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DELAWARE CHANCERY COURT UPHOLDS AIRGAS POISON PILL

To Our Clients and Friends:

On February 15, 2011, the Delaware Court of Chancery issued an important opinion upholding the continued vitality of the poison pill as an appropriate defensive measure for companies faced with takeover proposals deemed inadequate by the target's board of directors. Chancellor Chandler's 158 page decision in *Air Products & Chemicals, Inc. v. Airgas, Inc.* C.A. No. 5249-CC (Del. Ch. 2011) held that the maintenance of a poison pill by the Airgas board of directors was a reasonable response to an all cash, non-coercive, $70 per share tender offer by market rival Air Products & Chemicals, Inc. Despite the fact that Air Products' tender offer had been public for more than a year--during which time Air Products won a proxy contest to place three directors on Airgas's staggered board--and that Airgas stockholders were sophisticated and well-informed, the Court concluded that the Airgas board "acted in good faith and in the honest belief" that the $70 per share offer was inadequate, and therefore did not breach a fiduciary duty by failing to redeem the company's poison pill. The Court highlighted the fact that the independent directors appointed pursuant to Air Products' successful proxy efforts "changed teams" once they were appointed to the Airgas board--that is, Air Products' own nominees voted to maintain the poison pill that prevented the tender offer from going forward.

Chancellor Chandler acknowledged that the poison pill had "served its legitimate purpose" in delaying consummation of the offer by more than a year, "more time than any litigated poison pill in Delaware history," thereby giving Airgas sufficient time to communicate its plan to the stockholders. Nevertheless, Chancellor Chandler held that he was compelled by controlling Delaware law to respect the good faith and well-informed decision of the Airgas board to prevent the company's stockholders from tendering at a price that the board deemed inadequate. Chancellor Chandler expressed frustration with the state of Delaware law as he interpreted it, suggesting that the Delaware Supreme Court should consider modifying the doctrine of substantive coercion. The Delaware Supreme Court will not have an opportunity to address the matter with regards to Airgas, however, as Air Products ended its bid shortly after the decision was released. This decision demonstrates that a Delaware corporation--even one with a staggered board--can use a poison pill to prevent stockholders from tendering as long as the board has a good faith belief based on consultation with outside legal and financial advisers that the tender offer price is inadequate.

Background

Air Products had been interested in a business combination with Airgas since 2007, but considered Airgas overpriced at the time. After the onset of the global recession, Air Products privately approached Airgas in the Fall of 2009 with an offer to acquire the company for $60 in stock. The Airgas board of directors consulted with legal and financial advisers and unanimously voted to reject the offer, refusing to meet with Air Products. In late 2009, Air Products reaffirmed its interest in acquiring Airgas, raising the offer to $62 per share in cash and stock. Again, Airgas unanimously rejected the offer and declined to meet with Air Products.

Air Products publicly announced its intentions to launch a $60 per share all-cash, all-shares tender offer for Airgas in February of 2011. The Airgas board again unanimously agreed that Air Products' offer was too low and recommended to shareholders that they not tender their shares.

On March 13, 2010, Air Products nominated a slate of three directors for election at the 2010 Airgas annual meeting. It also proposed several amendments to Airgas's bylaws. In the run-up to the 2010 annual meeting, Airgas and Air Products waged a proxy contest. During this time, Air Products raised its offer to $63.50, which was again rejected by Airgas as "grossly inadequate."

On September 6, 2010, Air Products again increased its offer, this time to $65.50 per share. This offer too was unanimously rejected by the Airgas board as inadequate, and the Airgas board continued to decline to negotiate with Air Products. Eventually, at the annual meeting on September 16, 2010, the Air Products-backed nominees were elected to the Airgas board and the shareholders adopted the bylaw amendments proposed by Air Products.

Principals from both companies met to discuss the value of Airgas in November 2010. Among other things, the group discussed the assumptions underlying their respective valuations. However, this meeting did not yield a deal.

On December 9, 2010, the Air Products board met to discuss its options. This meeting resulted in an Air Products' "best and final" offer for Airgas, at $70 per share. The Airgas board did not truly believe that $70 was Air Products' best and final offer, but the Court credited Air Products' statements concerning the finality of its offer and treated the $70 per share offer as Air Products' "best and final" offer. On December 21, 2010, the Airgas board met to consider the $70 offer. This meeting included presentations by three independent financial advisors, each of which concluded that the offer was still inadequate. Ultimately, the Airgas board--including the Air Products-nominated directors--unanimously rejected the offer, and the board again recommended that shareholders not tender their shares.

