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DEAD HAND POISON PILLS: WILL GEORGIA CORPORATIONS CONTINUE TO ISSUE A LETHAL DOSE?

INTRODUCTION

With a renewed round of hostile takeovers in the 1990s, potential target corporations have searched for defensive measures to protect themselves.¹ Some companies have used a shareholder rights plan, also known as a “poison pill,” to fend off corporate predators.² When a party attempts to initiate a hostile takeover, a predetermined trigger (such as the acquirer buying a certain percentage of the outstanding stock) activates the rights plan.³ Once the plan is activated, all shareholders—except the party attempting the takeover—may buy additional shares of stock at a discounted rate, thus diluting the acquirer’s holdings.⁴ Most poison pills also provide that if the merger takes place by exchanging common shares of the target corporation for securities in the acquirer, shareholders of the target can purchase additional shares of the acquirer’s securities at discounted rates, thus diluting the acquirer’s capital structure.⁵ In this manner, a rights plan can increase the expense of a takeover and may ultimately discourage a takeover attempt.⁶

A shareholder rights plan is not an absolute barrier to a hostile acquisition, however.⁷ For example, by waging a proxy contest, a hostile acquirer could attempt to install its own board of directors and redeem the shareholder rights issued under the

2. See id. at 510 n.22.
3. See id. at 510-11.
4. See id. at 511-12.
5. See id.
plan before proceeding with the takeover. Because a rights plan alone is not an absolute takeover defense some boards have adopted a continuing director provision, also known as a "dead hand" provision, that works in conjunction with their shareholder rights plans. A continuing director provision allows only the board of directors that adopted the rights plan to redeem the rights. If existing directors refuse to redeem a rights plan against the wishes of a majority of shareholders, the shareholders cannot vote for a new board that would redeem the rights. Even after a successful proxy contest, newly elected directors would lack authority to remove the shareholder rights plan because they would not be continuing directors.

In Invacare Corp. v. Healthydyne Technologies, Inc., a United States district court upheld the controversial dead hand provision under Georgia law on both statutory and fiduciary grounds. Despite the provision's validity under Georgia law, in Carmody v. Toll Bros., the Delaware Chancery Court allowed a similar dead hand provision challenge to proceed on both statutory and fiduciary grounds. Because of the influence of Delaware corporate law on other states and the number of companies incorporated in Delaware, Carmody likely will have a significant impact on the use of continuing director provisions as an antitakeover defense in other jurisdictions.

This Note addresses how courts have treated continuing director provisions in poison pills. Part I traces the development, operation, judicial acceptance, and responses to the use of rights plans as an antitakeover mechanism and the emergence of the continuing director provision. Part II

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8. See Rosenzweig, supra note 6, at 381.
10. See id.
11. See id.
12. See id. at 533.
14. See id. at 1582.
15. 723 A.2d 1180 (Del. Ch. 1998).
16. See id. at 1191.
discusses the validity of continuing director provisions under Georgia law on both statutory and fiduciary grounds. Part III explains the challenges to continuing director provisions on fiduciary and statutory grounds under Delaware law. Part IV argues that courts should declare continuing director provisions invalid breaches of the directors' fiduciary duties, yet concludes that courts resolving questions under Georgia law are unlikely to apply the Delaware court's reasoning.

I. DEVELOPMENT OF POISON PILLS AS AN ANTITAKEOVER DEFENSE

A. The Operation of a Shareholder Rights Plan

Before the 1970s, dissident shareholders often used proxy contests to change boards of directors.18 During the 1970s, tender offers began displacing proxy contests as a means to change control of a corporation.19 In the 1990s, increased use of defensive measures and participation of institutional stockholders decreased the use of tender offers alone to force out management, and the numbers of combined proxy contests and tender offers rose.20 Responding to this renewed use of proxy contests and increased merger activities, incumbent boards increasingly have turned to shareholder rights plans.21 Typically, a board implements a shareholder rights plan without a shareholder vote.22 The plan entitles each common stockholder to one right per share of common stock owned; the

18. See Thomas, supra note 1, at 508.
19. See id.; see also Laura L. Cox, Comment, Poison Pills: Recent Developments in Delaware Law, 58 U. CIN. L. REV. 811, 812 n.4 (1989) (discussing the regulation and use of tender offers in control contests).
20. See Thomas, supra note 1, at 508-08; see also Irwin H. Warren & Kevin G. Abrams, Evolving Standards of Judicial Review of Procedural Defenses in Proxy Contests, 47 BUS. LAW. 847, 848-49 (1992) (noting that in the early 1990s bidders used combined proxy contests and tender offers when faced with an incumbent board that was unwilling to negotiate).
21. See Thomas, supra note 1, at 509-10.
rights are not severable from the common shares. The shareholders may not exercise these rights until a predetermined triggering event occurs, such as the accumulation of a certain percentage of the company’s common stock. Typically, one individual’s accumulation of 20 percent of a target company’s stock triggers a plan. Trigger levels vary, however, with some as low as 10 percent. Further, if faced with an emerging threat, directors can quickly lower the threshold level by calling a directors’ meeting to ratify a change in the plan. In addition to individual ownership, a voting agreement among shareholders who collectively own the threshold level may trigger a rights plan.

Once the triggering event occurs, the rights plan allows non-acquiring shareholders to exercise their rights. Most rights plans contain a “flip-in” provision that allows shareholders to purchase shares of a newly issued voting class of stock at discounted rates. Because the acquirer cannot purchase shares of the new class created by the rights plan, the plan significantly dilutes the acquirer’s holdings. Thus, the rights plan discourages the acquirer from accumulating the trigger level through purchase, tender, or the formation of formal voting agreements with other shareholders.

