

KEEPING SHAREHOLDER ACTIVISM ALIVE: A COMPARATIVE APPROACH TO OUTLAWING DEAD HAND PROXY PUTS IN DELAWARE

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Current trends in shareholder activism have brought to light the competing interests of management and stockholders. With a rise in shareholder activism, firms are continuing to include change in control provisions, known as proxy puts, in their debt agreements to counter activist success. Recent litigation regarding the use of these provisions has created a debate as to whether these provisions are valid under Delaware law. Moreover, companies and lending institutions have morphed these provisions into a more restrictive form, known as “dead hand proxy puts.” The controversy analyzed in this Note arises out of the use of dead hand proxy puts in debt agreements.

The Delaware Chancery Court has considered the issue of proxy puts in three recent cases. On no occasion has the court declared traditional or dead hand proxy puts invalid; the court, however, expressed skepticism toward these provisions. With a recognized entrenchment effect on management and a deterrent effect on the stockholder franchise, the court indicated that they could potentially be invalid in Delaware as a matter of public policy.

This Note considers the rise of shareholder activism in the United States and the use of both proxy puts and poison pills to defend against activist investors and hostile takeovers. It analyzes the current debate over dead hand proxy puts and compares these provisions to the already illegal dead hand poison pills. It ultimately argues that dead hand proxy puts should be outlawed in Delaware on the same basis as dead hand poison pills.

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INTRODUCTION

“Like an ‘imperial’ chairman you have taken steps to entrench yourself that we believe to be unconscionable,” wrote Carl Icahn to Joseph Cook, the Chairman of the Board of Amylin Pharmaceuticals.¹ Icahn, one of the largest shareholders of Amylin, scoffed at Cook’s dictatorial management style.² In doing so, he addressed Amylin’s defense mechanisms, which were standing in the way of a proxy fight—a poison pill and two proxy puts found in the company’s debt agreements.³ Icahn, hoping to enhance stockholder value, held Amylin up as a prime example of what is wrong with governance in most of corporate America and announced his intention to fix it.⁴

Amylin had lost \$5 billion in market value under current management, and its share price had fallen 75 percent since its peak in 2007.⁵ Icahn and Eastbourne Capital Management, a prominent activist investing firm, wanted control of a majority of the board.⁶ There was one problem—the company’s proxy puts prevented Icahn and Eastbourne from changing a majority of the board of directors.⁷ Specifically, the proxy puts provided that if a majority of Amylin’s board became comprised of “non-continuing directors,” the company’s debt would be accelerated and Amylin would be required to pay back \$915 million immediately.⁸ Thus, if they were successful in gaining a majority of the board, they would trigger the proxy puts in the company’s debt agreements.⁹

The Delaware Chancery Court recently has scrutinized dead hand proxy puts because of their effects on shareholders.¹⁰ With a traditional proxy put, such as the one in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*,¹¹ the current board of directors has the ability to approve a newly elected board.¹² Specifically, the traditional put allows the current board to give new directors status as continuing directors,

1. Letter from Carl Icahn to Joseph C. Cook, Jr., Chairman of the Board of Amylin Pharmaceutical, Inc. (Apr. 15, 2009), <http://www.prnewswire.com/news-releases/letter-from-carl-icahn-to-amylin-pharmaceutical-inc-61824557.html> [https://perma.cc/A4U8-E5ZA].

2. *Id.*

3. *Id.*

4. *Id.*

5. *See In Victory for Icahn, Amylin Chairman Is Ousted*, N.Y. TIMES: DEALB%K (June 2, 2009, 2:24 PM), http://dealbook.nytimes.com/2009/06/02/in-victory-for-icahn-amylin-chairman-is-ousted/?_r=0 [https://perma.cc/3LSK-4LWQ].

6. *Icahn, Amylin and the New Nuances of Activist Investing*, N.Y. TIMES: DEALB%K (Apr. 20, 2009, 10:31 AM), <http://dealbook.nytimes.com/2009/04/20/icahn-amylin-and-the-new-nuances-of-activist-investing/> [https://perma.cc/4QZP-QWAZ].

7. *Id.*

8. *See San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304, 310 n.7 (Del. Ch. 2009).

9. *See Icahn, Amylin and the New Nuances of Activist Investing*, *supra* note 6.

10. *See Amylin*, 983 A.2d at 315.

11. 983 A.2d 304 (Del. Ch. 2009).

12. *See id.*; *infra* Part II.A.

preventing the proxy put from being triggered.¹³ A mutation of this proxy put includes a dead hand feature, which effectively prohibits any new directors from being named as continuing directors, regardless of board approval.¹⁴ In recent Delaware litigation, including the case brought against Amylin, the Delaware Chancery Court has expressed skepticism over the validity of these dead hand provisions.¹⁵

Although change in control provisions have existed for decades, the proxy put has gained notoriety as a result of a wave of shareholder activism.¹⁶ Carl Icahn and other similar investors believe that these provisions both unlawfully entrench management and prevent them from properly changing a company's strategy to enhance shareholder value.¹⁷ Even if they believe, as in the case with Amylin, that the board of directors is harming the company more than helping it, activist investors are less likely to change the board of directors in light of the destabilizing financial effects the proxy contest will have on the company.¹⁸

The Delaware Chancery Court has not outlawed dead hand proxy puts, but has noted that their entrenching effects on management, and value reducing effects on the stockholder franchise, could render them unenforceable as a matter of law.¹⁹ In the most recent relevant case,²⁰ the Chancery Court broadly compared their effects to the effects of dead hand poison pills, which were outlawed in 1998.²¹ This Note seeks to analyze the legality of dead hand proxy puts. Specifically, it provides a comparative analysis between dead hand poison pills and dead hand proxy puts. In doing so, this Note argues that the Delaware Chancery Court should outlaw dead hand proxy puts on the same grounds that it outlawed dead hand poison pills. The dead hand feature in both defense mechanisms has a similar purpose and similar effects on shareholders and management. As a result, the Delaware Chancery Court ultimately should conclude that

13. T. Brad Davey & Christopher N. Kelly, *Dead Hand Proxy 'Puts' Face Continued Scrutiny from Plaintiffs Bar*, BLOOMBERG LAW (June 12, 2015), <http://www.bna.com/dead-hand-proxy-n17179927613/> [<https://perma.cc/24D6-FQQZ>].

14. Maxwell Murphy, *'Proxy Puts' Invite Shareholders, Attorneys to Come Knocking*, WALL STREET J. (June 1, 2015, 5:51 PM), <http://blogs.wsj.com/cfo/2015/06/01/proxy-puts-invite-shareholders-attorneys-to-come-knocking/> [<https://perma.cc/YKD5-BRFQ>]; *see infra* Part I.B.3.

15. *Amylin*, 983 A.2d at 315 (stating that the proxy puts might be unenforceable as against public policy); *see* Transcript of Oral Argument at 80, *Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, No. 9789-VCL (Del. Ch. Oct. 14, 2014) (asserting that proxy puts have a recognized entrenchment effect and that lenders were on notice as to the potential unenforceability of proxy puts).

16. *See infra* Part I.B.

17. Letter from Carl Icahn to Joseph C. Cook, Jr., *supra* note 1.

18. *See* Transcript of Oral Argument, *supra* note 15, at 72 (discussing the effect that a dead hand proxy put would have on shareholders' willingness to wage a proxy contest); *see also* DAVID WHISSEL, PERILOUS PROXY PUTS: EMBEDDED ANTI-TAKEOVER DEFENSES AND SHAREHOLDER RIGHTS 4 (2014) (explaining that a proxy put could potentially trigger a liquidity crisis, which would have dramatic financial consequences for shareholders).

19. *Amylin*, 983 A.2d at 315.

20. Transcript of Oral Argument, *supra* note 15, at 73.

21. *See infra* Part I.C.2 (discussing the illegalization of dead hand poison pills in Delaware).

dead hand proxy puts are unenforceable under the Delaware General Corporation Law (DGCL).

Part I of this Note addresses the rise of shareholder activism and the defense mechanisms used to counter activist success. Part II discusses recent Delaware litigation regarding proxy puts and provides a discussion of the competing interests and effects of dead hand proxy puts. Finally, Part III provides a comparative analysis of the dead hand proxy put and dead hand poison pill and, based on this analysis, concludes that the dead hand proxy put should be outlawed.

I. SHAREHOLDER ACTIVISTS: SHAKING UP CORPORATE BOARDROOMS ONE PROXY CONTEST AT A TIME

This part addresses the history of shareholder activism, as well as the increasing influence that activist hedge funds have on corporations. Part I.A discusses the rise of hedge fund activism in the United States. Part I.B and Part I.C analyze proxy puts, including dead hand proxy puts, as well as traditional and dead hand poison pills.

A. Shareholder Activism

One of the “hottest topic[s]” in corporate boardrooms today is shareholder activism.²² Shareholder activism is loosely defined as those actions taken by shareholders with the purpose of bringing about change within a public company, but without taking over the company.²³ Shareholder activism encompasses a number of activities that vary based on the investors’ desired results, as well as the timing of the intervention and the investors’ level of aggression in pursuing change.²⁴ Some activist investors focus on changing corporate governance practices, executive compensation plans, or social policies.²⁵ These investors are often less aggressive than activist hedge funds, whose goal is to seek significant change to a company’s corporate strategy, financial structure, management, or board of directors.²⁶

Activist hedge funds thus take a more assertive approach and often engage in offensive shareholder activism.²⁷ “[T]he most obvious circumstance in which offensive shareholder activism will make sense is where a potential activist ascertains that a company is ‘underperforming’

22. Sue Decker, *Keeping Activist Investors at Bay: How Corporate Boards Can Help*, FORTUNE (Feb. 3, 2015, 11:00 AM), <http://fortune.com/2015/02/03/keeping-activist-investors-at-bay-how-corporate-boards-can-help> [https://perma.cc/4NLD-2Y2C].

23. Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 HOUS. BUS. & TAX J. 301, 321–22 (2008); Paul Rose & Bernard S. Sharfman, *Shareholder Activism As a Corrective Mechanism in Corporate Governance*, 2014 B.Y.U. L. REV. 1015, 1017.

24. PWC, SHAREHOLDER ACTIVISM: WHO, WHAT, WHEN, AND HOW? 2 (2015).

25. *See id.* at 4; Rose & Sharfman, *supra* note 23, at 1018.

26. Rose & Sharfman, *supra* note 23, at 1018. This Note focuses on hedge fund activism, as it is the form of activism that proxy puts serve to deter.

27. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 56–57 (2011).

and that it will be feasible to prompt changes in financial policy or strategic direction likely to increase shareholder returns.”²⁸ Offensive shareholder activists accumulate a significant portion of the company’s stock for the purpose of forcing change.²⁹ They traditionally target companies that are underperforming relative to their peers and thus are failing to maximize shareholder wealth.³⁰ Once they have a stake in the company, activist investors may pursue public media campaigns, sponsor shareholder proposals, or initiate proxy contests to bring about change in the company.³¹

Part I.A.1 and Part I.A.2 discuss, respectively, hedge fund activism in the United States and the debate over the utility that activists provide to corporations. Then, Part I.A.3 addresses activists’ use of proxy contests as a strategy for gaining control over corporations.

1. The Rise of Hedge Fund Activism in the United States

Shareholder activism is not a new phenomenon in the United States.³² In the early 1940s, the Securities and Exchange Commission (SEC) adopted a regulation stating that “management must allow shareholder proposals that constitute a ‘proper subject for action by securities holders.’”³³ Shortly thereafter, shareholders began proposing changes to corporate structure and control.³⁴ One early example of shareholder activism is attributed to Benjamin Graham, a well-known value investor.³⁵ In 1947, through the operation of his trust company, Graham-Newman Corp., Graham participated in an unsuccessful campaign to obtain seats on the board of Bell Aircraft.³⁶ As a result of this campaign and those that followed,

28. John H. Armour & Brian R. Cheffins, *Origins of “Offensive” Shareholder Activism in the United States*, in *ORIGINS OF SHAREHOLDER ADVOCACY* 260 (Jonathan GS Koppell ed., 2011).

