this front-end loaded offer. (Higgins VII 141-42, A 559-60) Finally, Household itself acquired plaintiffs' company, Wallace-Murray, in a two-tier offer. (Moran I 59, A 435; II 104, A 449) Household will not assert that this transaction was unfair to the Wallace-Murray stockholders.

Household's witness conceded not only that two-tier offers are beneficial to target stockholders, but also that there are legitimate business reasons for structuring a takeover as a two-tier offer. (Higgins VII 139, A 557) Higgins agreed that an acquiror may wish to issue stock to the target stockholders to avoid increasing the debt on its own balance sheet (*id.*), and that a target stockholder may benefit because the second-step merger consideration received may be tax-free. (*Id.*; *see* Moran II 104, A 449) *See also* President's Report at 205 (Ex. B). Of course, the stockholder can sell any debt or equity securities he receives in the second-step merger. (Moran II 103, A 448)

The trial court also made passing reference to the attractiveness of Household to a so-called "bust-up" artist. (Op. at 41, A 330) Higgins rejected the contention that "bust-up" or "junk bond"-financed acquisitions do not benefit target stockholders:

> 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, A 589-90)

If the initial offer, whether by a "bust-up artist" or two-tier in form, is too low, the competitive market place has a means of dealing with that. Management can always seek a white knight. *See* President's Report at 204-05 (Ex. B).

The evidence thus proved that two-step offers, such as would have to be employed in any hostile acquisition of Household, yield the same material economic benefits to target stockholders as other takeover methods.

III. THE IMPACT OF THE HOUSEHOLD RIGHTS PLAN

The Rights Plan is "novel and complicated"; "its very complexity is designed to create uncertainty on the part of a potential acquiror." (Op. at 7, A 296) In fact, because the dilution from the flip-over is so potentially devastating, no acquiror will consummate a second-step merger and the Rights will never be exercised. Because no prospective acquiror can afford to acquire 100 percent of Household, no first-step tender offer for Household will succeed without board approval. The entire convoluted mechanism was designed to exist solely as a threat of "devastating" dilution to any acquiror not approved by the board. The trial court found the mechanism successful in that it effectively eliminates all hostile tender offers for Household. (Op. at 40, A 329)

A. The Threat Of Devastating Dilution To Potential Acquirors

The trial court's finding that the exercise of the flip-over or "poison pill" creates an "immediate and devastating" dilution (Op. at 8, A 297) is amply supported by the record.

Defendants suggested below that, in an attempt to reduce the impact of this dilution, a prospective acquiror could tender for shares and Rights as a unit. As the trial court found (Op. at 40-41, A 329-30), this would not work. If, as is not uncommon, 10 percent of the shares and Rights remained outstanding after the first-step tender offer (Higgins VII 120,

190-91, A 555, 580-81; DX 31, A 1063-66), there would remain approximately 6 million Rights outstanding. In a subsequent clean-up merger, the holders of those Rights would be entitled to purchase $1.2 billion worth of the acquiror's common stock for a total purchase price of $600 million. The resultant dilution of the acquiror's capital — $600 million — would indeed be both immediate and devastating. The lower the tender offer percentage yield, of course, the more devastating the dilution.[11]

B. The Threat Of Devastating Dilution Eliminates Hostile Offers For Household

The evidence below demonstrated conclusively that the threat of this devastating dilution will effectively eliminate hostile tender offers to acquire Household. (Op. at 40-41, A 329-30) Such offers, in order to gain 100 percent ownership, must involve either a two-tier or two-step transaction. The Plan eliminates both of these forms as viable methods of acquisition.

The trial court found that "the Plan will virtually eliminate hostile two-tier offers for Household." (Op. at 40, A 330)[12] Defendants' own witnesses agreed. Whitehead said that the Plan "absolutely stops" two-tier offers. (Whitehead VI 67, A 531) Higgins stated that only an irrational person would use the traditional structure of a two-tier offer in which cash is offered for 60 percent and stock is offered for the other 40 percent. (Higgins VII 157-60, A 567-70)

The trial court also found that hostile "tender offers which are not front-end loaded or conditioned by high min-

11. Defendants' expert witness Troubh ran through the same numerical analysis of a 100 percent takeover in which 80 percent of the stock and Rights are tendered in the first step. He agreed that the resulting dilution of the acquiror's capital — $1.2 *billion* — is of a magnitude that no company would be willing to accept. (Troubh VIII 55-58, A 592-95)

12. The trial court's definition of two-tier offers drew no distinction between two-step and two-tier offers. (*See* Op. at 11, n.2, A 300)

imum acquisition or the surrender of rights to avoid the dilution effect of the flip-over provision have little hope of succeeding." (Op. at 40, A 329) In so ruling, what the court found was that no two-step all cash offer can succeed; it recognized that front-end loading and high minimums are the only theoretical means of avoiding the Plan's devastating dilution, but held that they would not work.

The trial court is correct that an offer which is not front-end loaded cannot succeed. Stockholders will not accept less in the tender offer than they could receive in the second-step merger.[13] (Jensen IV 181-84, A 489-92; Bradley V 98-100, A 512-14; Abbott III 79-81, A 452-54; Greenberg IV 73-74, A 466-67) Since the Rights alone carry a $100 profit on the second step, the tender offer would have to be for more than $100 per share and Right tendered. No rational offeror could afford to front-end load his offer. Household has 60 million shares and Rights outstanding on a fully diluted basis. The minimum acquisition cost for Household in a transaction with a front-end loaded tender offer followed by a second-step merger would have to be in excess of $6 billion. Household's counsel so advised the board. (Moran I 154-55, A 443-44) Household's current market value is approximately $2 billion. No rational acquiror would pay three times Household's market value, as defendants' expert Troubh conceded. (Troubh VIII 95-98, A 596-99)

The trial court also correctly found that the prohibitive dilutive effect of the Rights cannot be avoided by imposing a high minimum condition on the tender offer and requiring

13. At trial defendants also suggested that the dilution effect could be reduced by *lowering* the premium paid in the first-step tender offer. The effect of such strategy is obvious: it will reduce the number of shares tendered in the first step thereby increasing the devastating second-step dilution — a classic vicious circle. Plaintiffs' experts demonstrated the impossibility of such an offer succeeding because of the gross disparity between the consideration offered in the two steps. (Greenberg IV 74-75, A 467-68; Abbott III 79-87, A 452-60; Jensen IV 180-92, A 488-500; V 49-52, A 507-10) The trial court credited this evidence in finding that an offer that was not front-end loaded would not succeed. (Op. at 40, A 329)

the surrender of the Rights. As the trial court found with respect to such an offer:

> It clearly would not attract the interest of arbitrageurs or large institutional investors without whose support a hostile tender offer cannot succeed.

(Op. at 41, A 330)

The evidence that arbitrageurs[14] and other institutional investors would have no interest in an offer with a very high minimum was overwhelming. Defense witnesses Higgins and Wilcox both testified that arbitrageurs do not like high minimum offers; Greenberg, an arbitrageur, categorically agreed. (Higgins VII 190, A 580; Wilcox IX 91, A 612; Greenberg IV 73, A 466) Such offers are perceived by the marketplace as "weak." (Higgins VII 185, A 577) There are also numerous practical reasons why offers conditioned on tender of a high minimum percentage of shares fail. These include stockholders who cannot be reached, lost certificates and individual stockholders' decisions to preserve appraisal rights. (Greenberg IV 73-74, A 466-67; Abbott III 79, A 452) Higgins testified that high minimums create uncertainty in the minds of stockholders as to whether the offer will succeed: "[With high minimums,] [y]ou will get less shares than you will if you have no minimum, or a very, very low minimum." (Higgins VII 185-86, A 577-78)

Another "extremely relevant" factor in determining whether a high minimum offer would be successful is the

14. Risk arbitrageurs, professional traders who purchase shares of target corporations at a small discount from the offering price, play an important role in tender offers by providing a market in shares of target companies during takeovers. They bear the risk of the deal being stopped or not going through in return for a small margin on a large number of shares should the deal succeed. (Greenberg IV 65-68, A 464-465B) "[T]he public gets a much higher price for their security because of the presence of the risk arbitrageur." (*Id.*) (*See also* Jensen IV 222-23, A 502-03)

amount of stock held by directors, officers and employee benefit plans. (Higgins VII 198, A 584) Defendants' expert Wilcox testified that "in general employees would not vote against management" (Wilcox IX 95, A 616), and his experience has shown that employee loyalty is very strong with respect to tender offers that management is opposing. (Wilcox IX 93-94, A 614-15) That is particularly true, he testified, when the employee benefit plans provide for pass-through tendering. (Wilcox IX 94, A 615) Household's board passed a resolution requiring pass-through tendering on the same day that it adopted the Rights Plan. (PX 191, A 724)

Household's directors and officers control 2.3 percent of the stock and the company's employee benefit plan controls an additional 4.6 percent. (PX 5 at 12, A 650; PX 41 at 3, A 680; Wilcox IX 93, A 614) Defendant director Rauch testified that he, his "friends" and his clients control in the aggregate approximately 7.5 percent of Household's stock. (Rauch Dep. 39-40, A 417-18)[15] Thus, insiders and employee benefit plans control somewhere between 7 and 14.5 percent of Household's stock. Simple arithmetic shows that a high minimum offer would not succeed.

In the light of all of the foregoing factors, it is not surprising that Household's own experts were unanimous that hostile offers with high minimum conditions have never been mounted. Higgins, the head of the Salomon Brothers mergers and acquisitions department, could not recall any tender offer with a minimum condition of even 80 percent. (Higgins VII 184-85, A 576-77) Salomon Brothers does not recommend such offers. (Higgins VII 185-86, A 577-78) Wilcox, who testified that he rendered services on approximately 250 tender offers, could not remember one in which he recommended anything approaching a 95 percent minimum; he did not believe that his company had ever recommended even an 85

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15. Rauch told Moran he would have no interest in tendering because of the low tax basis of the stock he controls. (Moran I 173, A 445)

percent minimum. (Wilcox IX 92, A 613) Finally, Higgins' chart, which was a table of statistics regarding "selected" completed tender offers compiled by Salomon Brothers specifically for this case, shows no minimum higher than 69 percent. (DX 31, A 1063-66)

C. Proxy Fights Are Restricted And Inhibited By The Plan

Broadly defined, a proxy contest is an attempt by a stockholder or stockholders opposed to policies of current management to accumulate proxies and shares to be voted to change those policies or management itself.

Shares can be accumulated in three ways: (1) through purchases of large blocks; (2) through the utilization of block voting by a stockholder group; and (3) through proxy solicitations. The first two methods are the most certain roads to success. A share bought is a vote owned. A share bought from a management supporter is the equivalent of two votes owned.[16] Proxies, on the other hand, are subject to revocation up to the time of the vote. These three methods are most effective when used together. Aranow & Einhorn, *supra*, at 14-21. By imposing a 19.9 percent ceiling on the number of shares which can be aggregated by the first two of these methods, the Plan eliminates the most effective techniques available to potential insurgents in waging a proxy contest. As the trial court found, the "Rights Plan's impact on proxy contests may ultimately alter the balance of power between shareholders and the board of directors. . . ." (Op. at 20, A 309)

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16. Aranow & Einhorn note that:

> [O]ne 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.

Aranow & Einhorn, *supra*, at 21.

The Plan imposes this 19.9 percent ceiling by providing that the Rights will "trigger" and become non-redeemable on the acquisition by a person of, or formation of a group holding, 20 percent of Household's shares. Defendants' witnesses were unanimous that such triggering of the Rights would be a disaster for Household and its stockholders by denying them the substantial economic benefits of any 100 percent acquisition of their company for ten years.

Defense expert 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, A 563) Non-redemption of the Rights would equally eliminate Household's ability to effect a negotiated transaction. (PX 183 at 3, A 688) The dilutive effects of the Rights would apply with equal devastation to a friendly offeror. Household's chairman Clark testified that non-redemption of the Rights would be harmful not only to the 20 percent acquiror, who triggered the Rights, but to the other stockholders of Household as well. (Clark VI 215-16, A 535-36) Defendants' witness Whitehead agreed: "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, A 529)

Because acquisition of 20 percent or formation of a 20 percent group would impose on the acquiror or insurgent group a material economic penalty (equal in kind but greater in degree than that suffered by all other stockholders of the company), insurgents will not pull the trigger on a gun which is pointed at their own heads. Clark's testimony on the point was direct and candid:

> I will agree with you that if you have an irrational person who is willing to put $400 million into a situation [a 20 percent acquisition] 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.

