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Corporate Alert

Delaware Court Upholds Airgas Board's Use of Poison Pill

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In a much-anticipated decision, the Delaware Chancery Court, on February 15, 2011, upheld the continuing use of a poison pill by the board of directors of Airgas, Inc. to fend off a year-long takeover attempt by Air Products and Chemicals, Inc.[1] In declining to order the redemption of the poison pill, the court concluded that the Airgas board had not breached its fiduciary duties by keeping the pill in place, even though the pill had blocked Air Products' all-cash, fully financed tender offer for all Airgas shares for over a year and Air Products had won a recent election contest for a third of the seats on Airgas' staggered board.

The decision serves as an important case clarifying the extent to which a board of directors can continue to use a poison pill to resist a hostile bid that it believes to be inadequate. The court ruled that a board can continue to fend off a hostile tender offer and is not required to abandon its pursuit of long-term value and allow stockholders the right to decide for themselves whether they want to tender their shares so long as the board can satisfy its burden under the two-prong test of *Unocal*,[2] which requires (i) the board to articulate a legally cognizable threat and (ii) that the board's defenses be reasonable responses to the threat posed. Specifically, "a board of directors, found to be acting in good faith, after reasonable investigation and reliance on the advice of outside advisors, which articulates and convinces the court that a hostile tender offer poses a legitimate threat to the corporate enterprise, may address that perceived threat by blocking the tender offer and forcing the bidder to elect a board majority that supports its bid."[3] The court found that the Airgas board had met its burden under *Unocal* to articulate a legally cognizable threat (the allegedly inadequate price of Air Products' offer, coupled with the fact that a majority of Airgas' stockholders would likely tender into that inadequate offer) and had taken defensive measures that fall within a range of reasonable responses proportionate to that threat.[4]

Background

In October 2009, Air Products privately approached Airgas about a potential acquisition or combination. After these advances were rebuffed, Air Products launched a hostile tender offer in February 2010 for all outstanding Airgas shares at a price of $60 per share, which the Airgas board rejected. In the spring of 2010, Air Products also commenced a proxy fight for the three board seats up for election at Airgas' 2010 annual meeting, which Airgas pushed back from May to September 2010. Air Products also sought stockholder approval at the 2010 annual meeting of a bylaw amendment that would have required Airgas to hold its 2011 annual meeting in January 2011, thereby giving Air Products the opportunity to win a majority of board seats in a span of just four months. The Air Products' nominees, all of whom Air Products promoted as being independent of Air Products, won the election, and the bylaw amendment was approved by the stockholders. The Delaware Supreme Court, however, ultimately ruled that the bylaw amendment was invalid. Consequently, Airgas is not expected to hold its next annual meeting before September 2011.

After their election to the Airgas board, the Air Products' nominees eventually concurred with the rest of the Airgas board in its determination that the Air Products' offer was inadequate, even though the Air Products offer had been raised several times and stood at $70 per share at the time of the court's decision. The Airgas board had repeatedly expressed the view that Airgas was worth at least $78 per share, while Air Products affirmed that its $70 per share offer was its "best and final" offer.

[1] *Air Products and Chemicals, Inc. v. Airgas, Inc. et al*., C.A. No. 5249-CC (Del. Ch. Feb. 15, 2011).
[2] *Unocal Corp. v. Mesa Petroleum Co*., 493 A.2d 946 (Del. 1985).
[3] *Air Products, supra* at 1.
[4] *Id*. at 3.

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Court's Analysis

Unocal Standard

In assessing the defensive actions of the Airgas board, the court applied the *Unocal* standard of enhanced judicial scrutiny,[5] which requires the board to show—

1. that it had reasonable grounds for believing a danger to corporate policy and effectiveness existed (i.e., the board must articulate a legally cognizable threat) and

2. that the board actions taken in response to that threat are reasonable in relation to the threat posed.

First Prong

The court explained that the first prong of the *Unocal* test is essentially process-oriented: the board has the burden of demonstrating good faith and reasonable investigation. In addition, however, the board must also demonstrate the reasonableness of the result of its investigation, that is, the board must actually articulate a legitimate threat to corporate policy and effectiveness.