29. Rose & Sharfman, *supra* note 23, at 1034.

30. See PWC, *supra* note 24, at 6–7.

31. See *id.* at 3–4; see also Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, in *INSTITUTIONAL INVESTOR ACTIVISM: HEDGE FUNDS & PRIVATE EQUITY, ECONOMICS & REGULATION* 40–41 (William W. Bratton & Joseph A. McCahery eds., 2015); *infra* Part I.A.3 (discussing the use of proxy contests).

32. See Gillan & Starks, *supra* note 31, at 39; see also Armour & Cheffins, *supra* note 28, at 254 (discussing traces of shareholder activism dating back to the first half of the twentieth century).

33. Gillan & Starks, *supra* note 31, at 41. This regulation is similar to the current Rule 14a-8, which governs the requirements for including shareholder proposals in a company’s proxy materials. 17 C.F.R. § 240.14a-8 (1998).

34. See Gillan & Starks, *supra* note 31, at 41.

35. Armour & Cheffins, *supra* note 28, at 257. Value investors purchase stocks of companies that they believe the market has undervalued. They make a profit when they purchase a stock at a deflated price and the price subsequently increases due to good news reaching the market. *Value Investing*, INVESTOPEDIA, <http://www.investopedia.com/terms/v/valueinvesting.asp> (last visited Apr. 29, 2016) [<https://perma.cc/7CGL-PMTK>].

36. Armour & Cheffins, *supra* note 28, at 257. In 1948, Graham also solicited proxies from New Amsterdam Casualty Co. shareholders to improve the company’s dividend payout. *Id.*

certain investors in the 1950s and 1960s gained notoriety as “proxyteers” for launching proxy contests for board control in U.S. public companies.³⁷

While there are thus traces of shareholder activism throughout the early twentieth century, hedge fund activism truly became prominent in the 1980s.³⁸ In the 1980s, an era commonly considered the “Deal Decade,” corporate raiders began buying up sizable portions of public companies.³⁹ At this time, activists mostly operated through publically traded companies, rather than privately controlled hedge funds, due to various restrictions imposed by the Investment Company Act of 1940.⁴⁰ A small number of activists, nevertheless, chose to operate through private investment companies.⁴¹ These practitioners are arguably the direct antecedents to the high profile activist hedge funds that gained considerable notoriety in the 2000s.⁴² For example, Warren Lichtenstein established a private fund, Steel Partners, in 1990 to buy a 9 percent interest in a steel company that he believed was undervalued.⁴³ He later formed Steel Partners II, which itself became a prominent hedge fund in the 2000s, “with a mandate to invest in undervalued firms and, if necessary, to seek to fix companies to increase shareholder return.”⁴⁴ Other individuals and institutional investors⁴⁵ began to create similar strategies, whereby they would buy up a sizable amount of an undervalued company and lobby for change.⁴⁶

Hedge fund activism continued to increase throughout the 1990s, in part because of regulatory changes that made it easier for activists to

37. See Cheffins & Armour, *supra* note 27, at 75.

38. See *id.* at 75–76.

39. See *id.*

40. *Id.* at 76–77. The purpose of the Investment Company Act of 1940 was to protect the public and the interest of investors from the risks associated with investment companies. Investment Company Act of 1940, 15 U.S.C. § 80a-1 (2012).

41. See Cheffins & Armour, *supra* note 27, at 77. An investment company generally is defined as “a company (corporation, business trust, partnership, or limited liability company) that issues securities and is primarily engaged in the business of investing in securities.” *Investment Companies*, SEC, <http://www.sec.gov/answers/mfinvco.htm> (last visited Apr. 29, 2016) [<https://perma.cc/K5SX-X3QY>].

42. See Cheffins & Armour, *supra* note 27, at 77.

43. *Id.*

44. *Id.*

45. An institutional investor is defined as “[s]omeone who trades large volumes of securities, [usually] by investing other people’s money into large managed funds.” *Investor*, BLACK’S LAW DICTIONARY (10th ed. 2014).

46. Carl Icahn, founder of Icahn Capital Management and Icahn Partners, is another well-known activist investor who began as a corporate raider in the 1970s. His investment philosophy entails buying up a sizeable portion of a company and promoting change, such as overthrowing management, reducing waste, or selling off divisions. His goal is to increase shareholder value by driving up share prices and subsequently selling his stake in the company. Some of his notable targets include Yahoo! and Time Warner. See Steven Bertoni, *The Raider’s Radar*, FORBES (Mar. 9, 2011, 6:00 PM), <http://www.forbes.com/forbes/2011/0328/billionaires-11-profile-carl-icahn-biotech-twa-raiders-radar.html> [<https://perma.cc/H22X-A4LN>]; see also Reem Nasr, *Carl Icahn Takes Stake in AIG, Demands Company Break Itself Up*, CNBC (Oct. 28, 2015, 9:36 AM), <http://www.cnbc.com/2015/10/28/carl-icahn-takes-stake-in-aig-demands-company-break-itself-up.html> (discussing one of Icahn’s recent well-known targets, American International Group) [<https://perma.cc/8GRU-2PXC>].

disseminate information to shareholders.⁴⁷ In 1992, the SEC amended its proxy regulations so that large shareholders had the ability to exercise their voting rights more effectively.⁴⁸ This amendment allowed for increased communication among shareholders, with fewer disclosure requirements.⁴⁹ It “made clear that most shareholders were free to make public statements, including speeches, press releases, newspaper advertisements, broadcast media, and internet communications.”⁵⁰ Individual investors, as well as institutional investors, could then easily combine their ownership interests and exert more influence over a company.⁵¹

Activists began playing an increasingly large role in corporate boardrooms in the early 2000s.⁵² The increase in activism at this time was partially in response to the discovery of high-profile corporate fraud at large U.S. corporations, such as Enron, Tyco, and Worldcom.⁵³ These scandals undermined confidence in both the quality of management and the idea that management was not adequately promoting shareholder value.⁵⁴ While the SEC and Congress mainly were concerned with corporations cleaning up their accounting, legal, and corporate governance issues, hedge funds reminded management not to ignore business strategy and shareholder returns.⁵⁵

2. Recent Trends in Hedge Fund Activism

Shareholder activism has gained “considerable speed” over the past five years, with the number of activist interventions increasing by 88 percent from 2010 to 2013.⁵⁶ Activist interventions have increased partly because hedge funds are able to raise more capital and thus dramatically increase

47. Cheffins & Armour, *supra* note 27, at 84.

48. Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1278–79 (2008).

49. *See id.*; Cheffins & Armour, *supra* note 27, at 90.

50. *See* Anabtawi & Stout, *supra* note 48, at 1277; *see also* Rose & Sharfman, *supra* note 23, at 1019 (stating that the SEC has shown support for shareholders through rules and policies, including those related to communication between shareholders in the context of proxy voting).

51. *See* Anabtawi & Stout, *supra* note 48, at 1277.

52. *See* Allan Murray, *Hedge Funds Are New Sheriffs of Boardroom*, WALL STREET J. (Dec. 14, 2005, 12:01 AM), <http://www.wsj.com/articles/SB113451884230621753?alg=y> [<http://perma.cc/58UM-MWK6>].

53. *See* Cheffins & Armour, *supra* note 27, at 84; *see also* David Benoit, *Activism's Long Road from Corporate Raiding to Banner Year*, WALL STREET J. (Dec. 26, 2015, 12:01 AM), <http://www.wsj.com/articles/activisms-long-road-from-corporate-raiding-to-banner-year-1451070910> (discussing shareholders' reactions toward management after the downfall of Enron and WorldCom) [<https://perma.cc/4MHB-TMRB>].

54. *See* Cheffins & Armour, *supra* note 27, at 84.

55. *See* Murray, *supra* note 52.

56. Peter Galuszka, *The Activist Era*, NAT. ASSOC. CORP. DIRECTORS DIRECTORSHIP, Mar. 29, 2014, at 34. In 2014 alone, 344 companies worldwide were subject to activist demands. *See* THE VALENCE GRP., *ACTIVIST INVESTING: AN ANNUAL REVIEW OF TRENDS IN SHAREHOLDER ACTIVISM* 8 (Josh Black ed., 2015). The number of demands increased by 18 percent from 2013. *Id.*

their assets under management.⁵⁷ As activist funds continue to grow, they target larger, iconic corporations that were “previously thought invulnerable due to their size.”⁵⁸ For example, hedge fund activists like Carl Icahn, Nelson Peltz, and Bill Ackman are buying ownership in some of America’s largest companies, including Proctor & Gamble, Yahoo!, and Apple, and then lobbying for strategic change.⁵⁹

Moreover, activist campaigns have been increasingly successful.⁶⁰ In 2014 alone, activist demands were met 74 percent of the time.⁶¹ More specifically, when the activists’ goal was to acquire board seats, the demands were met 73 percent of the time, allowing activists to gain board seats at 107 companies.⁶² Contributing to this success is not only the increase in hedge fund capital, but also an increase in support from institutional investors such as mutual funds and pension funds.⁶³ Since large mutual funds are often the biggest stockholders of a corporation, gaining their support puts “activist[s] on the path to victory, while losing it can spell doom.”⁶⁴ With support from institutional investors, activists can purchase a smaller stake in a company, spend less money, and still win.⁶⁵

Opponents of hedge fund activism argue that activists’ growth and increased success rate are hurting both corporate boardrooms and shareholders.⁶⁶ They contend that activists consider only short-term effects on share price, forcing management to ignore the long-term growth of the

57. FTI CONSULTING, THE SHAREHOLDER ACTIVISTS’ VIEW 2 (2015), <http://www.fticonsulting.com/~media/Files/us-files/insights/reports/shareholder-activism-parti.pdf> [https://perma.cc/4XBN-GXNF]. Through the second quarter of 2015, hedge fund activists held over \$120 billion in assets. See Giles Turner, *The Activist Floodgates Are Open*, WALL STREET J. (Aug. 7, 2015, 7:18 PM), <http://blogs.wsj.com/moneybeat/2015/08/07/the-activist-floodgates-are-open-j-p-morgan-says/> [https://perma.cc/SX4H-FV9P].

58. THE VALENCE GRP., *supra* note 56, at 6.

59. David Benoit & Vipal Monga, *Are Activist Investors Helping or Undermining American Companies?*, WALL STREET J. (Oct. 5, 2015, 1:55 PM), <http://www.wsj.com/articles/activist-investors-helping-or-hindering-1444067712/> [https://perma.cc/WC3F-ZY9J]; see also THE VALENCE GRP., *supra* note 56, at 6 (discussing an increase in activist investors’ campaigns against large U.S. companies).

60. THE VALENCE GRP., *supra* note 56, at 6.

61. *See id.* at 9.

62. David Benoit & Kirsten Grind, *Activist Investors’ Secret Ally: Big Mutual Funds*, WALL STREET J. (Aug. 9, 2015, 10:38 PM), <http://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910> [https://perma.cc/VY8R-W2C4]. For 2015, the number of activist campaigns increased to 360, and the board seats won in those campaigns increased to 127. See Benoit, *supra* note 53.

63. See Rose & Sharfman, *supra* note 23, at 1019; Benoit & Grind, *supra* note 62.

64. Benoit & Grind, *supra* note 62. Note that the plaintiffs in the cases discussed in Part II.A and II.C are pension funds.

