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A Primer On Pa. Takeover Case Law: Part 1

Law360, New York (March 24, 2014, 1:42 PM ET) -- Presented below is Part 1 of a brief survey of leading cases interpreting Pennsylvania corporate law in situations involving takeovers, proxy fights or other matters affecting corporate changes of control. This summary is by no means exhaustive. However, these are the cases that most frequently come up in our experience representing a broad range of Pennsylvania targets and bidders.

For years, Pennsylvania takeover case law was known as a "poor man's Delaware jurisprudence." Like their cousins in other states, the Pennsylvania courts frequently looked to the more robust Delaware case law to address corporate control matters. Takeover battles were infrequent, and when they did occur, the courts saw a mother lode of precedent in Delaware.

Matters began to change with the significant legislative overhauls of the Pennsylvania Business Corporation Law beginning in 1988. These overhauls modernized Pennsylvania's corporate code but also represented a marked departure from the statutes and common law in Delaware.

In 1990, the dam burst for good. Gov. Robert P. Casey signed into law controversial and unique takeover statutes widely hailed at the time as the toughest in the nation. With these changes and the takeover battles that followed, the Pennsylvania courts have been forced to carve out a distinctive niche in matters of state corporate case law.

To be sure, the courts still look to Delaware case law to fill in the interstices where the courts are presented with novel situations, or where prior Pennsylvania precedent or existing statutes are so similar to Delaware's that such deference makes sense. However, there is no question that on the most fundamental matters involving change-of-control situations, Pennsylvania case law is different — and sometimes, dimensionally so.

Poison Pills

AMP Inc. v. Allied Signal Inc.[1] On Aug. 10, 1998, Allied Signal Inc. commenced a hostile, all-cash tender offer for all of the shares of AMP Inc. and also commenced a consent solicitation designed to pack the AMP board with Allied Signal nominees.

At the time, AMP had in place a "dead-hand" rights plan, which provided that if a new majority of directors was elected in a proxy contest, only the continuing directors — that is, directors who were on the board prior to the change in majority — could vote to redeem the pill.

On Aug. 20, 1998, in response to the consent solicitation, AMP's board amended the pill to remove the

dead-hand provision and put in its place a “no-hand” provision. This made the pill nonredeemable and nonamendable should AMP’s disinterested board majority be replaced by a majority of new directors nominated by an unsolicited acquiring company — in this case, Allied Signal.

The revised pill would remain nonredeemable and nonamendable until Nov. 6, 1999, when the pill would expire. The board said it would not adopt a new rights plan for at least six months after the expiration of the no-hand pill. So AMP got breathing room, but not forever.

The federal district court held that the adoption of the no-hand pill was within the AMP board’s statutory authority and was not an ultra vires act or breach of fiduciary duty. The court cited Pennsylvania’s strong pill validation statute, BCL §2513, which authorizes “such terms as are fixed by the board.” The court further noted that BCL §1715 provides that the fiduciary duties of a board do not require it to redeem, modify or render inapplicable any rights plan adopted under BCL §2513.

The pill was not ultra vires because it addressed Allied Signal’s attempt to propose a merger, and only a board may propose a merger. Under BCL §1715, the AMP board could properly consider the intent and conduct of the hostile bidder, and the court was clearly concerned with the alleged conflict of interest presented by Allied Signal’s slate of affiliated, nonindependent nominees.

Finally, the court relied heavily on BCL §1715’s strong evidentiary deference to the business judgment of a disinterested board, and concluded that the finite nature of the pill militated against a finding of lack of good faith or self dealing under BCL §1715.

Takeaway

The Allied Signal case remains the most prominent case involving a Pennsylvania target’s use of a rights plan, in this situation as a “sword.” It forms bookends with another case, Norfolk Southern Corp. v. Conrail Inc.,[2] discussed in greater detail below.

In Conrail, a federal district judge, applying Pennsylvania law, refused to require the redemption of Conrail’s dead-hand poison pill instituted in connection with Conrail’s proposed acquisition by CSX Corp. Norfolk Southern Corp. was attempting to break up the deal through its hostile tender offer and had sued to have the pill redeemed. In this context, the Pennsylvania anti-takeover statutes were employed to use a rights plan as a “shield.”

The poison pill case law in Pennsylvania is a clear example where Pennsylvania’s statutory departure from Delaware’s common law has real-world consequences in takeover situations. “Slow-hand” and “no-hand” pills appear to be a dead letter in Delaware.[3]

Lockups and Fiduciary Duties

Norfolk Southern Corp. v. Conrail Inc.[4] On Oct. 15, 1996, Conrail and CSX executed a merger agreement under which CSX would acquire Conrail in a complex, two-tier transaction. The first tier would be a cash tender offer for 40 percent of Conrail’s stock, and the second tier would be a back-end stock-for-stock merger to be voted on by Conrail shareholders.

In order not to trigger “fair value” cash put rights by shareholders under Subchapter E of Chapter 25 of the BCL, which would have applied if anyone — friend or foe — acquired 20 percent or more of Conrail, the parties agreed to break down the tender offer into two tranches: First, CSX would tender for 19.9

percent of the Conrail stock and then, following a special meeting at which Conrail's shareholders would approve a charter amendment to opt out of the put right provision, CSX would tender for an additional 20.1 percent of the Conrail shares.