(Clark VI 216, A 536) Thus, the Plan effectively precludes any person or group from accumulating 20 percent of Household's shares.

The evidence at trial demonstrated overwhelmingly that the 20 percent ceiling severely inhibits the conduct of a successful proxy fight by insurgents. Each of defendants' expert witnesses conceded that it is a "truism" that the more shares insurgents own, the better are their chances in a proxy contest. (Wilcox IX 72, A 606; Troubh VIII 113-14, 115, A 602-03, 604; Higgins VII 171-72, A 574-75) As the trial court found, Wilcox "conceded . . . that the size of an insurgent's holdings does make a difference since it reduces the number of converts needed." (Op. at 46, A 335) Moreover, Wilcox and Troubh testified that an insurgent group may need to own substantially more than 20 percent to win a proxy contest. (Wilcox IX 101, A 618; Troubh VIII 113-14, A 602-03)

Wilcox testified on direct examination that a study of proxy contests since January 1, 1981, prepared by Georgeson & Co. ("Georgeson") for this case (DX 39, A 1067-1100), had revealed "no correlation between the size of an insurgent's holdings and the likelihood of success." (Op. at 46, A 335; Wilcox IX 85, A 607) He suggested rather that the key factor was the issues raised in the proxy contest. (Op. at 46, A 335) Since Wilcox was familiar with the issues involved in only some of the proxy contests surveyed, he was unable to offer any competent evidential support for his opinion. (Wilcox IX 86, A 608)

Wilcox conceded on cross-examination that the number of shares owned by the insurgents does have an impact on the outcome of proxy contests. (Wilcox IX 85, A 607) He also conceded that the percentage of contests won by management, where the dissidents held less than 20 percent, was *double* the percentage of contests won by management where

the dissidents held more than 20 percent of the stock. (Wilcox IX 89-90, A 610-11) Finally, Wilcox admitted that there were no management victories at all in his study where the insurgents owned 30 percent of the outstanding stock or more. (Wilcox IX 99, A 617)

Moreover, the Georgeson study itself shows that in proxy fights in which the insurgents held in excess of 20 percent, management won only 4 of the 21 contests. Insurgents won 8 outright and gained a favorable settlement in the rest[17], thus achieving a favorable result in more than 70 percent of the contests. (DX 39, A 1067-1100) None of those successful insurgents would have been permitted, under the Plan, to accumulate the 20 percent-plus stakes which formed the basis for his victory. Thus, Household's own evidence demonstrated that the 20 percent ceiling directly inhibits effective proxy challenges.

The President's Report describes a definite trend toward concentration in voting power within large public corporations. The Report reveals that, on the average, the five largest stockholders in 511 large corporations which were studied control about 25 percent of the corporation's shares, and the twenty largest stockholders control about 38 percent. Thus, on the average, the five largest stockholders in these corporations would need to obtain the agreement of stockholders controlling only one-third of the remaining shares in order absolutely to control the corporation — *if* those five stockholders were permitted to form a group.[18] A coalition of the twenty largest holders, on the average, would need coopera-

17. Results in two proxy contests were unknown. A favorable settlement is one in which insurgents were able to negotiate representation on the target's board either for their whole slate or individual members. (*See* Wilcox IX 88, A 609) In contrast, insurgents holding less than 20 percent achieved only a marginal percentage of favorable settlements. Holdings over 20 percent thus give insurgents a very large edge in negotiating a successful outcome to their proxy contests.

18. Since a proxy contest at a stockholders' meeting can be won with a majority of the quorum, the actual percentage required can be significantly less than 50 percent. 8 *Del. C.* §216.

tion from stockholders controlling only about one-fifth of the remaining shares (only about half of the coalition's own holdings) in order to control the corporation — but again *only if* they could band together for a common purpose. President's Report at 212-14 (Ex. B). The Plan would prohibit such groups.

On the basis of the foregoing record evidence, the trial court found that the Plan *does* materially inhibit proxy contests. It held that:

> (1) The Rights Plan has an "impact . . . on block voting" (Op. at 46, A 335);
>
> (2) The Rights Plan "deter[s] the formation of proxy efforts of a certain magnitude" (Op. at 48, A 337);
>
> (3) The Rights Plan "limit[s] the proxy activity of those opposed to the Board's present policies" (Op. at 49, A 338); and
>
> (4) The "Rights Plan's impact on proxy contests may ultimately alter the balance of power between shareholders and the board of directors." (Op. at 20, A 309)

IV. DEVELOPMENT AND ADOPTION OF THE HOUSEHOLD RIGHTS PLAN

In light of the extraordinary impact of the Household Rights Plan, it is highly significant that its adoption resulted from material misapprehensions as to the intentions of plaintiff Moran and of the terms and effects of the Plan itself. In order to consider the validity of the board's action in adopting the Plan, the events preceding and circumstances surrounding its adoption are important.

A. Household's Fear Of Hostile Takeovers

The evidence was undisputed that as long ago as 1974, Household was considering anti-takeover devices. (PX 6, A 665; PX 12, A 669-71) In 1983 and 1984, tender offer ac-

tivity quickened, and size alone no longer constituted an absolute defense. (Clark V 168, 199, 206, A 515, 520, 521; Higgins VII 38, A 547) There was increased use, in the takeover context, of "high yield" or "junk" bonds, which made financing for extremely large acquisitions more readily available. (Higgins VII 17-18, 35, A 543-44, 545) Household became increasingly aware of such attempts in its own industry and elsewhere. (Clark V 168, 199, A 515, 520)

In reaction, in very early 1984, Household requested Georgeson to evaluate the prospect of stockholder approval of a "fair price" amendment to the certificate of incorporation at Household's upcoming annual meeting.[19] (Op. at 3, A 292; *see also* Upton Dep. 123-24, A 430-31; Clark V 169, A 516)

On March 2, 1984, Georgeson opined that such an amendment would pass, but barely, with the estimated approval rate varying from 50.8 percent to 58.3 percent. (Op. at 3, A 292) The trial court found that management decided not to pursue such an amendment because it believed that there was not sufficient time available before the annual meeting (then scheduled for May 8, 1984, more than two months away) to present its position on the fair price amendment and because of the predicted closeness of the vote. (*Id.*)

The undisputed evidence established that Household executives were concerned that if the stockholders voted the amendment down, "it is essentially an 'announcement' that our shareholders would be receptive to a takeover. Failure to adopt the fair price provision would also be a public-relations disaster. . . ." (PX 44, A 684-85) Those same executives warned that a fair price provision "would not prevent a takeover of Household by a determined and well-financed bidder." Accordingly, they concluded, the benefits of a fair price provision (i.e., stockholder protection, without an effective

19. A fair price amendment is designed to ensure that, in two-tier offers, second-tier sellers are paid at least the highest price paid during the first tier unless the board decides otherwise, or a super-majority stockholder approval of the second step is obtained. (Op. at 3 n.1, A 292; James Dep. 50, A 387; Upton Dep. 121-23, A 428-30)

management entrenchment component) would not exceed the risks (i.e., encouragement of the very result which the amendment was designed to avoid — the acquisition of Household). (*Id.; see also* James Dep. 40-41, A 385-86; Clark V 173-74, A 518-19)

In June and July, 1984, Moran discussed with Household's chairman Clark and chief financial officer Dammeyer the possibility of management joining DKM in acquiring Household in a leveraged buyout. (Op. at 3-4, A 292-93) Moran's suggestion of a leveraged buyout with management's participation never got beyond the discussion stage. (Op. at 4, A 293) Moran never intended a hostile takeover of Household. (Moran I 122-23, A·436-37) The court below specifically found that his approach assumed the cooperation and participation of Household's management. (Op. at 5, A 294) The trial court also found that the "evidence supports Whitehead's assessment of Moran that he would not be a party to a hostile move against Household." (Op. at 54, A 343) The trial court dismissed Household's counterclaim charging Moran breached his fiduciary duties to Household by exploring a possible leveraged buyout as "totally lacking in evidential support." (*Id.*)

B. The Household Board's Information About And Consideration Of The Rights Plan

Having concluded that a fair price amendment would not solve the hostile takeover problem, Clark retained Wachtell, Lipton, Rosen & Katz, as special counsel, and Goldman, Sachs to formulate, jointly, an anti-raid policy for recommendation to the Household board at its August 14, 1984 meeting. (Op. at 5, A 294)

A three-page summary of the Rights Plan was mailed to all directors on August 7, 1984, as part of a package of materials to be discussed on August 14. (Op. at 6, A 295) Clark and Household's new general counsel, Richard Hull

("Hull"),[20] discussed the plan with selected directors on August 13 at a meeting to which Moran was not invited.

At the August 14 board meeting, the directors were advised that:

1. The Plan in no way inhibited, restricted or made more expensive proxy contests.

2. The Plan only prevented coercive two-tier offers.

3. Delaware counsel had opined that the Plan was legal and that the board would properly exercise its business judgment to adopt the Plan.

As shown *infra*, these representations were not accurate. The directors testified they placed heavy reliance on these representations in voting for the Plan. (*See, e.g.*, Upton Dep. 23, 135, A 427, 433; James Dep. 146-47, A 388-89; Brennan Dep. 125-26, A 354-55; Osler Dep. 8-9, A 396-97; Rasmussen Dep. 61-63, A 413-15)

The board was also led by Clark to believe falsely that there was an immediate need to adopt the Plan because plaintiffs were likely to launch imminently a hostile tender offer for Household. Whitehead so testified. (Whitehead VI 48-51, A 525-28) For that reason, the board rejected Whitehead's request that the vote on the Plan be deferred for later consideration and adopted the Plan over Moran's and Whitehead's objections. The action was taken after only very limited discussion (two hours at most), without review of the actual Plan, based on an inaccurate three-page summary of the Plan and on inaccurate oral representations. The court below found that:

> The complexity of the Plan, with its series of triggering events, was undoubtedly a challenge to the Board's under-

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20. Although Hull described the Plan's terms to these directors on August 13 (Clark V 248-49, A 522-23), he did not fully understand the effects of the Plan. (*See* Hull Dep. at 16-17, 32-34, A 377-78, 380-82)

> standing and some directors did not have a full appreciation of its many ramifications, particularly in the proxy area. The three page summary of the Plan does not reflect all of the intricacies contained in the 48 page formal Rights Agreement. . . .

(Op. at 42, A 331)

Subsequent to its adoption, Moran has twice introduced resolutions calling for the Plan to be submitted to the Household stockholders for their ratification or rejection. His resolutions failed for want of a second. The board has since declined to nominate him for re-election as a director because he sought to protect the rights of all Household stockholders by bringing this action and prosecuting this appeal.

ARGUMENT

I. THE HOUSEHOLD BOARD LACKS CORPORATE POWER TO ADOPT THE PLAN

The Household Right is an artificial and radical device. Its purpose is to make structural changes in the corporate body and grant plenary negotiating power to the board in tender offers. It creates a mechanism whereby stockholders of one corporation may visit devastating dilution on a second corporation whose identity is unknown at the time of the creation of the Right. It limits stock ownership by individuals or groups to less than 20 percent and thereby restricts block voting and interferes with fundamental stockholder franchise rights. All of these dramatic effects were found as fact by the court below. Yet nowhere does the court analyze the source of the board's power to adopt such an extraordinary device.

Household asserted below that section 157 of the DGCL granted its board the power to adopt the Plan. The Opinion cites that section (Op. at 37, A 326), but it is neither discussed nor analyzed. The Opinion does not analyze the framework of the DGCL nor does the court even discuss the crucial issues related to whether the board acted without authority and beyond its managerial power. These issues were argued in great depth to the court below and were simply ignored in the Opinion. The answers to these questions go to the roots of corporate power and, when the analysis is performed, condemn the Plan.