65. *Id.* Traditionally, a 5 percent ownership stake was the threshold for shareholder activists to be able to influence the target company. MARC ZENNER ET AL., THE ACTIVIST REVOLUTION: UNDERSTANDING & NAVIGATING A NEW WORLD OF HEIGHTENED INVESTOR SCRUTINY 6 (2015). More recently, activists have been successful while owning only less than 1 percent of a target company. *Id.*

66. John Carney, *Welcome to the Golden Age of Activist Investors*, CNBC (Aug. 14, 2013), <http://www.cnbc.com/id/100963166> [https://perma.cc/2UK6-PU9T]; Steve Denning, *The Seven Deadly Sins of Activist Hedge Funds*, FORBES (Feb. 15, 2015), <http://www.forbes.com/sites/stevedenning/2015/02/15/the-seven-deadly-sins-of-activist-hedge-funds/#b2efb2544477> [https://perma.cc/4BPM-QZZT].

company.⁶⁷ “Data show a broad array of companies have been plowing more cash into dividends and stock buybacks, while spending less on investments such as new factories and research and development.”⁶⁸ These commentators further argue that activism “create[s] a massive distraction for managers from the real task of management.”⁶⁹

Activists, on the other hand, are gaining popularity and, according to SEC Chairwoman Mary Jo White, losing their “distinctly negative connotation.”⁷⁰ Supporters of activist investing contend that shareholder activism represents a necessary check on corporate boardrooms and does not promote short-term gains at the expense of long-term performance.⁷¹ Carl Icahn explained that he has, as an activist investor, held many stocks for the long term—in some instances for over thirty years.⁷² He further defended activism by explaining that sometimes the wrong people are running corporations.⁷³ He has argued that his job is to clean up corporate America by removing bad managers and holding CEOs accountable.⁷⁴ Additionally, a recent study revealed that, in most cases, research and development, profits, and capital investment all improved in response to intervention.⁷⁵

3. The Use of Proxy Contests

Activist investors’ approaches to influencing a corporation “range from the relatively benign to extremely hostile.”⁷⁶ One example of the latter is

67. Carney, *supra* note 66; Stephen Foley, *Shareholder Activism: Battle for the Boardroom*, FIN. TIMES (Apr. 23, 2014), <http://www.ft.com/cms/s/2/a555abec-be32-11e3-961f-00144feabdc0.html#axzz3uykqgFpD> [https://perma.cc/V7RA-9AAF].

68. Vipal Monga, David Benoit & Theo Francis, *As Activism Rises, U.S. Firms Spend More on Buybacks than Factories*, WALL STREET J. (May 26, 2015), <http://www.wsj.com/articles/companies-send-more-cash-back-to-shareholders-1432693805> [https://perma.cc/C2BV-88XB].

69. Denning, *supra* note 66.

70. *Corporate Upgraders*, ECONOMIST (Feb. 13, 2014), <http://www.economist.com/news/leaders/21596518-america-should-make-life-easier-not-harder-activist-investors-corporate-upgraders> [https://perma.cc/C68F-MFVS].

71. Benoit & Monga, *supra* note 59; *see also* James Saft, *In Praise of Activist Investment*, REUTERS (Aug. 14, 2013, 4:34 PM), <http://www.reuters.com/article/us-column-activistinvestors-saft-idUSBRE97D17I20130814> (discussing that activists not only create short term gains, but also improve the long term performance of companies they target) [http://perma.cc/CL77-NGJ7].

72. The New York Times Conferences, *DealBook Conference 2015—Activist Investing*, YOUTUBE (Nov. 3, 2015), <https://www.youtube.com/watch?v=Gsn0WVLjpcs> [https://perma.cc/Q7RM-C7A8].

73. *Id.*

74. *Id.*

75. *See An Investor Calls*, ECONOMIST (Feb. 7, 2015), <http://www.economist.com/news/briefing/21642175-sometimes-ill-mannered-speculative-and-wrong-activists-are-rampant-they-will-change-american> [https://perma.cc/544J-A5V5]. A Harvard Law School study focused on the performance of firms targeted by activists in the five-year period after activist intervention. *See* Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1101 (2015). The study found no evidence that activist interventions create short-term gains at the expense of long-term performance. *See id.* at 1117.

76. *See* MARC ZENNER ET AL., *supra* note 65, at 7.

the use of proxy contests as a means of gaining control of the corporate board.⁷⁷ In a proxy contest, an activist shareholder will nominate its own slate of directors to the company's board.⁷⁸ Nominating a new board will allow them to make changes they deem necessary to enhance the value of the company.⁷⁹ Proxy contests also are used in the context of hostile takeovers, as corporate raiders often need to elect a new board of directors whose interest in a merger or acquisition aligns with their own.⁸⁰ Incumbent management often do not want to give up power, however; they "tend to have self-interested motives for maintaining control: they want to retain the private benefits (such as high salaries and perks) that are associated with exercising control."⁸¹ Thus, shareholders, through the use of proxy contests, can facilitate beneficial control changes, even if the incumbent management opposes the change.⁸²

Proxy contests are governed by a combination of federal regulation, state law, and corporate charter and bylaw provisions.⁸³ These rules regulate the disclosure of fraud in proxy solicitation, revocability of proxies, access by shareholders to corporate information, and time and place of shareholder meetings.⁸⁴ Activists have been increasingly successful in winning proxy contests.⁸⁵ As a result of these successes, corporate boards—with the help of lending institutions—increasingly are adopting defense provisions which inhibit shareholders' use of proxy contests to compel changes in a company's corporate structure or board of directors.⁸⁶

B. The Proxy Put Defense Mechanism

Corporate boards use various defense mechanisms both to ward off shareholder activists and to reduce the chances of an activist bringing about a successful proxy contest. This section explains the evolution of the proxy put, an embedded defense mechanism⁸⁷ that has conflicting implications. On the one hand, proxy puts serve as a device to protect creditors and

77. Armour & Cheffins, *supra* note 28, at 257.

78. See Steven Davidoff Solomon, *The Boardroom Strikes Back*, N.Y. TIMES: DEALBOOK (Apr. 21, 2015), <http://www.nytimes.com/2015/04/22/business/dealbook/the-boardroom-strikes-back.html> (describing examples of activist investors using proxy contests for board seats as a means of influencing strategic change at a company) [<http://perma.cc/42XX-R6NP>].

79. *Id.* Activists often seek change in the form of issuing a larger dividend, launching a share buyback program, or spinning off a business line. See Anabtawi & Stout, *supra* note 48, at 1279.

80. See Julian Velasco, *The Enduring Illegitimacy of the Poison Pill*, 27 J. CORP. L. 381, 383–84 (2002).

81. Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1077 (1990).

82. See *id.* at 1077–78.

83. See *id.* at 1082.

84. See *id.*

85. See BRENDAN SHEEHAN, TRENDS IN SHAREHOLDER ACTIVISM 579 (2014), http://ggainc.com/wp-content/uploads/2014/10/Shareholder_activism_October_20141.pdf [<http://perma.cc/9MKK-SS87>].

86. See *infra* Part I.B–C.

87. See *infra* notes 96–98 and accompanying text.

corporations from activist investors. On the other hand, they also serve as a device to entrench management, impede shareholder rights, and limit a board's ability to manage the business and affairs of the corporation. Part I.B.1 addresses poison puts, the antecedent to proxy puts. Part I.B.2 discusses proxy puts, a specific type of poison put. Finally, Part I.B.3 discusses dead hand proxy puts, which add more restrictive language to the traditional proxy puts.

1. Poison Puts

Poison puts—also known as event-risk covenants or change in control covenants—are contractual provisions commonly found in debt instruments.⁸⁸ They provide that, on the occurrence of a triggering event,⁸⁹ some consequential remedy will become available to the debtholders.⁹⁰ In many cases, poison puts are triggered by a change in control.⁹¹ Upon such change, the debtholder has the right, but not the obligation, to require a corporation to pay back the outstanding loan.⁹² Poison put provisions have been coined “unregulable takeover defenses” because they are not governed by shareholder vote.⁹³ Instead, they are subject to the full discretion of the contracting parties.⁹⁴

Poison puts frequently are found in documents governing large bond issuances, however, they are not limited in this respect.⁹⁵ Because these provisions are written into contracts, they are considered “embedded defenses.”⁹⁶ An embedded defense is an action taken by managers for supposed legitimate, nondefensive business reasons, but that also deters tender offers, hostile acquisitions, and activist interventions.⁹⁷ Managers often employ embedded defenses, such as change in control provisions in

88. See FREDERICK L. BERESKIN & HELEN BOWERS, POISON PUTS: CORPORATE GOVERNANCE OR MECHANISM FOR SHIFTING RISK? 1 (2015), <http://irrcinstitute.org/wp-content/uploads/2015/09/FINAL-Poison-Puts-Research-Sept-2015.pdf> [https://perma.cc/T2T6-4NGA].

89. A triggering event could be a change in control of the board of directors, a downgrade in bond rating, or the acquisition of a certain percentage of a corporation's shares. See Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L. REV. 931, 936–37 (1993).

90. See *id.*

91. See BERESKIN & BOWERS, *supra* note 88, at 1.

92. *Id.*

93. *Id.* at 2 (quoting Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 597 (2003)).

94. *Id.*

95. See WHISSEL, *supra* note 18, at 1. Poison puts may also be found in licensing agreements, employment contracts, credit revolvers, and lease agreements. *Id.*

96. Arlen & Talley, *supra* note 93, at 597; see also Guhan Subramanian, *The Emerging Problem of Embedded Defenses: Lessons From Air Line Pilots Ass'n Int'l. v. UAL Corp.*, 120 HARV. L. REV. 1239, 1242–43 (2007) (discussing embedded defenses as an antitakeover defense mechanism).

97. See WHISSEL, *supra* note 18, at 3–4; Arlen & Talley, *supra* note 93, at 597.

debt agreements, to insulate their own positions on the board rather than serve legitimate business purposes.⁹⁸

Debt holders created poison puts during the 1980s to hedge against the risk associated with restructurings, takeovers, and leveraged buyouts.⁹⁹ Bondholders also were interested in using these provisions to limit the risk associated with a decline in bond ratings, or deterioration in a company's financial performance.¹⁰⁰ If a rating agency downgraded a corporation's bonds after a takeover, bonds that were previously investment grade could turn into "speculative grade junk," forcing bondholders to realize an enormous loss.¹⁰¹

The RJR Nabisco leveraged buyout is considered the pivotal transaction in regard to promoting the use of poison puts in debt agreements.¹⁰² Kohlberg Kravis Roberts & Co. (KKR), a large private equity firm, announced that it was considering a leveraged buyout of RJR Nabisco.¹⁰³ As a result, the price of RJR Nabisco's bonds dropped by 20 percent, leaving bondholders facing losses of \$1 billion.¹⁰⁴ The acquisition also put RJR into greater debt and thus increased the chances of default.¹⁰⁵

In the aftermath of the RJR Nabisco buyout, corporate bond investors began to demand increased protection.¹⁰⁶ They became both more aware of, and concerned with, event risk—the risk that bond prices will decline as a result of a change in the capital structure of a firm.¹⁰⁷ In an effort to minimize this risk, banks began to negotiate poison puts into their agreements to prevent investment schemes that would change the capital structure of the firm.¹⁰⁸ Independent of the benefit to bondholders, these provisions were effective in insulating managers against both control change and proxy contests.¹⁰⁹

98. See WHISSEL, *supra* note 18, at 4 (discussing the use of embedded defenses as a management entrenchment device).

99. Steven Davidoff Solomon, *A Defense Against Hostile Takeovers Develops a Downside*, N.Y. TIMES: DEALBOOK (Nov. 25, 2014, 1:55 PM), <http://dealbook.nytimes.com/2014/11/25/a-defense-against-hostile-takeovers-develops-a-downside/> [<https://perma.cc/U8JM-SEV4>]; see also Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 J. FIN. 689, 689 (1991).

100. See Crabbe, *supra* note 99, at 696–97.

101. Kahan & Klausner, *supra* note 89, at 933. Between 1984 and 1988, rating agencies downgraded \$30.79 billion in investment grade bonds to speculative grade. These bonds were associated with capital restructurings. See Crabbe, *supra* note 99, at 689 n.1.

102. See Solomon, *supra* note 99; see also John C. Coffee Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495, 1519–21 (1990) (discussing the RJR Nabisco buyout).

103. See Solomon, *supra* note 99.

104. See Kahan & Klausner, *supra* note 89, at 932.

105. See Solomon, *supra* note 99.

106. See Crabbe, *supra* note 99, at 696–97.

107. See *id.*

108. See *id.*

109. See Kahan & Klausner, *supra* note 89, at 946.

2. Proxy Puts

A proxy put is a specific type of poison put designed to mitigate management's risk against actual or threatened proxy contests.¹¹⁰ While poison puts are triggered by a number of different events, proxy puts are specifically triggered by shareholders' use of a proxy contest to replace a majority of the board of directors.¹¹¹ Proxy puts also are considered "Hostile Control Change Covenants," defined as covenants that protect against a proxy challenge replacing a majority of a firm's directors.¹¹² "The triggering events included in Hostile Control Change Covenants reflect an intent to protect management, however, not bondholders."¹¹³ Commentators argue that these provisions, like traditional poison puts, can serve to entrench incumbent board members to the detriment of shareholders who wish to exercise their right to elect a new board through a proxy contest.¹¹⁴

A proxy put is thus a change in control covenant, often in a loan agreement, which typically gives the lender the right to demand redemption of any or all of the outstanding debt on the occurrence of a fundamental change, or a change in control.¹¹⁵ A change in control generally is defined as an event by which

a majority of the members of the board of directors or other equivalent governing body of the Company cease to be composed of individuals (i) who were members of that board or equivalent governing body on the first day of such period, (ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body or (iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body.¹¹⁶

These provisions make it more difficult for activist shareholders to change a majority of the board, namely because any new director will be considered noncontinuing,¹¹⁷ and if a majority becomes noncontinuing, there is a change in control and the proxy put is triggered.¹¹⁸ Traditional proxy puts allow the incumbent board to approve new directors, effectively rendering

110. See WHISSEL, *supra* note 18, at 2–3.

111. *See id.*

112. See Kahan & Klausner, *supra* note 89, at 952–54; WHISSEL, *supra* note 18, at 3–4.

113. Kahan & Klausner, *supra* note 89, at 953.

114. *See id.*; Solomon, *supra* note 99.