CSX was also granted an option by Conrail to buy additional shares so that, upon exercise after the tender offers, CSX's total ownership would be approximately 50 percent. The ostensible purpose of the first tender offer was to better assure passage of the charter amendment, and the ostensible purpose of the stock option was to better assure approval of the merger.

In addition to the extensive protections afforded by the Pennsylvania anti-takeover statutes, the Conrail-CSX merger agreement contained a number of specific lockup provisions designed to ward off any competing bids. Among other things, a no-shop or "lockout" provision prevented Conrail's board from negotiating with third parties, terminating the CSX transaction or approving a competing transaction for 180 days from the date of the merger agreement (later extended to 270 days and then two years).

Conrail agreed to keep its poison pill in place and not exempt from its terms any party but CSX. Conrail also granted CSX a $300 million break fee (approximately 3.5 percent of the total value of Conrail) and a stock option to acquire Conrail shares.

After the Conrail-CSX merger agreement was announced, Norfolk Southern, a competitor of CSX, commenced an unsolicited cash tender offer for all of Conrail's shares at a higher price. CSX, raising its bid, completed its 19.9 percent initial tender offer.

However, the Conrail shareholders rebelled en masse against what they perceived to be an inferior, cramdown Conrail-CSX deal and voted down the put statute charter amendment, despite the additional voting power gained by CSX via its tender offer. After further skirmishing and rebids, the parties agreed to a settlement under which Norfolk Southern and CSX carved Conrail into pieces.

As part of its attack on the Conrail-CSX merger agreement, Norfolk Southern sought a preliminary injunction in federal court in November 1996, arguing that the transaction was illegally coercive, that the Conrail board breached its fiduciary duties by agreeing to the provisions and ignoring the Norfolk Southern bid, and that the lockout and poison pill provisions were ultra vires. Ruling from the bench, the judge denied the motion.

The court placed heavy reliance on BCL §§1712 and 1715, the core fiduciary duty provisions governing Pennsylvania public corporations enacted as part of the 1990 anti-takeover statutes.

Those sections provide, among other things, that the directors' fiduciary duties run to the corporation, not to the shareholders per se; that the directors may consider all constituencies affected by the directors' actions, and not just the shareholders, primarily or otherwise; that the board's fiduciary duties do not require the board to redeem, modify or render inapplicable any poison pill, or render inapplicable any of the Pennsylvania anti-takeover statutes because of a takeover bid; and that, in assessing fulfillment of the board's fiduciary duties, no higher burden of proof applies just because the applicable matter involves a change of corporate control.

Most prominently, the court noted BCL §1715's presumption that any act by a board relating to matters of corporate control that has been approved by a majority of disinterested directors is presumed to comply with the standard of care unless it is proven by "clear and convincing" evidence that the disinterested directors did not act in good faith after reasonable investigation. The court also noted BCL

§§1502 and 1721, which provide that, in the first instance, the decision to accept or reject a takeover rests with the board, and there is no mandatory duty to respond to a takeover proposal.

The court dismissed Norfolk Southern's other related claims. It rejected Norfolk Southern's coercion argument, citing the absence of case law and the options available to the Conrail shareholders with respect to the tender offers and other decisions presented in the deal.

The court brushed aside Norfolk Southern's claim that the two-tier Conrail-CSX structure took the transaction outside of the protections of the antitakeover statutes. And, with an eye to the lockout provision, the court did not view entering into the merger agreement as an act beyond the board's general power to enter into contracts.

In a related decision several months later addressing the extension of the lockout period to 720 days, the court reiterated the arguments made in its earlier opinion. Interestingly, the court noted that the absence of a fiduciary duty provision did not mean one was not implicit, but that in any event there had been "no showing or claim that any situation has arisen as yet or will or is likely to arise in the future that would impose any sort of fiduciary duty upon the board of directors to disregard the lockout or the no-shop provisions."[5]

Takeaway

The Conrail case remains the high water mark in Pennsylvania takeover case law. Prior to the decision, there had been few Pennsylvania cases dealing in depth with defensive measures. The most prominent was probably Keyser v. Commonwealth National Financial Corp.,[6] where the court upheld a merger agreement's 24.9 percent stock option under Pennsylvania law, noting that such "lockup provisions ... are very common in bank mergers."

Another influential case prior to Conrail was Enterra Corp. v. SGS Associates,[7] where the court upheld a standstill agreement between Enterra Corp. and one of its substantial shareholders under the business judgment rule and concluded that the board was not obligated to submit such shareholder's takeover bid to the company's other shareholders.[8] These and the few other cases are largely unremarkable as to analysis or outcome.

To its supporters, the bellwether Conrail decision represents a middle-of-the-fairway approach by the court in applying the 1990 anti-takeover statutes — almost as if the Pennsylvania legislators had the Conrail takeover battle in mind when crafting the provisions. To its detractors, the decision represents an overly textualist approach to the statutes in a situation involving abdication of fiduciary duties and structural coercion of a sort never contemplated by the legislators.

