IN THE SUPREME COURT OF THE
STATE OF DELAWARE

JOHN A. MORAN AND THE DYSON-KISSNER-MORAN CORPORATION,	)	
Plaintiffs Below, Appellants,	)	
and	)	
GRETL GOLTER,	)	
Plaintiff-Intervenor Below, Appellant,	)	No. 37, 1985
v.	)	
HOUSEHOLD INTERNATIONAL, INC., a Delaware corporation, *et al.*,	)	
Defendants Below, Appellees.	)	

BRIEF AMICUS CURIAE OF INVESTMENT COMPANY INSTITUTE IN SUPPORT OF PLAINTIFFS-APPELLANTS

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NATURE OF PROCEEDINGS AND STATEMENT OF FACTS (Relating to Interest of Amicus Curiae)

By leave of court granted March 4, 1985, the Investment Company Institute (the "Institute"), *amicus curiae*, submits this brief in support of the prayer of plaintiffs-appellants John A. Moran, *et al.*, for reversal of the Chancery Court's judgment in favor of defendants-appellees Household International, Inc. and its directors (collectively, "Household"), entered on January 29, 1985.

The Institute is the national association of open-end investment companies (commonly known as mutual funds), their investment advisers and their principal underwriters. The Institute has 1140 investment company members, with over 20 million shareholders and assets of approximately $345 billion. Some of these shareholders are institutions, but the vast majority are individuals whose accounts in mutual funds that invest in equity securities average approximately $7,000. Many of the Institute's investment adviser and associate investment adviser members also provide investment advice and investment management services to non-investment company clients, including pension plans, charitable foundations and individuals. As the representative of a broad spectrum of investment interests, the Institute believes that, to the extent that any one entity is able to do so, it can speak for the interests of stockholders throughout the country.

The members of the Institute undoubtedly hold varying views as to the need for further legislation in the area of corporate takeovers, and as to the appropriateness under existing law of various measures taken in response to takeover efforts. However, the Institute is before this Court on a single, distinct issue which transcends these questions — whether a board of directors, acting without the consent of stockholders, has the right to change the fundamental structure of corporate governance. The Institute respectfully submits that, even if the board is acting with the best of intentions, it clearly does not have this power.

SUMMARY OF ARGUMENT

The Institute believes that Household's Rights Plan is in derogation of the underlying compact between a corporation and its stockholders. As the Chancery Court recognized, the Plan causes a "fundamental" reallocation of authority that "affects the structural relationship" between the corporation's board of directors and its stockholders. (Opinion at 36.) By effectively requiring board approval of all acquisition offers, substantial stock accumulations and concerted action by substantial stockholders, the Rights Plan shifts significant power from Household's stockholders to its board of directors. It deprives Household's stockholders of their basic

right, as owners of the corporation, to decide for themselves whether to sell their stock, and how to maximize the value of their investments. Such fundamental changes in the governing structure of a corporation cannot lawfully be imposed on the stockholder-owners without their consent.

ARGUMENT

THE RIGHTS PLAN IS INVALID AS A MATTER OF LAW

I. INTRODUCTION

The Delaware General Corporation Law is founded on the principle that stockholders — as the owners of a Delaware corporation — can and should make their own investment decisions, as well as any decision to reallocate corporate power. Every investor who buys voting stock in a Delaware corporation understands that, along with the potential economic benefit he hopes to realize on his investment, he is acquiring fundamental ownership rights that flow from the corporate structure itself, such as the right to elect and remove directors (8 Del. C. §§ 141, 211), the right to vote on fundamental corporate changes such as mergers and charter amendments (8 Del. C. §§ 242, 251), and the right to dispose of his shares as he sees fit, subject only to such restrictions as he has accepted or agreed to (8 Del. C. § 202). Certainly, the stockholder's economic interest is his paramount concern, but these ownership rights are no less important, since they allow him to protect and advance that interest.

At the same time that the law confers these valuable ownership rights on stockholders, it expressly precludes the board of directors of a Delaware corporation from usurping the fundamental rights and powers that have been given to the stockholders. Thus, for example, although individual directors may own and vote shares in a Delaware corporation, the board may not vote any treasury shares held by the company itself (8 Del. C. § 160(c)). Likewise, the statutory prohibition against circular voting prohibits a Delaware corporation from indirectly voting its own shares held by majority-owned subsidiaries (*Id.*). As to any matter subject to a stockholder vote, the board of directors may express its recommendation, but the final decision rests with the stockholders themselves.