Decision

In analyzing the validity of the poison pill, Chancellor Chandler first noted that the enhanced judicial scrutiny of the *Unocal* test[1] applied and not the business judgment rule. In doing so, he rejected the idea that a board could "just say no" to an offer. Turning to the first-prong of the *Unocal* test--whether there were reasonable grounds to believe that a danger to corporate policy and effectiveness existed--the Chancellor concluded that the only threat identified by the majority-comprised outside independent directors was that the offer was inadequately priced and that there was a risk that certain shareholders were willing to tender into such an inadequate offer. The Court held, however, that Delaware law deemed that this was sufficient to constitute a threat under *Unocal*.

Chancellor Chandler noted that the Delaware Supreme Court had identified substantive coercion--the possibility that shareholders will disbelieve management's views on value (or may have short-term profit goals in mind) and thereby mistakenly tender into an inadequately priced offer--as a threat in *Paramount Communications, Inc. v. Time, Inc.*[2] and *Unitrin, Inc. v. American General Corp.*[3] Chancellor Chandler noted that the *Time* court "explicitly rejected an approach to *Unocal* analysis that 'would involve the court in substituting its judgment as to what is a 'better' deal for that of a

corporation's board of directors.'"[4] The Chancellor notes that *Time* rejected then-Chancellor Allen's reasoning in *City Capital Associates v. Interco*,[5] which held that a poison pill could not be maintained in the face of a non-coercive offer whose sole threat was a mildly inadequate price.[6] Chancellor Chandler recognized that several recent cases decided by the Court of Chancery "have attempted to cut back on the now-broadened concept of 'substantive coercion,'" but until the Delaware Supreme Court decides otherwise, the narrower view of substantive coercion "is not the current state of our law."

In arguing for a finding of substantive coercion in this case, Airgas argued that the company was at risk from short-term merger arbitrageurs--shareholders who bought Airgas stock when Air Products first announced its offer in hopes that the merger would eventually consummate at a price higher than when they bought the stock (but lower than the Airgas board's valuation of the stock). Airgas argued that these shareholders would have tendered their shares for Air Products' $70 offer because they were interested in short-term profitability and perhaps overleveraged, thus "coercing" a minority of long-view focused shareholders into tendering as well. Chancellor Chandler found this risk to be real and, based on the adoption of substantive coercion as a threat in *Time* and *Unitrin* and that the Airgas board believed in good faith that the Air Products' offer was inadequate, held that Airgas passed the first prong of the *Unocal* test.

Under the second prong of the *Unocal* test, the target board must show "that any board action taken in response to th[e perceived threat] is 'reasonable in relation to the threat posed.'"[7] As Chancellor Chandler noted, the second prong of the *Unocal* test "engages the Court in a substantive review of the board's defensive actions: Is the board's action taken in response to th[e] threat proportional to the threat posed?"[8] This proportionality review first asks whether the defensive measure was either preclusive or coercive.[9] If not, the Court then must determine whether the board's response fell within a reasonable range of responses to the threat posed.[10]

Here, the Court concluded that the Airgas board's response to the takeover threat posed by Air Products--the poison pill plus a staggered board--was neither preclusive nor coercive and was within the range of reasonable responses to the threat. The Chancellor reasoned that Airgas's defensive measures were not coercive because the Airgas board was not trying to cram down a management-hatched plan in lieu of the proposed takeover--that is, the Airgas board was merely trying to maintain the status quo of proceeding with its long-term business plan.[11]

Turning to whether Airgas's defensive measures were preclusive, the Court identified the central issue as "whether [the] defensive measures are 'preclusive' [because] they make gaining control of the board realistically unattainable in the short term (but still realistically attainable sometime in the future), or if 'preclusive' actually means 'preclusive'--i.e. forever unattainable."[12] The Court recognized that the question "preclusive for now" versus "preclusive forever" was essentially moot, though, in light of the fact that no bidder has ever "successfully stuck around for two years and waged two successful proxy contests to gain control of a classified board in order to remove a poison pill."[13] Relying on the recent Delaware Supreme Court decision in *Versata Enters., Inc. v. Selectica Inc.*,[14] Chancellor Chandler concluded that a staggered board plus a poison pill would delay--but not ultimately prevent--a bidder from taking control of the board.[15]