Many rights plans also contain ‘flip-over’ provisions. The target company’s acquisition by merger “or other business combination transaction triggers a typical flip-over provision. Once the merger occurs, the flip-over provision allows rights holders to purchase the acquirer’s common stock at a fifty-

23. See Thomas, supra note 1, at 510.
24. See id. at 510-11.
25. See id. at 512.
26. See id.
27. See id. at 513.
29. See Thomas, supra note 1, at 511. See generally Cox, supra note 19, at 615-18 (discussing the varieties of shareholder rights plans and their operation).
30. See Cox, supra note 19, at 616.
31. See Thomas, supra note 1, at 511-12.
33. See Thomas, supra note 1, at 511.
34. Id.
percent discount.\textsuperscript{35} Therefore, a flip-over provision can devastate
the acquirer's capital structure and thereby discourage the
transaction.\textsuperscript{36}

Shareholder rights plans containing flip-over and flip-in
provisions prevent shareholders and shareholder groups from
acquiring large blocks of stock in the target company.\textsuperscript{37} The
possibility of "massive discriminatory dilution" encourages
potential acquirers to avoid accumulating the threshold level of
shares and triggering the rights plan.\textsuperscript{38} Thus, the rights plan
effectively limits the amount of stock that any shareholder can
acquire before waging a proxy battle.\textsuperscript{39} Rights plans can also
prohibit the formation of a voting coalition among shareholders
who collectively own a percentage of common stock that meets
the trigger level.\textsuperscript{40} Incumbent boards may be able to prevent
discussions among dissident groups by "threatening to trigger
the [r]ights [p]lan" when such discussions occur.\textsuperscript{41} For these
reasons, shareholder rights plans can empower directors to
negotiate acquisitions on their own terms and prevent takeovers
they oppose.\textsuperscript{42} For the same reasons, however, rights plans can
entrench incumbent directors.\textsuperscript{43}

\textsuperscript{35} See id.
\textsuperscript{36} See Carmody v. Toll Bros., 723 A.2d 1180, 1183 (Del. Ch. 1998); see also Animashaun,
supra note 22, at 176-79 (noting that the flip-over provision does not prevent the
acquisition of a controlling interest on the open market because the provision does not
become effective until the acquirer has gained all of the target's stock in a business
combination); Helman & Junewicz, supra note 22, at 773 (noting that the flip-over
feature can potentially double the value of the right holder's investment by allowing for
the purchase of the merged entity's stock at half price).
\textsuperscript{37} See Thomas, supra note 1, at 512.
\textsuperscript{38} Id.
\textsuperscript{39} See id.
\textsuperscript{40} See Randall S. Thomas & Kenneth J. Martin, The Impact of Rights Plans on Proxy
Contests: Reevaluating Moran v. Household International, 14 INT'L REV. L. & ECON. 327,
327 (1994).
\textsuperscript{41} Id.
\textsuperscript{42} See Cox, supra note 19, at 611; see also, Animashaun, supra note 22, at 184 (noting
that rights plans give target directors power to negotiate for higher prices for the target
company's stock from potential raiders). But see Helman & Junewicz, supra note 22, at
773 (recognizing that rights plans may not deter a bidder who is willing to pay enough
to offset the effects of flip-over and flip-in provisions).
\textsuperscript{43} See Cox, supra note 19, at 611.
B. Validity of Rights Plans as an Antitakeover Measure

Although rights plans can shift the power to consider acquisition offers from shareholders to directors, courts generally have found rights plans valid defensive measures. For example, in Moran v. Household International, Inc., the court declared shareholder rights plans valid under Delaware law. In Moran, Household adopted a rights plan in the absence of any specific threat of acquisition. The rights plan would be triggered if one person acquired twenty percent of the common stock, had the right to purchase or vote twenty percent of the common stock, formed a group acting together that controlled twenty percent of the common stock, or made a tender offer for thirty percent of the common stock. Once a triggering event occurred, shareholders could exercise their rights to flip in to purchase a new class of preferred stock. In addition, if a stock-swap merger occurred—in which Household’s common stock was exchanged for stock of the acquirer—the rights would flip over, entitling shareholders to purchase shares of the acquirer at half price, thus diluting the acquirer’s capital structure.

A group of shareholders sued to invalidate the directors’ decision to adopt the rights plan. The board argued that it was within its discretion to adopt a rights plan and specifically invoked the business judgment rule as authority for its decision. The shareholders argued that the court should apply ‘special scrutiny’ to the directors’ action because the rights plan altered the shareholders’ rights and could entrench the board members.

45. Id.
46. See id. at 1083.
47. See id. at 1084-85; see also Rosenzweig, supra note 6, at 382 (describing the structure of Household’s shareholder rights plan).
48. See Moran, 490 A.2d at 1068.
49. See id.
50. See id.
51. See id. at 1074.
52. See id. at 1074; see also Animashaun, supra note 22, at 185-88 (discussing the business judgment rule under Delaware law and its application in the context of a takeover defense); Cox supra note 19, at 620-24 (discussing the standard in Delaware for evaluating defensive tactics).
53. See Moran, 490 A.2d at 1074-75. By requesting the court to apply special scrutiny to
Delaware law leaves the operation of a corporation to the board of directors. Although directors are fiduciaries to the corporation, they cannot be held to the same standard as other fiduciaries because business decisions often entail a degree of risk. According to the business judgment rule, a court presumes that the directors' actions are valid. Therefore, a court examines directors' actions by the business judgment rule and does not substitute its own judgment for that of the directors; the presumption in favor of the board may only be overcome if the plaintiff can 'show' by a preponderance of the evidence that the directors' decision involved a breach of fiduciary duty.