115. See BERESKIN & BOWERS, *supra* note 88, at 1.

116. Davey & Kelly, *supra* note 13 (quoting *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 309 (Del. Ch. 2009)).

117. Continuing directors are those directors who were either in office at the origination of the debt agreement, or, in the case of traditional proxy puts, approved by a majority of the incumbent directors that were in office at the time of the agreement. *See id.*

118. *See id.* The change in control often constitutes an event of default in these debt agreements. *See id.*

them continuing directors. They still, however, deter investors from waging proxy contests out of a fear that the incumbent directors will not approve the new slate.¹¹⁹

Proxy puts serve as a tool for management to ward off shareholder activists' momentum for change.¹²⁰ Activist investors often lobby for board seats, thus implicating the proxy put.¹²¹ In response to the significant growth among these activists, more debt agreements are emerging with proxy put provisions.¹²² Plaintiffs' attorneys argue that the threat of a firm having to refinance its debt as a result of a proxy put being triggered discourages would-be activist investors from engaging with the company.¹²³

The Delaware Chancery Court recently addressed proxy puts, specifically in situations where a shareholder activist buys a significant portion of an underperforming company's shares and then launches a proxy contest to alter the majority of a board of directors.¹²⁴ The court appeared skeptical of proxy puts because of their entrenchment effects, though it has not outlawed their use entirely.¹²⁵ In two recent Delaware cases, analyzed in Part II.A and II.B, the companies' loan agreements included proxy put provisions, which allowed the creditor to require repayment of the companies' outstanding debt if a majority of the boards became noncontinuing.¹²⁶ The proxy put provisions in these Delaware cases allowed the shareholders to elect the new board—through a proxy contest or otherwise—as long as the incumbent board approved the dissident directors.¹²⁷ This is a feature of the traditional proxy put that has been eliminated in some credit agreements, the result of which creates a dead hand feature.¹²⁸

119. Liz Hoffman, *Banks Feel the Heat from Lawsuits*, WALL STREET J. (Apr. 28, 2015, 6:14 PM), <http://www.wsj.com/articles/banks-feel-the-heat-from-lawsuits-1430259260?alg=y> [<https://perma.cc/HF5L-264U>].

120. See Solomon, *supra* note 99; *supra* Part I.A.2.

121. See WHISSEL, *supra* note 18, at 5–7 (discussing the *Amylin* case, where activist investors Icahn and Eastbourne nominated a slate of directors who, if elected, would trigger the proxy put).

122. See Hoffman, *supra* note 119.

123. *Id.*

124. See generally *Kallick v. Sandridge Energy, Inc.*, 68 A.3d 242 (Del. Ch. 2013); *San Antonio Fire & Police Pension Fund v. Amylin Pharm.*, 983 A.2d 304 (Del. Ch. 2009); Transcript of Oral Argument, *supra* note 15.

125. See *Amylin*, 983 A.2d at 315; see also *Kallick*, 68 A.3d at 248 (stating that, given the proxy put's blatant entrenchment function, one would hope that the company not only put up a hard bargain, but also receive a clear economic advantage in exchange for the provisions).

126. See *infra* Part II.A–B. If a majority of the board became noncontinuing, and the lender chose to accelerate the debt under the agreement, the company would face disastrous financial results as it attempted to refinance. See Camisha L. Simmons, *Lenders & Directors Beware of the Dead-Hand Proxy Put*, AM. BANKR. INST. J., <http://nebula.wsimg.com/ac72391defcee29e597411f804d4c272?AccessKeyId=3B39241A60E84B884186&disposition=0&alloworigin=1> (last visited Apr. 29, 2016) [<https://perma.cc/6UFB-9H8V>].

127. See *infra* Part II.A–B.

128. See Simmons, *supra* note 126.

3. Dead Hand Proxy Puts

Both commentators and the Delaware Chancery Court have criticized a particular type of proxy put: the dead hand proxy put.¹²⁹ This is because these provisions prevent the incumbent board from neutralizing the put even if they approve the dissident slate of directors.¹³⁰ In other words, regardless of the incumbent board's approval of new directors, the new slate will still be considered "noncontinuing"; thus the debtholder will have the right to require the borrower to repurchase the debt.¹³¹ The language in these provisions makes it nearly impossible for shareholders to change the board of directors without triggering the proxy put.¹³²

Dead hand proxy puts and traditional proxy puts generally define a change in control the same way.¹³³ However, the following parenthetical is added to the traditional language:

[E]xcluding, in the case of both clause (ii) and clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors.¹³⁴

These provisions exclude from the definition of "continuing director" those whose nomination or assumption of office resulted from a proxy contest.¹³⁵ This type of dead hand proxy put thus hinders the shareholders from removing current board members and nominating a new slate of directors through a proxy contest.¹³⁶

As with traditional proxy puts, dead hand proxy puts also have become more important to corporations and creditors in light of the current wave of shareholder activism.¹³⁷ Plaintiffs' attorneys and other opponents of these provisions argue that they serve as an entrenchment mechanism for management and a restraint on the stockholder franchise.¹³⁸ Nevertheless, proponents of the dead hand feature argue that they are necessary for the

129. See generally Transcript of Oral Argument, *supra* note 15. See also *infra* Part II.

130. Simmons, *supra* note 126.

131. *Id.*

132. See F. William Reindel et al., *Dead Hand Proxy Puts: What You Need to Know*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 10, 2015), <http://corpgov.law.harvard.edu/2015/06/10/dead-hand-proxy-puts-what-you-need-to-know/> [<https://perma.cc/99JA-FYFR>].

133. See *supra* note 116 and accompanying text.

134. Davey & Kelly, *supra* note 13 (quoting *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 309 (Del. Ch. 2009)).

135. See Simmons, *supra* note 126.

136. See *id.*

137. Hoffman, *supra* note 119.

138. See generally Verified Class Action Complaint, *Stein v. Curtiss-Wright Corp.*, No. 11352 (Del. Ch. Jul 30, 2015); WHISSEL, *supra* note 18, at 3.

proxy put to be effective.¹³⁹ Further, they contend that the dead hand proxy put serves a legitimate business interest, namely protecting creditors.¹⁴⁰

C. *The Poison Pill Defense Mechanism*

In addition to the use of proxy puts, boards also adopt poison pill provisions as a means to defend against unwanted change and hostile takeovers. These provisions, like proxy puts, have developed over time to include a dead hand feature. Dead hand poison pills and dead hand proxy puts have strikingly similar effects on both corporate boards and shareholders.¹⁴¹ Part I.C.1 provides a background on poison pills—which are currently legal in Delaware—while Part I.C.2 discusses dead hand and no hand poison pills, which the Delaware courts have outlawed.

1. Poison Pills

During the 1980s, corporations developed defenses specifically designed to ward off hostile takeovers.¹⁴² Poison pills are shareholder rights plans¹⁴³ intended to make hostile takeovers difficult for the acquirer, “either by making the acquisition poisonously expensive or by placing a bidder in a lesser position vis-à-vis the other shareholders.”¹⁴⁴ While in place, the poison pill is an insurmountable barrier to a hostile takeover.¹⁴⁵ Poison pills can be implemented easily without a shareholder vote, and “[t]he only way to counter a poison pill is to have it removed.”¹⁴⁶

A board usually will adopt poison pills in an amendment to the company’s bylaws.¹⁴⁷ The terms of the poison pill generally authorize the creation of new securities and “[r]ights to purchase those securities.”¹⁴⁸ Both of these poison pills serve to dilute the value of the investment; therefore, “acquirers are careful to avoid ‘swallowing’ the poison pill.”¹⁴⁹

139. See Reindel et al., *supra* note 132; see also Kevin Miller, *Food for Thought: Conflicting Views on the “Knowing Participation” Element of Aiding & Abetting Claims*, 9 DEAL LAW. 1, 1 (2015) (discussing the need for proxy puts to protect creditors).

140. See Hoffman, *supra* note 119; see also Part II.D.2 (discussing arguments in favor of the use of dead hand proxy puts to protect creditors).

141. See *infra* Part III.

142. PATRICK A. GAUGHAN, *MERGERS, ACQUISITIONS, AND CORPORATE RESTRUCTURING* 153–54 (4th ed. 2007).

143. Poison pills are referred to as shareholder rights plans because the purpose of the poison pill device is to distribute rights to shareholders, entitling them to purchase stock or other securities upon a triggering event. See JAMES D. COX & THOMAS LEE HAZEN, *CORPORATE COUNSEL GUIDES: CORPORATION LAW* § 23:7 (2012).

144. *The Targets Strategy in a Multistep Acquisition*, in *CORPORATE ACQUISITIONS, MERGERS, AND DIVESTITURES* § 10:46 (2015).

145. See Velasco, *supra* note 80, at 382.

146. *Id.*

147. Charles M. Yablon, *Poison Pills & Litigation Uncertainty*, 1989 DUKE L.J. 54, 58.

148. *Id.* At the time the board adopts the shareholder rights plan, the rights lack economic value and are not exercisable until the occurrence of a specified triggering event, such as a merger or takeover. See Suzanne S. Dawson, Robert J. Pence & David S. Stone, *Poison Pill Defensive Measures*, 42 BUS. LAW. 423, 423–24 (1987).

149. Jordan M. Barry & John William Hatfield, *Pills & Partisans: Understanding Takeover Defenses*, 160 U. PA. L. REV. 633, 642–43 (2012).

Generally, poison pills contain a provision that allows for the board of directors to redeem the pill.¹⁵⁰ If the board redeems the pill, the acquirer is able to go through with the takeover without triggering the pill's negative consequences.¹⁵¹ If, however, the board will not redeem the pill, the acquirer likely will attempt to replace a majority of the board through a proxy contest.¹⁵² If successful, the new board will redeem the pill, and the acquisition will occur without the dilutive effects of the poison pill being triggered.¹⁵³

The Delaware Supreme Court upheld the validity of the poison pill in *Moran v. Household International, Inc.*¹⁵⁴ Fearing a leveraged buyout, Household International, Inc. amended its bylaws to include a shareholder rights plan "as a preventive mechanism to ward off future advances."¹⁵⁵ The *Moran* court concluded that DGCL section 157 provides sufficient authority for the board to adopt the rights plan.¹⁵⁶ Specifically, section 157 provides the power to issue rights to purchase shares of capital stock.¹⁵⁷ Moreover, the court found that the rights plan did not limit the voting power of individual shareholders and had only a minimal effect on proxy contests.¹⁵⁸

2. Dead Hand Poison Pills and No Hand Poison Pills

As discussed above, a potential acquirer can wage a proxy contest to elect a new board that is willing to redeem a poison pill, thus avoiding the pill's negative effects.¹⁵⁹ To prevent such an election, boards gradually altered poison pill provisions to create "dead hand" and "no hand" poison pills.¹⁶⁰ A dead hand provision requires that the poison pill be redeemed only by "continuing directors," defined as directors who were in place at the

150. See Dawson et al., *supra* note 148, at 427.

151. Barry & Hatfield, *supra* note 149, at 644.

152. See *id.*

153. See *id.*

154. 500 A.2d 1346 (Del. 1985). Household International was a diversified holding company with subsidiaries in the financial services, transportation, and merchandising industries. See *id.* at 1349.

