IN THE

SUPREME COURT OF THE STATE OF DELAWARE

JOHN A. MORAN and THE DYSON-KISSNER-MORAN CORPORATION, *Plaintiffs Below-Appellants*,	)	
and	)	No. 37, 1985
GRETL GOLTER, *Plaintiff Intervenor Below-Appellant*,	)	No. 47, 1985 (Consolidated)
v.	)	Appeal from Judgment of the Court of Chancery in and for New Castle County in C.A. No. 7730
HOUSEHOLD INTERNATIONAL, INC., a Delaware corporation, DONALD C. CLARK, THOMAS D. FLYNN, MARY JOHNSTON EVANS, WILLIAM D. HENDRY, JOSEPH W. JAMES, MITCHELL P. KARTALIA, GORDON P. OSLER, ARTHUR E. RASMUSSEN, GEORGE W. RAUCH, JAMES M. TAIT, MILLER UPTON, BERNARD F. BRENNAN and GARY G. DILLON, *Defendants Below-Appellees.*	)	

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

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INTRODUCTION

Issue has been joined on numerous points in the opening briefs. This Reply Brief is devoted to the core of the dispute.

This case, perhaps more than any other, places before this Court questions which go to the fundamental nature of the Delaware corporation. Until now, the pattern of corporate governance set forth in the DGCL[1] allocated power between the stockholder owners of the corporation and the professional managers. Stock was regarded as the personal property of its owner (section 159); it was purchased with a view to making a profit.

The professional managers, on behalf of the stockholders, controlled the assets which are the source of the stockholders' profits. The stockholder owners were given certain means to exercise control over these managers. They could replace them at annual elections of directors. They could buy more shares or join with others to increase their proportionate voice in choosing directors and fixing the fundamental corporate structure and policies in the certificate of incorporation. If management did not perform well for the stockholder owners, they faced being voted out of office or having someone replace them who was willing to pay a control premium for the shares and the right to manage the corporation.

The Rights Plan fundamentally changes the relationship of the owners to the professional managers. Stockholders no longer have the power to decide to sell their own personal property to anyone willing to pay a premium for a control block of shares. Such a sale now requires board permission because such an offer cannot be successful without it.

1. The defined terms and form of citation to the record and plaintiffs' Appendix used in the "Opening Brief of Appellants John A. Moran and The Dyson-Kissner-Moran Corporation" ("POB") also will be used in this brief. The "Answering Brief of Defendants Below-Appellees" will be referred to herein as "DAB."

Similarly, stockholders can no longer buy, or join with others holding, 20 percent of Household's shares in order to increase their proportionate voice in corporate affairs or to replace management. To do so would trigger and vest the Rights, make Household acquisition-proof, and — as Household Chairman Clark conceded — be harmful to all of Household's stockholders. (Clark IV 216, A 536)

The court below was unquestionably correct in finding that the Rights Plan caused "a fundamental transfer of a power from one constituency (shareholders) to another (the directors)" (Op. at 36, A 325), "produces changes within the corporate structure" (Op. at 54-55, A 343-44) and "may ultimately alter the balance of power between shareholders and the board of directors. . . ." (Op. at 20, A 309) As the court below found, the Plan makes the board the "prime negotiator" in hostile tender offer situations. The decision whether a tender offer can be made has been taken from the stockholders and given to the board. (Op. at 36, A 325) In effect, the board unilaterally acted to bar virtually all hostile tender offers for Household.

The radical nature of this action is illustrated by reference to the Williams Act and section 203. The Congress, as a matter of national policy, provided that stockholders, and not directors, should have the decisive voice as to whether a tender offer is acceptable. Directors were permitted to advise stockholders and even to oppose tender offers, but Congress denied them the power to veto tender offers. Similarly, the General Assembly, in section 203, expressly declined to give the boards of Delaware corporations the right to veto tender offers. Both nationally and in Delaware the legislative bodies determined that tender offers provided benefits to stockholders in the form of premium prices and as an external discipline on management that should not be compromised by giving management the decisive voice.

Household's board has unilaterally reversed those legislative judgments. The result is to alter the fundamental relationship between the owners and the managers which has historically existed in the Delaware corporation. The issue for this Court is whether the Household board had the power to make such a radical alteration in the nature of the corporation without either legislative action or stockholder consent. This very question was posed to Household's expert witness, Raymond Troubh, who is both a lawyer and an investment banker. His response is the same as ours:

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

(Troubh VIII 61, A 1110)

The ultimate issue for this Court is whether the board had the power to grant itself a veto over tender offers and severely limit the formation of proxy groups.[2] Put another way, does the board have the power unilaterally to alter the fundamental power relationship between the stockholder owners and the directors? In statutory terms, this Court must decide whether section 157 can be read to authorize a device labeled a right to purchase stock, but which is designed never to be exercisable and in fact functions only as

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2. A veto is exactly what Household's expert Jay Higgins believes Household's board *should* have:

> Q: I am not talking about endorsing or recommending. . . . I am talking about the board of directors placing itself, like Horatio at the bridge, between buyers and sellers and having a near veto power upon whether the transaction is made. Do you think they should have such power?
>
> A: Very definitely, sir.