Of course, it is in the nature of public corporations that ownership and management do not rest in the same individuals. Indeed, it would be wholly impracticable for public stockholders to participate in the day-to-day business affairs of their company. Because the stockholders cannot do this for themselves, Delaware corporation law, together with the certificate of incorporation, give directors the power to supervise, and officers the power to run, the business of the company. But management is not granted the power to do that which the stockholders can do for themselves, and that which inheres in the basic concept of stock ownership — the right to make fundamental decisions as to who is to control the corporation, and whether

to sell or retain their stock. A basic presumption of the law is that these rights cannot be taken by directors from stockholders without their consent, no matter how well-intentioned the directors may have been. To permit these rights to be taken from stockholders is to sanction the ultimate fragmentation of corporate interests — the divorce of ownership from the rights of ownership.

This principle was most recently reaffirmed by the United States Court of Appeals for the Second Circuit, in *Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984). There, in striking down transactions by which a board of directors sought to take from the company's stockholders the ability to decide whether a possible acquisition of the company was in the best interests of the company and its stockholders, the court observed that:

> the responsibility of the court is to insure that rules designed to safeguard the fairness of the takeover process be enforced. *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.*

Id. at 258 (emphasis added).

A device like the Rights Plan at issue here undermines the principles of corporate democracy and stockholder rights embodied in the Delaware General Corporation Law. It separates stockholders — the ultimate owners of a corporation — from the rights and benefits of their ownership. It replaces stockholder democracy with a system of corporate governance whereby the board of directors arrogates to itself the power of ownership, *i.e.*, the power to decide the corporation's "ultimate destiny," on the premise that the stockholder-owners simply do not have the competence to make this decision for themselves. *

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*Indeed, Household concedes that the Rights Plan is based on the premise that, in a takeover context, stockholders cannot make the fundamental decisions that ordinarily inhere in stock ownership. Thus, for example, Household's Post-Trial Brief in the court below (at 40) states that: "in takeover and non-takeover situations alike, it is the directors, not the shareholders, who have the responsibility — and the burden — for the corporation's governance." But in the takeover context, one critical aspect of corporate "governance" is the right to decide whether to sell shares — a right that belongs to stockholders and not directors.

Similarly, in its Pre-Trial Brief (at 42), Household sought to justify its Plan with the postulate that "shareholders at large are not in as good a position as

(Footnote continued)

By issuing a purported stock dividend, Household's board of directors has taken from the stockholders, and given to itself, the power to consider and pass upon all acquisition offers for the company and its shares. Although purporting only to deter supposedly "harmful" partial or two-step acquisition efforts, the Rights Plan in fact acts to deter and prevent all unfriendly offers for the company's shares, however beneficial to stockholders. Moreover, it severely undercuts the right of stockholders to join together to influence or replace incumbent management, whether by proxy contest or otherwise, even where such stockholders have no intention to seek to change the ownership of the company. In sum, the Rights Plan effectuates an impermissible reallocation of corporate power from stockholders to directors — a result which, under the principles of corporate democracy, cannot be accomplished without the consent of the governed.

Since this case concerns matters of fundamental corporate governance, questions of motive and concepts like the "business judgment" rule are ultimately inapposite. Thus, the Institute needs not and does not contest the *bona fides* of Household's directors in adopting the Rights Plan; the Plan is invalid regardless of whether Household's board believed it was acting in the stockholders' best interests.† By the same token, while it seems doubtful that the Rights Plan is in technical compliance with Delaware's General Corporation Law, the Institute is not concerned with such statutory issues as whether the rights are of a kind envisioned by 8 Del. C. § 151. Whether or not Household's stockholders would be free under the provisions of the Delaware General Corporation Law to authorize a device like the Rights Plan if the matter were put to them, it was simply beyond the authority of the directors to impose the Plan on them.

**Footnote continued from previous page*
the Board of Directors to evaluate the worth of the company, and in any event, are in no position at all to negotiate with a putative acquiror in an effort to obtain a higher price." But in fact, in a takeover situation, stockholders can "negotiate" by tendering or refusing to tender their shares, and the market, if allowed to operate freely, will produce any bidder willing to offer a higher price. As this Court has recently noted, "Delaware law does not presume that shareholders act contrary to their own best interests." *Saxon Industries, Inc. v. NKFW Partners*, Del. Supr., No. 234, 1984, slip op. at 8 (Feb. 15, 1985) (Appendix Ex. A).