155. *Id.* The rights plan provided that Household common stockholders were entitled to the issuance of one right per common share if certain triggering events occurred. See *id.* at 1348. There were two triggering events written into the plan: the announcement of a tender offer for 30 percent of Household's shares and the acquisition of 20 percent of Household's shares. See *id.*

156. *Id.* at 1353. In addition to finding authority under section 157, the court also found that the board had inherent authority, under DGCL section 141(a), to manage the corporation's business and affairs. *Id.*

157. DEL. CODE ANN. tit. 8, § 157(a) (2011).

158. See *Moran*, 500 A.2d at 1355. The court explained that, despite the poison pill, shareholders could still make a tender offer and bring a proxy contest. They might do this by making the tender offer conditional on the rights being redeemed, or by forming a group to purchase only 19.9 percent of the shares and solicit proxies for consent to remove the board and redeem the rights. *Id.* at 1354.

159. See *supra* Part I.C.1.

160. Peter V. Letsou, *Are Dead Hand (and No Hand) Poison Pills Really Dead?*, 68 U. CIN. L. REV. 1101, 1112-14 (2000); COX & HAZEN, *supra* note 143, § 23:7.

time the pill was adopted, or are supported by those directors.¹⁶¹ A no hand provision limits the board's ability to redeem the pill once a majority of the board has been replaced.¹⁶² These provisions provide that even successful proxy contests, which replace an incumbent board with a new slate of directors, will not prevent the pill from being triggered.¹⁶³

The dead hand poison pill makes it even more difficult—indeed nearly impossible—to use a proxy contest to gain control of the corporation's board for the purpose of redeeming the pill.¹⁶⁴ In a takeover scenario, an acquirer often tenders an offer to buy the outstanding shares of the target and initiates a proxy contest to nominate a slate of directors who will redeem the pill.¹⁶⁵ With dead hand poison pills, electing a new slate of directors will automatically trigger the poison pill because only continuing directors may redeem the rights plan.¹⁶⁶ Thus, where there is a dead hand poison pill, shareholders are less likely to initiate proxy contests to elect new board members.

In *Carmody v. Toll Bros., Inc.*,¹⁶⁷ the Delaware Chancery Court considered whether dead hand poison pills were subject to legal challenge on the basis that they violated the DGCL and the fiduciary duties of the board of directors.¹⁶⁸ The court ultimately denied the defendants' motion to dismiss, finding that the dead hand rights plan was subject to legal challenge on both statutory and fiduciary duty grounds.¹⁶⁹

The Toll Brothers rights plan was adopted as a preemptive defensive mechanism, in that it was not in response to any specific threat.¹⁷⁰ What distinguished the Toll Brothers rights plan from traditional poison pills was a dead hand feature, which provided that “it authorizes only a specific, defined category of directors—the ‘Continuing Directors’—to redeem the Rights.”¹⁷¹

The court first concluded that the statutory claims were legally cognizable on the grounds that they may have the effect of limiting the board's power conferred by DGCL section 141(a), which authorizes the board to manage the business and affairs of the corporation.¹⁷² The court referred to a New York Supreme Court case,¹⁷³ which invalidated a similar continuing director provision, on the basis that it “effectively limits the

161. Letsou, *supra* note 160, at 1103; Velasco, *supra* note 80, at 383–84.

162. *See* Letsou, *supra* note 160, at 1103.

163. *See id.* at 1114.

164. *Id.* at 1101–02.

165. *See id.* at 1101.

166. *See id.*

167. 723 A.2d 1180 (Del. Ch. 1998).

168. *See id.* at 1182.

169. *See id.* at 1184–85. The motion did not focus on whether the rights plan was invalid, but rather on whether the complaint stated a legally cognizable claim for invalidity. *Id.*

170. *See id.* at 1183.

171. *Id.* at 1184.

172. DEL. CODE ANN. tit. 8, § 141(a) (2011). The statute states that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors.” *Id.*

173. *Bank of N.Y. Co. v. Irving Bank Corp.*, 528 N.Y.S.2d 482 (Sup. Ct. 1988).

powers of the future board.”¹⁷⁴ Specifically, even if the stockholders properly elect a new board but the incumbent board does not approve the directors, the future board may not redeem the shares.¹⁷⁵

The Chancery Court considered whether the plaintiffs had a valid claim for breach of the duty of loyalty¹⁷⁶ based on (1) the disenfranchisement of shareholders’ rights and (2) the reasonableness of the adopted dead hand defense mechanism.¹⁷⁷ The complaint alleged that the dead hand provision “purposefully disenfranchises the company’s shareholders without any compelling justification” because the shareholders would be powerless to elect a new board that would be willing and able to redeem the poison pill and accept the bid.¹⁷⁸ The court determined, while avoiding the merits, that the complaint stated legally cognizable claims, in turn making it clear that the adoption of the defensive mechanism could be coercive under Delaware law and may represent a breach of statutory and fiduciary duties of the Toll Brothers board.¹⁷⁹

The Delaware Supreme Court in *Quickturn Design Systems v. Shapiro*¹⁸⁰ explicitly reinforced the *Toll Bros.* ruling. Indeed, it went one step further and openly invalidated the use of dead hand and no hand poison pill provisions.¹⁸¹ In *Quickturn*, Mentor Graphics Corp., the hostile bidder, wanted to acquire Quickturn, a publically traded company whose business competed with Mentor’s.¹⁸² Mentor announced a tender offer for all outstanding common shares of Quickturn and also announced that it intended to solicit proxies to replace Quickturn’s board.¹⁸³

Shortly after Mentor’s announcement, Quickturn amended its rights plan to include a no hand, or delayed redemption, provision.¹⁸⁴ “The [d]elayed [r]edemption [p]rovision provide[d] that, if a majority of the directors are replaced by stockholder action, the newly elected board cannot redeem the rights for six months if the purpose or effect of the redemption would be to facilitate a transaction with an [i]nterested [p]erson.”¹⁸⁵

The Delaware Supreme Court concluded that the delayed redemption plan was invalid because, similar to the dead hand poison pill, it deprived a newly elected slate of directors from fulfilling its statutory duty to manage

174. *Toll Bros.*, 723 A.2d at 1191 (quoting *Irving Bank Corp.*, 528 N.Y.S.2d at 484).

175. *See id.*

176. The duty of loyalty requires an undivided and unselfish loyalty to the corporation and shareholders and demands that any director not only protect the corporations’ interests, but also refrain from harming the corporation or its shareholders. Satisfying the duty of loyalty requires a director to put the interests of the corporation and stockholders before his or her private interests. *See* Randy J. Holland, Distinguished Jurist Lecture, *Delaware Directors’ Fiduciary Duties: The Focus on Loyalty*, 11 U. PA. J. BUS. L. 675, 683 (2009).

177. *See Toll Bros.*, 723 A.2d at 1189–90.

178. *Id.* at 1193.

179. *Id.* at 1182.

180. 721 A.2d 1281 (Del. 1998).

181. *Id.* at 1292.

182. *See id.* at 1283.

183. *See id.* at 1285.

184. *See id.* at 1289.

185. *Id.* An interested person is defined as “a party that ‘directly or indirectly proposed, nominated or financially supported’ the election of the new board.” *Id.* at 1290.

the corporation under section 141(a), in addition to its fiduciary duties to shareholders.¹⁸⁶ Specifically, the court focused on section 141(a), finding the delayed redemption provision invalid because it prevented the newly elected board from having full discretion “to manage and direct the business and affairs of a Delaware corporation.”¹⁸⁷

Moreover, the delayed redemption plan limited the directors’ decisions regarding management and prevented the new board from redeeming the rights plan “to facilitate a transaction that would serve the stockholders best interests, even under circumstances where the board would be required to do so because of its fiduciary duty to the Quickturn stockholders.”¹⁸⁸ As a result, the Delaware Supreme Court invalidated the use of no hand delayed redemption provisions, stating that no defensive measure that inhibits a board from discharging its fiduciary duties can be sustained.¹⁸⁹

II. DEAD HAND PROXY PUTS POPPING UP IN DELAWARE

Part II addresses the current litigation in the Delaware courts surrounding the use of both proxy puts and dead hand proxy puts. Part II.A and II.B provide an analysis of two recent cases involving traditional proxy puts. Part II.C then discusses the most recent case, which involves the use of a dead hand proxy put. Finally, Part II.D provides a discussion of the debate regarding the legitimacy of these provisions, considering their effects on stockholders, creditors, and management.

A. *Reluctant Acceptance in San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*

In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, Amylin Pharmaceuticals faced a proxy contest initiated by two investors seeking to replace a majority of the board of directors.¹⁹⁰ The change in the majority of the board, without the current board’s approval, would trigger financially harmful provisions in Amylin’s indenture and credit agreement.¹⁹¹ The issue in this case was “whether a commonplace provision found in a trust indenture governing publically traded notes prevents the issuer’s board of directors from ‘approving’ as ‘continuing directors’ persons nominated by stockholders in opposition to the slate nominated by the incumbent directors.”¹⁹²

186. *See id.* at 1291–92.

187. *Id.* at 1292.

188. *Id.* at 1292–93.

189. *Id.* at 1293.

190. *See San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304, 307 (Del. Ch. 2009); *supra* note 8 and accompanying text.

191. *Amylin*, 983 A.2d at 306–07.

192. *Id.* at 306.

1. The Proxy Put Provisions

The suit in *Amylin* arose out of a change in control provision in a 2007 note indenture adopted by the board.¹⁹³ This indenture provided that noteholders have the right to redeem any or all of their notes at face value upon the occurrence of a “[f]undamental [c]hange.”¹⁹⁴ It further defined a fundamental change as occurring if “at any time the [c]ontinuing [d]irectors do not constitute a majority of the [c]ompany’s [b]oard of [d]irectors.”¹⁹⁵ At the time of the suit, the board was composed of twelve continuing directors.¹⁹⁶ The indenture agreement did allow for new directors to become continuing if approved by the incumbent board and did not explicitly contain dead hand language. However, the indenture trustee argued for a reading with that effect.¹⁹⁷

Amylin’s credit agreement also contained a continuing director’s provision.¹⁹⁸ In this agreement, a change in control¹⁹⁹ triggered an event of default, which accelerated the debt unless the provision was waived.²⁰⁰ The change in control provision allowed for a change in the board’s composition if the incumbent board approved them, unless the new nomination resulted from an actual or threatened proxy contest.²⁰¹ If both provisions were triggered—those in the indenture and credit agreement—Amylin would be forced to repay up to \$915 million immediately.²⁰²

2. The Proxy Contest

The change in control provisions in the indenture and credit agreement came to the attention of the shareholders in 2009, when Icahn Partners LP, owner of 8.8 percent of outstanding Amylin shares, notified the company that it would be nominating a slate of five directors.²⁰³ At the same time, Eastbourne Capital, owner of 12.5 percent of Amylin’s shares, notified the

193. *Id.* at 307; see also *Icahn, Amylin and the New Nuances of Activist Investing*, *supra* note 6 (explaining the facts giving rise to the lawsuit against Amylin).

194. *Amylin*, 983 A.2d at 307–08.

195. *Id.* Section 1.01 of the indenture defined continuing directors as:

- (i) individuals who on the [i]ssue [d]ate constituted the [b]oard of [d]irectors and
- (ii) any new directors whose election to the [b]oard of [d]irectors or whose nomination for election by the stockholders of the [c]ompany was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the [i]ssue [d]ate or whose election or nomination for election was previously so approved.

Id.

196. *Id.*

197. *Id.* at 314–15.

198. See *id.* at 308–09.

199. See *supra* notes 116, 134 and accompanying text for the exact wording in the credit agreement.

200. *Amylin*, 983 A.2d at 308.

201. See *id.* While not defined as such in the *Amylin* case, by the nature of its terms, this provision was a dead hand proxy put.

202. *Id.* at 310 n.7.