(VII 215-16, A 586-87)

a means of transferring power from the stockholder owners to their hired managers.

In considering these issues, there are fundamental points worth bearing in mind. The articulated "evil" that the defendants were addressing was two-tier offers in which a higher price was paid on the front end. (Op. at 43, A 332) If the need for protection against this evil is so apparent, why have defendants rebuffed every suggestion that the Household stockholders be permitted to decide whether they wish such "protection" by voting on the Plan? If the evil is unequally priced offers, why does the Plan operate with respect to *all* hostile offers? It could easily have been designed to trigger only if a two-tier front-end loaded offer were made. Why was so radical a plan adopted, impacting as it does both proxy and property rights, when a fair price charter amendment[3] would have completely solved the perceived two-tier problem?

If unequally priced offers were the problem, why was the Rights Plan designed to trigger if stockholders with no purpose other than the replacement of management were to form a group holding 20 percent? Why is there an exception to this 20 percent rule for employee stock ownership groups likely to be loyal to management? Defendants' explanation, echoed by the court below (Op. at 48, A 337), is that the 20 percent group prohibition is essential to the Plan because 20 percent is the threshold for measuring control. The Rights trigger at that point because otherwise anyone, acting individually or with others, who reached that threshold might elect a new board, which could redeem the Rights and thereafter pursue a two-tier plan of acquisition. (Op. at 48, A 337) In other words, the proxy restrictions are intended to

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

ensure that a new board with different policies will not be elected by a majority of the shares. Can it be the law of Delaware that holders of a majority of the shares (acting singly or in concert) are not entitled to elect whomever they want with whatever policies they favor? Do defendants assume that the courts of Delaware are not adequate to remedy any breach of fiduciary duty by new management or a controlling stockholder? Have not defendants sought to ensure that their policy against hostile tender offers could not be changed by stockholders acting together to elect a new board with a different policy?

The underpinning for the Plan and the board's adoption of it was the belief, articulated by director Whitehead, that directors are better able than stockholders to decide whether an offer is fair and should be accepted. (Whitehead VI 65, A 530) On that basis he, and the other directors, justified removing the decision from the owners of the shares and granting it to themselves. If such a fundamental right of personal property can be arrogated simply because the professional managers believe in good faith that they can better exercise it, is any stockholder right immune from seizure? More than 50 percent of Household's shares are held by institutions who are themselves fiduciary holders. On what basis do the Household directors claim to be more capable of deciding at what price to sell shares than these investment professionals? If it is in the interests of Household's stockholders to have their directors decide whether a tender offer is acceptable, why have the directors been unwilling to ask the stockholders for this power?

* * *

Household answers none of these questions. Rather its principal defense is that it is immune from judicial scrutiny because this poison pill device is just another takeover defense in a long line of takeover defenses. In fact, Household seems to want to bunch all strategies to defend against takeovers together as if they stand or fall as one. Household takes that approach in the statement of facts (DAB 10-14) and in the argument. (DAB 44, 47-50, 52-53) But only the particular poison pill device adopted by Household is at issue in this case. Unlike any other device cited, its sole purpose and effect is to produce material structural change in the governance of the corporation without the consent of the owners. Household must defend the device it adopted and, in this appeal, the Court is called upon to rule only on that device.

The position of the plaintiffs on the legal points is quite simple: (1) the Household Rights Plan is not authorized by section 157 because that section authorizes rights to purchase stock, not devices labeled "rights" intended solely to shift corporate governance powers from stockholders to the board; (2) the "flip-over" which produces the threat of "devastating" dilution lacks any statutory basis; and (3) the Household board cannot, without stockholder consent or legislative authorization, unilaterally adopt a plan intended solely to alter the corporation's governance structure by transferring stockholder power to the board. To hold otherwise would also place Delaware law squarely in conflict with federal constitutional and statutory principles.

This Court should review the legal holdings below *de novo* and should reverse the decision below if errors of law are found. *Rohner v. Niemann*, Del. Supr., 380 A.2d 549, 552 (1977).

ARGUMENT

I. SECTION 157 DOES NOT AUTHORIZE THE HOUSEHOLD RIGHTS PLAN.

Household's sole claim for authority for the Plan is section 157 of the DGCL, which authorizes the issuance of "rights . . . entitling the holders thereof to purchase from the corporation any shares of its capital stock. . . ." (DAB 62)[4] Household's argument is that section 157 authorizes it to issue rights to purchase Household preferred stock, and that the 2 for 1 dilutive flip-over is implicitly authorized by section 157 because it is necessary to protect the economic value of those rights. (DAB 67-69)

This argument makes no sense because (a) the Rights to purchase preferred stock were designed never to be exercisable by their holders and, thus, are sham rights with little or no value and (b) even if the Rights were to become exercisable, the $100 profit promised by the 2 for 1 flip-over would never be rationally related to whatever nominal value, if any, the Rights to buy preferred stock might then have. The flip-over simply cannot be justified as protecting a value that does not exist.