In light of this conclusion, the Court proceeded to analyze whether "the ability to obtain control of Airgas's board in the future is realistically attainable." As the Court saw it, Air Products only had two options to continue its pursuit of Airgas: (1) calling a special meeting to remove the entire board with a supermajority of outstanding shares or (2) waiting until Airgas's 2011 annual meeting to nominate another slate of directors.[16] Although the Court found that calling a special meeting at which a supermajority vote of outstanding shares would be necessary to replace the entire board was not realistically attainable,[17] it concluded that "obtaining a simple majority of the voting stock [at the 2011 annual meeting] is significantly less burdensome than obtaining a supermajority vote of the outstanding shares."[18] Indeed, the Court found that "an Air Products victory at the next annual meeting is very realistically attainable."[19] Whether or not to pursue that option is a business decision to be made by Air Products. Thus, the Court held that Airgas's defensive measures were not preclusive.[20]

Finally, the Court turned to the last part of *Unocal*'s second prong: whether a defensive measure is within the range of reasonable responses to the perceived threat. In this case, "the board is simply maintaining the status quo, running the company for the long-term, and consistently showing improved financial results each quarter."[21] Therefore, "[t]he board's actions do not *forever* preclude Air Products, or any bidder, from acquiring Airgas or from getting around Airgas's defensive measures if the price is right. In the meantime, the board is preventing a change of control from occurring at an inadequate price."[22] Thus, Airgas's defensive measures were within the range of reasonable responses to the perceived threat of the inadequate bid of Air Products.

Significance

The Usefulness of the Poison Pill. This decision further demonstrates that a Delaware corporation with a staggered board can successfully resist an all-cash, all-shares, fully-financed structurally non-coercive tender offer even after losing a proxy contest to the bidder. The target board can prevent shareholders from tendering as long as the board has a good faith belief based on consultation with outside legal and financial advisers that the tender offer price is inadequate.

The Target Board's Process. Practitioners and potential merger targets should be keenly aware that the processes employed by the target board, most notably the retention of outside legal and financial advisers, continues to be closely scrutinized by Delaware courts. Under *Unocal*, the target board must conduct a "reasonable investigation" in "good faith" to serious offers. The Court lauded the Airgas board for consulting with legal counsel and three independent financial advisors in evaluating the tender offer, and also highlighted the independence of the majority of the board. This process, the court held, "easily passes the smell test."

The Continuing Evolution of Delaware Anti-Takeover Law. While Chancellor Chandler upheld the Airgas poison pill on the grounds that a target board's reasonable judgment concerning the adequacy of a tender offer must be respected, he also agreed with Vice Chancellor Strine that courts should not "ascribe rube-like qualities to stockholders. If the stockholders are presumed competent to buy stock in the first place, why are they not presumed competent to decide when to sell in a tender offer after an adequate time has been afforded them?"[23] Therefore, there is at least some support for the idea that a poison pill that permits for the shareholders to become informed and for the target to explore all of its

options might serve its purpose but ultimately become unnecessary through the passage of time. Interested parties should continue to monitor the Delaware Court of Chancery and Delaware Supreme Court for further developments.

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[1] The *Unocal* test was first enunciated in the 1985 case *Unocal v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985). To pass the test, and fall within the deferential protection of the business judgment rule, the target board must show that (1) there are reasonable grounds to believe that a danger to corporate policy and effectiveness exists and (2) the adoption of the defensive measure is neither preclusive nor coercive and is otherwise reasonable in relation to the threat posed. *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995) (citing *Unocal*).

[2] 571 A.2d 1140 (Del. 1990) (hereinafter, *Time*).

[3] 654 A.2d 1361 (Del. 1995).

[4] Citing *Time*, 571 A.2d at 1153.

[5] 551 A.2d 787 (Del. Ch. 1988).

[6] *Id.* at 798-99.

[7] *Id.* at 77 (quoting *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995)).

[8] *Id.* at 78-79.

[9] *Id.*

[10] *Id.*

[11] *Id.* at 121.

[12] *Id.* at 122.

[13] *Id.*

[14] 5 A.3d 586 (Del. 2010)

[15] *Id.* at 123-26.

[16] *Id.* at 127.

[17] *See id.* at 136

[18] *Id.*

[19] *Id.*

[20] *Id.* at 138.

[21] *Id.* at 143-44.

[22] *Id.* at 144.

[23] *Chesapeake v. Shore*, 771 A.2d 293, 328 (Del. Ch. 2000).

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, or any of the following:

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