Section 157, the sole source of board power pointed to by Household, neither deals with the corporate structure, nor authorizes the transfer of power between the constituent groups in the corporation.[21] To the contrary, section 157

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21. In this context, the business judgment rule is utterly beside the point. Household in its post-trial brief ("DTB") stated that it "do[es] not claim that the business judgment rule authorized the transaction." (DTB at 36, A 233) This Court has twice held in the last four years that the business judgment rule is not a source of power for acts of a board of

has long been recognized to authorize traditional *financing* devices, not poison pills. Yet, the Opinion below can only be read to derive from section 157, without reasoned discussion, corporate power exercisable by the board of directors to arrogate to itself a power of veto over tender offers and to limit stockholder ownership and franchise rights. Such an interpretation is nowhere found in the statute itself, its legislative history, its purpose or case law construction.

If section 157 is interpreted to transform a traditional financing statute into a grant to the board of unprecedented structural power, that section becomes a statutory grant which not only violates basic principles of state corporate law, but also transgresses fundamental federal interests. Such a grant of statutory authority would place a substantial and adverse burden on interstate commerce and would violate the Commerce and Supremacy Clauses of the United States Constitution.

A. Standard And Scope Of Review

The holding of the court below that the Plan is authorized under section 157 and apparent rejection of plaintiffs' arguments that section 157, as so applied, violates the United States Constitution are strictly legal holdings. This Court must review such legal holdings for errors of law *de novo* and should reverse the trial court if such errors of law are found. *Rohner v. Niemann*, Del. Supr., 380 A.2d 549, 552 (1977).

B. Neither Section 157 Nor Any Other Section Of The DGCL Authorizes The Plan

1. *The Plan is an unlawful manipulation; it is both mislabeled and sham*

Every facet of the Household Plan is sham and labeled to mislead. The "Right" is not now exercisable and was designed and intended never to be exercised. The sole purpose of the Plan is to prevent the "triggers" that would make it

directors. *Zapata Corp. v. Maldonado, supra*, 430 A.2d at 782; *Aronson v. Lewis, supra*, 473 A.2d at 811-12.

come to life. The Right is not intended to function in accordance with its terms but, on the contrary, is intended never to function in accordance with its terms.

Even if it were exercisable, the Right is not a right as that device is known in corporate finance. A right is a "method of financing the capital requirements of a corporation already in existence." Fletcher, *Cyclopedia of the Law of Corporations*, vol. 19, §8975, at 156 (rev. perm. ed. 1975). The financing of Household is not the purpose or function of the Plan.

The action of the Household board on August 14, 1984 was said to be the declaration of a "dividend." A dividend is a division of corporate earnings or surplus for the benefit of the stockholders. *Penington v. Commonwealth Hotel Const. Corp.*, Del. Supr., 155 A. 514, 517 (1931); *Fulweiler v. Spruance*, Del. Supr., 222 A.2d 555, 558 (1966). The "dividend" of a "Right" created by the Plan divides no corporate property and does not increase by one iota the assets of the stockholders. When the "Rights dividend" was declared, no stockholder received property. The Right remains inert and "stapled to the share." The Right will never be available for trading unless the Plan fails and one of the "triggers" sought to be prevented by the *in terrorem* effect of the Plan were to be "pulled" by an unfriendly acquisition of an interest in Household. In addition, the Right has no balance sheet impact and no economic value. (Op. at 38-39, A 327-28)

The "preferred stock" made subject to the Right is also illusory. It is purposely "out-of-the-money" and intended to remain so during the life of the Right.[22] It is of no value today and will have value only if Household stock triples in price. Such a development may be possible but the possibility is so speculative that, even if the Rights were triggered and traded separately, they will have little, if any, present worth. The record established that Household stock, now trading at about $35 per share, has not traded higher than $40 per share during the past fifteen years. (Clark VI 149, A 533)

22. *See* footnote 4, *supra*.

The exercise by the Household stockholders of the Right for the Class A preferred would be the last thing Household wants. Should the miracle occur and Household stock triple in price, the Right would still not be available for conversion by a stockholder unless one of the triggers were pulled and the Rights became detached from the shares. But if the Right were ever exercised for the preferred, it would no longer threaten, by the "flip-over," the dilution of an unwanted acquiror. The sole purpose of the Plan would thereby fail.

Household chairman Clark informed stockholders on August 14, 1984 that "your Board of Directors declared a dividend of one preferred stock purchase right on each outstanding share of Household International Common Stock. . . ." (PX 211 at 1, A 882). In fact, however, the "Right" was not a right, the "dividend" was not a dividend and the "preferred stock" was never intended to issue. The entire device was a sham intended to achieve a structural change in the corporation. As such, it is an unlawful manipulation and should be struck down as unauthorized by the statute. *Aldridge v. Franco Wyoming Oil Co.*, Del. Supr., 14 A.2d 380 (1940); *Telvest, Inc. v. Olson*, Del. Ch., C.A. No. 5798, Brown, V.C. (Mar. 8, 1979) (Ex. C).

2. *The Plan serves no purpose for which section 157 was intended*

The "flip-over" is the Plan's central operative device. (Op. at 7-8, A 296-97) The sole purpose of the flip-over and, therefore, of the Plan, is to make the board the controlling negotiator in tender offers and thereby prevent a takeover not approved by the board. (PX 211 at 2, A 883) This purpose is achieved by threatening an unfriendly acquiror with massive dilution. The sole purpose of the Plan is thus utterly unrelated to corporate finance.

As Justice Moore, citing *Kelley v. Mayor and Council of Dover*, Del. Ch., 300 A.2d 31 (1972), recently pointed out:

> [E]quity regards substance rather than form.

Monroe Park v. Metropolitan Life Insurance Co., Del. Supr., 457 A.2d 734, 737 (1983); *DMG, Inc. v. Aegis Corp.*, Del. Ch., C.A. No. 7619, Brown, C. (June 29, 1984) (Ex. G). The Plan, in substance, is a structural change in the corporation. The attempt to clothe it in the form of a financing device must therefore be disregarded. In order to justify the adoption of the Plan, Household must point to a source of authority which empowers its board to make this structural change. Household cited section 157 as its source of authority. The court appears to have agreed. In upholding the Plan on that basis, the court below must have construed section 157 to permit a device the sole purpose of which is corporate structural change. No such purpose was intended by the General Assembly. Such a construction is contrary to section 157's manifest purpose, legislative history and a cohesive interpretation of the DGCL.

Nothing in the legislative history of section 157 remotely suggests that its purpose had anything to do with corporate control in general or takeover defense in particular. The predecessor to section 157 was the Act of March 22, 1929, ch. 135, § 6, 36 Del. Laws 374-76. *See* Arsht, *A History of Delaware Corporation Law*, 1 Del. J. Corp. Law 1, 11 (1976). That Act was passed to recognize explicitly the existing practice of granting rights and options to purchase stock. *See* Berle, *Investors and the Revised Delaware Corporation Act*, 29 Colum. L. Rev. 563, 570 (1929). The warrants and rights statutorily recognized were to be issued as a "method of financing the capital requirements of a corporation already in existence." Fletcher, *Cyclopedia of the Law of Corporations*, vol. 19, § 8975, at 156 (rev. perm. ed. 1975).

Statutes granting corporate power must be construed consistently with their purpose. In *Aldridge v. Franco Wyoming Oil Co., supra*, for example, the Supreme Court held that a charter provision was invalid because its purpose was not consistent with the power granted by the portion of the DGCL that, in form, was said to authorize it. The defendant corporation had two classes of stock, common and Class A. The charter provided that no person could be elected a director if 40 percent of Class A stock was cast against his election. The Class A stock was issued pursuant to then section 13 of the DGCL, which authorized the creation of a class of stock with voting rights expressed in the charter. Chief Justice Layton found that "the right attached to the Class A stock is not, in reality, a voting right as such right is generally understood" because a voting right is the right to express an affirmative preference or choice, rather than a right to veto. 14 A.2d at 381. Thus, the Chief Justice stated:

> If the extraordinary power conferred on the Class A stock is to be upheld, some provision of the law must be found which, either by express words or necessary intendment, authorizes the creation of the power. It is sufficient to say that the right conferred on the special class of stock, in the *guise of a voting right*, is not within the intendment of the law as it is now written. . . .

Id. (emphasis added).

Chancellor Brown's widely reported decision of *Telvest, Inc. v. Olson, supra*, as he reaffirmed it four years later in *National Education Corp. v. Bell & Howell Co.*, Del. Ch., C.A. No. 7278, Brown, C. (Aug. 25, 1983) (Ex. D) is consistent with *Aldridge*. The Chancellor stated in *National Education Corp.* that the *Telvest* preferred

> was clearly a sham insofar as it purported to be a 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. For these reasons, the Chancellor held that the issuance of the preferred was not authorized by section 151(a). The doctrine is also familiar in other areas of the law. *See Application of Penny Hill Corp.*, Del. Supr., 154 A.2d 888, 891-92 (1959) ("To determine the significance of these clauses as they appear in this statute, we must look into the purpose and intention of the Legislature. . . ."); *E. I. du Pont de Nemours & Co. v. Clark*, Del. Supr., 88 A.2d 436, 439 (1952) ("Whatever the nature of the statute under construction may be, the primary object of construction is to reach a result in conformity with the supposed policy of the statute.").

This construction of section 157 is reinforced by two fundamental principles of corporate law which limit the reach of statutory grants of power to corporate boards. Such statutory powers are granted by the legislature subject to limitations derived from the rules that (1) "corporate powers are held in trust, and must be used fairly by those who exercise them, notwithstanding apparently unrestricted statutory language" and (2) "powers conferred on the board may . . . be used only to achieve purposes related to the management of the corporation's business — that is, used only to effectuate decisions of the kind . . . labeled business (e.g., issuing stock to increase working capital), rather than the kind . . . labeled

structural." Eisenberg[23], *Modern Corporate Decisionmaking*, 57 Calif. L. Rev. 1, 142-43 (1969) (footnotes omitted) ("*Modern Corporate Decisionmaking*"). *Accord Schnell v. Chris-Craft Industries, Inc.*, Del. Supr., 285 A.2d 437 (1971). In the same article, Professor Eisenberg points out that:

> Corporate law has traditionally distinguished powers from purposes. It is well established that corporate powers can be exercised only to achieve legitimate (law-and-charter-approved) corporate purposes. It is also well established that board powers can be exercised only to achieve legitimate board purposes. Thus, despite the issuance-of-stock provisions . . . the board may not . . . issue stock for the purpose of reallocating control.

Modern Corporate Decisionmaking at 142. *See also* authorities cited therein at pp. 143-44, fns. 435-46.

The Household board has, by the Plan, sought in substance to reallocate corporate control in the form of an issue of securities. The Plan is not and could not be authorized by section 157, the sole statutory provision asserted by Household to grant that power to the board. The Plan should be struck down.

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23. Professor Eisenberg is the present editor of Cary and Eisenberg, *Cases and Materials on Corporations*, now in its 5th edition and published by The Foundation Press.

3. *A plain reading of sections 157 and 121(a) of the DGCL indicates that they do not authorize the Plan*

A plain reading of section 157 demonstrates that its explicit terms would not authorize even genuine rights to acquire some other corporation's stock. Section 157, in pertinent part, reads as follows:

> Subject to any provisions in the certificate of incorporation, every corporation may create and issue, whether or not in connection with the issue and sale of any shares of stock or other securities of the corporation, rights or options entitling the holders thereof to purchase from the corporation any shares of *its*[24] capital stock of any class or classes, such rights or options to be evidenced by or in such instrument or instruments as shall be approved by the board of directors.

(Emphasis added.)

The flip-over provision of the Rights purports to grant the holder the power to buy the stock of an as yet unknown "raider" corporation for one-half of its market value. The explicit language of section 157 authorizes no such extraordinary result. To find broader authorization would require impermissible judicial legislation. *See Chrysler Corp. v. State*, Del. Supr., 457 A.2d 345, 349 (1983); *Federal United Corp. v. Havender*, Del. Supr., 11 A.2d 331, 337 (1940).