203. *Id.* at 309. This nomination alone would not trigger the provisions because a change of five directors would still leave the majority of the board continuing. *Id.*

company of its intent to nominate another five directors.²⁰⁴ If ten new directors were elected to the board, the provisions in both agreements would be triggered, and the lenders would have the right to recall the debt.²⁰⁵ Eastbourne questioned the legitimacy of the provisions and requested that the board “remove any obstacle to the operation of the stockholder franchise, including ‘approving’ the dissident slates for purposes of the 2007 [n]otes and obtaining any necessary consents or waivers from the lenders under the [c]redit [a]greement.”²⁰⁶

3. The Chancery Court Decision

The San Antonio Fire & Police Pension Fund (SAFPPF), an owner of shares in Amylin, filed a class action suit against the company and its individual directors.²⁰⁷ The claims against Amylin included: (1) breaches of the fiduciary duties of care and loyalty by adopting the credit agreement and indentures, (2) breaches of the fiduciary duties of care and loyalty by failing to approve the nominated slate of directors, and (3) breaches of the fiduciary duties of care and loyalty in disclosing the risks presented by the continuing directors provisions in Amylin’s annual report.²⁰⁸ SAFPPF had also brought suit against Bank of America, the underwriter of the credit agreement, for aiding and abetting the breach of fiduciary duties.²⁰⁹ The court recognized the restrictive nature of the language in the credit agreement, which specifically excluded approval for directors appointed through a proxy contest.²¹⁰ However, because the claims were settled out of court through an agreement between Amylin and Bank of America, the court did not provide a remedy for the credit agreement’s dead hand provisions.²¹¹

The Chancery Court then addressed whether the Amylin board had both the power and right, under the indenture, to approve the dissident slate of directors.²¹² The Chancery Court ultimately concluded that, regardless of whether the Amylin board endorsed or recommended the dissident slate of directors, the board retained the power to approve them.²¹³ Thus, it held that the board may approve the nominated directors, while simultaneously supporting and endorsing their own slate.²¹⁴ The court proclaimed that the board has the right to approve the stockholder nominees if the board

204. *Id.*

205. *See id.* at 309–10.

206. *Id.* at 310.

207. *Id.*

208. *Id.* The parties decided to settle some of the claims outside of court. As part of these settlement negotiations, Eastbourne and Icahn agreed to reduce the number of nominated directors. As a result, no more than five stockholder-nominated directors would have been elected. With less than a majority of the board changing, the continuing director provisions would not be triggered. *Id.*

209. *Id.* at 311.

210. *Id.*

211. Davey & Kelly, *supra* note 13.

212. *Amylin*, 938 A.2d at 312.

213. *Id.* at 314.

214. *Id.*

determines, in good faith, that the newly approved directors would not materially harm the company.²¹⁵

Thus, the court rejected the indenture trustee's interpretation, which would have denied the incumbent board the flexibility of approving the slate of new directors without endorsing them. This interpretation of the provision would have effectively written in dead hand language that would prohibit any change in the majority of the board as a result of any contested elections for the life of the indenture agreement. The court recognized that preventing any election of stockholder nominees resulting from a proxy contest might serve as a prohibited entrenchment mechanism for the incumbent board.²¹⁶

The Chancery Court expressed skepticism toward indentures that do not allow the current board to both approve the new directors and stop the proxy put from being triggered.²¹⁷ It stated, "Provision[s] so strongly in derogation of the stockholders' franchise rights would likely put the trustee and noteholders on constructive notice of the possibility of its ultimate unenforceability."²¹⁸ The court also noted that if such a constricting provision did exist, the board would need to prove that, in exchange, it was obtaining extraordinary economic value for the corporation that was otherwise unavailable.²¹⁹ The *Amylin* court suggested that provisions with such "eviscerating effect[s] on the stockholder franchise" might raise serious concerns regarding the board's exercise of its fiduciary duties, as well as the degree to which the provision might be unenforceable as against public policy.²²⁰

Thus, the Chancery Court did not outlaw proxy puts or continuing director provisions in *Amylin*. However, the court was highly skeptical of those provisions that would leave the board without the ability to prevent the triggering of a proxy put.²²¹ The court interpreted the indenture to avoid such a restrictive view of the board's ability to approve a new slate of directors.²²² Moreover, the court put borrowers and lenders on notice that provisions with restrictive dead hand features may, ultimately, be unenforceable.²²³

*B. Requiring Substantial Risk:
Kallick v. Sandridge Energy, Inc.*

*Kallick v. Sandridge Energy, Inc.*²²⁴ also involved a proxy contest to change the makeup of the board of directors of Sandridge Energy.²²⁵ TPG-

215. *Id.* at 313. At this stage in the suit, the *Amylin* board had already agreed to approve the dissident slate of directors, as long as the court allowed it to do so. *Id.*

216. *Id.* at 314–15.

217. *Id.*

218. *Id.* at 315 n.32.

219. *Id.* at 315.

220. *Id.*

221. *Id.*

222. *Id.*

223. *Id.*

224. 68 A.3d 242 (Del. Ch. 2013).

Axon, a hedge fund holding 7 percent of Sandridge shares, wished to de-stagger the Sandridge board.²²⁶ Gerald Kallick, another Sandridge shareholder, supported the TPG-Axon proxy solicitation and brought claims alleging breach of fiduciary duty against the Sandridge board.²²⁷ The issue in this case, again, arose out of a proxy put that would be triggered if a majority of Sandridge's board changed.²²⁸ If the shareholders chose to elect a new slate of directors, the proxy put would cause \$4.3 billion worth of Sandridge notes to become due.²²⁹ At the time of the litigation, the incumbent board had left the slate of directors nominated by TPG-Axon unapproved and took the position that even if the debt came due, Sandridge's financial position would not be jeopardized.²³⁰

1. The Proxy Put Provision

The Sandridge note indentures included a change of control provision, which, when triggered, would require Sandridge to offer to repurchase its existing debt.²³¹ This provision, although entrenching on the board if they refused to approve the new slate of directors, did not contain a dead hand feature. As a result, the incumbent board had the ability to “neutralize the effect of the [p]roxy [p]ut by ‘approving’ the TPG-Axon slate of directors, in accordance with the terms of the indentures.”²³²

225. *Id.* at 244.

226. *Id.* The staggered board was implemented via the company's bylaws. Therefore, it could be changed by stockholder vote. *Id.* A staggered board “is a governance practice in which only a fraction (typically a third) of the members of the board of directors is elected each year, rather than all at once.” *Definition of Staggered Board*, FIN. TIMES, <http://lexicon.ft.com/Term?term=staggered-board> (last visited Apr. 29, 2015) [<https://perma.cc/M4EE-VQNX>]. Staggered boards are known as a takeover defense mechanism because they increase the amount of time a hostile bidder has to wait to replace a majority of the board. *See id.*

227. *Kallick*, 68 A.3d at 245.

228. *Id.* at 244.

229. *Id.* at 245.

230. *Id.* Originally, the incumbent board warned shareholders that triggering the proxy put was risky. *See id.* However, the board then claimed that, because the notes were trading above the repurchase price set in the indenture, debtholders were not likely to require payment at a below-market price. *See id.*

231. *Id.* at 244. The notes state that a change in control occurs if, during any period of two consecutive years, individuals who at the beginning of such period constituted the [b]oard of [d]irectors of the [c]ompany or any [s]uccessor [p]arent (together with any new directors whose election to such board or whose nomination for election by the stockholders of the [c]ompany or any [s]uccessor [p]arent, as the case may be, was approved by a vote of 66 2/3% of the directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved), cease for any reason to constitute a majority of such [b]oard of [d]irectors then in office.

Id. at 250 (emphasis omitted).

232. *Id.*

2. The Proxy Contest

The proxy put came to the attention of stockholders after TPG-Axon filed its preliminary consent solicitation statement.²³³ TPG-Axon initiated the solicitation after a disappointing performance following the company's initial public offering.²³⁴ TPG-Axon demanded that the board be declassified and that it investigate alternative strategies intended to maximize shareholder value.²³⁵ The Sandridge board warned the stockholders that under the terms of its senior notes, any change in control would require the company to pay back its outstanding debt.²³⁶

3. The Chancery Court Decision

Kallick, favoring the change requested by TPG-Axon, brought suit and argued that the board breached its fiduciary duties in refusing to approve the slate nominated by TPG.²³⁷ The Chancery Court applied the intermediate standard of review expressed in *Unocal Corp. v. Mesa Petroleum Co.*²³⁸ This standard in effect removes director self-interest from the equation, because the board is required to justify their actions as reasonable.²³⁹ The incumbent board argued that the business judgment rule should apply to its decision not to approve the board of directors.²⁴⁰ The court, however, found that in "situations where board[s] of directors make decisions that

233. *Id.* A consent solicitation is a statement mailed to shareholders, in lieu of an annual meeting, asking them to vote for a specific change to the company. DEL. CODE ANN. tit. 8, § 211(b) (2011). TPG-Axon's consent solicitation, in this case, requested that shareholders send back the consent card in favor of its proposal to amend the company's bylaws and replace the entire board with a new slate of qualified directors. See Martinne Geller, *UPDATE 2-TPG-Axon Moves Ahead with Plan to Oust SandRidge Board*, CHI. TRIB.: REUTERS (Dec. 24, 2012), http://articles.chicagotribune.com/2012-12-24/news/sns-rt-tpg-axon-sandridgeboard-update-211e8no4hg-20121224_1_sandridge-energy-tpg-axon-sandridge-shares [https://perma.cc/84YW-VADU].

234. *Kallick*, 68 A.3d at 249.

235. *Id.*

236. *Id.* at 250.

237. *Id.* at 245.

238. 493 A.2d 946 (1985). In *Unocal*, the Delaware Supreme Court held that, in the context of takeovers, the business judgment rule does not apply to a board's decision "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interest, rather than those of the corporation." *Id.* at 954. Instead, the court should apply a heightened standard, which involves a two-part test. First, the directors must show that they had reasonable grounds for believing that a threat to the corporation existed. *Id.* Next, the board must show that the defensive measure adopted was reasonable in relation to the threat posed. *Id.* at 955.

239. *Kallick*, 68 A.3d at 259. Kallick argued for the *Blasius* standard of review, which requires greater scrutiny than *Unocal*. See *id.* at 258. The court rejected this argument because the board's refusal to accept the new slate of directors was not "taken for the sole or primary purpose of thwarting a shareholder vote." *Id.* (citing *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988)). The *Blasius* standard of review requires the board to demonstrate a compelling justification for its actions. See *Blasius*, 564 A.2d at 661; Stephen Byeff, Note, *The Spirit of Blasius: Sandridge As an Antidote to the Poison Put*, 115 COLUM. L. REV. 375, 409–15 (2015) (arguing that the Chancery Court should have applied the *Blasius* standard of review).

240. *Kallick*, 68 A.3d at 257.

have clear implications for their continued control,” *Unocal* applies as an “equitable tool[] to protect stockholders against unreasonable director action that has a defensive or entrenching effect.”²⁴¹

Applying *Unocal*, the Chancery Court held that the Sandridge board failed to provide a reasonable justification for refusing to approve the board; therefore, the incumbent board’s actions represented a violation of its fiduciary duty of loyalty.²⁴² The court found that, consistent with *Amylin*, a board violates its fiduciary duties when it fails to approve a dissident slate simply because it is running against the incumbent board.²⁴³ The board must uphold the duty of loyalty and decline to approve a nominated slate of directors only if those candidates would pose “a material threat of harm to the corporation.”²⁴⁴ Here, the incumbent board could not identify a substantial risk in approving the nominated board, and approving the directors would not have been a breach of a contractual duty of good faith and fair dealing to creditors.²⁴⁵ As a result, the court held that the incumbent board was obliged to approve the new directors, regardless of its opinion that they were not as qualified.²⁴⁶ In other words, the board’s decision could not rest on the idea that “[they] are better than the new guys and gals, so keep [them] in office.”²⁴⁷

The Chancery Court’s decision in *Sandridge* reaffirms the standard of review for directors’ actions in contests for corporate control, while also providing that a board of directors has an affirmative fiduciary duty to neutralize a proxy put, unless doing so would pose a substantial risk to the company or its creditors.²⁴⁸ The Chancery Court also noted its concern, as it did in *Amylin*, with directors receiving substantial economic value for putting these provisions into credit agreements and suggested that independent directors should police their use to mitigate their entrenching effects.

C. A Figurative Sword of Damocles:

Pontiac General Employees Retirement System v. Ballantine

The most recent discussion of dead hand proxy puts emerged in *Pontiac General Employees Retirement System v. Ballantine*²⁴⁹ (*Healthways*). The case arose out of a loan agreement between Healthways, Inc. and SunTrust

241. *Id.* at 258 (citing *Unocal*, 493 A.2d at 954–55).