Despite Pennsylvania's statutory rejection of the Revlon Inc. v. Mac Andrews & Forbes Holdings Inc. and Unocal Corp.[9] v. Mesa Petroleum Co.[10] doctrines in Delaware case law, members of the takeover bar still speculate how the case would have been decided under Delaware law.

Although the initial Conrail-CSX proposal may have been viewed as a strategic, "non-Revlon" transaction under Delaware law, there is considerable difference of opinion as to what substantive outcomes on the defensive matters would have been different if the case had been decided in the Delaware Court of Chancery under the Unocal standards.

However, the denouement of the great Conrail takeover battle points to one ineluctable conclusion

reached by most sophisticated observers: The law of market forces is national in scope, and Conrail's breathtaking dismemberment in the public square by the competing bidders is a reminder that state laws and judicial decisions are often not showstoppers in takeover battles.

Derivative Suits

Cuker v. Mikalauskas.[11] Cuker involved a garden variety shareholder derivative suit claim with respect to alleged financial mismanagement at a public utility, PECO Energy Co. PECO set up a special committee of independent directors, which eventually found that the complaint lacked merit. The lower court held that as a matter of public policy the company lacked the power to terminate pending derivative litigation.

The Pennsylvania Supreme Court reversed, holding that the business judgment rule permits a board to terminate such proceedings pursuant to BCL §1721, which vests general powers in the board. In so ruling, the Pennsylvania Supreme Court adopted §§7.02-7.13 of the American Law Institute Principles of Corporate Governance, which set forth a comprehensive mechanism to address shareholder derivative suits by companies acting through independent directors (typically "special litigation committees").

Unlike in Delaware, where a shareholder can either make a demand on the board of a company to file suit or file a suit on its own if the complaint pleads with particularity acts that show demand on the board would be futile, in Pennsylvania, a shareholder claimant must make a demand on the board and cannot sue claiming "demand futility."

Under Cuker, the actions of a special litigation committee in dismissing a derivative suit typically will be covered by the business judgment rule unless the shareholder can prove to a court that the special litigation committee was not disinterested, was not assisted by counsel, did not prepare a written report, lacked independence, did not perform an adequate investigation, or did not act in good faith.

Takeaway

The synergistic effects of the 1990 Pennsylvania anti-takeover statutes when combined with Cuker's teachings provide a powerful deterrent against shareholder derivative claims in takeover litigation in Pennsylvania.[12] The broad constituency provisions, heavy burden on challenging independent directors' actions and rejection of Delaware's heightened duties on directors in takeover situations under BCL §1715 lay down a heavy gauntlet for strike suitors to overcome.

As discussed above, BCL §1717 provides further that the duty of the board of directors is solely to the corporation and cannot be enforced directly by shareholders. As a result, these actions get funneled into Cuker's panoply of procedural requirements and its deference to special litigation committees under the business judgment rule.

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[1] C.A. No. 98-4405, 1998 U.S. Dist. LEXIS (E.D. Pa. Oct. 8, 1998).

[2] C.A. No. 97-7167, 1997 U.S. Dist. Lexis 978 (E.D. Pa Jan. 9, 1997, aff'd per curiam, No. 96-2025 (3d Cir. March 7, 1997).

[3] Cf. Carmody v. Toll Brothers Inc., 723 A.2d 1180 (Del. Ch. July 24, 1998) (invalidating a dead-hand provision because, among other reasons, it created voting power distinctions not expressed in the charter, interfered with the directors' statutory power to manage the company's affairs, disenfranchised stockholders without a compelling justification, and was a disproportionate and unreasonable defensive measure); Quickturn Design Systems Inc. v. Shapiro, 721 A.2d. 1281 (Del. 1998) (invalidating a dead-hand provision on similar grounds).

[4] C.A. No. 96-CV-7167 (E.D. Pa. Nov. 19, 1996).

[5] Norfolk Southern Corp. v. Conrail Inc., C.A. No. 96-CV-7167, 1997 U.S. Dist. LEXIS 978 (E.D. Pa. Jan. 9, 1997).

[6] 644 F. Supp. 1130 (M.D. Pa. 1986).

[7] 600 F. Supp. 678 (E.D. Pa. 1995).

[8] See also Baron v. Strawbridge & Clothier, 646 F. Supp. 690 (E.D. Pa. 1986) (refusing to conclude that directors had engaged in self-dealing in connection with a stock reclassification plan that was put in place to defend against a hostile takeover by a substantial shareholder whose tender offer the board had determined to be financially inadequate).

[9] 501 A.2d 1239 (Del. Ch. 1985).

[10] 493 A.2d 946 (Del. 1985).

[11] 692 A. 2d 1042 (Pa. 1997).

[12] Fundamental Partners, et al. v. Gaudet, et al., No. 11112589 (Phila. Ct. Com. Pl., Nov. 23, 2011); In re H.J. Heinz Co. Deriv. & Class Action Litig., No. GD-13-003108 (Pa. Ct. Comm. Pls. Allegheny Cnty April 29, 2013).