To avoid the clear language of the statute, Household argued that the flip-over provision was identical to anti-destruction clauses found in certain convertible securities (Defendants' Pre-Trial Brief ("DPTB") 81-90, A 146-55),

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24. Section 151(e), relating to preferred stock, contains the same limitation. Section 151(b), by contrast, expressly provides that stock may be redeemed for "securities of the same or another corporation. . . ."

a view the court below may have adopted, once again without analysis. (Op. at 39, A 328) Such an argument cannot withstand scrutiny. Pursuant to an anti-destruction clause, the issuing corporation guarantees the securityholder that the corporation will not enter into any agreement of merger or other combination in which the current value of the security's convertibility feature is not preserved. An anti-destruction clause, by protecting the value of the security in a business combination, serves a financing purpose by making the security of sounder value in its initial sale or later transfer between holders. Such a clause is bargained for by the securityholder and is supported by consideration. The sole purpose of the clause is, thus, the preservation of the value of the security in which it appears. *See Broad v. Rockwell International Corp.*, 642 F.2d 929, 945 (5th Cir.), *cert. denied*, 454 U.S. 965, 102 S. Ct. 506 (1981).

Anti-destruction clauses may be implicitly authorized by section 121(a) of the DGCL because they are "incidental" to a corporation's statutory power to finance itself by the issuance of convertible securities. But the flip-over is not "incidental" to any provision in the Rights or to any feature of any Household security. To the contrary, the flip-over is the Plan's central operative device. (Op. at 7-8, A 296-97) Exercise of the Right for securities of the acquiror will not preserve the conversion value of the Right into preferred; it will destroy that right. The flip-over is in no way dependent on the existence of a Right to convert into the preferred stock. Rather, it is an independent right to create extraordinary theoretical value by ostensibly permitting the holder to purchase a "raider's" common stock for half-price. As shown above, the value is entirely hypothetical since the dilution caused by the exercise of the Rights is so extraordinary that no acquiror will proceed.

Household's effort to issue Rights to acquire preferred shares at three times the market price may be legal, but as a practical matter, it is pointless. To say, as the court did, that the "economic substance [of the preferred] is somewhat be-

lied by the fact that, on present projections at least, even Household views them as 'out of the money'. " (Op. at 38, A 327) is, in our opinion, an understatement. But even if the court were precisely correct, no one would contend that, so far as the Plan is concerned, a right to acquire out-of-the-money preferred is any more than a tag-along to the flip-over.

In writing that the "combined economic significance [of the preferred and the Right] will be obvious — they serve to protect shareholders from the coercion of a partial tender offer," (Op. at 39, A 328) the court below recognized that the only purpose of the Right, even when combined with the newly created preferred, was to create the flip-over right to dilute an acquiring company and prevent tender offers unblessed by the board. The preferred adds nothing to the flip-over except camouflage. The best that can be said for the preferred is that in making the Plan as a whole look more conventional, the conversion right into an out-of-the-money preferred is "incidental" to the flip-over.

Since the Plan is contrary to the plain language of section 157, it is unauthorized and should be struck down.

4. *Household's use of section 157 is contrary to the pattern of the DGCL*

As the court below held, the purpose of the Plan is to set up the board as a "bargaining agent" with prospective tender offerors so that the board may negotiate for stockholders. (DTB 39, A 234) The court held that "[t]hrough its power to redeem the rights before a triggering event occurs the Household board has assumed a plenary negotiating role." (Op. at 56, A 345) That purpose is alien to section 157 and so construing it leads to a result which is inconsistent with the clear intent of the General Assembly in 1976 when it enacted section 203.[25]

25. Where the General Assembly intended to have the board serve as a bargaining agent, it specifically so provided in the relevant sections of the DGCL. *See, e.g.*, sections 251 *et seq.*, 271, 275.

In adopting section 203, the General Assembly recognized that tender offers are beneficial both to corporations and their stockholders. Section 203 was passed when many other states were considering or had adopted statutes designed to deter tender offers by imposing disclosure and substantive fairness standards which, unless waived by the target company's board, could substantially delay or defeat hostile tender offers.[26] Delaware chose not to give the board the power to interfere with, or deter the making of, tender offers. Section 203 is a "notice" statute, the basic requirement of which is to give timely advice to the target of the offeror's intention to make a tender offer. The drafters of section 203 determined that:

> [R]egulation 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.

Berkowitz, *Delaware Tender Offer Regulation*, 2 Del. J. Corp. Law 373, 374 (1977) (footnotes omitted); to the same effect, Arsht, *A History of Delaware Corporation Law*, 1 Del. J. Corp. Law 1, 20 (1976).

Since the purpose of the Plan contravenes the intent of the General Assembly in adopting section 203, section 157 may not be construed to authorize the Plan. The Plan should be struck down.

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26. *See, e.g.*, Illinois Business Takeover Act, Ill. Rev. Stat. ch. 121-1/2 (1979) ¶137.51 discussed in *Edgar v. MITE Corp., supra;* Idaho Takeover Statute, Idaho Code §§ 30-1501-13 (Cum. Supp. 1977), discussed in *Great Western United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on venue grounds sub nom. Leroy v. Great Western United Corp.*, 443 U.S. 173, 99 S. Ct. 2710 (1979).

C. If It Authorizes The Rights Plan, Section 157 Of The DGCL Violates The United States Constitution

The United States Supreme Court and various federal circuit courts have held repeatedly that state takeover statutes, which impede and thwart nationwide tender offers under the cloak of stockholder protection, violate the Commerce Clause of the United States Constitution, U.S. Const., art. I, §8, cl. 3. *E.g., Edgar v. MITE Corp.*, 457 U.S. 624, 102 S. Ct. 2629 (1982); *Mesa Petroleum Co. v. Cities Service Co.*, 715 F.2d 1425 (10th Cir. 1983); *Telvest, Inc. v. Bradshaw*, 697 F.2d 576 (4th Cir. 1983); *Martin-Marietta Corp. v. Bendix Corp.*, 690 F.2d 558 (6th Cir. 1982); *National City Lines, Inc. v. LLC Corp.*, 687 F.2d 1122 (8th Cir. 1982); *Great Western United Corp. v. Kidwell*, 577 F.2d 1256 (5th Cir. 1978), *rev'd on venue grounds sub nom. Leroy v. Great Western United Corp.*, 443 U.S. 173, 99 S. Ct. 2710 (1979). The court below apparently construed section 157 as granting boards a greater power over tender offers even than that conferred by state takeover statutes — the power to veto *any* hostile tender offer through the adoption of the Plan. Unless that construction is reversed, section 157 will be rendered unconstitutional under the teachings of *MITE* and its progeny. It will substantially and unjustifiably burden interstate commerce and frustrate the basic Congressional purpose and regulatory scheme embodied in the federal Williams Act governing tender offers.[27]

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27. Because section 157, so construed, would stand as an obstacle to the accomplishment of the policies underlying the Williams Act, it would be void under the Supremacy Clause of the United States Constitution, U.S. Const., art. VI, cl. 2. *See Hines v. Davidowitz*, 312 U.S. 52, 67, 61 S. Ct. 399, 404 (1941). The Williams Act seeks to protect investors through a "market approach," whereby "the offeror and the incumbent managers of a target company . . . present fully their arguments and then . . . *let the investor decide for himself.*" *Great Western United Corp. v. Kidwell, supra*, 577 F.2d at 1276 (emphasis added); *accord Edgar v. MITE Corp., supra*, 457 U.S. at 633-34, 102 S. Ct. at 2636-37 (opinion of White, J.); *Kennecott Corp. v. Smith, supra*, 637 F.2d at 187-88. The Vice Chancellor's construction of section 157 to permit an incumbent man-

The Commerce Clause of the United States Constitution serves as a limitation on the power of states to regulate or interfere with the free flow of commerce between the states. *Lewis v. BT Investment Managers, Inc.*, 447 U.S. 27, 100 S. Ct. 2009 (1980). This limitation applies equally to actions affecting interstate commerce by private entities where a state statute authorizes the entity's actions and is its source of power. *Wilson v. Black Bird Creek Marsh Co.*, 27 U.S. 245 (1829) (Marshall, C.J.) (Delaware statute empowering a private corporation to build a dam across a navigable tidal creek was subject to the limitations of the Commerce Clause); *accord Cardwell v. American River Bridge Co.*, 113 U.S. 205, 5 S. Ct. 423 (1885) (state statute authorizing a private corporation to erect a bridge across navigable river). Of course, the powers of a Delaware corporation derive solely from the state constitution and the DGCL. *Davis v. Louisville Gas & Electric Co.*, Del. Ch., 142 A. 654, 656 (1928); *Federal Mining & Smelting Co. v. Wittenberg*, Del. Supr., 138 A. 347, 349 (1927). It is irrelevant to the constitutional analysis whether the legislature specifically intended to grant such power in enacting the statute or whether the judiciary has interpreted the statute to do so. *See Shelley v. Kraemer*, 334 U.S. 1, 14-15, 68 S. Ct. 836, 842-43 (1948).

In *Edgar v. MITE Corp.*, *supra*, the Supreme Court ruled that the Illinois Business Takeover Act (the "Illinois Act") was unconstitutional because it placed a substantial burden on interstate commerce without furthering any legitimate local interests. The Illinois Act (i) required a tender offeror to file a registration statement with the Secretary of State (the "Secretary") 20 days prior to the commencement of the offer,

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agement veto power over tender offers upsets the neutrality between a tender offeror and target management which Congress sought to establish through the Williams Act. Because section 157, so construed, would significantly favor management at the expense of stockholders, it would be preempted by the Williams Act. *See Edgar v. MITE Corp.*, *supra*, 457 U.S. at 633-34, 102 S. Ct. at 2636- 37 (opinion of White, J.); *Kennecott Corp. v. Smith*, *supra*, 637 F.2d at 188.

(ii) subjected the offer to a substantive fairness hearing at the option of the Secretary or the subject board, and (iii) authorized the Secretary to prevent the offer from going forward if he found the offer to be unfair or the disclosure inadequate. 457 U.S. at 627, 102 S. Ct. at 2633.

The Supreme Court found that the Illinois Act burdened interstate commerce because of its "nationwide reach which purports to give Illinois the power to determine whether a tender offer may proceed anywhere." 457 U. S. at 643, 102 S. Ct. at 2642; *accord Mesa Petroleum Co. v. Cities Service Co., supra*, 715 F.2d at 1429; *Martin-Marietta Corp. v. Bendix Corp., supra*, 690 F.2d at 565. The Court determined that the Act's impact on interstate commerce was substantial and unjustifiable. 457 U.S. at 645, 102 S. Ct. at 2643.

Section 157, if interpreted to authorize the Plan, is invalid under the teaching of *MITE*. If so construed, section 157 would impose a greater burden on interstate commerce than the Illinois Act, balanced only by state interests which the Supreme Court found insufficient in *MITE*.[28]

Like the Illinois Act, section 157, if so interpreted, could not be justified by any purported motive to protect local investors. The court below held that Household's board could adopt the Rights Plan to protect Household's stockholders from two-tier offers which the board deemed coercive. (Op. at 42-43, A 331-32) The *MITE* Court unequivocally held that the protection of non-resident stockholders was not a legitimate state interest. *Edgar v. MITE Corp., supra*, 457 U.S. at 644, 102 S. Ct. at 2642. As of August, 1984, Household had 25,705 stockholders, holding 48,961,000 shares of the out-

28. Because section 157, on its face, does not raise any constitutional questions, this Court can and should adopt an interpretation of the statute in which both state and federal law are harmonized. *See, e.g., Aprile v. State*, Del. Super., 143 A.2d 739, 743 (1956), *aff'd*, Del. Supr., 146 A.2d 180 (1958); *Collison v. State*, Del. Supr., 2 A.2d 97, 107 (1938); *De Canas v. Bica*, 424 U.S. 351, 357 n.5, 96 S. Ct. 933, 937 n.5 (1976); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 127, 96 S. Ct. 373, 389-90 (1973).

standing common stock. (PX 229, A 885-88) Few of those stockholders reside in Delaware.