242. *Id.*

243. *Id.* at 246.

244. *Id.*

245. *Id.*

246. *Id.* at 260–61.

247. *Id.* at 255.

248. *See id.* at 260–61. The court recognized that it should take into account, in a limited fashion, the effect that approving the slate of directors would have on creditors. *See id.* at 260. However, the directors were under no obligation to place a greater emphasis on creditors’ interests when deciding whether to approve the directors for purposes of the proxy put. *See id.* at 260 n.95.

249. No. 9789-VCL (Del. Ch. Oct. 14, 2014). Although the court denied the defendants’ motion to dismiss, the parties ultimately settled the case out of court. *See Simmons, supra* note 126.

Bank.²⁵⁰ The agreement originally contained a continuing director proxy put, with no dead hand feature.²⁵¹ Under this agreement, the incumbent board had the ability to approve a dissident slate of directors to prevent the acceleration of the outstanding debt with SunTrust.²⁵² After stockholders pressured Healthways to declassify its board, but before a proxy contest was threatened or initiated, the board and SunTrust amended the loan agreement to contain a dead hand feature.²⁵³ Healthways continued to face stockholder dissatisfaction, and North Tide Capital, owner of 11 percent of Healthways, expressed its intent to wage a proxy contest to gain representation on the board.²⁵⁴ Shortly thereafter, Pontiac General Employees Retirement System (PGER), a beneficial owner of Healthways, made a 220 demand²⁵⁵ to inspect the company's books and records and found nothing to suggest that Healthways received "extraordinarily valuable economic benefits" that might justify the proxy put.²⁵⁶

1. The Dead Hand Proxy Put

PGER then challenged the change in control provision in the 2012 amended agreement,²⁵⁷ which included dead hand language meant to prevent a change in control resulting from proxy solicitations.²⁵⁸ The

250. See Simmons, *supra* note 126; see also Davey & Kelly, *supra* note 13 (explaining the agreement between Healthways and SunTrust).

251. Transcript of Oral Argument, *supra* note 15, at 69–70.

252. *Id.* at 30–31 (discussing the additional amendment, which added the dead hand language to the agreement).

253. *Id.* at 68–69.

254. *Id.* at 70–71. North Tide ultimately came to a resolution with Healthways and gained board seats without waging the proxy contest. *Id.* Therefore, this appointment did not trigger the dead hand provision of the proxy put.

255. DGCL section 220 provides that any stockholder, upon stating his or her proper purpose, has a right to inspect the books and records of the corporation. See DEL. CODE ANN. tit. 8, § 220 (2011).

256. Transcript of Oral Argument, *supra* note 15, at 71.

257. "Change in control" is triggered in the 2012 loan agreement by a number of different events, including when, "during [a] period of 24 consecutive months, a majority of the members of the board of directors . . . of the [b]orrower cease to be composed of individuals who are [c]ontinuing [d]irectors." *Id.* at 6.

258. *Id.* The dead hand language appears in the definition of continuing directors, which the court paraphrases from the 2012 loan agreement:

Continuing directors means, ". . . with respect to any period . . . individuals (A) who were members of the board . . . of the [b]orrower on the first day of such period, (B) whose election or nomination to that board . . . was approved by individuals referred to in clause (A) . . . or (C) whose election or nomination to that board . . . was approved by individuals referred to in clauses (A) and (B) above constituting at the time of such election or nomination at least a majority of [the] board or equivalent governing body."

Id. The definition includes the following dead hand language:

[E]xcluding, in the case of both clauses (B) and (C), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board.

provision provided that a change of control would constitute an event of default, giving the creditors the right to redeem their debt.²⁵⁹ The loan agreement did, however, provide that the board could approve a dissident slate of directors, in which case the new directors would constitute continuing directors and the proxy put would not be triggered.²⁶⁰ However, it made an exception for directors nominated pursuant to a proxy contest.²⁶¹ Directors nominated pursuant to a proxy solicitation would remain noncontinuing even if the board approved them.²⁶² Thus, their nomination still would constitute a change in control, and the directors would be left powerless to stop the proxy put from being triggered.

2. Claims Against Healthways for Breach of Fiduciary Duties

In *Healthways*, the Chancery Court considered claims against both Healthways and SunTrust, the lending institution that wrote the provision into the loan agreement.²⁶³ The court found that, specific to this case, the claim against the board for a breach of fiduciary duty in adopting the provision was ripe.²⁶⁴ The dead hand proxy put was adopted in the wake of increased “stockholder opposition[] and identified insurgency.”²⁶⁵ Moreover, because the company had traditionally not included dead hand provisions in its agreement, the court was skeptical of the change in historical practice of the company’s debt and the lack of evidence suggesting that there was informed consideration for the amendment.²⁶⁶ The court thus found that the dispute was sufficiently ripe as to the entry of the proxy put into the credit agreement because “the stockholders of the company are presently suffering a distinct injury in the form of the deterrent effect.”²⁶⁷

Moreover, the court spelled out the negative implications of dead hand proxy puts, consistent with the skeptical views expressed in *Amylin* and *Sandridge*. The court expressed distaste regarding their impact on the stockholder franchise and the status of the board of directors.²⁶⁸ Moreover,

Id. at 6–7. This dead hand provision was added in the fifth amendment and did not exist in the prior loan agreements. *Id.* at 6.

259. *Id.* at 6–7.

260. *See id.*

261. *See id.* at 7.

262. *See id.* (describing the dead hand language in the credit agreement).

263. *See Davey & Kelly, supra* note 13. The Chancery Court declined to dismiss the stockholder challenge of the dead hand proxy put on ripeness grounds, finding that including a dead hand provision in the agreement may have caused present injury to the stockholders. Transcript of Oral Argument, *supra* note 15, at 71.

264. Transcript of Oral Argument, *supra* note 15, at 77. The court explained that whether a dispute is ripe hinges on a practical assessment of “whether the interests of the party seeking relief outweigh the concerns of the Court in postponing review until the question arises in some more concrete and final form.” *Id.* at 72.

265. *Id.* at 76.

266. *Id.* at 75–76.

267. *Id.* at 78. The court explained that Delaware courts have consistently found that disputes are ripe when there is a stockholder deterrent effect. *Id.* at 73.

268. *Id.* at 79–80.

the court recognized the deterrent effect on a shareholder's decision to run a proxy contest, regardless of whether the proxy contest was already underway.²⁶⁹ The court noted that the proxy put creates a "Sword of Damocles"²⁷⁰ situation, because the shareholders will have the negative implications of the proxy put hanging over them when deciding to elect a new board.²⁷¹ The court further noted the "recognized entrenching effect" that the dead hand provision had on the board and the restraint on the stockholder franchise.²⁷²

The Delaware Chancery Court associated the dead hand proxy put with the dead hand poison pill in *Toll Bros.*²⁷³:

The problem in *Toll Brothers* was that a rights plan containing a dead hand feature in a pill would have a chilling effect on, among other things, potential proxy contests such that the stockholders would be deterred, they would have the Sword of Damocles hanging over them, when they were deciding what to do with respect to a proxy contest.²⁷⁴

Bringing the point home, the court further explained: "That's exactly what the effect is of the dead hand proxy put in this case."²⁷⁵ The *Toll Bros.* court held that the deterrent effect of the poison pill, despite the fact that there was no proxy contest underway, created a legally cognizable claim.²⁷⁶ In observing that the dead hand proxy put had the same deterrent effect as the dead hand poison pill, the *Healthways* court used *Toll Bros.* as a basis for denying the defendants' motion to dismiss.²⁷⁷

3. Claims Against SunTrust for Aiding and Abetting

The court also considered Pontiac's claim against SunTrust for aiding and abetting the directors' breach of fiduciary duty.²⁷⁸ SunTrust argued that it had legitimate business reasons for wanting the protection afforded by the dead hand provision.²⁷⁹ It further argued that one of the main reasons for including the provision was that, as a lender, it always wanted to know its borrower.²⁸⁰ The court, however, was skeptical of the creditor's legitimate business interests and was not willing to dismiss the aiding and abetting claim.²⁸¹ The court reasoned that this made little sense in the

269. *Id.* at 80.

270. "Sword of Damocles" is an expression used to illustrate that there is "an impending disaster." *Sword of Damocles*, MERRIAM WEBSTER, <http://www.merriam-webster.com/dictionary/sword%20of%20Damocles> (last visited Apr. 29, 2016) [<https://perma.cc/F7VG-ER5C>]. The expression refers to the legend of Damocles, servile courtier to King Dionysius I of Syracuse, who was forced to sit under a sword that hung by a single hair. *Id.*

271. Transcript of Oral Argument, *supra* note 15, at 73.

272. *Id.* at 80.

273. *See id.* at 74; *Carmody v. Toll Bros.*, 723 A.2d 1180 (Del. Ch. 1998).

274. Transcript of Oral Argument, *supra* note 15, at 74.

275. *Id.*

276. *See supra* Part I.C.2.

277. Transcript of Oral Argument, *supra* note 15, at 74–75.

278. *Id.* at 78–80.

279. *See id.* at 25–26.

280. *Id.* at 26.

281. *Id.* at 81.

context of publically held companies that have annual board elections and frequent CEO turnovers.²⁸² Furthermore, in the wake of *Amylin* and *Sandridge*, the court concluded that SunTrust was on notice that proxy puts, including those with a dead hand feature, were suspect due to their negative impact on the stockholder franchise and their management entrenchment effect.²⁸³

The court also noted that bondholders have a right to enter into “arm’s-length transaction[s]” in which they bargain for protection.²⁸⁴ However, it suggested that there are other ways for creditors to receive protection without using a mechanism that has such an entrenching effect on management.²⁸⁵ These include raising interest rates or demanding that the company obtain certain favorable financial metrics.

The dead hand proxy put in *Healthways* created the same effect that the *Amylin* court categorized as overly restrictive, entrenching on management, and debilitating to the stockholder franchise. The Delaware Chancery Court previously had expressed distaste for these provisions, which put such grave restrictions on the board’s ability to approve new directors who are appointed by means of a proxy contest.²⁸⁶ However, the court has yet to provide a per se legal analysis declaring their invalidity or limiting the use of proxy puts to those that do not include dead hand provisions.

D. The Debate Surrounding Dead Hand Proxy Puts

This section discusses the varying uses and effects of dead hand proxy puts. These proxy puts have an impact on shareholders, management, and creditors. Each of these parties plays a significant role in defending or denouncing the use of proxy puts. Part II.D.1 discusses how dead hand proxy puts effect shareholders. Part II.D.2 focuses on how dead hand proxy puts affect management. Finally, Part II.D.3 addresses their impact on creditors.

1. The Stockholder Franchise

Dead hand proxy puts have a significant impact on stockholders’ rights, including their ability to wage a successful proxy contest.²⁸⁷ Plaintiffs’ attorneys argue that these provisions have the purpose and effect of coercing stockholders and preventing proxy contests.²⁸⁸ Because the

282. *Id.* 25–26.

283. *Id.* at 80.

284. *Id.* at 32.

285. *Id.* at 34. The court distinguished the proxy put as “very different from a purely economic provision” because of the entrenching effects on management.” *Id.*

286. *See generally* Kallick v. Sandridge, 68 A.3d 242 (Del. Ch. 2013); San Antonio Fire & Police Pension Fund v. Amylin Pharms. Inc., 983 A.2d 304 (Del. Ch. 2009).

287. WHISSEL, *supra* note 18, at 4.

288. *See* Verified Class Action Complaint, *supra* note 138, at 2, 13 (arguing that the risk of having to repay debt because of the dead hand proxy put has a coercive effect on the shareholders willingness to campaign for removal of the current board and to vote for directors of their own choice).

company's debt will become due if a majority of the board is elected through a proxy contest, attorneys and commentators argue that stockholders are less likely to remove the board through proxy solicitation.²⁸⁹ If stockholders go through with the proxy contest, this will force the company to refinance its debt or renegotiate with its lenders to waive the provision.²⁹⁰ If unable to refinance or renegotiate, the company will face detrimental financial consequences, including the potential for a liquidity crisis.²⁹¹ Because shareholders will not likely exercise their right to vote for new directors if it means financial insolvency for the company, the dead hand proxy put effectively protects incumbent boards from removal and has "eviscerating effect[s] on the stockholder franchise."²⁹²

Indeed, the Chancery Court in *Healthways* recognized the potential negative effects that dead hand proxy puts could have on the shareholders' ability to threaten or initiate a proxy contest.²⁹³ It explained that prohibiting or deterring proxy contests can result in stockholder disenfranchisement because the presence of dead hand proxy puts promotes fear over changing the board of directors.²⁹⁴ With the dead hand mechanisms in place, shareholders likely will choose not to vote out an incumbent board because new directors will be powerless to redeem the dead hand proxy put.