†A board of directors might well believe that it was in the stockholders' best interests, for example, to unilaterally adopt a "fair price" amendment or a staggered board of directors. But whatever its motives, the board would be powerless to do so, for in a corporate democracy, such fundamental structural questions are for the stockholders to decide.

In the financially momentous context of tender offers and other such acquisitions, where hundreds of millions of dollars in premiums to stockholders may be at stake, the reallocation of corporate power sanctioned by the Chancery Court has no place. As Judge Weinfeld stated in *Conoco Inc. v. Seagram Co., Ltd.*, 517 F. Supp. 1299 (S.D.N.Y. 1981):

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

Id. at 1303 (footnote omitted; emphasis added). These fundamental principles of stockholder self-determination are plainly at stake in the present case, and the alternatives — corporate democracy or autocracy — are clear.

II. THE RIGHTS PLAN DEPRIVES STOCKHOLDERS OF IMPORTANT CORPORATE RIGHTS AND ECONOMIC BENEFITS

Prior to the adoption of the Rights Plan, each Household stockholder could consider and decide for himself whether to sell his shares to a person seeking to acquire control of the company. Armed with the disclosures mandated by the federal securities laws, he could make his own judgment as to whether, for example, it would serve his individual economic interest to sell some or all of his shares to a buyer on the open market or to tender shares into a tender offer. He could decide for himself whether the price was right and whether he wished to contribute his shares to the potential acquiror's cause. Acting alone or together with his fellow stockholders, he could himself acquire, by tender offer or otherwise, as many shares as he deemed appropriate to advance his interests and the interests of the company. In addition, he could join forces with as many other stockholders as

he wished, to seek to influence or even replace management, in order to maximize the fruits of his investment.

Thus, absent the Rights Plan, Household's stockholders had plenary power to decide who should own and control the company, whether and under what circumstances to buy more shares or dispose of their shares and whether to join with other stockholders in order to influence or bring about a change in management. The Rights Plan takes this power away from Household's stockholders and transfers it to the board of directors. It does this by erecting a barrier to *all* acquisition offers, substantial stock accumulations and concerted action by substantial stockholders — a barrier that can only be removed by the board itself, acting in its sole discretion.*

The "flip-over" feature of the Rights, as the Chancery Court pointed out, causes "devastating" dilution of an acquiror who seeks, without board approval, to effectuate a merger with Household. (Opinion at 8.) This aspect of the Rights effectively prevents *any* tender offer that contemplates such a merger unless it has been sanctioned by the board, not just the supposedly "harmful" ones emphasized by Household. Indeed, the court below found that the kind of offer that could avoid the disastrous impact of the Rights "has never been attempted and it is questionable that such as approach would succeed." (Opinion at 40.)

We believe that stockholders have an inherent right to consider supposedly "harmful" as well as "beneficial" offers, and that a board of directors' role in this context is to present a more favorable economic alternative or to persuade stockholders not to tender.† But in any event, the deterrence of supposedly harmful offers hardly can justify the deterrence of all offers. In sum, the Rights Plan would be invalid under any circumstances, since it alters fundamental corporate structure, but it certainly cannot be justified on the premise that it deters only "harmful" offers.

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*The Rights are irrevocably "triggered" if any person acquires 20% or more of Household's stock, or if a group of shareholders owning 20% or more of the stock joins together to seek to influence management, whether by proxy contest or otherwise. Thus, the Rights Plan prevents Household's stockholders from participating in or benefiting from any of the stock accumulation and group stockholder activities that trigger the Rights.

†The board could also, of course, ask stockholders to adopt such structural changes as a supermajority requirement, staggered board, or perhaps even a poison pill. But for whatever reason, this alternative was not pursued here.

III. THE REALLOCATION OF CORPORATE POWER BY MEANS OF A DEVICE LIKE THE RIGHTS PLAN IS CONTRARY TO DELAWARE LAW

A. A Board of Directors Cannot Alter Fundamental Corporate Structure Without Stockholder Consent

There are few cases in which a board of directors has attempted anything like the reallocation of corporate power effectuated by the Rights Plan here. But when this has been attempted, the courts have held that directors do not have the power to impose on stockholders a fundamental change in corporate governance, regardless of whether the board's action might have otherwise constituted a good faith exercise of business judgment. Indeed, it is well settled that:

> Generally as an attribute of stock ownership, *every stockholder has the right to the continuation of the existing corporate structure* until changed by merger, consolidation or otherwise in accordance with proper action taken *by the stockholders* in conformity with the applicable statutory and corporate procedural requirements.