Moreover, any asserted stockholder protection from "coercive" two-tier offers to be gained from the Plan is outweighed by the harm to Household stockholders by depriving them of their right to participate in all hostile tender offers. *Edgar v. MITE Corp., supra*, 457 U.S. at 643, 102 S. Ct. at 2642. The court below questioned the existence of this right. (Op. at 43-44, A 332-33) Congress, by passage of the Williams Act, acted explicitly to preserve " 'the opportunities [for stockholders] which result from the competitive bidding for a block of stock of a given company,' namely *the opportunity to sell shares for a premium over their market price.*" *Edgar v. MITE Corp., supra*, 457 U.S. at 633 n.9, 102 S. Ct. at 2636 n.9 (quoting 113 Cong. Rec. 24666) (opinion of White, J.) (emphasis added).

Finally, the "internal affairs doctrine" could not immunize section 157, if so interpreted, because, like the Illinois Act, it would regulate the relationship between stockholders and third parties. The trial court specifically found that by adopting the Rights Plan, the Household directors unilaterally restricted the "right of shareholders to participate in non-management sanctioned tender offers" in order to "increase its bargaining power in tender offers." (Op. at 30, A 319) The Household directors are thus impermissibly allowed to act as a buffer between stockholders and any potential tender offeror. (Op. at 36, A 325) The Court in *MITE* specifically rejected the claim that the Illinois Act served a legitimate "internal affairs" interest. The Court held that the "internal affairs doctrine" is inapplicable in the context of tender offers because such offers "contemplate transfer of stock by stockholders to a third party and do not themselves implicate the internal affairs of a target company." 457 U.S. at 645, 102 S. Ct. at 2643.

* * *

The conclusion is inescapable that the trial court committed plain error in concluding that section 157 authorized either the issuance of the Rights or the result Household sought to achieve through adoption of the Plan. The trial court's overly broad reading of section 157 ignores the General Assembly's purpose in enacting that section and its clear intention not to give boards of directors of Delaware corporations the power to interfere with or deter the making of tender offers. Furthermore, the trial court's error would needlessly cast a provision of the DGCL in direct conflict with the federal constitution and place Delaware law at odds with federal law and policy. A proper construction of section 157, invalidating the Rights and the Plan, is required to avoid a finding of unconstitutionality and to give effect to the intention of the General Assembly in enacting section 157. *Aprile v. State*, Del. Super., 143 A.2d 739, 743 (1956), *aff'd*, Del. Supr., 146 A.2d 180 (1958); *Collison v. State*, Del. Supr., 2 A.2d 97, 107 (1938). Such a construction requires that the Plan be struck down.

II. THE PLAN'S ALTERATION OF HOUSEHOLD'S FUNDAMENTAL CORPORATE STRUCTURE AND USURPATION OF STOCKHOLDER RIGHTS WAS BEYOND THE BOARD'S AUTHORITY

It is beyond the power of any board of directors acting without stockholder approval to alter the fundamental structure of a corporation by reallocating power from the stockholders to the board. Thus, even if *corporate* power existed under the DGCL to issue the Rights, the trial court was plainly wrong in validating the board's exercise of that power without the consent of Household's stockholders.

Directors of Delaware corporations possess managerial power to operate the business of the corporation in the interests of the stockholders. This centralization of decision-making power in the board is key to the economic success of the corporate form of business organization. *See* President's Report at 187-88 (Ex. B). This principle of law is, however, limited by its purpose. It does not validate board action taken to alter the corporate structure or the contract among the stockholders and the corporation. Decisions of that nature do not require centralized decision-making.

> Courts traditionally have dealt with decisions to make a change in the corporate structure (organic change) or purpose (ultra vires) as a special area, separate and apart from the normal business decision.

Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint*, 35 Geo. Wash. L. Rev. 562, 564 n.16 (1967) (citation omitted). Rather decisions to change the corporate structure by reallocating power or by limiting the rights of suffrage are made by the legislature or by the stockholders acting on the advice of the directors. *See*, *e.g.*, DGCL § 242. Unilateral board action to effect such a

change is unauthorized and invalid. The Opinion below ignores this basic principle; it would vest control in boards over the structure and destiny of Delaware corporations and reduce the stockholder-owners to wards of the managers.

A. Standard And Scope Of Review

The standard and scope of review of the Vice Chancellor's finding that the board had the authority to adopt the Plan without stockholders' consent is the same as that stated in Argument I.A., *supra*.

B. The Board Was Unauthorized To Usurp The Stockholders' Right To Receive And Accept A Hostile Tender Offer By Changing Household's Fundamental Structure

The Rights Plan was "calculated to alter the structure of the corporation" (Op. at 36, A 325); it "results in a fundamental transfer of a power from one constituency (shareholders) to another (the directors)." (*Id.*) The Vice Chancellor found that the reallocation of power "affects the structural relationship between the Board and the shareholders" and is the "fundamental result" of the Plan. (*Id.*) These findings rested on the Vice Chancellor's conclusion that the Plan's deterrent effect on hostile offers vested in the board a "plenary negotiating" power, including the power to block all hostile acquisition efforts. (Op. at 56, A 345) In a later opinion, the Vice Chancellor explained the case here on appeal as one where "the board's conduct served to accomplish a shift in the internal structure of [Household] in such a way as to transfer power from the shareholders to management." *Edelman v. Phillips Petroleum Co.*, Del. Ch., C.A. No. 7899, Walsh, V.C., slip op. at 7 (Feb. 12, 1985) (Ex. E). These extraordinary findings required a holding that the board's conduct was unauthorized and violated its most basic duty to stockholders.

Over 100 years ago the United States Supreme Court, in *Chicago City Railway Co. v. Allerton*, 85 U.S. 233, 234-35

(1874), recognized that the managerial powers of boards do not extend to the alteration of a corporation's fundamental structure:

> The general power to perform all corporate acts refers to the ordinary business transactions of the corporation, and does not extend to a reconstruction of the body itself. . . .
>
> * * *
>
> If the directors alone could do it, they could always perpetuate their own power.

See also Commercial National Bank v. Weinhard, 192 U.S. 243, 248-49, 124 S. Ct. 253, 256 (1904) ("Corporate powers conferred upon a board of directors usually refer to the ordinary business transactions of the corporation"); *Ostlind v. Ostlind Valve, Inc.*, 165 P.2d 779, 791 (Ore. 1946); Morawetz, *A Treatise on the Law of Private Corporations* §512, at 477-80 (2d ed. 1886) ("The general authority of the directors of a corporation extends merely to the supervision and management of the company's ordinary or regular business. A board of directors has no implied authority to make a material and permanent alteration of the business or constitution of a corporation. . . ."); Clark & Wormser, *Handbook of the Law of Private Corporations*, at 609-10 (3d ed. 1916).

This basic principle of corporate law has continued to govern the internal affairs of corporations as an expression of the right of stockholders — the owners — to determine the fundamental structure and ultimate destiny of a corporation. The Court of Appeals of Maryland restated the principle in *Warren v. Fitzgerald*, 56 A.2d 827, 832-33 (Md. 1948):

> Generally speaking, a corporation's ordinary business powers are vested in its directors; its constituent powers, relating

> to fundamental changes in its corporate structure, objects or purposes, are reserved to the stockholders, to be exercised (under present Maryland law) on recommendation of the directors.

Ballantine, *Private Corporations* §97, at 320 (1927) is to the same effect:

> A general provision in the charter of a corporation or the general law, that "*all the corporate powers* shall be vested in and exercised by a board of directors, and such officers and agents as said board shall appoint," refers merely to the ordinary business transactions of the corporation, and does not extend to other acts which are not ordinarily within the powers of the directors, but are done or authorized by the stockholders only, — as the reconstruction of and fundamental changes in the corporate body, increase of the capital stock, etc.

(Footnote omitted; emphasis in original.) *See also* Eisenberg, *Modern Corporate Decisionmaking*, *supra*, at 86-91.

The court below explicitly found that the adoption of the Rights Plan produced just such "fundamental" changes in Household's corporate body. That finding was fully supported by the record. Nevertheless, the Vice Chancellor held that the board could produce such changes without the assent of stockholders. That conclusion is flatly contrary to fundamental principles of corporate law and requires reversal.

The defendants cited no case holding that directors have express authority to alter the fundamental structure of Household without a vote of stockholders. Rather they and

the Court below relied on cases addressing *managerial* actions taken by boards of directors in the context of hostile acquisitions. (Op. at 33-37, A 322-26) None of these cases involved a reallocation of power from the stockholders to the board and, thus, none supports the result reached below. *See* pp. 73-74, *infra*. Boards of directors have a role to play in dealing with takeover bids; they have the right and the duty to exercise their managerial powers in an informed, rational and disinterested manner. *Pogostin v. Rice*, Del. Supr., 480 A.2d 619, 624 (1984).

But courts are careful to ensure that, in exercising their managerial powers in the context of a threatened takeover, directors do not alter the corporate structure or usurp the stockholders' right to determine the corporation's ultimate fate. As the Second Circuit Court of Appeals said in its landmark decision of *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255, 258 (2d Cir. 1984):

> 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.

That is no longer true at Household.[29] Household's stock-

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29. *See also Indiana National Corp. v. Rich*, 712 F.2d 1180, 1185 (7th Cir. 1983) ("[M]anagement does not represent the interest of shareholders in relation to who ultimately *wins* any potential struggle for control...") (emphasis in original); *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, supra*, 637 F.2d at 187-88

holders now hold their shares subject to the unlimited and undefined power of the board to usurp basic rights of stockholders whenever the directors believe it is "reasonable" or "rational" to do so. Such a usurpation is illegal and inequitable. The Plan should be struck down.

C. The Board Was Unauthorized To Restrict The Stockholders' Rights Of Fair Corporate Suffrage

To make more effective its impact on tender offers, the Rights Plan fundamentally limits the ability of Household stockholders to own shares and associate together to protect their investment through concerted voting action. Proxy contests are an essential means for stockholders to preserve and enhance the value of their investments. As Justice Moore stated:

> The machinery of corporate democracy . . . [is a] potent [tool] to redress the conduct of a torpid or unfaithful management.

Aronson v. Lewis, supra, 473 A.2d at 811.

Stockholders of Delaware corporations always have been permitted freely to associate with their fellow stockholders in any size group for the purpose of discussing matters of mutual interest and acting together in voting their shares. No corporation other than Household has ever been permitted, without stockholder assent, to prohibit investors from acquiring as many shares as their financial resources allow to make effective their voice in corporate management. These deliberate effects of the Plan substantially impact the ability of Household's present or future stockholders to engage in proxy contests and thereby serve to entrench management.

NOTES *(Continued)*

(the Williams Act allows shareholders to "exercise a knowledgeable and unfettered choice" concerning tender offers).

1. *The Plan's impact on rights of ownership and suffrage effects an unauthorized change in the fundamental structure of Household*

Although the Vice Chancellor recognized that the Plan's impact on "block voting" (Op. at 46, A 335) and its deterrence of "proxy efforts of a certain magnitude" (Op. at 48, A 337) were "troublesome" (Op. at 45, A 334), he nevertheless found these effects of the Plan justified as part of the board's effort "to increase its bargaining power in tender offers." (Op. at 30, A 319) To achieve this end, the Household board deliberately altered the basic rights of free corporate suffrage previously enjoyed by Household's stockholders. The avowed purpose of the Plan (even if it were legitimate, but *see* Pt. I, *supra*) cannot justify the Plan's impact on the rights of ownership and suffrage.

The defendants say that:

> The purposes of the Plan would be totally undermined if holders of 20% or more of the shares could put together a group of shareholders committed by agreement to concerted action with respect to a block of stock large enough to be deemed effective control of Household.

(DTB 57-58, A 237-38) The Vice Chancellor agreed. He said that the "proxy contest effect . . . is part of the overall design of the Plan to limit the impact of partial tender offers deemed destructive of shareholder interests. Without this feature the Plan is of limited value." (Op. at 48, A 337) The Vice Chancellor also agreed, erroneously, that the Plan's impact on proxy contests can be justified by this expediency. Without citation to any valid authority, the Vice Chancellor concluded that:

> The right of a shareholder to vote his stock is not immutable if the goal is not

> entrenchment and the voting change is otherwise within the board's authority.