Delaware courts have applied a modified business judgment rule in certain cases where directors take actions against a threat to their control of the corporation, such as a tender offer. Under the modified business judgment rule, when a board reacts to a takeover, it must first show that its actions were reasonable in light of the threat posed. If the board satisfies the initial inquiry, the burden shifts back to the shareholder to show that the board breached its fiduciary duty under the traditional business judgment rule.

In Moran, the court agreed with the shareholders that when defensive tactics alter the structure of the corporation and result "in a fundamental transfer of power from one constituency (shareholders) to another (the directors)[,]" the directors must initially show that the plan was not adopted

the directors' actions, the plaintiffs tried to shift the burden to the directors to prove that their actions were fair and reasonable and to negate the presumption that the directors would have under the business judgment rule. See id. at 1074. 54. See DEL. CODE ANN. tit. 8, § 141(a)(1988); see also Animashaun, supra note 22, at 185. 55. See Moran, 490 A.2d at 1074. 56. See Animashaun, supra note 22, at 185; see also Rosenzweig, supra note 6, at 383 (noting that under the traditional business judgment rule, there is a presumption that directors take action in an informed manner, in good faith, and with the best interests of the corporation in mind). 57. Animashaun, supra note 22, at 185; see also Rosenzweig, supra note 6, at 375-76 (discussing directors' fiduciary duty to the corporation and shareholders and explaining the standards of conduct under the business judgment rule). 58. See Animashaun, supra note 22, at 186; see also Rosenzweig, supra note 6, at 383 (explaining that the modified business judgment rule adopted in Moran originated in Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)). 59. See Animashaun, supra note 22, at 187. 60. See id.
merely to retain control but was motivated by "a reasonable belief that the [p]lan was necessary to protect the corporation from a perceived threat." 61 Once the directors show that the plan was not adopted to retain control, the burden of demonstrating the fairness of the plan reverts to the plaintiffs under the traditional business judgment rule standard. 62 The court in Moran found that the directors met their initial burden because the rights plan complied with Delaware law, was not used primarily to entrench management, and served a rational defensive purpose. 63 The court also found that the rights plan fell within the business judgment rule because it protected the corporation from coercive partial tender offers. 64

In dicta the court warned that rights plans "create the potential for the misuse of directorial authority." 65 Although concerned about the effect rights plans would have on proxy contests, the court found that "while the [r]ights [p]lan does deter the formation of proxy efforts of a certain magnitude, it does not limit the voting power of individual shares." 66 Therefore, shareholders could still wage a successful proxy contest, despite the obstacles presented by rights plans. 67 The court also noted that rights plans represented a "bargaining tool" that management could use to get otherwise unavailable concessions. 68

The court recognized, however, that a rights plan could be used "to deter the acquisition effort entirely." 69 Under the modified business judgment rule, courts do not allow directors

62. See id.; see also Cox, supra note 19, at 627-30 (discussing further application of the modified business judgment rule in relation to poison pills and other antitakeover defensive measures). But see Thomas, supra note 1, at 557 (arguing that courts should place the burden concerning poison pills on directors even after an initial showing of good faith because of the chilling effect on proxy contests).
63. See Moran, 490 A.2d at 1082.
64. See id.; see also Cox, supra note 19, at 625-27 (summarizing the court's ruling). See generally Helman & Junewicz, supra note 22, at 777 (discussing the standard of scrutiny in Delaware applied to poison pills after the Moran decision).
65. Moran, 490 A.2d at 1083.
66. Id. at 1079-80.
67. See id.
68. See id. at 1083.
69. Id.
to wield an unlimited power to decline tender offers. If an offer is reasonable and no alternatives surface after a reasonable time, directors may breach their fiduciary duty if they use a poison pill to refuse to redeem the rights. Therefore, directors can use a shareholder rights plan as a defensive measure when such a response is reasonable, but when the board appears to use the plan only to entrench itself, courts may declare the plan invalid.

C. Post-Moran Circumvention of Poison Pills and the Evolution of Defensive Responses

After the court in Moran validated the use of rights plans, such plans became an important antitakeover tool. Although rights plans were powerful defenses, acquirers could circumvent them by soliciting shareholder proxies to remove an incumbent board. If successful, the acquirer could install its own board and redeem the poison pill rights before proceeding with a tender offer. Consequently, to succeed in acquiring a target with a rights plan, an acquirer had to be “willing to spend the additional capital necessary to overcome the dilutive effects of the pill.” In response, incumbent boards developed various counter strategies to prevent a hostile bidder from electing a new board.