15 W. Fletcher, *Cyclopedia of the Law of Corporations*, § 7063 (rev. perm. ed. 1983) (emphasis added).*

That a board of directors may not, by unilateral action, reallocate corporate power from the stockholders to itself is clear from the recent decision of the Court of Appeals for the Second Circuit in *Norlin Corp. v. Rooney, Pace Inc., supra*, 744 F.2d at 255, 258 — a decision recognizing that even in today's volatile takeover world, "decisions affecting a corporation's ultimate destiny are for the shareholders to make in accordance with democratic procedures." Fearful of a takeover by Piezo Electric Products, Inc., which had purchased some 32% of Norlin's stock on the market over a short period of time, Norlin issued new common and voting preferred stock to a wholly-owned subsidiary and to a newly created employee stock option plan (the "ESOP"), the trustees of which were all

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*This right to the continuation of the corporate structure, except as modified by stockholder action, is "just as valuable and real as other attributes of ownership of corporate shares, such as the right to vote shares, to share in dividends and to transfer the shares." *Watson v. Washington Preferred Life Insurance Co.*, 502 P.2d 1016, 1019 (S. Ct. Wash., *en banc*, 1972). *See also Wylain, Inc. v. TRE Corp.*, Del. Ch., 412 A.2d 338, 344 (1980) ("The stockholders of a Delaware corporation have certain specific and enforceable rights under their contract with the corporation and the State, for example: to be able to vote on fundamental corporate changes.").

members of the Norlin board. The result of these transactions was that Norlin's directors controlled 49% of the corporation's outstanding stock.

In defense of these actions, Norlin contended that the transfer of shares to the ESOP was intended to benefit employees and that a Piezo takeover would be detrimental to Norlin's business and financial situation. Norlin emphasized that:

> the board needed to consolidate control to "buy" time to explore financial alternatives to a Piezo takeover. The company asserts that the shareholders will benefit if the directors are insulated from challenges to their control, for an interim period of unspecified duration, so that all of Norlin's future operations can be considered with professional guidance.

Id. at 267.

The Second Circuit struck down this attempt by Norlin's board of directors to usurp the stockholders' power to decide for themselves whether to participate in a change of control of their company, notwithstanding the board's claim — identical to Household's here — that this shift of corporate power would benefit the stockholders by enabling the board to act in their financial interest. Having found its "most important duty" to be the protection of "the fundamental structure of corporate governance," the court explained that:

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

Id. at 267 (emphasis added).

Thus, the court explicitly rejected the notion of exclusive board control that is the predicate for Household's Rights Plan. While directors may believe that they best know what stockholders should do with their shares, and may act out of the best of motives, the decision is simply not theirs to make. Directors might also believe, in the best of faith, that in a time of corporate turmoil their terms of office should be extended to five years, or that there should be an absolute prohibition against tender offers being presented to stockholders without board approval. But their recourse, as long as there is corporate democracy, must be to the stockholders, and not to their own beliefs, no matter how well-intentioned.

The decision of the Court of Chancery in *Telvest, Inc. v. Olson*, Del. Ch., No. 5798 (March 8, 1979) (Appendix Ex. B), stands with *Norlin* as a

fundamental statement of these principles. In *Telvest*, the directors of Outdoor Sports Industries, Inc. ("OSI") sought to defend against a take-over attempt by Telvest. Acting unilaterally, without stockholder approval, the OSI directors purported to create a series of preferred stock with an 80% class vote on business combinations with any party owning 20% or more of the outstanding voting stock of the company. The preferred stock was issued, in "piggy-back fashion," as a pro-rata dividend to OSI's existing stockholders.

The result of this "purported stock dividend," the court explained, was that OSI's common stockholders no longer had the right to approve or disapprove certain business combinations by a majority vote. *Id.* at 7. Instead, because of the supermajority vote of the piggy-back preferred, such combinations could be defeated by as few as 20% of those same common stockholders. Since the OSI board retained the power to waive the supermajority provision, it had effective control over acquisition offers for the company.