(Op. at 47, A 336)[30]

In so holding, the court below committed plain error. A board may not restrict voting power "on the theory that such action is needed to curtail a threat to corporate existence presented by a large concentration of stock in one shareholder." *Telvest, Inc. v. Olson*, *supra*, slip op. at 15; *see also Norlin Corp. v. Rooney, Pace Inc.*, *supra*, 744 F.2d at 265-66. Proxy contestants may not — solely by unilateral board action — be prohibited from purchasing as many shares as their resources permit or from aggregating their holdings with those of other stockholders, even if such holdings exceed 20 percent or some greater or lesser number considered to represent effective control of a company. *Id.*; *see also* Argument II.B., *supra*.

The illegality and unreasonableness of the Plan's restrictions on ownership and suffrage rights is further proven by the fact that the board was completely uninformed of these effects. To support his erroneous conclusion, the Vice Chancellor found that the "Household Board was advised of the ramifications of the Rights Plan on proxy contests and believed the inclusion of such a feature [was] essential." (Op. at 49, A 338) In fact, it is uncontroverted that Household's counsel advised the board that the Rights Plan would have *no* effect on proxy contests. The minutes of the meeting of the Household board of directors on August 14, 1984 show that the directors were advised that:

> The Plan in no way restricts, inhibits or makes more expensive a proxy contest to elect a new Board of Directors.

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30. In support of this statement, the court below referred only to *National Education Corp. v. Bell & Howell Co.*, *supra*, which contains no holding at all but rather expressed Chancellor Brown's inability in the time allowed to determine that either side had shown a likelihood of success.

(PX 203 at 8, A 797) Given this explicit advice, it cannot seriously be argued that the Household board was told that the Rights Plan would, as the Vice Chancellor found, "deter the formation of proxy efforts of a certain magnitude." (Op. at 48, A 337)

At the August 14 board meeting the directors accepted the representation by counsel without question. As Clark testified:

> Q. . . . The only thing that you heard [at the August 14 board meeting] about proxy contests was that they would not be impaired; isn't that right, that they could continue on just as they always had or words to that effect?
> A. Yes, words to that effect.

(Clark VI 191, A 534) Clark's testimony was underscored by other directors who believed that the Plan would not inhibit or restrict proxy contests and relied on that belief in voting for it. (Kartalia Dep. 89-90, A 392-93; Tait Dep. 49-51, A 422-23; Osler Dep. 63, A 405; *see also* Clark Dep. 90-92, A 360-62; Rauch Dep. 81, A 419; Hendry Dep. 61-63, A 373-75) When measured against this undisputed evidence, the Vice Chancellor's conclusion that the board was aware of the impact of the Plan on proxy contests and believed the inclusion of such a factor was essential (Op. at 49, A 338) is totally lacking in evidential support[31] and not binding on this Court.

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31. This finding was itself contradicted by the Vice Chancellor's explicit conclusion that

> The complexity of the Plan, with its series of triggering events, was undoubtedly a challenge to the Board's understanding and some directors did not have a full appreciation of its many ramifications, *particularly in the proxy area*.

(Op. at 42, A 331; emphasis added)

Smith v. Van Gorkom, Del. Supr., No. 255, 1982, Horsey, J., slip op. at 21 (Jan. 29, 1985) (Ex. F); *Nardo v. Nardo*, Del. Supr., 209 A.2d 905, 911-12 (1965).

2. *The Plan entrenches Household's board in office*

The Plan also has the illegal effect of entrenching Household's board in office by insulating them from effective proxy challenge. Courts have repeatedly struck down directors' attempts so to insulate themselves. *E.g.*, *Giuricich v. Emtrol Corp.*, Del. Supr., 449 A.2d 232 (1982); *Schnell v. Chris-Craft Industries, Inc.*, Del. Supr., 285 A.2d 437 (1971); *Lerman v. Diagnostic Data, Inc.*, Del. Ch., 421 A.2d 906 (1980); *Holly Sugar Corp. v. Buchsbaum*, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,366 (D. Colo. Oct. 28, 1981). Such board conduct is inequitable and will not be tolerated because it obstructs legitimate efforts of dissident stockholders and serves to perpetuate management in office. *Schnell, supra*, 285 A.2d at 439.

The Rights Plan is inequitable in that it restricts proxy contests to a far greater extent than necessary even to achieve the supposed purpose offered by the defendants. By restricting stockholders' ability to wage a proxy contest "for the purposes of voiding the Rights Plan incident to a two-tiered plan of acquisition" (Op. at 48, A 337), the Plan also effectively inhibits and restricts the exercise of fundamental voting rights (i) by *all* stockholders, not merely a potential acquiror and (ii) for *whatever* reason, not merely to make a two-tier acquisition. Household stockholders are thus materially hindered in waging an effective proxy challenge to oust a board of directors for poor performance, to oppose a proposed acquisition which stockholders may determine to be against their best interest or to assert their views effectively with respect to *any* other matter properly before the stockholders. The theoretical threat of a circumvention of the Plan by a potential offeror does not justify the sweeping deterrent effects of the Plan on all efforts to wage a proxy contest. *See Schnell v. Chris-Craft Industries, Inc.*, *supra*; *Lerman v. Di-*

agnostic Data, Inc., supra. Compare San Francisco Real Estate Investors v. Real Estate Investment Trust of America, 701 F.2d 1000,1005 (1st Cir. 1983); *B & H Warehouse, Inc. v. Atlas Van Lines, Inc.*, 490 F.2d 818, 827 (5th Cir. 1974).

The Plan obstructs the legitimate efforts of any Household stockholder to oppose any management initiative and serves to perpetuate the board in office. *Schnell, supra*, 285 A.2d at 439. Defendants admitted that the Plan's primary purpose is to "deter any attempt to acquire [Household] in a manner or on terms not approved by the Board." (PX 211 at 2, A 883) Defendants further conceded that for the Plan to be effective, it would have to bar the formation of groups of stockholders "committed by agreement to concerted action with respect to a block of stock large enough to be deemed effective control of Household." (DTB 57-58, A 237-38)[32] Because hostile tender offers and proxy contests are the only means available to stockholders to replace incumbent management, the Plan's admitted deterrence of both mechanisms demonstrates its inevitable effect of entrenching the Household board. The fact that a 20 percent holding may be deemed to constitute "control" does not justify preventing insurgent groups from reaching that level in seeking to displace a board

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32. By undercutting proxy fights the Plan contributes to its deterrence of tender offers. The defendants argued below that if the board rejects a fair offer, stockholders can pressure the board by threatening or launching a proxy fight. (DTB 46-47, A 235-36; Higgins VII 63-67, 165-66, A 549-53, 571-72) But that pressure is less effective because of the Plan's unfair restriction of proxy fights. Defendants' witnesses said a board is never forced to accept an attractive proposal. Higgins testified that a board can reject a fair offer (Higgins VII 153-54, A 564-65), is usually "not interested in considering the sale of their business" (Higgins VII 37, A 546) and — like "Horatio at the bridge" — should have a "veto power" over tender offers for Household. (Higgins VII 214-16, A 585-87) If pressure on the board, in Higgins' words, "does not mean in any way that they would capitulate" (Higgins VII 63, A 549) when there are no Rights outstanding, a board will surely not feel compelled to accept an attractive offer when the Rights are outstanding and effectively hinder proxy contests.

of directors.[33] If defendants' witnesses are correct and an insurgent group needs substantially more than 20 percent to win a proxy contest (Wilcox IX 99, 101, A 617, 618; Troubh VIII 113-14, A 602-03), the Plan is even more effective in entrenching management.

In light of the certain deterrent impact of the Rights Plan on effective proxy challenges, the Plan cannot be justified — as the court below did — on the basis that insurgents holding less than 20 percent of the target's stock *can* prevail in certain proxy contests. (*See* Op. at 48-49, A 337-38) In *Lerman v. Diagnostic Data, Inc., supra*, Chancellor Brown explained the principle first enunciated by this Court in *Schnell*:

> In *Schnell*, the incumbent board amended the by-laws to do away with the established, annually recurring meeting date in such a manner as to give the board the power to fix the date anywhere within a two-month span. Then the board advanced the date forward one month from the former by-law date so as to allow the insurgent shareholders only some six weeks, as opposed to more than two months, in which to wage a proxy battle. . . .
>
> [T]he inequitable action taken in *Schnell* had the effect of hindering the efforts of the challengers by severely curtailing the time in which they had to comply with the Securities and Ex-

33. While defendants selected 20 percent as the threshold stock ownership, the Plan permits the board by amendment to the Rights Agreement to change that figure. Indeed, in view of the 5 percent threshold for control contained in certain statutes, *see, e.g.*, section 13(d) of the Securities Exchange Act of 1934 and section 105d of the New Jersey Casino Control Act, N.J.S.A. 5:12-105d, the argument could be made that a threshold as low as 5 percent is justified.

> change Commission requirements, to contact shareholders, etc. *It did not put the challengers out of business but*, the Supreme Court found, *it unfairly hindered their ability* to present their position to the stockholders within the allotted time, *and, because it was intended to do so, this was found to be wrong.*

421 A.2d at 912 (emphasis added).

Plaintiffs need not show that the Rights Plan puts insurgents "out of business" but rather that it would "unfairly hinder their ability" to mount a successful challenge to incumbent management. As the uncontradicted evidence demonstrates, management clearly has a significant advantage in proxy contests when insurgents own less than 20 percent of their company's stock. *See* pp. 25-29, *supra*. Since the Plan gives that advantage to the Household board, it is inequitable, thwarts stockholder opposition and serves to perpetuate management's control of Household. The Plan should therefore be struck down.

* * *

For these reasons, the board had no power to adopt the Plan, to restructure Household by granting itself a "plenary negotiating role" in all takeovers (Op. at 56, A 345), or to restrict the rights of suffrage of Household's stockholders. None of those acts can be accomplished without, at a minimum, the consent of the stockholders. Otherwise, as the United States Supreme Court recognized over a century ago, "[i]f the directors alone could do [these things], they could always perpetuate their own power." *Chicago City Railway Co. v. Allerton*, *supra*, 85 U.S. at 235. The Plan is a blueprint for directors to augment their power, for whatever reason, at the expense of the rights of the stockholders — who own the corporation. It is unnatural and contrary to basic premises of corporae law and the free market system. It cannot be allowed to stand.

III. THE BUSINESS JUDGMENT RULE IS WHOLLY INAPPLICABLE TO THE DEFENDANTS' UNAUTHORIZED AND UNFAIR ALTERATION OF HOUSEHOLD'S FUNDAMENTAL CORPORATE STRUCTURE

The Opinion below departs sharply from established principles of law by affording business judgment rule protection to the board's unauthorized, structural alteration of the relationships among Household, its stockholders and the board. Even if there had been corporate power exercisable by the board to adopt the Rights Plan, the board's action in doing so cannot be accorded any presumption of regularity. Courts accord a presumption of propriety under the business judgment rule to *managerial* acts of directors taken rationally, in good faith, and in an informed manner. *Zapata Corp. v. Maldonado, supra; Aronson v. Lewis, supra.* Deference to managerial acts does not extend to decisions, like that to adopt the Plan, which do not depend on the business expertise of directors or do not express the managerial power of the board. Especially where such decisions change the corporate structure, courts will not accord directors a business judgment rule defense; "the rule [is] simply inapplicable to validate decisions" of that nature. Note, *The Continuing Viability of the Business Judgment Rule as a Guide for Judicial Restraint,* 35 Geo. Wash. L. Rev. 562, 564 n.16 (1967) (citation omitted).[34]

Moreover, the director-defendants were "interested" in the Plan's adoption and have failed utterly to satisfy their burden of proving the fairness of the Plan to Household's stockholders. Finally, the Opinion below conclusively shows that

34. The theory of the business judgment rule also rests on a recognition that directors must be afforded protection against liability for simple negligence in making ordinary business decisions in the management of the corporation. *See* Arsht, *The Business Judgment Rule Revisited,* 8 Hofstra L. Rev. 93, 94-95 (1979). Since plaintiffs only challenge the directors' authority to adopt the Rights Plan and do not seek damages, that rationale of the business judgment rule is not applicable here. *See, e.g., Plaza Securities Co. v. Datapoint Corp., supra.*

the board was misinformed about key aspects of the Plan's operation, in particular, its impact on proxy contests and any-or-all tender offers. For these reasons, the business judgment rule is not available as a defense to the directors. The court below committed reversible error in concluding otherwise.