Some boards faced with a proxy contest amended their bylaws or exercised an existing option in the bylaws to delay shareholder meetings; this gave board members time to explore

70. See Animashaun, supra note 22, at 190-91.
71. See id.
72. See id.; see also Anthony Augliera, Note, Shareholder Rights Plans: Saying No to Inadequate Tender Offers, 57 FORDHAM L. REV. 803, 830-31 (1989) (arguing that boards should not have to redeem pills for inadequate offers unless they act in bad faith or without adequate information).
73. See Rosenzweig, supra note 6, at 374; see also Helman & Junewicz, supra note 22, at 771 (indicating that over 300 companies adopted poison pills after their validity was established in Moran); Thomas, supra note 1, at 510 (noting that almost half of America’s large, publicly-traded companies have rights plans, and the rest could implement one as quickly as they could call a board meeting).
75. See id.
76. Rosenzweig, supra note 6, at 380
77. See Carmody, 723 A.2d at 1186; see also Rosenzweig, supra note 6, at 381 (noting that an acquirer may use a number of strategies to minimize the impact of rights plans).
other alternatives. For example, in Stahl v. Apple Bancorp, Inc., when faced with a proxy contest for the election of directors combined with a tender offer by a shareholder, the board of directors delayed its annual meeting to consider other options. The shareholder argued that the delay was not to protect the interest of the corporation, “but [was] designed principally to entrench [the] defendants in office.” Yet, the court found the delay within the directors’ power because the annual meeting date had not been set and the corporate bylaws permitted the postponement.

The Delaware Chancery Court has declared invalid other boards’ actions, including delaying a shareholders’ meeting to solicit votes and expanding the board’s size to retain control. In Aprahamian v. HBO & Co., the directors already had set a date for the annual meeting and had begun to solicit proxies. When the board learned it might lose the proxy contest, it postponed the meeting. The court found that the delay did not serve the stockholders’ interests, and because the directors had no right to continue to serve on the board, the directors would suffer no harm if defeated.

In Blasius Industries v. Atlas Corp., Atlas directors voted to create two new board positions in response to a possible takeover by Blasius. In an attempt to gain control, Blasius

78. See Carmody, 723 A.2d at 1186.
79. Id. at 1185 (Del. Ch. 1990).
80. See id. at 1119-20.
81. Id. at 1118.
82. See id. at 1124; see also Carmody, 723 A.2d at 1186; Kidsco Inc. v. Dinsmore, 674 A.2d 483 (Del. Ch. 1995) (holding that the directors’ decision to amend the target company’s bylaws to extend the minimum time required for calling a special shareholder’s meeting in the face of a hostile proxy contest was not invalid because the primary purpose was to entrench the incumbent directors).
83. See Carmody, 723 A.2d at 1186. Courts have evaluated the decision to delay a stockholders’ meeting under the factual circumstances of each case. See Warren & Abrams, supra note 20, at 656-57.
84. 531 A.2d 1204 (Del. Ch. 1987).
85. See id. at 1208; see also Carmody, 723 A.2d at 1186.
86. See Aprahamian, 531 A.2d at 1208.
87. See id.
88. 651 A.2d 651 (Del. Ch. 1988)
89. See id. at 652. Blasius quickly acquired more than nine percent of Atlas’s shares and announced its intention to force the current management to restructure or obtain control of the corporation itself. See id. at 653.
sought stockholder consent to add eight new board members. Although some evidence indicated that the board had acted to entrench itself, the court found that the board acted in good faith. Nevertheless, the court found that even if the directors had acted in the interest of the corporation, the addition of the new positions was “invalid and must be voided.”

D. Adoption and Operation of Continuing Director Provisions

As the previous discussion indicates, when faced with a proxy contest and a hostile tender offer, directors “could in good faith employ non-preclusive defensive measures to give the board time to explore transactional alternatives.” Before the development of continuing director provisions, however, target boards could not “erect defenses that would either preclude a proxy contest altogether or improperly bend the rules to favor the board’s continued incumbency.” In search of such an absolute takeover defense, some boards added continuing director provisions to their rights plans. Continuing director provisions, also known as “dead hand” provisions, allow only the incumbent board members or their designated successors to redeem the rights issued under a rights plan. Under such a plan, shareholders and potential acquirers have little incentive to expend the money and effort to wage a proxy contest to remove the incumbent board because the new board cannot remove the rights plan. Compared to other defensive measures, only continuing director provisions have turned out to be absolute “show stoppers” in the takeover market.

90. See id. at 652.
91. See id.
92. Id.
94. Id. at 1187.
95. See id.; see also Dewey, supra note 17, at A12 (noting a study that showed 280 out of 1800 rights plans reviewed in 1997 contained continuing director provisions).
96. See Carmody, 723 A.2d at 1187.
97. See id.; Invacare Corp. v. Healthdyne Techs. Inc., 968 F. Supp. 1578, 1579 (N.D. Ga. 1997). See Gordon, supra note 9, at 552, for a description of other versions of dead hand pills, which allow a supermajority vote of shareholders to remove the provision or allow for a limited period of time in which only the continuing directors can remove the pill before a new board may be free to vote it out.
98. See Carmody, 723 A.2d at 1187.
II. JUDICIAL ACCEPTANCE OF DEAD HAND POISON PILLS IN GEORGIA

A. The Facts of Invacare

In *Invacare Corp. v. Healthdyne Technologies Inc.*, the court denied Invacare’s motion for a preliminary injunction, finding the continuing director provision of Healthdyne’s rights plan valid under Georgia law. Invacare proposed an acquisition that Healthdyne’s board rejected as inadequate. Invacare then made “an all cash tender offer for all outstanding shares of Healthdyne common stock for $13 per share.” Healthdyne’s board again opposed the measure, and Invacare announced its intention to propose its own slate of directors for Healthdyne’s next annual meeting.