Although the preferred stock issuance was, in form, authorized by 8 Del. C. § 151(a) and by OSI's certificate of incorporation, the court held that the board of directors could not — without the approval of OSI's common stockholders — issue a class of preferred stock which altered the voting rights of those stockholders:

> It seems more logical to conclude that where the holders of the common stock are given the right to approve certain transactions by only the majority vote required by the applicable statutes, that right cannot be changed short of an amendment to the certificate of incorporation approved by the stockholders pursuant to 8 Del. C. § 242. *I am aware of no policy evident in the Delaware Corporation Law, and I have been referred to none, which would empower a board of directors to alter existing voting rights of shareholders for the supposed good of the shareholders without permitting the shareholders to be heard on the matter.*

Id. at 14 (emphasis added).

Moreover, the court expressly rejected OSI's contention — indistinguishable from that advanced by Household in support of the Rights Plan — that the alteration of shareholder voting rights was "necessary to insure the survival of the corporation and to protect [the] shareholders." *Id.* at 3. The cases cited by OSI, which dealt with purchasing the stock of a dissident faction so as to avoid what justifiably appeared to be a threat to the well-being of the corporation, were held not to support OSI's position.* As the court put it:

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*Kors v. Carey, Del. Ch., 158 A.2d 136 (1960); *Cheff v. Mathes*, Del. Supr., 199 A.2d 548 (Del. 1964); *Kaplan v. Goldsamt*, Del. Ch., 380 A.2d 556 (1977).

> Those cases do not purport to authorize management, without putting the matter to the shareholders, to superimpose new strictures on existing shareholder 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.

Id. at 15. Thus, the court recognized that there could be no business judgment or other justification for changing the structure of corporate governance, *without stockholder consent*, as a means of forestalling a change of control.

In the similar context of a membership corporation, this Court has ruled that a board of trustees cannot unilaterally change the structure of the corporation, albeit by technically valid means, without the consent of the members affected by that change. *In re Osteopathic Hospital Association of Delaware*, Del. Supr., 195 A.2d 759, *aff'g* Del. Ch., 191 A.2d 333 (1963). There, this Court invalidated a by-law amendment that effectively diluted the power of the existing members of the corporation to control the admission of new members, even though the charter gave the board the authority to amend the by-laws, and the amendment itself was properly enacted.

Prior to the amendment, the members of the corporation had exclusive control over the admission of new members. The amendment altered this by giving full membership status to all the trustees, only some of whom had theretofore been members. In defense of the by-law, the corporation argued that it would "alter the organization in keeping with preferred and presumably recommended methods of hospital administration." 191 A.2d at 338. There was no claim that the trustees had acted out of an ulterior motive. 195 A.2d at 764.

Nonetheless, this Court ruled that the amendment was "patently unreasonable as a matter of law" because the board had unilaterally changed the structure of the corporation and because, regardless of whether the board was self-interested, the amendment gave the board an inherently dangerous capability of maintaining control over the membership process. Such a change, the Court concluded, should not have been made without the original members' approval. *Id.* at 765.*

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*The analysis of the Chancery Court in *Osteopathic Hospital* is instructive:

> It may be that the trustees voting on such proposal acted with the highest motives and in the best interest of the corporation, but the possibility of abuse is real. I am persuaded that a *change of so fundamental a character in the structure* of this rather unique organization could not validly be carried into effect by the *unilateral action* of the trustees taken here. Something more is necessary to validate such an amendment where, as here, there is a sudden

(Footnote continued)

The Court's decision in *Osteopathic Hospital* is fully applicable here. Regardless of whether the Rights Plan is valid in form, and regardless of the motives or intentions of the Household board, the fact remains that the Rights Plan deprives the company's stockholders of their long-standing right to consider and pass upon acquisition offers for their shares, and gives the board the capability of maintaining continued control over the company. As in *Osteopathic Hospital*, such a change cannot lawfully be made without the stockholders' consent.