A. Standard And Scope Of Review

The Vice Chancellor's application of the business judgment rule to the adoption of the Plan presents a mixed question of law and fact. *See Smith v. Van Gorkom*, *supra*, slip op. at 21. This Court's standard of review of findings of fact following a full evidentiary hearing is as stated in *Smith v. Van Gorkom*, *supra*, slip op. at 21, *quoting Levitt v. Bouvier*, Del. Supr., 287 A.2d 671, 673 (1972):

> In an appeal of this nature "this court has the authority to review the entire record and to make its own findings of fact in a proper case. In exercising our power of review, we have the duty to review the sufficiency of the evidence and to test the propriety of the findings below."

In applying that standard and governing principles of law to the record and decision below, this Court will reverse the trial court where it finds that the trial court's "ultimate finding" concerning the board's conduct was "not the product of a logical and deductive reasoning process." *Smith v. Van Gorkom*, *supra*, slip op. at 21-22.

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

As the court below found, the Rights Plan vests in the directors substantial new powers which strengthen and

maintain their control of the company. Even assuming, *arguendo*, that directors may legally alter the fundamental corporate structure and that statutory power existed to issue the Rights, the directors' action was nonetheless "interested" and not 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 to stockholders. The board failed to carry that burden.

1. *The "interest" of the directors required them, at a minimum, to demonstrate the fairness of the Plan*

This Court has held that when directors use corporate powers to preserve their control, they become interested directors and have the burden of proving the fairness of the challenged transaction. *Bennett v. Propp*, Del. Supr., 187 A.2d 405, 409 (1962). This principle was recently reaffirmed in two Court of Chancery opinions. *Good v. Texaco, Inc.*, Del. Ch., C.A. No. 7501, Brown, C. (May 14, 1984) (Ex. H), involved a challenge to the repurchase by Texaco for cash and new voting preferred shares of 9.7 percent of its common stock from a dissident group. The dissident group agreed to vote the newly issued shares (approximately 5 percent of the total voting shares of Texaco) in accordance with the Texaco board's recommendation. In denying a Rule 23.1 motion to dismiss for failure to make demand prior to suit, 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 defend-

> ant 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).[35] *See also Seibert v. Harper & Row, Publishers, Inc.*, Del. Ch., C.A. No. 6639, Berger, V.C., slip op. at 9-11 (Dec. 5, 1984) (Ex. I).

Similarly, in *Norlin Corp. v. Rooney, Pace Inc.*, *supra*, the Second Circuit Court of Appeals, applying New York law, held that directors, who vested in themselves voting power over shares issued to an ESOP and a subsidiary, were "interested" directors and had the burden of proving the fairness of their actions. 744 F.2d at 265. 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 264. *See Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 382 (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*

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35. 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.

> *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).

Despite this compelling recent case law, the Vice Chancellor, citing *Cheff v. Mathes*, Del. Supr., 199 A.2d 548, 555 (1964), required only that the defendant directors "show that their adoption of the Plan was 'reasonable at the time'." (Op. at 37, A 326) He said:

> The burden thus placed may be viewed as a burden of going forward on a showing of reasonableness rather than a burden of persuasion. Because of the protection afforded directors by the business judgment rule the latter burden does not shift and remains with the plaintiffs.

(Op. at 37, A 326) The Vice Chancellor did not cite or discuss *Good, Norlin* or *Seibert*.

The court's reading of *Cheff* is in error. *Cheff* dealt with a stock repurchase — a transaction specifically permitted to directors under the DGCL without stockholder approval and one which does not alter the fundamental structure of the corporation to augment the directors' control or otherwise place greater power in their hands. In *Cheff*, this Court required the directors to show that their action was prompted by a reasonable belief that the dissident share ownership posed a threat to "corporate policy and effectiveness." 199 A.2d at 555. Household's board acted without specific authority and for the very purpose of transferring an important power to control the destiny of the corporation from the stock-

holders to the board. Here, no threat to corporate *policy* or *effectiveness* was involved. The board in *Cheff* used a statutory power for the purpose for which it was designed. Household's board used a financing statute to achieve an anti-takeover goal. *Cheff* is not apposite, let alone controlling authority.

As a result of their arrogation of power previously held by Household's stockholders, the directors were "interested" in the adoption of the Rights Plan. At a minimum, they therefore had the burden — which they did not meet — of demonstrating the Plan's fairness to Household and its stockholders.

2. *The Plan is unfair*

The Vice Chancellor found that the board had an "informed basis for believing that Household was vulnerable to a two-tier takeover and that the adoption of a defensive plan was required," (Op. at 41, A 330) and further found that there was "ample cause for concern" because the "coercive nature" of two-tier tender offers is "well documented." (Op. at 43, A 332) The hypothetical possibility that a "coercive" front-end loaded two-tier offer might some day be made for Household can hardly justify a structural change in Household. It certainly cannot justify the Plan's devastating impact on *all* non-management approved tender offers or its severe restrictions on share ownership, suffrage and alienation.

Contrary to the finding below, the "coercive" nature of two-tier tender offers is not "well documented." As discussed *supra* at pages 17-20, the financial benefits from two-tier offers are substantial and undisputed. Both the SEC Study and the President's Report have recently supported this conclusion. The evidence below showed no instance in which a two-tier tender offer succeeded at an unfair price. Defendants' own witnesses confirmed both the fairness and propriety of the two-tier offers in which they or their firms had been involved.

Thus, even had the Plan been limited in its effect to two-tier tender offers, the board could not have shown its fairness. The evidence is clear, however, that the Plan has a far broader reach and radically weakens the stockholders' role in each of the recognized corporate change of control mechanisms. The Plan effectively bars ownership of 20 percent of Household's stock by an individual or group. The Plan significantly inhibits and restricts the right of potential insurgents to wage an effective proxy contest to remove management or for any other purpose. The Plan makes all hostile tender offers impractical, including offers for 100 percent of the shares. The defendants' own letter to stockholders seeking to justify the Plan admits 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, A 883) No reason cited by the Vice Chancellor can justify these sweeping and overly broad effects on the rights of stockholders.

The court in *Norlin* recognized that board conduct having such effect on stockholder rights is unjustifiable and illegal. There the directors claimed it was fair for them to arrogate the power to stop a takeover simply because the particular takeover they were seeking to avoid was, in their judgment, unfair. The court rejected the defense out of hand:

> We reject the view, propounded by Norlin, that once it concludes that an actual or anticipated takeover attempt is not in the best interests of the company, a board of directors may take any action necessary to forestall acquisitive moves. The business judgment rule does indeed require the board to analyze carefully any perceived threat to the corporation, and to act appropriately when it decides that the interests of the company and its shareholders might be jeopardized. As we have explained, however, the duty of

> loyalty requires the board to demonstrate that any actions it does take are fair and reasonable. We conclude that Norlin has failed to make that showing.
>
> * * *
>
> 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.

744 F.2d at 265-67.

The Household board might prefer to be the final arbiter on tender offers. But institutional stockholders, who hold over 50 percent of Household shares, would, as Whitehead conceded, "prefer to make that decision themselves." (Whitehead VI 65, A 530; PX 41 at 3, A 680) 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 84, 156, A 554, 566)

Whitehead testified that the board was justified in taking the decision from all stockholders because there were "small stockholders . . . who are less equipped to determine whether a particular premium is fair or not in the long-term interests of the stockholders." (Whitehead VI 65, A 530) Similar arguments have received short shrift from the courts:

> Counsel for Conoco . . . [urge] 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 Inc. v. Seagram Co., 517 F. Supp. 1299, 1304 (S.D.N.Y. 1981) (footnotes omitted).

The new power of the board comes at the expense of the stockholders' rights — including their right to engage in proxy contests and to alienate freely their shares. Those rights are themselves a means of producing optimum value by fostering a free market for corporate control. *Edgar v. MITE Corp., supra,* 457 U.S. at 643, 102 S. Ct. at 2642; President's Report at 189 (Ex. B); (Jensen IV 174-76, A 483-85). The existence of that market is of significant value to stockholders (Jensen IV 135, 174-75, A 470, 483-84) and is an integral part of the legal structure erected by Congress and the General Assembly. The stockholder owners of a 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.

Notwithstanding the Plan's extreme and unwarranted invasion of stockholder rights, the Vice Chancellor also appeared to have relied on the anecdotal testimony of two defense witnesses, Tower[36] and Troubh in concluding that the

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36. On cross examination Tower could offer no evidence of any unfair takeover having been consummated. (Tower X 87-88, A 637-38)

Plan was *less* objectionable than actions taken by boards of other corporations in the face of hostile tender offers. A review of what courts have said in reviewing defensive actions of boards in specific takeover situations does not support Tower's and Troubh's assertions or the Vice Chancellor's conclusion that the drastic remedy of stopping all hostile takeover activity is justified as protective of the interests of the stockholders or the corporation. The discussion of defensive devices in those cases lends no support to defendants' claim of business judgment protection.

The cases reveal that where boards seek to alter the fundamental structure of a corporation, they do so by proposing an amendment to the corporation's charter for approval by the stockholders. *See, e.g., FMC Corp. v. R.P. Scherer Corp.*, Del. Ch., C.A. No. 6889, Longobardi, V.C., slip op. at 4-5 (Aug. 4, 1982) (Ex. J); *Martin Marietta Corp. v. Bendix Corp.*, Del. Ch., C.A. No. 6924, Brown, C., slip op. at 3-4 (Sept. 19, 1982) (Ex. K). No case cited to the Vice Chancellor validated a board's unilateral usurpation of power.

The cases reveal as well that, where boards have abused their powers in the context of a takeover, courts have not hesitated to act to protect the interests of the corporation and the stockholders. *See, e.g., Condec Corp. v. Lunkenheimer Co.*, Del. Ch., 230 A.2d 769 (1967) (sham stock issuance); *Gimbel v. Signal Cos.*, Del. Ch., 316 A.2d 599, *aff'd*, Del. Supr., 316 A.2d 619 (1974) (unfair price in sale of subsidiary); *Norlin Corp. v. Rooney, Pace Inc., supra* (unfair arrogation of voting power); *Royal Industries, Inc. v. Monogram Industries, Inc.*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,863 (C.D. Cal. Nov. 29, 1976) (asset acquisition solely for purpose of erecting antitrust barrier to takeover).

Finally, the cases show that where board action is validated by the courts, that action was both an expression of the directors' managerial powers and beneficial to the stockholders. *See, e.g., GM Sub Corp. v. Liggett Group, Inc.*, Del. Ch., C.A. No. 6155, Brown, V. C., slip op. at 4 (Apr. 25, 1980) (Ex. L) (Liggett's sale of "crown jewel" asset for twenty-two times

earnings compared with tender offer price of eight times earnings). In each of those cases, the terms and conditions of the transaction were dictated in part by real market considerations. *See, e.g., Buffalo Forge Co. v. Ogden Corp.*, 555 F. Supp. 892, 900 (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 104 S. Ct. 550 (1983); *Crouse-Hinds Co. v. InterNorth, Inc.*, 634 F.2d 690, 692, 695 (2d Cir. 1980); *Northwest Industries, Inc. v. B.F. Goodrich Co.*, 301 F. Supp. 706, 708-09 (N.D. Ill. 1969); *Treadway Cos., Inc. v. Care Corp.*, 638 F.2d 357, 366 (2d Cir. 1980).

None of those cases involved a measure which imposed a severe economic penalty on the corporation and all its stockholders if a stockholder should buy as little as 20 percent of the company's stock. None of those cases involved a measure which imposed such a penalty if groups of stockholders seek to join together to protect their investment by consolidating their holdings in an amount over 20 percent and trying to displace the board. None of them involved a measure which renders potential takeover bids impossible by imposing astronomical added costs on all hostile acquisitions. 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 business judgment rule to the Household board's adoption of the Plan. The Plan should be struck down.

