Condec Corp. v. Lunkenheimer Co., 230 A.2d 769 (Del. Ch. 1967)

VALIDITY OF STOCK-ISSUANCE DEVICE TO PREVENT TAKEOVER BY CORPORATE OUTSIDERS

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Acquisition of corporate control by outsiders frequently involves a public offer to purchase shares in the corporation at a stated price (public tender offer).[1] When management reasonably and in good faith believes that acquisition and control by outsiders[2] will not be in the best interests of the corporation, it may take action to prevent takeover. Both the issuance of new shares of voting stock to those who will vote with management (stock-issuance device) and the repurchase of corporate stock with company funds (stock-purchase device)[3] are effective methods of resisting stock purchase offers made by outsiders. There are, however, objections to their use. Both devices insulate management against shareholder action.[4] Furthermore, it is difficult to determine whether they are adopted to achieve legitimate business objectives of the corporation or merely to perpetuate corporate control.[5] Despite the similarity of the two methods, courts have at times viewed them differently, emphasizing the potential abuse of the stock-issuance device, while admitting the possibility that a properly motivated repurchase plan is an appropriate defensive weapon for management. Delaware courts, in recent stock-purchase cases,[6] have recognized in management an expanded discretion in determining corporate policy. An opposite view of the stock-issuance device was implied in *Condec Corp. v. Lunkenheimer Co.*[7]

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1. As a means of acquiring corporate control, the public tender offer has been resorted to with increasing frequency. In 1960, there were only eight such offers involving corporations listed on both the American Stock Exchange and the New York Stock Exchange; in 1965, the number increased to forty-four, twenty-nine involving companies listed on the New York Exchange and fifteen on the American Exchange. In the first six months of 1966, thirty-two such offers were reported. Cohen, *A Note On Takeover Bids and Corporate Purchases of Stock,* 22 BUS. LAW. 149 (1966); Fleischer & Mundheim, *Corporate Acquisition By Tender Offer,* 115 U. PA. L. REV. 317 (1967).

2. It should be emphasized that there is nothing *per se* immoral about the use of the takeover bid, and its advantages have been recently suggested. Manne, *Mergers and the Market for Corporate Control,* 73 J. POL. ECON. 110 (1965).

3. The stock purchase device usually involves repurchase of the shares from the outsiders, but may consist of purchases from stockholders who might otherwise sell to the outsiders.

4. *See generally* Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control,* 65 MICH. L. REV. 259 (1966); Fleischer & Mundheim, *supra* note 1.

5. Brudney, *supra* note 4, at 271.

6. *See* note 13 *infra.*

7. 230 A.2d 769 (Del. Ch. 1967).

Condec Corporation, after failing to interest the management of Lunkenheimer Company in a business merger,[8] sought to acquire control of Lunkenheimer by public tender offer. On February 6, 1967 the first of two public tender offers was made by Condec and resulted in the acquisition of 21,000 shares of Lunkenheimer common stock. On April 21 Condec made a second tender offer seeking an additional 190,000 shares. The avowed purpose of this offer was to give Condec a majority of the 414,000 shares of Lunkenheimer stock then outstanding. By May 9 a sufficient number of Lunkenheimer shares had been offered to give Condec an equitable majority of Lunkenheimer's outstanding common stock. Therefore, by May 10 Condec had received sufficient irrevocable proxies to hold a majority interest, but, since the transfer of the shares was not complete, actual control of Lunkenheimer had not been gained.

Meanwhile, the Lunkenheimer directors, believing that control by Condec was not in the best interests of the company, sought to block the takeover. To achieve this objective before a sufficient number of shares could actually be transferred to Condec, Lunkenheimer used the stock-issuance device—in conjunction with a two-part agreement with United States Industries, Inc. (USI). On May 9 the Lunkenheimer directors approved the issuance of 75,000 shares of authorized but unissued common stock. Under a stock purchase agreement of the same date, the 75,000 shares were to be transferred to a wholly owned subsidiary of USI (United States Industrial Corporation (USIC)), for 75,000 shares of USI special preference stock. The second agreement, entered May 10, provided for transfer to USI of Lunkenheimer's entire business and assets in return for 416,000 additional shares of special preference USI stock. To be executed, this agreement required a majority approval by Lunkenheimer shareholders. If the sale provided in the second agreement was not consummated, the first agreement, including the 75,000 share issuance, was to be cancelled.