At the time, Healthdyne had in place a shareholder rights plan to guard against hostile takeovers. Healthdyne’s rights plan contained a continuing director provision that required any redemption or alteration of the rights plan to be approved by at least one director who had been a member when the plan was adopted. Thus, if Invacare successfully replaced the incumbent board through a proxy vote, “the new Board of Directors could not redeem the rights plan because they would not be ‘continuing directors.’” Invacare sued, seeking a preliminary injunction declaring the continuing director provision invalid. Invacare also proposed a bylaw requiring the current directors to eliminate the continuing director

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100. See id. at 1581.
101. See id. at 1579.
102. Id.
103. See id. Invacare subsequently made two more offers, the latter of which was for $15 a share, but Healthdyne also rejected these. See id.
105. See Invacare, 988 F. Supp. at 1579. The continuing director provision also provided that subsequent directors elected to the board with the approval of continuing directors could alter or amend the rights plan. See id.
106. Id.
107. See id.
provision. Healthdyne filed a counterclaim, asking the court to declare the proposed bylaw invalid and to enjoin solicitation of proxy votes approving it.

B. The Statutory Challenge to the Continuing Director Provision

The court rejected Invacare's argument that the continuing director provision was illegal under Georgia law, which grants directors the power to run corporations. Invacare claimed that the continuing director provision violated the law because it limited the power of future directors to eliminate the continuing director provision. Invacare contended that because the provision did not appear in either the bylaws or the articles of incorporation the limitation violated Georgia Code section 14-2-801(b). Invacare also argued that the court should follow Bank of New York v. Irving Bank Corp., in which the court invalidated a continuing director provision under New York law. There, the court found that the continuing director provision violated a statutory requirement that any limitation on the power of the directors must be included in the certificate of incorporation.

The court rejected Invacare's argument because, unlike the New York statute, Georgia law does not require limitations on a board's powers to be placed in the articles of incorporation; instead, the "board of directors [retains] sole discretion to determine the terms and conditions of the rights agreement."

108. See id. 109. See id. at 1581. 110. See id. at 1580; O.C.G.A. 14-2-801(b) (1994) (providing in pertinent part that "all corporate powers shall be exercised by . . . the corporation's board of directors, subject to any limitation set forth in the articles of incorporation, bylaws . . . or agreements among the shareholders which are otherwise lawful"). 111. See Invacare, 968 F. Supp. at 1580. 112. See id. 113. 1528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988). 114. See id. at 486. The court found that Irving Bank's rights plan violated a portion of the business corporations statute. See id. 115. See Bank of New York, 528 N.Y.S.2d at 485. 116. Invacare, 968 F. Supp. at 1580. Georgia law provides: "nothing contained in Code Section 14-2-601 shall be deemed to limit the board of directors' authority to determine, in its sole discretion, the terms and conditions of the rights, options, or warrants issuable pursuant to this Code section. Such terms and conditions need not be set forth in the articles of incorporation." O.C.G.A. § 14-2-624(c)(1994).
The court found that Code section 14-2-624 contained no limit that would restrict directors from exercising their discretion to “include a provision which limits the authority of future boards of directors [and] to read such an exception into [Code section] 624 is clearly contrary to the plain language of the statute.” 117 The court further noted that the official comment to Code section 14-2-624(c) states that a board’s authority to determine the conditions of a rights plan is limited only by its fiduciary obligations to the corporation. 118

C. The Fiduciary Challenge Under Georgia Law

The court in Invacare also rejected the argument that the continuing director portion of the rights plan violated the directors’ fiduciary duties under Georgia law. 119 Code section 14-2-830(a)(1) requires directors of Georgia corporations to exercise good faith and act in the best interest of their corporations. 120 Georgia courts apply the business judgment rule to determine if directors have satisfied their statutory fiduciary duty. 121

The court in Invacare did not reach the merits of the fiduciary duty argument. 122 Instead, the court noted that Invacare did not argue or prove that the directors breached their fiduciary duties by adopting the continuing director provision. 123 Nevertheless, the court found that Healthdyne’s board did not breach its fiduciary duty. 124

The court also rejected Invacare’s call for a “compelling justification” requirement for actions that interfere with shareholder voting rights. 125 The court found that the continuing

117. Invacare, 988 F. Supp. at 1580. Although Code sections 14-2-1111 and 14-2-1133(b) do not relate to the rights at issue in Invacare, the court noted that they do allow for the use of continuing director provisions as a defense in takeover cases, demonstrating that the provisions do not violate public policy in Georgia. See Invacare, 988 F. Supp. at 1580-81; see also O.C.G.A. § 14-2-1111, -1133(b)(1994).
118. See id. at 1580. But see Gordon, supra note 9, at 538 (arguing that the court misconstrued the legislative history of Code section 624(c), which was adopted to counter a 1989 decision that invalidated all poison pills under Georgia law).
120. See O.C.G.A. § 14-2-830(a)(1) (1994); see also Invacare, 988 F. Supp. at 1581.
122. See Invacare, 988 F. Supp. at 1581.
123. See id. (noting that Invacare only argued for a per se rule of invalidity).
124. See id.
125. See id. The court distinguished Healthdyne’s continuing director provision from
director provision did not interfere with the voting rights because shareholders remained free to elect a new board of directors.\textsuperscript{128} The court also declared the compelling justification standard inconsistent with the directors' fiduciary duty standard under Georgia law.\textsuperscript{127}

\textit{D. Invacare's Proposed Bylaw}

The court also declared invalid Invacare's proposed bylaw requiring Healthdyne's directors to remove the continuing director provision.\textsuperscript{129} The court found that the bylaw violated Code section 14-2-624(c), which grants directors sole discretion to determine the conditions of rights limited only by their fiduciary obligations to the corporation.\textsuperscript{129}