A. The Plan Is Designed To Prevent The Exercise Of The Rights.

Section 157 does not authorize a Delaware corporation to issue a right to acquire another corporation's shares. If it stood alone, the flip-over would be just such a right and would not be authorized by section 157. There is no dispute about this, and Household denies that it has issued such a right. (DAB 67) Therefore, in devising the Plan,

4. The only other section cited by Household, section 151(g), merely authorizes the filing of certificates setting forth rights and preferences in preferred stock. Household admits that the business judgment rule is not an independent source of power for a board of directors. (DAB 2)

Household's advisors found it necessary to make it look as if the flip-over was part of a right that, in form, was authorized by section 157.

For this purpose, Household created a right to purchase preferred stock and sought to make it appear that the flip-over was in some way supportive of that right. It was necessary to make that right a sham right because the anti-takeover weapon of "devastating" dilution is in the flip-over and would be lost if the right were ever exercised and converted into preferred stock. Thus, the Rights created by Household are not now exercisable and will only become exercisable if the Plan fails and one of the triggers is pulled. If the Plan failed and the Rights became exercisable today, Rights holders would be entitled to buy for $100 a preferred share with essentially the same characteristics as a common share — presently worth about $35. Obviously no rational person would do so. Even if the stock reached its supposed long-term value in ten years of $100, the Right to buy the preferred would still have no value since no one would pay money for the right to purchase a $100 security for $100.[5] The Right to purchase preferred was designed never to be worth exercising because, if it ever became exercisable and worth exercising, the flip-over would be lost and, with it, the board's power to use the flip-over to preclude hostile tender offers.

Household ducks all of these arguments because they are beyond dispute and have no answer. Household's Chairman Clark testified at trial that the "probability" that the Rights would ever become exercisable was "zero." (Clark VI

5. A stockholder exercising his Right today for $100 would receive preferred stock worth about $35 — a $65 loss. Even if Household stock were to fully realize its supposed "long-term value" of $100, exercise of a Right for the payment of $100 would yield the stockholder neither a gain nor a loss. By contrast, operation of the flip-over, which is said to "protect" the economic value of the Right, would give that same stockholder $200 worth of the acquiror's securities for his $100 payment — a $100 profit.

216, A 536) The Rights to purchase the preferred are empty structures; their only purpose is to create the appearance of a statutory basis for the flip-over.

What section 157 authorizes are genuine rights to purchase stock. The section does not authorize the creation of something called a "right" which is designed *never* to entitle its holders to purchase stock. We do not argue that section 157 authorizes only actions having as their *sole* purpose the financing of the company. Defendants' suggestion to the contrary is misplaced. (DAB 62-63) What we do say is that *no* section of the DGCL, including section 157, authorizes a device that, like the Plan, has *no* function or purpose related to the function or purpose of the section cited for authority. No court has ever held otherwise.

B. The Flip-Over Is Not An Anti-Destruction Clause.

As is now apparent, the $100 profit to be reaped on the purely theoretical exercise of each flip-over bears no rational relationship to the non-existent economic value of the right to purchase preferred stock.[6] In the teeth of this indisputable fact, Household argues that the flip-over is just like anti-destruction clauses which are "customary features of a wide variety of corporate securities" and which are intended "*to protect the economic value of the underlying securities.*" (DAB 68, emphasis added) Household never tells us how the flip-over protects the economic value of the underlying security — the right to purchase the preferred. That is because it does not do so. The flip-over is simply a device to bring about a material transfer of power from the stockhold-

6. Household has never explained why a 2 for 1 flip-over is necessary to protect the Right. The massive dilution of the acquiror occasioned by the flip-over is barely acknowledged in Household's brief; there is a single footnote acknowledgment that this provision is "the only thing unusual about the Rights Plan." (DAB 68 n.*) Of course, the flip-over *is* the Rights Plan. It is the flip-over that compels the dilution which is the point of the Plan.

ers to the board, and has no protective relationship whatever to the right to purchase preferred stock.

Defendants baldly assert that the flip-over can be justified under section 157 because, they say, it confers on stockholders the "economic value" of stopping "unfair and coercive acquisition techniques." (DAB 69) This so-called "economic value" derives solely from the flip-over's anti-takeover effect and has no connection with protecting the meaningless right to purchase preferred. The flip-over does not protect the value of an underlying security; it is not at all like an anti-destruction provision and is not implicitly authorized by section 157.

Household cites *Wood v. Coastal States Gas Corp.*, Del. Supr., 401 A.2d 932 (1979), and *B.S.F. Co. v. Philadelphia National Bank*, Del. Supr., 204 A.2d 746 (1964), as cases dealing with anti-destruction clauses. The clauses in those cases protected the convertibility features of underlying convertible debentures (*B.S.F.*) and underlying convertible preferred stock (*Wood*) by ensuring holders an *equivalent* value for the right of conversion in the event of a merger. In each such case, the security holders had bargained and paid for the features protected in the anti-destruction clauses.[7] These cases provide no precedent for Household's flip-over, which was imposed on stockholders without their consent and does not protect the value of any "underlying security" or any feature of any such security.