The May 9 issuance of 75,000 shares effectively blocked the attempted takeover by Condec, since Condec now owned or had an interest in less than a majority of Lunkenheimer shares. Condec brought an action in the Delaware Court of Chancery seeking to cancel that issuance alleging it served no legitimate corporate purpose. The Vice-Chancellor found that the stock had been issued solely to allow control to pass to USI, rather than Condec. He ignored management's defense of a good faith belief that takeover by Condec was not in Lunkenheimer's best interests. The

8. Initially, Condec had proposed a merger to Lunkenheimer; thereafter several other business proposals were rejected by the Lunkenheimer management which felt that control by Condec was not in the best interests of the corporation.

challenged transaction was held to be inherently improper, because it permitted an equitable majority shareholder to have its voice in corporate affairs reduced by a transaction designed primarily to affect control.[9]

There is substantial judicial precedent, both in Delaware[10] and elsewhere,[11] for the proposition relied upon by the Vice-Chancellor that shares of stock may not be issued for the primary purpose of manipulating corporate control. Where a stock-issuance device, rather than a stock-purchase device, is challenged, courts seldom reach the issue raised by the Lunkenheimer management—whether its actions were for the common good or private advantage.[12] In the stock-purchase cases, on the other hand, the court does ask *why* management was concerned about control.[13] Although the stock-purchase device is mechanically different from the stock-issuance device—eliminating the outsiders' votes rather than diluting them—the primary purpose of maintaining corporate control is common to both. The refusal to examine motive in the stock-issuance cases is questionable considering the similarity of purpose and effect of the two devices.

The courts have determined the propriety of stock purchases by management through application of the "business judgment rule." Under this standard corporate directors are permitted to eliminate outsider threats to control, if they can show that the purchases were made in the reasonable and good faith belief that loss of control would be harmful to the corporation.[14]

9. The decision was appealed to the Delaware Supreme Court, but the appeal was dismissed as moot, when, pending appeal, USI withdrew its offer to purchase Lunkenheimer's assets, thereby cancelling the Lunkenheimer—USIC stock exchange.

10. Canada Southern Oils, Ltd. v. Manabi Exploration Co., 33 Del. Ch. 537, 96 A.2d 810 (Ch. 1953); Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (Ch. 1941); Bowen v. Imperial Theatres, Inc., 13 Del. Ch. 120, 115 A. 918 (Ch. 1922); Kingston v. Home Life Ins. Co. of America, 11 Del. Ch. 258, 101 A. 898 (Ch. 1917).

11. Schwab v. Schwab-Wilson Mach. Corp., 13 Cal. App. 2d 1, 55 P.2d 1268 (1936); Trask v. Chase, 107 Me. 137, 77 A. 698 (1910); Andersen v. Albert & J.M. Anderson Mfg. Co., 325 Mass. 343, 90 N.E.2d 541 (1950); Elliott v. Baker, 194 Mass. 518, 80 N.E. 450 (1907); Luther v. C.J. Luther Co., 118 Wis. 112, 94 N.W. 69 (1903). *But see* McPhail v. L.S. Starrett Co., 257 F.2d 388 (1st Cir. 1958).

12. *See* Yasik v. Wachtel, 25 Del. Ch. 247, 256, 17 A.2d 309, 313 (Ch. 1941). The court stated that issuance of shares by directors solely to perpetuate or obtain voting control constitutes a breach of the fiduciary duty owed shareholders.

13. Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964); Bennett v. Propp, 41 Del. Ch. 14, 187 A.2d 405 (Sup. Ct. 1962); Martin v. American Potash & Chem. Corp., 33 Del. Ch. 234, 92 A.2d 295 (Sup. Ct. 1952); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960).

14. Israels, *Corporate Purchase of Its Own Shares—Are There New Overtones?*, 50 CORN. L.Q. 620, 624 (1965).

While case law reveals precedent for the rejection of the business judgment rule in stock-issuance cases,[15] *dicta* in one stock-purchase case suggests that if management can prove that the stock was issued in the reasonable belief that corporate welfare was threatened by the outsiders, the transaction should be sustained. The court in *Kors v. Carey*[16] asserted that since the directors are fiduciaries of the shareholders, they may in the "exercise of their honest business judgment"[17] take valid steps to eliminate a threat to the well-being of the corporation,[18] a principle equally applicable to the stock-issuance cases.

There is justification, on the other hand, for the proposition that directors should not determine whether retention of control is in the best interests of the corporation. It is undesirable to permit elected management the choice of whether or not to retain office.[19] However, assuming the validity of the business judgment rule in stock-purchase cases, the same rationale would warrant application of a good faith defense in the stock-issuance cases. Management should have some means of blocking takeover by outsiders when it is clearly not in the best interests of the corporation. For example, in the principal case management presented evidence that Condec had over-extended itself financially and was too dependent on fluctuating defense contracts.[20] And in a stock-purchase case management successfully argued that the corporation's method of marketing its product would be harmfully altered by outsider takeover.[21] Although directors faced with a public tender offer can inform shareholders that sale of their stock is not sound policy, such a procedure is not likely to be effective against a tender offer at premium rates. When directors are motivated by defensible views regarding the best interests of the corporation, the business judgment rule should be applied in the stock-issuance cases.[22]

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15. *See* Elliott v. Baker, 194 Mass. 518, 522-23, 80 N.E. 450, 452 (1907); Luther v. C.J. Luther Co., 118 Wis. 112, 124, 94 N.W. 69, 73 (1903).