Invacare argued that Code sections 14-2-202(b), 14-2-801(b), and 14-2-1020(c) authorized its proposed bylaw.\textsuperscript{130} Invacare argued that these provisions granted shareholders the right to limit the board's discretion to adopt a continuing director provision.\textsuperscript{131} The court rejected Invacare's argument, however, finding that the proposed bylaw interfered with the directors' "authority under [Code section] 624(c) to set the terms and conditions of the rights agreement."\textsuperscript{132} The court further noted

\begin{footnotes}
\item[128] See \textit{Id.} 968 F. Supp. at 1551.\textsuperscript{128} See Invacare, 968 F. Supp. at 1581. \textit{But see} Gordon, supra note 9, at 535 (noting that the court merely concluded that the continuing director provision did not infringe upon the shareholders' right to elect without carefully considering any fiduciary duty argument).
\item[128] See id.
\item[129] See id. at 1582.
\item[130] See id.; see also O.C.G.A. § 14-2-202(b)(1994) (providing that "[a]rticles of incorporation may set forth . . . [p]rovisions . . . [d]efining, limiting, and regulating the powers of the corporation, its board of directors, and shareholders"); O.C.G.A. § 14-2-801(b) (1994) (providing that "[a]ll corporate powers shall be exercised by . . . and the business affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation, bylaws . . . , or agreements among the shareholders which are otherwise lawful"); O.C.G.A. § 14-2-1020(c) (1994) (stating that "[a] bylaw limiting the authority of the board of directors . . . may only be adopted, amended, or repealed by the shareholders").
\item[131] See Invacare, 968 F. Supp. at 1581.
\item[132] Id. at 1582.
\end{footnotes}
that any authority granted to shareholders under Code section 14-2-801(b) did not apply to corporations with shares listed on a national securities exchange. In sum, the court held that “Invacare’s proposed bylaw [was] invalid as a matter of law.”

III. CONTINUING DIRECTOR PROVISIONS UNDER DELAWARE LAW

A. The Facts of Carmody

In Carmody v. Toll Bros., the Delaware Court of Chancery found that Carmody’s complaint challenging a poison pill’s continuing director provision stated a valid claim. As did the court in Invacare, the court in Carmody examined the provision’s validity on both statutory and fiduciary grounds; however, the court in Carmody reached the opposite conclusion on both issues.

The Toll Brothers board adopted a rights plan to guard against a hostile takeover. When the board adopted the plan, Toll Brothers faced no impending threat of acquisition. However, an acquirer would trigger the plan by obtaining fifteen percent of the company’s outstanding common shares or “[commencing] . . . a tender offer or exchange offer that would result in a person or group beneficially owning 15 [percent] or more of the company’s outstanding common shares.” Once the triggering event occurred, the rights would flip in, entitling each rights holder to buy two shares of Toll Brothers common stock at half price, thus “massively diluting the value of the holdings of the unwanted acquiror.” The rights plan also contained a flip-over provision that entitled the holder to

133. See id.
134. Id.
135. 723 A.2d 1180 (Del. Ch. 1998).
136. The Delaware Chancery Court primarily refers to the continuing director provision as a “dead hand” provision. See id. at 1184.
137. See id. at 1195.
138. See id. at 1192-93.
139. See id. at 1183.
140. See id. The court noted that the building industry, in which Toll Brothers was engaged, was going through a period of consolidation that posed the risk of a takeover for the company. See id.
141. Id. at 1183.
142. Id.
purchase the acquirer's common stock at half price after a merger or business combination.\textsuperscript{143}

Carmody's complaint alleged that these provisions made any hostile acquisition cost prohibitive and deterred acquisitions that the board did not approve.\textsuperscript{144} The Toll Brothers rights plan also included a continuing director provision that allowed only continuing directors to redeem the rights.\textsuperscript{145} Carmody argued that the continuing director provision eliminated a proxy contest as a means for a "hostile acquirer [sic] to gain control, because even if the acquirer [won] the contest, its newly elected director representatives could not redeem the [r]ights."\textsuperscript{146} The plaintiff further argued that the continuing director provision disenfranchised shareholders because "all shareholders that wish[ed] the company to be managed by a board empowered to redeem the [r]ights" would have to vote for the incumbent directors.\textsuperscript{147}

\textbf{B. The Statutory Challenge Under Delaware Law}

The court in \textit{Carmody} found that the complaint stated a valid statutory argument against the continuing director provision of the Toll Brothers rights plan.\textsuperscript{148} Section 141(d) of Delaware's Code provides that directors or classes of directors may only have different voting powers if the certificate of incorporation contains a statement setting forth the distinctions.\textsuperscript{149} Under the rights plan's continuing director provision, only continuing directors could vote to redeem the rights.\textsuperscript{150} Therefore, the plaintiff argued the provision afforded continuing directors

\textsuperscript{143} See id. Once activated, the flip-over provision would affect the acquirer's capital structure and dilute the interests of its original shareholders. See id.
\textsuperscript{144} See id. at 1184.
\textsuperscript{145} See id.
\textsuperscript{146} Id.
\textsuperscript{147} Id.
\textsuperscript{148} See id. at 1190. The court first addressed the defendants' arguments that the claim was not ripe and that the claims were derivative and must be dismissed because the plaintiff failed to make a demand on the board. See id. These arguments are beyond the scope of this Article.
\textsuperscript{149} See id. at 1190-91; see also DEL. CODE ANN. tit. 8, § 141(d) (1998) (providing that "[t]he terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors").
\textsuperscript{150} See Carmody, 723 A.2d at 1182.
different voting rights than newly elected directors; because the Toll Brothers certificate of incorporation did not allow directors to have distinctive voting power, the provision violated section 141(d).\textsuperscript{151}