Not surprisingly, Household has found no precedent for what it did. That failure results because Household's advisors invented, and its board adopted, a device without an-

7. *Wood* construes the terms of the anti-destruction clause based on "the contractual terms agreed upon when the class of preferred stock is created." 401 A.2d at 937. That is, the class bargained and paid for these rights to preserve the value contributed to the security by its conversion feature. Here the stockholders neither bargained nor gave consideration. On the contrary, they had removed from them, without their consent, their power to accept tender offers and their full power to wage proxy contests.

cestry — the flip-over — whose sole purpose is to use the fear of its destructive effect to change Household's structure of corporate governance and permit its board to bar those tender offers it does not like. The flip-over accomplishes that result without statutory authority or consent of the stockholders and the board — the only legitimate ways to achieve such a result. It must be struck down.

C. Section 157 Is Unconstitutional If Construed To Authorize Adoption Of The Rights Plan.[8]

It is inadequate to say, as Household does, that "constitutional limitations upon . . . state regulation have [no] bearing on the private conduct of corporate directors who issue securities under DGCL §157 or take other steps having anti-takeover implications." (DAB 70) Directors act pursuant to state statutory authority. Where that authority is constitutionally infirm, the acts of directors pursuant to that authority are also subject to challenge.

We do not suggest that the provisions of the DGCL are, in general, subject to attack simply because actions taken pursuant to their authorization may have an anti-takeover purpose or effect. The distinction between the Rights Plan and the other defensive actions taken by boards discussed at pp. 19-21, *infra*, is that the Rights Plan has no economic justification other than as a device designed to prevent hostile tender offers. Those other actions may occur in inter-

8. The defendants' contention that we did not raise this argument below is a serious distortion of the record. The constitutional issues were raised at all stages of the litigation below. Our pre-trial memorandum devoted an entire section to the argument. (*See* Plaintiffs' Pre-Trial Memorandum of Points and Authorities 56-60, A 127-31) The argument was discussed at length in the opening argument of plaintiffs' counsel at trial. (*See* I 34-40, A 1102-08) In addition, even though constitutionality was not one of the areas in which further briefing was requested by the Vice Chancellor, the issue was again mentioned in the post-trial briefing. (*See* Plaintiffs' Post-Trial Memorandum of Points and Authorities 39-40, A 204-05) The issue is therefore properly before this Court.

state commerce, but they also have legal and economic significance relating to the corporation's internal affairs wholly apart from any anti-takeover effect.[9] That is not true of the Rights Plan.

No one would dispute that an act of the General Assembly banning hostile tender offers for stock of Delaware corporations would be unconstitutional. Similarly, a statute expressly authorizing boards by resolution to prohibit hostile tender offers would be unconstitutional under the rationale of *Edgar v. MITE Corp.*, 457 U.S. 624, 102 S. Ct. 2629 (1982). As interpreted by the Vice Chancellor, section 157 is just such a law. It permits boards of directors of Delaware corporations, through the device of an empty Rights Plan, to stop hostile acquisition efforts and to deter proxy contests. To avoid rendering section 157 unconstitutional, the Plan must be struck down.

9. Data Probe Acquisition Corp. v. Datatab, Inc., 722 F.2d 1 (2d Cir. 1983), *cert. denied*, 104 S. Ct. 1326 (1984), is distinguishable for this reason.

II. THE HOUSEHOLD BOARD, THROUGH THE RIGHTS PLAN, CANNOT LEGALLY ALTER THE CORPORATION'S GOVERNANCE STRUCTURE WITHOUT STOCKHOLDER CONSENT.

In our opening brief, we pointed out that a fundamental change in the corporate governance structure — such as the Plan's transfer of power from Household's stockholders to the board — is invalid without stockholder consent. (POB 51-63; *see also* Brief *Amicus Curiae* of Investment Company Institute) Defendants' somewhat confusing response entirely misses the mark. First, they appear to argue that the trial court was wrong in concluding that the Plan effects a fundamental change in Household's corporate governance structure. (*See, e.g.*, DAB 2, 4, 10-11) Second, they dispute the notion that changes in the structure of corporate governance of Delaware corporations require a stockholder vote and seek to portray this poison pill device as just another anti-takeover measure. (DAB 13-14, 64-66) They are wrong on both counts.

A. The Plan Fundamentally Alters Household's Corporate Governance Structure.

The DGCL sets forth a corporate governance structure for Delaware corporations and prescribes an allocation of power between the directors and the stockholders. Under the DGCL, stockholders do not have managerial authority, but they are not left without powers to influence management and, thus, to protect their investment. Among these are the power to vote on a wide variety of matters, and the power to receive and consider offers to purchase their stock — including tender offers by offerors willing to pay a premium for control and the resulting privilege of managing the corporation.[10]

10. The pattern of Delaware law takes a clear concrete form if one looks at the specific statutory provisions relating to the ownership rights of stockholders: the right to elect and remove directors (sections 141,

