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Delaware Chancery Court Enjoins "Inequitable" Actions of Controlling Stockholder

The recent opinion of the Delaware Chancery Court in *Hollinger International Inc. v. Conrad M. Black, et al.*, in addition to being a richly detailed and colorful account of the contest between Hollinger International and its controlling stockholder, is instructive to M&A practitioners on the power of equitable arguments in contests for control. The case illustrates the limits the Delaware courts can place on the inequitable use of a stockholder's statutory rights, such as the right to amend by-laws, and confirms the ability of a controlled company to use a poison pill to prevent inequitable actions on the part of its controlling stockholder.

The facts, which have been the subject of extensive press coverage in recent months, can be summarized as follows. Hollinger International Inc., a Delaware public company, is controlled by Hollinger Inc., a Canadian company that holds 30.3% of Hollinger International's equity and 72.8% of its voting power. Conrad Black, the former Chairman and CEO of Hollinger International, controls The Ravelston Corporation Limited, which holds 78% of Hollinger Inc.'s common stock. Faced with accusations of unauthorized self-dealing, on November 15, 2003, Black entered into an agreement with Hollinger International (the "Restructuring Proposal") whereby he agreed to resign as CEO, repay certain funds to Hollinger International and devote his principal time and energy to a "strategic process" involving the development of value maximizing plans for Hollinger International, such as the sale of the company or some of its assets. Black also agreed to refrain from consummating a transaction involving the sale of his interest in Hollinger Inc., except in limited circumstances.

The Court found that Black immediately violated his undertaking by negotiating, without the Hollinger International board's knowledge, to sell his interest in Hollinger Inc. to David and Frederick Barclay, who were interested in the Daily Telegraph, a Hollinger International asset. On January 17, 2004, Black announced an agreement for the sale of his interest in Hollinger Inc. to a company owned by the Barclays. On January 20, the Hollinger International board responded by forming a committee of independent directors which began considering the adoption of a rights plan to protect the strategic process against the threat posed by the Barclays transaction. Three days later, Black caused Hollinger Inc. to file a written consent amending the by-laws of Hollinger International to require, among other things, unanimous action by the Hollinger International board for any significant decision, abolishing the independent committee and effectively preventing the independent directors from creating obstacles to the Barclays transaction. Believing the by-law amendments to be invalid, the independent directors adopted a rights plan with standard "flip-in" and "flip-over" provisions that would have been triggered had the Barclays transaction proceeded without board approval.

In its complaint, Hollinger International sought to have the by-law amendments declared ineffective because they were adopted in bad faith and for an inequitable purpose and sought a preliminary injunction against the Barclays transaction as resulting from Black's breaches of the Restructuring Proposal and breaches of fiduciary duties. Black and Hollinger Inc. counterclaimed seeking a declaration that the rights plan was invalid primarily because (1) it is statutorily improper for a board of directors to adopt a rights plan that is triggered by a sale of control of the corporation's controlling

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stockholder as an entity and (2) alternatively, it is an unreasonable response under *Unocal* or an improper disenfranchisement under *Blasius*.

With respect to the by-law amendments, the Court rejected Hollinger International's claim that they were inconsistent with the Delaware General Corporation Law ("DGCL"). Citing the rule of *Schnell v. Chris-Craft* that "inequitable action does not become permissible simply because it is legally possible," the Court found that the by-law amendments were "clearly adopted for an inequitable purpose and have an inequitable effect" and "complete a course of contractual and fiduciary improprieties" on Black's part. They were designed to end-run the strategic process that Black had agreed to support in the Restructuring Proposal. For these reasons, the Court declared the by-law amendments ineffective.

As to the rights plan, the Court rejected defendants' argument that Delaware law does not permit the adoption by a company of a rights plan which would be triggered by the sale of the company's parent. Defendant's could not cite any authority in support of that claim and the court pointed out that "standard rights plans are drafted precisely to cover up-stream transactions of this kind."

Examining the rights plan under *Unocal*, the Court found that the board had satisfied its duty of care in adopting it because they understood the basic manner in which the plan operated even if directors did not understand all the complex workings of the plan. The Barclays transaction represents a sufficient threat under *Unocal* because, if consummated, it would thwart the strategic process that Black had contractually promised to support and would deny Hollinger International the bargained-for benefits of the Restructuring Proposal.[1] The Court also found the adoption of the rights plan in this case to be a proportionate response to the threat posed. The Court warned, however, that the "proportionality of the Rights Plan's use now will not sustain its use forever" and that, once Hollinger International has completed its strategic process, further use of the rights plan would be "suspect".

The Court rejected the defendants' argument that the rights plan was subject to the *Blasius* compelling justification standard, because the rights plan does not affect Hollinger Inc.'s voting rights in any way since Hollinger Inc. remains free to elect a new board. For these reasons, the Court upheld the adoption of the rights plan as legally permissible under the DGCL and consistent with the fiduciary duties of the Hollinger International directors to protect the corporation.

Finally, the Court granted Hollinger International a preliminary injunction against the Barclays transaction and further breaches of the restructuring proposal. *Hollinger International Inc. v. Conrad M. Black, et al.,* C.A. No. 183-N, Del. Ch. Feb. 26, 2004.[2]

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[1] It is worth noting that the Court made clear that in "typical" circumstances the replacement of a subsidiary's controlling stockholder with another through a transaction at the parent level would pose no cognizable threat to the subsidiary and thus would not justify use of a rights plan.

[2] Paul Weiss represented Hollinger International in this litigation.

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This memorandum constitutes only a general description of the *Hollinger* opinion. It is not intended to provide legal advice and no legal or business decision should be based on its contents. Any questions concerning the foregoing should be addressed to any of the following New York-based members of our Mergers and Acquisitions Group:

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