The defendants argued that, although the provision created one class of directors with greater power than other directors, it was not invalid because "corporations may lawfully delegate specific tasks . . . to a special committee of less than the full board without any requirement that the committee's delegated powers be spelled out in the certificate of incorporation."\textsuperscript{152} The court rejected the defendants' special committee argument because special committees do "not impose long term structural power-related distinctions between different groups of directors of the same board."\textsuperscript{153} Further, the current or successor board could abolish a special committee established by a previous board.\textsuperscript{154}

The court found that because the continuing director provision established a class of directors with distinctive rights, which was not allowed for in the Toll Brothers certificate of incorporation, it violated the plain language of Delaware Code section 141(d).\textsuperscript{155} The court also found that Code section 141(d) vests exclusively in the shareholders the power to elect directors with disparate voting power.\textsuperscript{156} The court concluded that because the Toll Brothers certificate of incorporation lacked any provision allowing the election of directors with disparate voting power, "the complaint state[d] a claim that the 'dead hand' feature of the [r]ights [p]lan is ultra vires, and hence, statutorily invalid under Delaware law."\textsuperscript{157}

Because the continuing director provision prevented a future, duly-elected board from redeeming the rights, the court found that the provision impermissibly interfered with the directors' statutory duty to manage the corporation.\textsuperscript{158} The court therefore

\textsuperscript{151} See id.
\textsuperscript{152} Id. at 1180.
\textsuperscript{153} Id. at 1192.
\textsuperscript{154} See id.
\textsuperscript{155} See id. at 1180-92.
\textsuperscript{156} See id.
\textsuperscript{157} Id.
\textsuperscript{158} See id. at 1192-94; see also DEL. CODE ANN., tit. 8 § 141(a)(1998) (providing that "[t]he business and affairs of every corporation organized under this chapter shall be managed
accepted the plaintiff's argument that by depriving future boards of the power to redeem the pill, the continuing director provision deprived them of the ability to negotiate even a business combination that served the corporation's best interest. 159

The court relied on Bank of New York Co. v. Irving Bank Co., 160 noting that, although not identical, both the Delaware and New York statutes required the certificate of incorporation to state any limits on the directors' powers. 161 For these reasons, the court allowed the statutory challenge to the rights plan to proceed. 162

C. The Fiduciary Challenge Under Delaware Law

Having found that the complaint stated a claim on statutory grounds, the court in Carmody also indicated in dicta that the provision also violated the directors' fiduciary duties. 163 The complaint rested on two theories, both of which the court found "cognizable under Delaware law." 164 The test set out in Blasius 165 requires a compelling justification for anything that interferes with the shareholders' right to vote. 166 The court also relied upon Unitrin, Inc. v. American General Corp., 167 which set out a modified version of the business judgment rule, under which the board must show that it had reasonable grounds to adopt its provision and that the provision was reasonable in relation to the grounds for adoption. 168

by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation"). Invacare asserted a similar argument under Georgia Code section 14-2-801(b). See Invacare v. Healthdyne Techs., Inc., 968 F. Supp. 1578 (N.D. Ga. 1997).

159. See Carmody, 723 A.2d at 1192-93.
161. See Carmody, 723 A.2d at 1191-92; see also DEL. CODE ANN., tit. 8 § 141(a)(1998); N.Y. BUS. CORP. LAW § 620 (McKinney 1998). But see O.C.G.A. § 14-2-801(b) (1994) (allowing such limitations to be placed in the bylaws or articles of incorporation).
162. See Carmody, 723 A.2d at 1192. The defendants also argued that the rights plan did not interfere with a proxy contest, but the court concluded that this fiduciary argument was nonresponsive to the statutory claims. See id.
163. See id. at 1193.
164. Id.
165. 564 A.2d 651 (Del. Ch. 1988).
166. Carmody, 723 A.2d at 1193.
167. 651 A.2d 1381 (Del. 1995).
168. See Carmody, 723 A.2d at 1194; Unitrin, 651 A.2d at 1373.
Although courts usually judge the validity of antitakeover defensive measures by the modified business judgment rule, the court requires a board to "satisfy the more exacting Blasius standard." The court focused on the Delaware Supreme Court's rationale for validating poison pills in Moran because "if the board refused to redeem the plan, the shareholders could exercise their prerogative to remove and replace the board." The court noted that because a newly elected board cannot redeem the rights, a continuing director provision eliminates shareholders' ultimate recourse—the ballot box, which the court described as "the safety valve which justifies a board being allowed to resist a hostile offer [that] a majority of shareholders might prefer." The defendants denied any shareholder disenfranchisement because the continuing director provision did not preclude dissatisfied shareholders from electing new directors. The court responded that, although the shareholders could vote for new directors, the continuing director provision denied the shareholders any real choice because only the continuing directors could redeem the rights under the plan. Therefore, the court found that "the plaintiffs ['] Blasius-based breach of fiduciary duty claim [was] cognizable under Delaware law." 