The court below found that the Rights Plan was calculated to alter the corporate governance structure and that it "results in a fundamental transfer of a power from one constituency (shareholders) to another (the directors). . . ." (Op. at 36, A 325) Specifically, the court found that the Rights Plan will effectively eliminate hostile tender offers to acquire Household. (Op. at 40-41, A 329-30; *see* POB 21-25) Clearly, as the court also found, "to the extent that such a purchaser is deterred, the ability of a particular shareholder to sell his shares is limited." (Op. at 44, A 333) Equally clearly, the power of *all* stockholders to tender into an offer at a premium — and thus to hold management accountable in the most direct way possible for the results of its stewardship — is also eviscerated. The point is made clearly by the SEC in its *amicus* brief: "The Rights Plan . . . gives Household's management an absolute veto over any tender offer. This plan simply will not allow a non-management approved tender offer to be made for Household." (SEC Brief 18) The court also determined that "the Rights Plan does deter the formation of proxy efforts of a certain magnitude. . . ." (Op. at 48, A 337) Again, the SEC's *amicus* brief dramatically underscores the point: "[The Plan will] have a significant deterrent effect on proxy contests against management, [and will] thereby entrench management against efforts to oust it. . . ." (SEC Brief 3)

The defendants contend that the Plan does not effect any structural change in Household's corporate governance. (DAB 2, 4) Presumably their argument is based on their claims that the Plan "neither results in any outflow of money from the corporation nor impairs its financial flexibility," "has no adverse effect upon Household's balance sheet, assets or income statement," "does not impair the day-to-day

NOTES *(Continued)*
211); the right to vote on fundamental corporate changes — amendments to the certificate, mergers, sale of all or substantially all corporate assets, and dissolutions (sections 242, 251, 271, 275); and the right to the free transfer of stock (sections 159, 202).

conduct of Household's businesses or dilute earnings per share," "has no adverse tax consequences for the corporation or its shareholders," and "has not adversely affected the market price of Household's stock. . . ." (DAB 20) These claims regarding financial impact do not meet the point; they have nothing to do with whether a stockholder vote is required on the Plan.

The alteration of the corporate governance structure — *not* the effects, if any, on the finances of the corporation — requires a stockholder vote. It is irrelevant whether or not the Plan has an effect on Household's finances or capital structure. The relevant question is whether or not the Plan alters the corporation's governance structure. The defendants cannot dispute the trial court's holding that the Plan results in a fundamental transfer of power from stockholders to directors. The court's finding in that respect was based on substantial evidence, remains essentially unchallenged and is indisputably correct.

B. Stockholder Powers Within The Corporate Governance Structure Cannot Be Altered Without Stockholder Consent.

In response to our argument that stockholder powers within the corporate governance structure cannot be altered without stockholder consent, defendants argue that Delaware law does not require a stockholder vote on every action of a board that has a "fundamental" effect on the corporation or which causes "structural" changes in the corporation's asset composition, balance sheet or stockholder list.[11] (DAB

11. The decisions refusing to grant injunctive relief with respect to rights plans similar to the one adopted by Household lend no support to Household's position in this Court, since neither court issued a final ruling on the merits of the plan and each court relied, without analysis, on the *Moran* decision appealed from here. *See Horwitz v. Southwest Forest Industries, Inc.*, CV-R-84-467 ECR (D. Nev. Mar. 19, 1985) (Ex. M), *appeal docketed* (9th Cir. Apr. 16, 1985); *APL Corp. v. Johnson Controls, Inc.*, 85-C-990 (E.D.N.Y. Mar. 25, 1985) (Ex. N).

In *Asarco, Inc. v. MRH Holmes a Court*, C.A. No. 85-1123 (D.N.J.

64-67) They cite Chancellor Quillen's familiar opinion in *Gimbel v. Signal Cos.*, Del. Ch., 316 A.2d 599, *aff'd*, Del. Supr., 316 A.2d 619 (1974), and a recent Chancery Court decision, *Lowenschuss v. Option Clearing Corp.*, Del. Ch., C.A. No. 7972, Brown, C. (Mar. 27, 1985) (Ex. P). They make no effort to discuss or distinguish the numerous cases and authorities set out at pages 52 to 55 of our opening brief which flatly hold that boards of directors are not authorized to alter structures of corporate governance without stockholder approval.

Gimbel and *Lowenschuss* are no doubt correct, but they are also beside the point. Neither case considered whether a board could effect a change in the corporation's governance structure without stockholder approval. *Gimbel* concerned the sale of an asset which the court found did not constitute "all or substantially all" of the corporation's assets within the meaning of section 271 and, thus, did not require a stockholder vote under the language of that section. 316 A.2d at 608. The court rejected as contrary to section 271 the argument that a vote should be required in any event because the assets being sold were "an independent, important branch" of the company's business. *Id.* at 605. The board had the power to sell the assets, and there was no suggestion that the purpose of the sale was to accomplish permanent change in the company's governance structure.

NOTES *(Continued)*
May 1, 1985) (Ex. O), in spite of an extremely broad reading of the role of the business judgment rule in the takeover context, the court struck down an issue of poison pill preferred that altered underlying stockholder voting rights because the New Jersey statute which confers on the board the power to alter rights and preferences in preferred stock did not grant "express authority" for a board to change the voting power of stockholders within a particular class. Slip op. at 27. In so doing the court expressly approved as "sound and persuasive" the holding in *Telvest, Inc. v. Olson*, Del. Ch., C.A. No. 5798, Brown, V.C. (Mar. 8, 1979) (Ex. C), that a board of directors which unilaterally alters the existing voting rights of its stockholders exceeds its power under the statute and the act is, therefore, *ultra vires*. *Asarco*, slip op. at 35.