C. The Household Board Did Not Exercise Informed Business Judgment In Adopting The Rights Plan

Uninformed or misinformed decisions of a board of directors, made in unnecessary haste, are not subject to protection under the business judgment rule. *Smith v. Van Gorkom, supra.* Even if the business judgment doctrine were otherwise applicable, the circumstances surrounding the board's adoption of the Rights Plan renders it inapplicable in this case. "[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, supra*, 473 A.2d at 812 (emphasis added); *accord Smith v. Van Gorkom*, supra, slip op. at 23; *Gimbel v. Signal Cos., supra*, 316 A.2d at 611.

The Household board did not exercise, and could not have exercised, informed business judgment in adopting the Plan during its August 14 meeting. The board members lacked any expertise and were forced to rely entirely on their advisors. As shown below, their advice was in certain respects materially inaccurate. Goldman, Sachs representative McMahon characterized his own presentation as his "standard speech" and "anti-raid pitch." (McMahon IX 207, 219-21, 223-24, A 619, 621-23, 625-26)

In a three-page summary of the Plan and in the presentations at the August 14 meeting — which together formed the totality of the board's information on the Plan — the board was told three crucial facts about the Plan's impact which were not correct.

First, the board was advised that "[t]he Plan in no way restricts, inhibits or makes more expensive a proxy contest to elect a new Board of Directors." (PX 203 at 8, A 797) As shown at Argument II. C., *supra*, the directors accepted this representation without question, and relied upon it in adopting the Plan. Director Hendry's testimony was unequivocal:

> Q. Would you have supported the rights plan if you had been told that the plan would inhibit stockholders from soliciting proxies to replace the Board of Directors?
>
> * * *
>
> A. No, I would not have. The answer is clearly no. I would not have.

(Hendry Dep. 62-63, A 374-75)

The court below, however, found that the Plan *does* inhibit and restrict proxy contests. *See* Argument II. C., *supra*.

Second, the board was advised that the Plan would most likely deter two-tier, front-end loaded offers (PX 203 at 8, A 797) and would "channel any takeover proposals for Household . . . into the cash-for-all-the-stock type rather than the two-tier, bust-up, boot-strap type." (*Id.* at 7, A 796)

Again, the directors relied on this representation in adopting the Rights Plan. (Rauch Dep. 82, A 420; *See also* Brennan Dep. 83-84, 138-39, A 349-50, 356-57; Kartalia Dep. 97-99, A 394A-94C) 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, A 411; *see also* 34, 36, 101, A 401, 403, 407). However, as shown above, the evidence established, and the court below found, that the deterrent effect of the Plan reaches far beyond allegedly coercive two-tier offers. It effectively precludes virtually all hostile acquisitions of Household. (Op. at 40-41, A 329-30; *see also* pp. 21-25, *supra*)

Third, the board was told that Delaware counsel had opined that "the Plan is legal and that its adoption is within the business judgment of the Board." (PX 203 at 9, A 798) Numerous members of the board relied explicitly on this representation. (*See, e.g.*, Upton Dep. 23, 135, A 427, 433; James Dep. 146-47, A 388-89; Brennan Dep. 125-26, A 354-55; Osler Dep. 8-10, A 396-98; Rasmussen Dep. 61-63, A 413-15) This representation was inaccurate. Delaware counsel's opinion explicitly did not express an opinion on the flip-over provision of the Rights, which the trial court found constituted their "real impact." (Op. at 7-8, A 296-97) Rather, Delaware counsel opined *only* that "the Rights will constitute validly issued and outstanding rights to subscribe to the Preferred Stock of the Company." (PX 238 at 6, A 894)

Moreover, far from opining that the adoption of the Plan was within the exercise of the board's business judgment, Delaware counsel's opinion simply *assumes* that to be the case. (PX 238 at 3, A 891) Delaware counsel specifically disclaimed in open court having opined that the adoption of the Plan was within the board's business judgment. (Transcript of Argument on Plaintiffs' Motion to Compel and Defendants' Motion for a Protective Order, dated Sept. 17, 1984, at 56-57, A 64-65)

Key features of the Plan also 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, A 538-40; Evans Dep. 71, A 364) The directors also did not discuss the rationale for choosing 20 and 30 percent as the levels for triggering events (McMahon IX 236, A 629; Tower X 87, A 637; Osler Dep. 51, A 404), or for including any tender offer trigger at all in the Plan. (Evans Dep. 83-84, 88, A 365-66, 367; Brennan Dep. 107-08, A 352-53) No one asked about or was told why the flip-over was designed to dilute an acquiror by a factor of two to one. (Osler Dep. 18, A 399; Flynn Dep. 83-84, A 370-71) As Osler said, "I obviously don't know the answer to that because I didn't make up the plan." (Osler Dep. 18, A 399) Even Goldman, Sachs representative McMahon, who testified as a defense witness on the Plan at trial, did not know the derivation of the 20 and 30 percent triggers. (McMahon IX 235-36, A 628-29)

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[37] than the

37. 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, A 408-09) The directors were led to believe they had to act precipitously because a hostile tender offer from plaintiffs was imminent. (Whitehead VI 49-50, A 526-27) As the trial court found, that was simply untrue. (Op. at 54, A 343)

boards in *Gimbel* and *Smith*, the Household board transferred fundamental rights from the stockholders to itself, 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 results must not be allowed to stand.

* * *

For these reasons, the business judgment rule is wholly inapplicable to the Household board's adoption of the Plan. The directors were "interested" in the Plan, and must prove its fairness. They did not, and cannot. The Plan transfers fundamental powers to the board from the stockholders without their consent. The only justification for the Plan pales in comparison to its sweeping effects on the rights of stockholders. Finally, the board, acting in unreasonable and unnecessary haste, was fundamentally misinformed as to the operation and effects of the Plan. It did not and could not have exercised informed business judgment. The Plan should be invalidated.

IV. THE PLAN ILLEGALLY RESTRAINS THE ALIENATION OF HOUSEHOLD STOCK

Under section 202(b) of the DGCL, no restraint on alienation is valid unless consented to by the stockholders. The Plan's deterrent effect on all tender offers and artificial ceiling on stock purchases act as a restraint on alienation and are the direct result of the Plan's alteration of Household's basic structure. By sharply reducing the number of potential buyers willing to buy Household stock by open market purchases or by tender offer, the Plan "severely circumscribes" selling opportunities for Household stockholders, without their consent. *See Joseph E. Seagram & Sons, Inc. v. Conoco, Inc.*, 519 F. Supp. 506 (D. Del. 1981).

A. Standard And Scope Of Review

The standard and scope of review of the Vice Chancellor's finding that the Plan was not an illegal restraint on alienation is the same as that stated in Argument I.A., *supra*.

B. All Non-Consensual Restraints On The Alienation Of Stock, Whether Direct Or Indirect, Are Illegal

The court below's holding that restraints on alienation not consented to by stockholders may be imposed by a board (Op. at 44, 54, A 333, 343) is contrary to Delaware authority. This Court has recognized that "one of the essential incidents to the ownership of property is the right to dispose of it in the manner provided by law." *Lawson v. Household Finance Corp.*, Del. Supr., 152 A. 723, 728 (1930). Stock is the personal property of the stockholder. DGCL §159.

Stockholders' power freely to alienate their shares was codified in DGCL § 202(b), under which restraints may be created only by the charter, by-laws or agreement among the stockholders. While certain restraints on the alienation of stock are permitted by DGCL § 202, these restraints are permitted *only* with stockholder consent. Professor Folk has em-

phasized that "the common law in Delaware should be liberally construed to sustain restrictions which the corporation *and its stockholders* deem appropriate." Folk, *The Delaware General Corporation Law: A Commentary and Analysis*, at 201 (1971) (emphasis added).

Joseph E. Seagram & Sons, Inc. v. Conoco, Inc., *supra*, is the only case found which tests the legality of a non-consensual restraint under Delaware law. At issue was the validity of a by-law that prohibited the transfer of stock to an alien if the transfer would result in aliens owning more than 20 percent of Conoco's stock. Chief Judge Latchum held the by-law was illegal under section 202 because it reduced the number of potential purchasers of Conoco stock, thus impinging on the ability of Conoco stockholders to sell their stock freely. The court held that a board of directors could not unilaterally reduce the number of prospective purchasers absent stockholder consent. 519 F. Supp. at 513.

The Vice Chancellor read *Seagram* to apply only to board action that prohibited the actual transfer of shares on the books of the corporation. (Op. at 45, A 334) In fact, *Seagram* held that it was illegal for a board to impose "restrictions which could . . . severely circumscribe an existing shareholder's market for selling Conoco stock . . . without the consent of the shareholder." 519 F. Supp. at 513.

The Plan stops anyone from acquiring more than 20 percent of Household's stock (*see* pp. 25-29, *supra*) and, therefore, circumscribes the stockholders' market for selling Household stock to the same degree as a restriction on transfer. Under *Seagram*, the Plan is illegal because, without the consent of Household's stockholders, it severely reduces the number of potential purchasers of their Household stock and diminishes the stock's attractiveness to any potential purchasers who remain. These effects are of "significant economic consequence." 519 F. Supp. at 513.

The Vice Chancellor's narrow reading of *Seagram* to prohibit only direct restraints on transfer ignores the principle that Chancery "looks to the substance of a transaction, not to

its form." *DMG, Inc. v. Aegis Corp., supra; see also Monroe Park v. Metropolitan Life Insurance Co., supra,* 457 A.2d at 737. Consistent with this principle, courts have condemned direct and indirect restraints alike, since both forms of restraints deprive stockholders of the power to sell their stock freely.

In *Greene v. E.H. Rollins & Sons, Inc.*, Del. Ch., 2 A.2d 249 (1938), the court invalidated an indirect restraint on alienation by a device which was not a transfer restriction in form, but like the Plan erected practical economic barriers to the free alienation of shares. There, the charter provision gave the board of directors the right to repurchase company stock at book value from stockholders the board determined to be "unsuitable." Because the repurchase price could be far below market and there was no way for a potential purchaser to know if he would be deemed "unsuitable," the number of potential purchasers of the company's shares was severely limited. *Id.* at 253.

The court in *Greene* held that the charter provision — which imposed a potential economic penalty on the purchasers of shares, thereby "narrowing the field of possible alienees" — constituted an unlawful restraint on alienation. *Id.* Under *Greene*, board action like the adoption of the Rights Plan, the demonstrated effect of which is to reduce the number of potential buyers, illegally restrains alienation. *Greene* is supported by *San Francisco Real Estate Investors v. Real Estate Investment Trust of America*, 701 F.2d 1000 (1st Cir. 1983) (by-law which eliminates voting, dividend and distribution rights for any shares held by a single holder in excess of 9.8 percent of the outstanding shares struck down as violative of a declaration of trust provision that shares should be freely transferable).

Although they were cited to him, the Vice Chancellor did not discuss *Greene* or *San Francisco Real Estate Investors*. Those cases, and *Seagram*, show that it is equally illegal for

a board to restrict transfer by imposing penalties on ownership in excess of certain levels as it is for a board to impose an explicit restriction on transfer.

* * *

For these reasons, the Plan is illegal as a non-consensual restraint on alienation. *Seagram* requires that the Plan be struck down.

CONCLUSION

For the reasons stated and based on the authorities cited herein, the Plaintiffs Below-Appellants respectfully urge the Court to reverse the judgment below and enter judgment on their behalf voiding the Plan as unauthorized and illegal.

Respectfully submitted,

SKADDEN, ARPS, SLATE,
MEAGHER & FLOM

By /s/ Irving S. Shapiro
Irving S. Shapiro
Rodman Ward, Jr.
Stuart L. Shapiro
Stephen P. Lamb
Thomas J. Allingham II
Andrew J. Turezyn
One Rodney Square
P.O. Box 636
Wilmington, Delaware 19899
(302) 429-9200
Attorneys for Plaintiffs-Below
Appellants

Of the New York Bar:

Michael W. Mitchell
Jeffrey Glekel
Jeremy A. Berman
Joseph A. Guglielmelli

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