In its decision upholding the Rights Plan, the Chancery Court pointed out that, prior to the adoption of the Plan, Household's management considered "various charter amendments which would render a takeover more difficult," including a "fair price" amendment. (Opinion at 3). Thereafter, for reasons that are the subject of dispute between the parties, the company decided not to pursue such an amendment. (*Id.*) We need not speculate as to why Household did not seek its stockholders' approval of the more extreme anti-takeover device that it did adopt, for it is clear that, as *Norlin* and *Telvest* show, even if there had been the time pressure of an ongoing tender offer, structural corporate changes must be approved by stockholders.†

B. The Rights Plan Has No Independent Economic Substance That Would Justify Its Impact on Corporate Structure

The business judgment rule cannot, we submit, ever justify a change in fundamental corporate structure: it deals, as its name suggests, with the

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departure from the past form of corporate organization coupled with a *complete absence of affirmative action by the group whose interests are adversely affected.*

191 A.2d at 336 (emphasis added).

†For example, in *Martin Marietta Corp. v. Bendix Corp.*, Del. Ch., No. 6942 (September 9, 1982), *aff'd.*, Del. Supr., No. 298, 1982 (September 21, 1982) (Appendix Ex. C), Bendix sought to enact a supermajority voting requirement for certain mergers and a prohibition against stockholder action by written consents, in order to thwart a defensive "pac-man" tender offer for Bendix shares by the target company, Martin Marietta. Although the stockholder meeting to vote on these proposals had been scheduled on just ten days' notice, the Chancery Court denied Martin Marietta's motion to enjoin the meeting, noting that Bendix had no real alternative, since "[t]he sought-after result is not something that the incumbent board [of Bendix] can accomplish on its own." *Id.* at 22.

business of a corporation and not its governing structure.* Certainly, it cannot support a device like the Rights Plan, which has no independent economic substance that could justify the board's invocation of the corporate mechanisms for issuing stock dividends and rights.

Actions taken by a target company in response to an actual or threatened change of control usually involve substantive business transactions, and in such cases, the courts' traditional reluctance to "second guess" the wisdom of management's business decisions has often been reflected in a liberal application of the business judgment rule.† There has been much debate as to the appropriate balance between this rule and the strict principles of fiduciary duty that underlie Delaware corporate law. But this debate need not be resolved on the present appeal, for the Rights Plan has no purpose or effect other than to place the issue of corporate control in the hands of management by permanently reallocating corporate power. Such a utilization of the corporate machinery, without any economic substance, is impermissible under any standard.

Here again, the question is not whether Household's motives and intentions in adopting the Rights Plan were benign, but whether a board of directors, for any purpose, may utilize its access to corporate mechanisms such as stock and rights dividends — which were plainly designed for financial purposes — in order to fundamentally shift the balance of corporate authority. The answer is that the directors have no such power.

The reason for this is clear. To permit the use of a financing device, such as a stock issuance, for a non-financial purpose, is to permit an end run around the system of corporate governance embodied in Delaware law. For example: the board of directors of a Delaware corporation may certainly issue additional stock for the purpose of raising capital, even though such stock issuance has a dilutive impact on other shareholders. It could also issue stock in a substantive business transaction, even in the face of a hostile tender offer, so long as the transaction is consistent with its fiduciary duties. However, it is clear that, as *Norlin* teaches, the board could not validly issue such stock for the sole purpose and effect of diluting a stockholder who would otherwise have sufficient shares to effectuate a merger, any more than the board could unilaterally amend the corporate charter to raise the percentage vote required for a merger.

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*To continue the analogy previously used, it is inconceivable that a determination by directors to extend their terms of office could be justified under the business judgment rule, no matter how well-intentioned the directors may have been.

†*See, e.g., GM Sub Corp. v. Liggett Group, Inc.*, Del. Ch., No. 6155 (April 25, 1980) (Appendix Ex. D).

The Delaware courts have consistently acted to maintain the integrity of the Delaware corporation law by assuring that its provisions are not used as mechanisms for accomplishing inequitable or otherwise unauthorized results. For example, in *Schnell v. Chris-Craft Industries, Inc.*, Del. Supr., 285 A.2d 437, 439 (1971), this Court struck down a by-law amendment that obstructed efforts by dissident stockholders to wage a proxy fight, on the ground that it was "contrary to established principles of corporate democracy." The Court emphasized that "inequitable action does not become permissible simply because it is legally possible." *Id. Accord, Lerman v. Diagnostic Data, Inc.*, Del. Ch., 421 A.2d 906, 912 (1980) (court enjoined facially valid anti-takeover by-law amendments that changed annual meeting date, and thereby thwarted proxy contestant, without regard to whether the board's action was intentionally inequitable.)

Most instructive here is *Condec Corp. v. Lunkenheimer Co.*, Del. Ch., 230 A.2d 769 (1967). There, Condec had obtained tenders of a majority of the outstanding common stock of the target company, Lunkenheimer. Immediately thereafter, Lunkenheimer issued a block of its own stock to a friendly third party, U.S. Industries, in connection with an agreement to sell its business and assets to U.S. Industries.