In *Lowenschuss*, the plaintiff conceded that section 160 plainly authorized share repurchases and could only argue that the size of the repurchase program at issue (up to 50 percent of the outstanding) would bring about "fundamental" changes, not in the structure of governance, but in the corporation's financial make-up. Slip op. at 7, 9. Chancellor Brown easily concluded that it was unworkable to suggest that share repurchase programs require stockholder approval where their effect on the company's financial structure is "fundamental" but not when the effect is less dramatic. As in *Gimbel*, the statute had explicitly granted the board the power to perform the challenged act and there was no showing that the board's purpose in performing the act was to alter the structure of corporate governance. Slip op. at 12.

Unlike the situation in *Lowenschuss*, the Vice Chancellor here found that the effect of the Plan is on the allocation of power between the stockholders of Household and the board. He called this effect "fundamental" because this reallocation of power brings about an important change in the governance structure of Household. In their effort to make *Lowenschuss* fit, defendants seize on the word "fundamental" and, thus, ignore the actual finding of the Vice Chancellor below — that the Plan, unlike any other device considered by a court, was conceived, designed and implemented as a means of making a lasting structural alteration in the allocation of power within Household.[12]

The Plan's purpose of altering Household's structure of corporate governance was well known to the defendants when the Plan was adopted and was, in any case, obvious. Those who designed the Plan intended it to strengthen the

12. In addition, the Chancellor specifically noted in *Lowenschuss* that the stockholders were in fact given an opportunity indirectly to pass on the propriety of the exchange offer at issue there, because they were given the option to tender or refuse to tender their shares into the exchange offer. Slip op. at 11. In fact, an overwhelming 90 percent majority approved the offer by tendering their shares. *Id.*

hands of directors. (PX 211, A 882-84) The board was told that the Plan would give it the power to act as "bargaining agent" in tender offers. (PX 203, A 790-801) The carefully crafted letter to stockholders supports the Vice Chancellor's finding and explicitly said that the Plan would deter offers for Household not approved by the board. (PX 211 at 2, A 883)

Neither *Gimbel* nor *Lowenschuss* contradicts the authorities cited at pages 52 to 55 of our opening brief (and nowhere discussed by defendants) which squarely hold that boards of directors are not authorized to alter the governance structure of a corporation without the assent of the owners. The principle is obvious. If a board can adopt a rights plan without a stockholder vote for any purpose that it concludes is "reasonable" or "rational," no powers previously reserved to the stockholders as owners of the corporation are secure.

C. No Case Cited By Defendants Supports Household's Adoption Of The Plan.

In addition to *Gimbel* and *Lowenschuss*, defendants also cite numerous other cases involving defensive actions not approved by stockholders which, they claim, have resulted in "radical changes in the companies' structures" and "adverse business or financial impacts." (DAB 11, 47-51)

These cases are no more help to Household than *Gimbel* and *Lowenschuss*: not one involved a corporate act designed solely or primarily to change the corporate governance structure through a transfer of power from stockholders to directors. *That* alteration of the balance of corporate power is the fundamental purpose and effect of the Plan as the court below found. Such a fundamental change requires stockholder consent. If radical business or financial changes resulted from the defensive actions in defendants' cases — a proposition we do not accept — those changes were incidental to the proper exercise of a board power (as, for example, the sale of an asset or the issuance of securities), which already existed in the board under the structure of corporate governance established by the DGCL. No case involved an act which in and of itself created a *new* power in the board taken from its stockholders — as the Household board has done here. This distinction between the Plan and every other defensive device cited by the defendants is fundamental to corporate law and condemns the Plan. The cases cited by defendants are distinct from the present case in numerous other respects.

In every case cited by defendants at pages 47-49 of their brief, the defensive measure taken by the board had legal and economic significance wholly apart from any anti-takeover effect. Each involved a transaction of economic substance.[13] In each case, the corporation exchanged something of material value (*e.g.*, cash, authorized but unissued or treasury securities, or assets) for something else, also of material value (*e.g.*, cash, the company's own shares, securities of another corporation, or real assets). *See Edelman v. Phillips Petroleum Co.*, Del. Ch., C.A. No. 7899, Walsh, V.C. (Feb. 12, 1985) (Ex. E) (purchase of dissident's stock by Phillips); *Lowenschuss v. Option Clearing Corp.*, *supra* (self-tender by Phillips into which over 90% of Phillips' outstanding common stock was tendered); *Carter Hawley Hale Stores, Inc. v. The Limited, Inc.*, C.A. No. 84-2200-AWT (C.D. Cal. Apr. 17, 1984) (Ex. Q) and *S.E.C. v. Carter Hawley Hale Stores, Inc.*, 587 F. Supp. 1248 (C.D. Cal. 1984) (repurchase of its shares by Carter Hawley in open market at market price; issuance of preferred stock in return for $300 million); *Pogo Producing Co. v. Northwest Industries, Inc.*, No. H-83-2667, slip op. at 2-3 (S.D. Tex. May 24, 1983) (Ex. R) (self-tender by Pogo at same price as

13. The single arguable exception, *Enterra Corp. v. SGS Associates*, [Current] Fed. Sec. L. Rep. (CCH) ¶ 91,919 (E.D. Pa. Jan. 9, 1985) involved a hotly negotiated standstill agreement, in which both sides exchanged commitments which, while arguably not of *economic* value, were nevertheless certainly viewed as having material value by the parties to the agreement. *See id.* at 90,538.