Relying on the Unitrin test, the court found the continuing director provision an unreasonable defensive measure. The court noted that under this test, a defensive measure was "disproportionate (i.e., unreasonable) if it was either coercive or preclusive." The court found the continuing director provision coercive because it forced the shareholders to vote for incumbent directors if they wanted the rights redeemed.

169. See Unitrin, 651 A.2d at 1373.
170. Carmody, 723 A.2d at 1193.
171. Id. (citing Moran v. Household Int'l, Inc., 500 A.2d 1546, 1555 (Del. 1985)).
172. Id. at 1193-95; see also Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 959 (Del. 1985).
173. See Carmody, 723 A.2d at 1193.
174. See id. at 1194.
175. Id.
176. See id. at 1195; see also Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).
177. Carmody, 723 A.2d at 1195.
178. See id.
Accordingly, the court concluded that continuing director provisions’ coercive effect on proxy contests made them preclusive under the *Unitrin* test.  

IV. CONCLUSION 

Since their validation under Delaware law, rights plans have become a common antitakeover defense. However, the same court that validated rights plans warned that they created a potential for misuse. In *Moran*, the court accepted the validity of the rights plan because the plan did not render the target company acquisition-proof, but rather gave the directors a powerful negotiating tool. After *Moran*, if faced with a board that refuses to redeem a rights plan, a majority of shareholders could elect a new board willing to redeem the rights or sue the directors for breach of fiduciary duty.

The advent of the continuing director provision may have effectively eliminated shareholders’ ability to take their grievances to the ballot box. Under such provisions, shareholders remain free to vote in a new board, but that new board lacks the power to redeem the rights plan. Because only continuing directors can eliminate a rights plan’s threat to an acquirer if shareholders desire an acquisition, shareholders are forced to vote for the continuing directors. Therefore, because a continuing directors plan may either discourage a dissident group from initiating a proxy contest altogether or prevent a newly elected board from removing the rights plan, it strips “the shareholders of their sovereignty as owners of the company.” Courts should declare continuing director provisions invalid as a matter of law because they inhibit proxy contests.

179. See id.
180. See *Moran v. Household Int'l, Inc.*, 490 A.2d 1059 (Del. Ch. 1985), aff'd, 500 A.2d 1346 (Del. 1985); Rosenzweig supra note 6, at 744.
181. See *Moran*, 490 A.2d at 1083.
182. See id.
183. See *Gordon*, supra note 9, at 523.
184. See *Lese*, supra note 7, at 2211.
185. See *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1193 (Del. Ch. 1998).
186. See id.
188. See id. at 2211 (arguing that the primary purpose of continuing director provisions is to entrench the incumbent board).
The *Carmody* decision indicates that courts will hold continuing director provisions invalid under Delaware law.\textsuperscript{189} Although the court allowed the challenge to the continuing director provision on a statutory basis, it did so only because the certificate of incorporation did not authorize the provision.\textsuperscript{190} Future boards might avoid a similar result by placing authorization in a company's certificate of incorporation.

However, under the modified business judgment rule applied to defensive measures under Delaware law, courts likely will find continuing director provisions invalid as a breach of the directors' fiduciary duty to the corporation.\textsuperscript{191} Delaware law permits corporate boards to take defensive steps as long as those steps do "not entirely foreclose a hostile bidder." \textsuperscript{192} The court in *Carmody* found that a continuing director provision went too far because it effectively foreclosed a hostile bidder and thus violated the directors' fiduciary duty.\textsuperscript{193}

Because of Delaware's influence in corporate law, other jurisdictions likely will follow *Carmody*.\textsuperscript{194} However, courts are unlikely to find that continuing director provisions violate directors' fiduciary duties under Georgia law.\textsuperscript{195} The court in *Invacare* did not decide the fiduciary duty issue because Invacare argued only for a per se rule of invalidity.\textsuperscript{196} The court in *Invacare* merely refused to require a compelling justification for devices that interfere with shareholders' voting rights, however.\textsuperscript{197} Thus, the possibility remains that courts could find that continuing director provisions violate directors' fiduciary duties under Georgia law. The court's conclusory statement that continuing director provisions "[do] not infringe on the

\textsuperscript{189} See generally *Carmody*, 723 A.2d at 1180. This decision did not declare that dead hand poison pills were invalid but found that the complaint would survive a motion to dismiss. See id.

\textsuperscript{190} See id. at 1190-91; see also Bank of New York v. Irving Bank Corp., 528 N.Y.S.2d 482 (N.Y. Sup. Ct. 1988) (holding a continuing director provision invalid under a similar statutory provision).


\textsuperscript{192} Dewey, supra note 17 at A12.

\textsuperscript{193} See *Carmody*, 723 A.2d at 1195.

\textsuperscript{194} See Dewey, supra note 17 at A12.


\textsuperscript{196} See id.

\textsuperscript{197} See id.
shareholders' right to elect a new board" suggests that the Northern District of Georgia court might find that the device does not breach directors' fiduciary duties.198

Finally, if continuing director provisions remain valid under Georgia law but invalid under Delaware law, Georgia corporations may enjoy an advantage in defending against hostile takeovers.199 Thus, Georgia may become a more attractive place for companies to incorporate.

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198. Id.
199. See generally Gordon, supra note 9, at 533 (noting, in an article written before Carmody, that the Invacare decision is likely to increase the popularity of continuing director provisions). But see William B. Shearer III, Comment, Poison Pills: Are Dead Hand Pills Dead In Georgia?, 50 Mercer L. Rev. 809 (1999) (arguing that Georgia courts are likely to follow Delaware's lead in limiting the use of dead hand poison pills).