Lunkenheimer sought to justify the stock issuance as a legitimate defensive maneuver, pointing out that, among other things, Condec had poor financial record and that, in contrast to the proposed transaction with U.S. Industries, the Condec offer ignored 49% of Lunkenheimer's shareholders. *Id.* at 774. The transaction apparently complied, in form, with the relevant statutory provisions. *Id.* at 775. Moreover, it was not established that the directors who approved the transaction had been motivated by self-interest. *Id.* at 776-77.

Nonetheless, the court invalidated the stock issuance. In doing so, the court focused on the substance and effect of the transaction, finding that it had no financial purpose, "brought no money into the Lunkenheimer treasury," and was primarily intended to prevent Condec from acquiring control of Lunkenheimer. *Id.* at 775, 777.

The transaction's lack of any economic substance was a critical factor in the court's decision. The court observed that Delaware's rule against the use of a corporation's financial machinery as a means of affecting corporate control

> does not mean that stock issued to raise money to eliminate a deficit is to be invalidated merely because defendant directors thereby fairly avail themselves of an opportunity to acquire additional shares to fortify their natural desire to remain in control. Where, however, the objective sought in the issuance of stock is not merely the pursual of a business purpose but also to retain control, it has been held to be a mockery to suggest that the "control" effect of an agreement in litigation is merely incidental to its primary business objective.

Id. at 776-77.

Thus, the court concluded that the stock issuance was

> clearly unwarranted because it *unjustifiably strikes at the very heart of corporate representation* by causing a stockholder with an equitable right to a majority of corporate stock to have his right to a proportionate voice and influence in corporate affairs to be diminished by the simple act of an exchange of stock which brought no money into the Lunkenheimer treasury, was not connected with a stock option plan or other proper corporate purpose, and which was obviously designed for the primary purpose of reducing Condec's stock holdings in Lunkenheimer below a majority. . . . This . . . is a case of a stockholder with a contractual right to voting control being deprived of such control by what is virtually a corporate legerdemain. *Manipulation of this type is not permissible.*

Id. at 777 (emphasis added).

The *Condec* court found that the Lunkenheimer directors had used the form of a stock issuance for the sole purpose of overriding the will of a majority of the company's stockholders.* The court concluded that the Lunkenheimer board's attempt to use this corporate mechanism for such a purpose was invalid, even though self-interest on the board's part had not been shown. Regardless of whether such a showing can be made, a board of directors cannot prevent a change of control by means of a transaction that has no independent economic substance, any more than it could accomplish the same result through a simple board resolution.

Finally, we note that there can be no serious claim that the Rights Plan has the kind of independent economic significance that could possibly give it validity. Its stated and advertised purpose was solely as an anti-takeover measure. Indeed, Household intended the preferred stock to be "out of the money," and a "selling point" of the Plan was that it "involved no significant expenditure of corporate funds and imposed no new obligations upon Household's treasury." (Opinion at 38-39.) The other supposed

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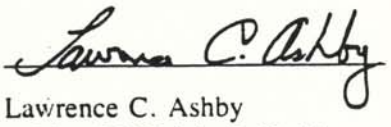
*The *Condec* court was concerned not only with the right of Condec, as the majority stockholder, to exercise its voting control, but also with the right of the stockholding majority that sold to Condec to freely dispose of their shares. Thus, the court criticized Lunkenheimer's "lack of concern" for the stockholders who had accepted the Condec offer. *Id.* at 776. Like the stock issuance in *Condec*, the Rights Plan allows Household's board to override the will of the majority of the company's shareholders by preventing them from transferring control of the company as they see fit. Indeed, the Rights Plan is far more extreme a device than that used in *Condec*, since it effectuates a permanent structural change, whereby the stockholders are prevented from having the opportunity even to consider, let alone accept, acquisition offers for their shares.

indications of economic substance mentioned by the Chancery Court — *e.g.*, that the Rights are separately tradeable, and that the preferred would survive a merger at a stated exchange rate (*id.*) — are simply external trappings that have significance only on paper. To rely on such matters to justify what is an unprecedented redistribution of corporate power would so exalt form over substance as to render meaningless the fundamental principles of Delaware corporate law.

CONCLUSION

By reason of the foregoing, the Institute respectfully submits that the decision of the Court of Chancery should be reversed.

Respectfully submitted,



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