Northwest's hostile tender); *Martin Marietta Corp. v. Bendix Corp.*, 549 F. Supp. 623, 625 (D. Md. 1982) (counter-tender by Marietta for Bendix at a price conceded by Bendix to be advantageous to Marietta); *Gearhart Industries, Inc. v. Smith International, Inc.*, 592 F. Supp. 203 (N.D. Tex.), *aff'd in part, rev'd in part*, 741 F.2d 707, 722-24 (5th Cir. 1984) (Gearhart's issuance of warrants with sale of debentures for approximately $70 million as necessary part of financing package, terms of which were negotiated at arms' length); *Whittaker Corp. v. Edgar*, 535 F. Supp. 933, 938, 941-42 (N.D. Ill.), *aff'd*, Nos. 82-1305, 82-1307 (7th Cir. Mar. 5, 1982) (in effect, sale by Brunswick Corp. of major asset, valued by hostile offeror Whittaker at $350 million, for approximately $420 million); *GM Sub Corp. v. Liggett Group, Inc.*, Del. Ch., C.A. No. 6155, Brown, V.C., slip op. at 4 (Apr. 25, 1980) (Ex. L) (Liggett's sale of "crown jewel" asset for twenty-two times earnings compared with tender offer price of eight times earnings); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 380-84 (2d Cir. 1980) (Treadway issued block of authorized but unissued common stock at market price); *Buffalo Forge Co. v. Ogden Corp.*, 555 F. Supp. 892, 905 (W.D.N.Y.), *aff'd*, 717 F.2d 757 (2d Cir.), *cert. denied*, 104 S. Ct. 550 (1983) (Buffalo Forge's sale of treasury stock at price exceeding initial tender offer price to obtain a higher bid);[14] *Cheff v. Mathes*, Del. Supr., 199 A.2d 548 (1964) (purchase of dissident's stock); *Panter v. Marshall Field & Co.*, 486 F. Supp. 1168, 1194 (N.D. Ill. 1980), *aff'd*, 646 F.2d 271 (7th Cir.), *cert. denied*,

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14. Particularly instructive is the court's comment on the effect of Buffalo Forge's defensive action:

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

555 F. Supp. at 906.

454 U.S. 1092, 102 S.Ct. 658 (1981) (purchase of six major stores by Marshall Field found by lower court not to be "unsound business ventures").

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

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

In each case, the terms and conditions of the transaction were dictated in part by considerations outside the control of the board. In the cases of asset sales and purchases, stock issues, sales and exchanges, and standstill agreements, the terms were negotiated at arms' length with third parties. *See, e.g., GM Sub*, slip op. at 4; *Buffalo Forge*, 555 F. Supp. at 900; *Gearhart Industries*, 592 F. Supp. at 224-25; *Treadway*, 638 F.2d at 366; *Enterra*, ¶ 91,919 at 90,538. In the cases of the Carter Hawley repurchase program, Pogo self-tender and Marietta counter-tender, the terms were dictated by market forces.

Unlike every case cited to justify it, the Household Plan has no economic substance. It derives no authority from, and serves no purpose of, the statute cited as its source of power. Its terms were conjured up unilaterally by the Household board and its advisors solely to grant the board the power to block tender offers.

Defendants argue that some of the defensive actions in their cases affected stockholder rights as drastically as the Plan because they fundamentally altered the corporation's *asset* structure and thereby reduced its value. As noted above, the cases cited by defendants are *all* to the contrary. Had a transaction been found by the court to cause a detrimental impact on the target company or unfairly deprive its stockholders of their powers of governance, the transaction would have been enjoined. *See Gimbel v. Signal Cos., supra; Norlin Corp. v. Rooney, Pace Inc.*, 744 F.2d 255 (2d Cir. 1984). No such injunction was issued in any of the cases cited by defendants.

None of the actions approved in the cases cited by defendants was intended to, nor did it, shift corporate power to impose a structural deterrent to hostile takeovers and interfere with the free exercise of corporate governance. Those actions cannot serve as precedent for the Plan.

Defendants also argue that their usurpation of stockholder power without stockholder approval is saved by the doctrine of independent legal significance. (DAB 66) That doctrine is simply not relevant because, as shown in Point I, the Plan is not authorized under DGCL sections 157 or 151(g). Even if it were so authorized, the Household board's unilateral exercise of that authority solely to take powers of governance from its stockholders condemns the Plan under a long line of unchallenged authority both in Delaware and elsewhere. (POB 51-63)[15]

15. *See also* Eisenberg, Modern Corporate Decisionmaking, 57 Calif. L.Rev. 1, 142-45 (1969).