The court easily concluded that the Airgas board satisfied the procedural aspects of the first prong of *Unocal*. Among other things, all of the Airgas directors other than the CEO were outside independent directors, the board relied on the advice of three outside independent financial advisors (including a financial advisor approved by the Air Products' nominees) who had all concluded that the offer was inadequate and the board relied on the advice of legal counsel, with the Air Products' nominees having their own additional independent counsel. Even the Air Products' nominees had concurred in the board's determination that the offer price was inadequate, and these nominees had testified that they had no reason to believe that the Airgas directors had breached their fiduciary duties.

The court had only slightly more difficulty assessing whether the result of the board's procedure was the articulation of a legitimate threat. The court found that the only threat the board discussed was the inadequate price of Air Products' offer. According to the court, the alleged inadequate price, when coupled with the fact that a majority of Airgas' stock was held by merger arbitrageurs who might be willing to tender into such an inadequate offer, was the only real "threat" alleged.[6]

The Chancery Court discussed the pertinent Delaware case law at length and concluded that it was clear under Delaware Supreme Court precedent that inadequate price can be a valid threat to corporate policy and effectiveness. Under Delaware law, inadequate price is considered to be a form of substantive coercion in that there is a risk that stockholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value (or, the Chancery Court noted, in the case of merger arbitrageurs who may have short-term profit goals in mind, they may simply ignore the board's recommendation).[7]

Chancellor Chandler, however, also expressed his own skepticism that inadequate price alone in the context of a nondiscriminatory, all-cash, all-shares, fully financed offer poses any real threat—particularly given the wealth of information available to Airgas' stockholders.[8] Chancellor Chandler noted that the Airgas board had had a full year to educate stockholders on the alleged inadequacy of Air Products' offer, more time than any litigated poison pill in Delaware history. While Chancellor Chandler was of the view that the Airgas stockholders have all that they need to know to make an informed decision, he nevertheless concluded that, under existing Delaware law, inadequate price is a legally cognizable threat that a board of directors may resist irrespective of stockholders' desires and that it is not the court's place to substitute its judgment for that of the board in evaluating the relative merits of long-term versus short-term investment goals for stockholders.

[5] The court rejected defendants' contention that the business judgment rule, not *Unocal*, should apply where the bidder's own director nominees agree with the incumbent directors after receiving advice from a new financial advisor.
[6] *Id*. at 106-7.
[7] *Id*. at 7, 87.
[8] *Id*. at 8.

Second Prong

Having concluded that the Airgas board satisfied the first prong of *Unocal*, the court turned its attention to the second part of the *Unocal* standard and addressed whether the continued maintenance of Airgas' defenses were proportionate to the threat posed by Air Products' offer.[9]

Under the second *Unocal prong*, the target board bears the burden of showing that its defenses are not preclusive or coercive, and if neither, that they fall within a range of reasonableness. Under established Delaware law, a response is preclusive if it makes a bidder's ability to wage a successful proxy contest and gain control of the target's board "realistically unattainable." The court acknowledged that, although Airgas' staggered board makes obtaining control of the board realistically unattainable in the short term, the Delaware Supreme Court had recently held that the combination of a classified board and a poison pill does not constitute a preclusive defense because the combination only delays—but does not prevent—a hostile acquirer from obtaining control of the board.[10]

Having concluded that Airgas' defenses were not coercive or preclusive, the court then addressed whether the board's response fell within a range of reasonableness to the threat posed. Based on its previous factual findings, the court had little trouble concluding that the maintenance of the board's defensive measures was reasonable. Citing Delaware Supreme Court precedent, the court noted that the "fiduciary duty to manage a corporate enterprise includes the selection of a time frame for the achievement of corporate goals. *That duty may not be delegated to the stockholders* ... Directors are not obligated to abandon a deliberately conceived corporate plan for a short-term stockholder profit unless there is clearly no basis to sustain the corporate strategy."[11]

