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"No Mas" to "Just Say No"?

Recent takeover battles are bringing into question the continued vitality of the "just say no" defense, which allows boards of directors of target companies to combine refusal to negotiate and an unwillingness to waive structural defenses (such as a poison pill or Section 203 of the Delaware corporate code) to frustrate advances from unwanted suitors.

The current takeover battle between Airgas and Air Products highlights one of the key areas of uncertainty in Delaware law today—the continued vitality of the "just say no" defense to unsolicited advances. Stated simply, if upheld, the "just say no" defense allows the board of directors of a target company to combine a refusal to negotiate and an unwillingness to waive structural defenses such as a poison pill or its less-effective statutory counterpart, Section 203 of the Delaware corporate code, to frustrate advances from an unwanted suitor. The defense is unique to the U.S. market—by comparison to the swift resolution of the recent Cadbury/Kraft hostile offer mandated by UK takeover rules, the defense can result in protracted battles that last for months, and sometimes years, oftentimes despite support for an offer from target shareholders.

Despite its popularity in the public (well, the dealmakers') imagination, the "just say no" defense has a somewhat limited judicial pedigree. The case most often cited as establishing the validity of the defense is a 1995 Federal decision applying Delaware law to the defense by Wallace Computer against a hostile bid from Moore. In that case, the court upheld the refusal by Wallace's board to redeem a pre-existing poison pill in the face of a non-coercive premium tender offer that was accepted by nearly 75% of Wallace's shareholders. This ruling was seemingly inconsistent with the holdings in two 1988 Delaware Chancery decisions (*Interco* and *Grand Metro*) where redemption of a poison pill was mandated. The court held in the *Wallace* case that the mere refusal to redeem a historical poison pill can be viewed as defensive, thereby triggering the enhanced scrutiny of *Unocal* to the board's decision. However, the court found that the board's decision satisfied the two requirements of the *Unocal* test of defensive measures—the board's good faith and sound investigation showed reasonable grounds for the board's belief that a danger to corporate policy and effectiveness existed (i.e., the danger that shareholders, tempted by the premium, would tender at an inadequate price in ignorance of the true value of the target) <u>and</u> the retention of the poison pill, even beyond the period necessary to formulate an alternative plan to maximize shareholder value, was reasonable and proportionate to the danger posed. As such, the board's defense was entitled to the presumptions of the "business judgment rule" and would not be second-guessed by the court.

Since that time, "just say no" has emerged as an accepted defensive tactic to hostile offers. It is best described as a "tactic" because, like the poison pill itself (one of the defense's key ingredients), it very rarely is pursued to the end in the face of a determined and persistent suitor offering a premium price that is supported by target shareholders—rather, it is most often used by a target board to delay the inevitable in the hopes of unearthing a "white knight" suitor or at least extracting a higher price from the bidder.

While never addressed fully and directly by a Delaware state court decision, judicial scrutiny of elements of the "just say no" defense has appeared in recent years. In the bitter 18-month battle between Oracle and PeopleSoft in 2004, VC Strine's comments appeared to suggest that he was considering requiring PeopleSoft to lift its poison pill to allow Oracle to complete its offer, which was supported by more than 60% of the target's shareholders. No judgment was ultimately rendered in that case because of a settlement in connection with an agreed merger. That said, the court's apparent skepticism of PeopleSoft's "just say no" defense in that case may have been more a reflection of distaste for the lengthy scorched-earth defense implemented by Peoplesoft (including its implementation of a "customer poison pill" alongside its traditional shareholder rights plan) than a wholesale rejection of the defense.

More recently, some commentators have read the Delaware Supreme Court in *Gantler vs. Stephens* as confirming that the liberal "business judgment rule" standard would apply to a "just say no" decision absent self-interest on the part of directors. However, it is doubtful that the court's holding should be read broadly to cover a board's defensive posture in the face of an unsolicited and non-coercive premium offer supported by target shareholders. In the case, target shareholders sued the First Niles board for abandoning a sale process that they themselves initiated despite receiving offers that its financial advisor found to be within the range of reasonableness. No defensive measures were taken—the challenged action was merely the abandonment of the board's own sale process—and therefore *Unocal* standards were not implicated.

With the expected increase in hostile activity, it is inevitable that the "just say no" defense will continue to be a feature of the defensive toolbox, as well as the subject of legal challenge by hostile suitors (e.g., Airgas' Delaware suit challenging Air Products' refusal to negotiate). The defense appeared, and was challenged in court, in the recent Broadcom/Emulex and KPN/iBasis hostile offers, but, as in many such cases, no court decision was issued because of the abandonment of the offer and entry into a negotiated deal, respectively.

We believe that any judicial evaluation of a "just say no" defense will probably turn on the specific facts and circumstances of the relevant situation. A non-exhaustive list of factors that a court would likely take into account in evaluating the board's defense includes:

- the size of the premium offered, including increases in price from the initial offer
- the identity of the bidder (strategic vs. financial) and the form of consideration offered (cash vs. stock)
- whether the offer is structurally and substantively coercive and/or is being made by an affiliated shareholder
- the level of support for the offer among target shareholders, as reflected in tenders or voting for an acquirer's slate in a proxy contest
- the ability and timetable for the target shareholders and/or the acquirer to replace the target board (which would facilitate completion of a deal), including if the target board is classified
- whether the structural defenses (e.g., poison pill) existed prior to the offer being made or were enacted as a specific response to the offer
- the duration of the defensive posture (i.e., has sufficient time passed to allow any superior bidder to emerge and/or for the target board to offer a convincing alternative)
- whether the board of the target has engaged in a thoughtful process and assessment, including as to valuation, supported by analysis from management and outside advisors and reflected in the minutes of its meetings
- whether the target board has obtained an "inadequacy" opinion from its financial advisors, including on increased bids.

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When properly viewed as primarily a tactic rather than an end, it becomes apparent that the vitality of the "just say no" defense is not and will not be the subject of a simple "yes or no" answer from the Delaware courts. Instead, the specific facts and circumstances of each case will likely determine the extent to which (and for how long) a court will countenance a target's board continuing refusal to negotiate with, or waive structural defenses for the benefit of, a hostile suitor. It is also true that the public's evaluation of the propriety of the defense often will be made with the benefit of hindsight—while the board of Wallace was lauded for its tenacious defense because of the company's near-term outperformance following its rejection of Moore's offer, the steep decline in Yahoo's price following its 2008 rejection of Microsoft ensures that its board's defensive actions will be subject to critical scrutiny.

Underlying all of the above is the changed corporate governance environment over the last several years. The *Wallace* case was decided during, and may be viewed as an expression of, the board/management-centric (paternalistic) period of corporate governance regulation. With the shift in the last several years in Federal, and to a lesser extent Delaware, law empowering stockholders at the expense of the board of directors, it is quite possible, depending on the factors outline above, that a different outcome would be obtained.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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