III. THE PLAN DOES UNLAWFULLY RESTRICT THE STOCKHOLDERS' RIGHT OF FAIR CORPORATE SUFFRAGE.

The Vice Chancellor found that "the Rights Plan does deter the formation of proxy efforts of a certain magnitude. . . ." (Op. at 48, A 337) He found that the Plan has an "impact . . . on block voting." (Op. at 46, A 335) He found that the Plan "limit[s] the proxy activity of those opposed to the Board's present policies" (Op. at 49, A 338), and that its "impact on proxy contests may ultimately alter the balance of power between shareholders and the board of directors." (Op. at 20, A 309) The SEC, in its brief, concludes that the Plan will have even more serious consequences on the conduct of proxy contests. As the agency principally responsible for the administration of the federal proxy rules, the SEC says that the Plan will "have a significant deterrent effect on proxy contests against management, [and will] thereby entrench management against efforts to oust it. . . ." (SEC Brief 3)

The conclusion that the Plan's 20 percent limitation on share ownership or group formation will deter proxy contests is, in any case, only common sense. It takes no analysis to understand that a stockholder group is more likely to succeed when the group members control 25 or 30 percent of the vote than when they control less than 20 percent. Numerous defense witnesses conceded the point. (*See, e.g.*, Wilcox IX 72, A 606; Troubh VIII 113-15, A 602-04; Higgins VII 171-72, A 574-75)

Household cites to the direct testimony of Wilcox for the proposition that the Plan would not inhibit a stockholder from being able to wage a successful proxy fight. Household concludes from this that the Plan does not *prevent* a successful proxy challenge. (DAB 30) Household simply ignores the clear evidence that the Plan makes such a challenge substantially more difficult and less likely to succeed. Wilcox conceded on cross-examination that the percentage of contests won by management when the dissidents held less than 20 percent was double the percentage of contests won by management when the dissidents held more than 20 percent of the stock. (Wilcox IX 89-90, A 610-11) The Georgeson & Co. study presented by Wilcox showed that when insurgents held 20 percent or more of a company's stock, they were able to win a proxy contest (in whole or in part) or force a settlement with management 50 percent more often than when insurgents held less than 20 percent. (DX 39, A 1067-1100)[16] Thus, as the SEC said:

> the effect of the [Plan's] limitation in inhibiting proxy contests, or consent solicitations, is beyond conjecture.

(SEC Brief 24)

The defendants' concession that they chose a 20 percent trigger because 20 percent "is a well recognized threshold for measuring control" (DAB 31 n.**) also condemns the Plan on its face as an illegal restriction on fair corporate suffrage. Defendants cannot reasonably state that 20 percent ownership is a "threshold" of control of the company, but at the same time argue that prevention of the formation of a 20 percent group will not inhibit the ability of insurgents to win proxy contests. They recognize implicitly that 20 percent is a "threshold" of control exactly because ownership levels above 20 percent carry with them the ability to influence management and obtain board representation. (DAB 31 n.**, 37 n.*)

The 20 percent limitation on proxy contests triggers the Rights and makes them unredeemable irrespective of the group's purpose or its goals. Any group in excess of 20 percent formed to change management due to perceived leth-

16. Thus, the only empirical evidence in the record shows that the holding of 20 percent or more of a company's stock is a significant advantage in a proxy contest, and that limiting insurgents to less than 20 percent will greatly enhance management's ability to win a contest.

argy, inefficiency or worse triggers the Rights whether or not the group's goal relates to the acquisition of a single share of Household stock. Thus, for the avowed purpose of stopping "creeping" acquisitions and the like, Household has broadly limited the ability of its stockholders — including a majority of its stockholders — to replace management for any reason. Nothing Household cites justifies the sweeping breadth of this intrusion into basic stockholder franchise rights.

Defendants misread *Schnell v. Chris-Craft Industries, Inc.*, Del. Supr., 285 A.2d 437 (1971), and *Lerman v. Diagnostic Data, Inc.*, Del. Ch., 421 A.2d 906 (1980), in arguing that Delaware law does not condemn the Plan's impact on the proxy contest mechanism. In order for the Plan to be held invalid as a violation of the stockholders' right of fair suffrage, plaintiffs need not show that the Plan absolutely prevents dissidents from waging a successful proxy fight. Rather, as Chancellor Brown noted in *Lerman*, all that must be shown is that the Plan may unfairly hinder a dissident's efforts to oust the board:

> [T]he inequitable action taken in *Schnell* had the effect of hindering the efforts of the challengers by severely curtailing the time in which they had to comply with the Securities and Exchange Commission requirements, to contact shareholders, etc. It did not put the challengers out of business but, the Supreme Court found, it unfairly hindered their ability to present their position to the stockholders within the allotted time, and, because it was intended to do so, this was found to be wrong.

421 A.2d at 912.

As has been shown, the Plan "unfairly hinders" insurgent efforts to oust the board by prohibiting accumulation of stock positions large enough to maximize chances of su cess. While it may not put the stockholder out of busines the Plan substantially increases management's power at th expense of the stockholders, just as did the unfairly trur cated solicitation in *Schnell*. The Plan's effect on the abilit of stockholders to wage a successful proxy contest require that the Plan be nullified.

CONCLUSION

For the reasons stated herein and for the reasons stated in Plaintiffs Below-Appellants' Opening Brief, we respectfully urge the Court to reverse the judgment below and enter judgment in our favor declaring the Rights Plan void as unauthorized and illegal.

SKADDEN, ARPS, SLATE,
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