Based on his factual findings, Chancellor Chandler stated that he could not conclude that there was "clearly no basis" for the Airgas' board's belief in the sustainability of its long-term plan.[12] In the court's view, the record had demonstrated that the Airgas board, composed of a majority of outside independent directors, had acted in good faith and, with the assistance of numerous outside advisors, concluded that the Air Products' offer clearly undervalued the company. Moreover, the three Air Products' nominees had "wholeheartedly joined in the board's determination – what is more, they believe it is their fiduciary duty to keep Airgas' defenses in place."[13] In assessing the reasonableness of the Airgas defenses, the court also noted that it was Air Products' own tactical decision to pursue a proxy contest in which it promoted a slate of independent directors who promised to take a "fresh look" at the Air Products' offer, rather than run a slate of nominees who were committed to redemption of the poison pill.[14]

Conclusion

The Delaware Chancery Court's decision squarely addresses the issue of when, if ever, a board must abandon its long-term strategy in the face of a hostile tender offer and allow stockholders to make their own decision about whether they want to tender their shares. The court concluded that a well-informed board acting in good faith to a reasonably perceived threat may continue to "say no" to a hostile tender offer, even if it is an all-cash, all-shares, fully financed offer that has been outstanding for more than a year, the stockholders are fully informed about the board's position on the inadequacy of the offer and the incumbent board has lost an election contest for a third of the seats on the target's staggered board. While the court made clear that its decision should not be read as an endorsement of a "just say never" defense,[15] the case does clearly endorse "Delaware's long-understood respect for

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[9] In addition to its poison pill and a staggered board, Airgas' defenses also include Section 203 of the Delaware General Corporation Law, which Airgas has not opted out of, and a supermajority merger approval provision in its certificate of incorporation that requires that any merger with a stockholder owning more than 20 percent of Airgas' stock be approved by at least a 67 percent stockholder vote unless (i) approved by a majority of disinterested directors or (ii) certain fair price and procedural requirements are met.

[10] *Id.* at 123, citing *Versata Enterprises, Inc. v. Selectica, Inc*., 5 A.3d 586 (Del. 2010). The court also discussed the viability of Air Products' possible use of a provision in Airgas' charter that allows 33 percent of the outstanding shares to call a special meeting and to remove the entire board without cause by a vote of 67 percent of the outstanding shares, but concluded that, even if that use of this mechanism was not realistically attainable, Air Products still had the option of running a proxy contest at the 2011 annual meeting.

[11] *Id*. at 143, citing *Paramount Commc'ns, Inc. v. Time, Inc*., 571 A.2d 1140, 1154 (emphasis added by Chancery Court).

[12] *Id.* at 139.

[13] *Id.*

[14] *Id*. at 140-141.

[15] The court also noted that, in this case, Air Products had run a slate of nominees committed to taking an independent look at its bid and that those nominees had ultimately shared the view of the rest of the Airgas board that Air Products' offer was inadequate. Consequently, the court was not addressing the continuing use of a poison pill in a situation in which the bidder has successfully elected a slate of nominees who are committed to redeeming the poison pill, but who are unable to convince the majority of a target's staggered board to do so.

reasonably exercised managerial discretion."[16] So long as the board acts in good faith and in accordance with its fiduciary duties, "the power to defeat an inadequate hostile tender offer ultimately lies with the board of directors."[17]

CONTACT INFORMATION

If you have any questions concerning this alert, please contact —

Rick L. Burdick
rburdick@akingump.com
202.887.4110
Washington, D.C.

Patrick J. Dooley
pdooley@akingump.com
212.872.1080
New York

Daniel I. Fisher
dfisher@akingump.com
202.887.4121
Washington, D.C.

Jeffrey L. Kochian
jkochian@akingump.com
2.872.8069
New York

Joseph L. Motes III
jmotes@akingump.com
214.969.4676
Dallas

C.N. Franklin Reddick III
freddick@akingump.com
310.728.3204
Los Angeles

[16] *Id*. at 152.
[17] *Id*. at 3.