16. 39 Del. Ch. 47, 158 A.2d 136 (Ch. 1960).

17. *Id.* at 55-56, 158 A.2d at 141.

18. This general proposition set out in the *Kors* case would appear to embrace the situation in *Condec.* The *Condec* court, however, rejected this *dicta* and determined that unlike the situation in the stock-purchase cases, the challenged transaction was employed to manipulate control and, therefore, the motivation of the directors was not considered. Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 777 (Del. Ch. 1967).

19. *See* Comment, *Buying Out Insurgent Shareholders with Corporate Funds,* 70 YALE L.J. 308, 316 (1960).

20. Condec Corp. v. Lunkenheimer Co., 230 A.2d 769, 771 (Del. Ch. 1967).

21. Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Sup. Ct. 1964).

22. In considering the applicability of the business judgment rule to stock-issuance cases, the courts appear to differentiate close and publicly held corporations. In the case of the publicly held corporation, the court is likely to consider motives of cor-

From the shareholders' point of view there is little difference between the stock-issuance and stock-purchase cases. Both control devices dilute shareholder voting power and thus enable management to deprive shareholders of a choice between conflicting policies. In the stock-purchase situation this dilution of shareholder voting power is caused (1) by eliminating alternative directors and policies from which the shareholders might choose, and (2) by eliminating a shareholder with a sufficiently large block of shares to effectively challenge the incumbents. Shareholder interests are similarly shackled by the stock-issue device because directors are permitted at their own discretion to increase the number of votes necessary to remove them from office. Action by directors which restricts the shareholders' contractual or statutory right to determine who shall manage corporate affairs should be permitted only if management can demonstrate that they were motivated solely by the well-being of the corporation. This question can be tested in either an issuance or repurchase situation by application of the business judgment rule.

The *Condec* situation would seem an attractive one for judicial restraint, because Lunkenheimer's shareholders were in fact provided an opportunity to choose between control by Condec or USI. In order to consummate the stock-issuance agreement, the Lunkenheimer stockholders had first to approve the sale agreement with USI. Assuming *arguendo* that the Lunkenheimer directors were acting for personal benefit, the shareholders theoretically could protect themselves by rejecting the sale to USI.[23] The existence of this opportunity to choose between alternative policies could have been used to justify a different result in *Condec*.

Clearly the stock-issuance device cannot be used to diminish a majority shareholder's right to his proportionate voice in corporate affairs. The *Condec* decision is a valid application of this principle. However, *Condec* should not foreclose application of the business judgment rule in all cases challenging use of the stock-issuance device. The court's determination in both the stock-purchase and stock-issuance cases should ultimately turn on *when* and *why* the particular device is being employed, rather than

porate well-being as justification for a stock issuance. However, the cases involving a close corporation emphasize the interest of the acquiring shareholder and rarely consider the motives of management. *See* Brudney, *supra* note 4, at 266-67.

23. While such a rejection required a majority vote, in light of the fact that USI controlled 75,000 newly-issued shares, and would, of course, vote in favor of the proposed sale, the actual percentage of votes needed to defeat the transaction would have been approximately sixty percent of the outstanding shares prior to the issuance. Furthermore, it is possible that Lunkenheimer issued enough shares to USI to assure that USI and the incumbent directors would have sufficient votes to approve the sale of assets, thereby effectively eliminating the alternative of shareholder rejection.

merely on *whether* it is used to manipulate control. In cases like *Condec,* when the stock-issuance device is used after the outsiders have gained an equitable majority, the business judgment rule should not be available as a defense. However, if management employs the stock-issuance device before the outsiders have acquired a majority interest, the business judgment test is a proper standard for examining the action of management. In cases where the business judgment rule is a permissible standard, management should bear the burden of justifying its action, since it is best able to explain its purposes.[24] The emphasis in these cases would be shifted from protection of shareholders seeking to acquire control to protection of all interested shareholders. By examining motive, the business judgment rule can afford an effective safeguard against possible abuses by directors seeking to enhance their own power by means of the stock-issuance device.

24. Placing the burden of proof on management recognizes the current trend of limiting management discretion in conflict of interest situations. Brudney, *supra* note 4; Fleischer & Mundheim, *supra* note 1; Israels, *supra* note 14; Comment, 62 COLUM. L. REV. 1096 (1962); Comment, 50 CORN. L.Q. 302 (1965); Comment, 1965 DUKE L.J. 412; Comment, 78 HARV. L. REV. 1253 (1965); Comment, *supra* note 19.