2. The Entrenchment Effect

In adopting dead hand proxy puts, creditors and directors also entrench incumbent directors, while appearing to serve a legitimate business purpose.²⁹⁵ Commentators suggest that "management is active in placing poison put covenants in indenture agreements for the purpose of entrenchment."²⁹⁶ Furthermore, managers have substantial control over placing these provisions in debt agreements.²⁹⁷ As a result, management has the opportunity to adopt provisions that are self-serving and contrary to the interests of the corporation, the shareholders, or lenders.²⁹⁸

On more than one occasion, the Delaware Chancery Court has taken the opportunity to note the "recognize[ed] entrenching effect" of dead hand proxy puts.²⁹⁹ The court is skeptical of the provisions because they insulate

289. *See id.*; WHISSEL, *supra* note 18, at 4–5.

290. *See supra* Part I.B.3.

291. *See* WHISSEL, *supra* note 18, at 2.

292. *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 315 (Del. Ch. 2009).

293. *See* Transcript of Oral Argument, *supra* note 15, at 74.

294. *Id.*

295. *See* WHISSEL, *supra* note 18, at 4.

296. *Id.*; *see also* Solomon, *supra* note 99.

297. Arlen & Talley, *supra* note 93, at 597; *see supra* Part I.B.1. Proxy puts, as discussed above, are embedded defenses that prove difficult to regulate because they are implemented without shareholder oversight. *See* Kahan & Klausner, *supra* note 89, at 947.

298. *See* Kahan & Klausner, *supra* note 89, at 954.

299. Transcript of Oral Argument, *supra* note 15, at 80; *see also* *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 306 (Del. Ch. 2009) (proposing

directors from proxy contests, preventing stockholders from changing management.³⁰⁰ The court, however, has recognized that there are other purposes to the proxy put provisions and has suggested that “independent directors . . . monitor poison puts to ensure that they are not being adopted solely as entrenchment devices.”³⁰¹ Bargaining to exclude them, and accepting them only in exchange for significant economic value, may provide sufficient evidence that the board did not adopt the provision for the purpose of entrenchment.³⁰²

Opponents of both traditional proxy puts and dead hand proxy puts argue that these “director-centric poison puts” are more about entrenching incumbent board members than addressing the concerns of lending institutions.³⁰³ They further argue that proxy puts, used as hostile control change covenants, do not take into account whether bond values are adversely affected by a change in control.³⁰⁴ Instead, they “reflect[] an unabashed pursuit of management’s parochial interests.”³⁰⁵ Thus, these covenants arguably protect management, conferring only an incidental benefit on bondholders.³⁰⁶ Moreover, in some instances bond values are likely to improve if an inefficient board is replaced in a proxy contest.³⁰⁷ Yet, the provisions in the hostile control change covenants prevent this improvement by limiting shareholders’ ability to remove management.³⁰⁸ Management, in those instances, is protected at the expense of the bondholders.³⁰⁹

Poison puts, as well as dead hand proxy puts, generally also may entrench management by deterring acquisition activity.³¹⁰ In a recent study conducted at the University of Delaware, scholars found that “firms that had bonds with poison puts are less likely to be either acquirers or targets” of an acquisition.³¹¹ However, firms are more likely to include poison puts in

that a dead hand provision in the indenture would serve as a possible entrenchment mechanism).

300. See *supra* Part II.A–C.

301. BERESKIN & BOWERS, *supra* note 88, at 3 (referring to *Kallick v. Sandridge Energy, Inc.*, 68 A.3d 242 (Del. Ch. 2013)).

302. See *id.*

303. See Solomon, *supra* note 99; see also WHISSEL *supra* note 18, at 3 (stating that the utility of proxy puts is almost entirely based on their ability to entrench management).

304. WHISSEL, *supra* note 18, at 4; Kahan & Klausner, *supra* note 89, at 954.

305. Kahan & Klausner, *supra* note 89, at 954.

306. WHISSEL, *supra* note 18, at 4; Kahan & Klausner, *supra* note 89, at 954–55.

307. Kahan & Klausner, *supra* note 89, at 954.

308. *Id.*

309. *Id.*

310. See BERESKIN & BOWERS, *supra* note 88, at 5 (discussing the inevitable entrenchment effect that results because poison puts reduce acquisition activity); see also Part I.B.2.

311. BERESKIN & BOWERS, *supra* note 88, at 5. The empirical study considered the terms “proxy puts” and “poison puts” synonymously, referring to the proxy puts in both the *Amylin* and *Sandridge* cases as poison puts. *Id.* at 1–3. Additionally, the study considered poison puts with triggering events, such as when “any person or group acquires 50 [percent] or more of the issuer’s voting stock,” as well as a proxy put with a triggering event, such as “any time the majority of the board of directors ceases to be those who were directors at the time of issuance.” *Id.* at 1 n.1.

debt agreements if they are in industries associated with acquisition activity and are less likely to issue poison puts if they have other antitakeover provisions in place.³¹² “[P]oison puts are used by firms in consolidating industries that wish to avoid acquisition activity in general, which admittedly could also reflect an entrenchment effect.”³¹³ These scholars acknowledged the entrenchment effect that is associated with fewer acquisitions, yet ultimately concluded that the use of proxy puts is primarily driven by bondholders’ efficient contracting considerations.³¹⁴

3. Legitimate Business Concerns: The Lending Institutions

As noted above, dead hand proxy puts are contractual agreements involving third party creditors.³¹⁵ Boards of directors include a change in control provision in a credit agreement or indenture in the form of a proxy put after negotiation with the contracting parties. Commentators argue that because a proxy put is not unilaterally adopted by the board of directors, but rather negotiated with a third party in protection of that third party’s rights, the proxy put serves a legitimate business purpose.³¹⁶

With the rise of hedge fund activism, lending institutions have increasingly bargained to include proxy put provisions in their agreements to protect against activists.³¹⁷ Since the beginning of 2014, nearly two hundred companies have struck new loan agreements that include these provisions.³¹⁸ Lenders arguably bargain for these provisions to protect against “debt-financed buybacks, dividends, and restructurings, favored by such [activist] investors, which deteriorate credit.”³¹⁹ With the surge of shareholder activism targeting corporate boardrooms, banks argue that proxy puts protect them from dissident directors who are focusing on short-term goals that are inconsistent with the goals of the banks.³²⁰ “A few years ago, [the proxy put] wasn’t necessarily front of mind for most boards or lenders, but with the level of activism we’re seeing today, that has changed.”³²¹

Moreover, commentators also argue that the dead hand proxy put serves the legitimate commercial interest of a bank wanting to know its borrower because “[c]reditor’s don’t want to wake up one day and find out someone else is driving the train.”³²² Knowing the borrower ensures confidence that business strategy will remain constant over the life of the credit

312. *Id.* at 12–13.

313. *Id.* at 6.

314. *See id.* at 22; *infra* Part II.D.2.

315. *See supra* Part II.D.3.

316. *See* Davey & Kelly, *supra* note 13; Hoffman, *supra* note 119.

317. *See* Hoffman, *supra* note 119.

318. *Id.*

319. BERESKIN & BOWERS, *supra* note 88, at 3.

320. *See* Reindel et al., *supra* note 132.

321. Hoffman, *supra* note 119 (quoting an attorney who heads the shareholder activism group at Vinson & Elkins LLP).

322. *Id.*; *see also* Reindel et al., *supra* note 132.

agreement.³²³ Essentially, the banks want to know who they are dealing with and want to avoid lending money to a board of directors that is shortly thereafter ousted for a new slate of directors with a completely different strategy for the company.³²⁴ Creditors argue that the dead hand provisions are the only way of providing them with the certainty of knowing that if a company's board changes, they can get out of the debt agreement.³²⁵

In the University of Delaware study discussed above, the results showed that including proxy puts in credit agreements was evidence of efficient contracting on the part of bondholders.³²⁶ The study found that a firm's use of poison puts corresponded with its use of other related covenants, such as bond rating decline covenants, "likely reflecting bondholders with legitimate concerns related to acquisitions and risk shifting."³²⁷ Finally, the results of this study also showed that firms that issue debt with poison puts have significantly higher institutional ownership, as opposed to individual.³²⁸ The researchers concluded that this evidenced "stronger external monitors—again, an explanation that is consistent with a governance structure complemented by contractual protections for bondholders . . . and inconsistent with weak governance and/or managerial entrenchment."³²⁹

However, another empirical test analyzing the function of change in control covenants in bond agreements concluded otherwise.³³⁰ Marcel Kahan and Michael Klausner found that hostile change in control covenants, strictly triggered by proxy contests or hostile acquisition, can offer substantially less protection to bondholders than covenants that are triggered purely by a ratings decline.³³¹ They argued that a ratings decline covenant, moreover, does not discriminate between actions that management favors or disfavors.³³² While recognizing that ratings decline covenants are not a perfect fix, Kahan and Klausner concluded that pure ratings decline covenants "provide the most complete coverage of events that threaten bondholders and reflect no intrusion of managerial self-interest."³³³

323. See Reindel et al., *supra* note 132.

324. See Solomon, *supra* note 99.

325. See Hoffman, *supra* note 119.

326. See BERESKIN & BOWERS, *supra* note 88, at 21.

327. *Id.*

328. *Id.* at 14–15. Sixty-four percent of poison put firms are owned by institutional investors, as compared with fifty-nine percent for firms that do not use poison puts in their debt. *Id.*

329. *Id.* at 15.

330. See Kahan & Klausner, *supra* note 89, at 959.

331. *Id.*

332. *Id.*

333. *Id.* at 960; see also Coffee, *supra* note 102, at 1520 (stating that the most obvious protection for bondholders from event risk is not a poison put, but "an upward interest rate shift in the event of a rating downgrading").

III. DEAD HAND PROXY PUTS ARE INVALID AS A MATTER OF DGCL

The legal confusion over dead hand proxy puts has caused an increase in litigation against both corporations and lending institutions. In the wake of *Healthways*, plaintiffs' attorneys continue to bring actions on behalf of shareholders, arguing that they are negatively affected by the use of dead hand proxy puts in credit agreements.³³⁴ Dead hand proxy puts are strikingly similar in effect to dead hand and no hand poison pills, which have been outlawed by the Delaware courts.³³⁵

A comparative analysis of dead hand poison pills and dead hand proxy puts provides a basis for suggesting that the Delaware Chancery Court outlaw dead hand proxy puts. While there are recognizable differences in the two defense mechanisms, they have similar implications for shareholders' ability to wage proxy contests, which result in management entrenchment. Moreover, both ultimately have inhibiting effects on boards of directors' ability to carry out their obligations under DGCL section 141. In light of these concerns, Part III explains the similarities and differences between the two mechanisms and argues that dead hand proxy puts should be invalidated on the same grounds that the court used in *Quickturn* to invalidate no hand and dead hand poison pills.³³⁶

A. *Dead Hand Proxy Puts Vs. Dead Hand Poison Pills*

This part discusses the similarities and differences between dead hand proxy puts and dead hand poison pills. Part III.A.1 discusses the similar purpose of the defense mechanisms, while Part III.A.2 focuses on their similar effects on the stockholder franchise. Part III.A.3 and III.A.4 discuss the similar effect on management and ultimately argue for the illegalization of dead hand proxy puts in Delaware.

1. A Similar Purpose: Takeover Defense

When comparing dead hand poison pills and dead hand proxy puts, it is important to consider whether the two defense mechanisms serve the same purpose. The dead hand poison pill is a shareholder rights plan that a company adopts in connection with the threat of a tender offer or as a predefensive measure.³³⁷ The purpose and effect of the poison pill is to thwart hostile bidders.³³⁸ However, the dead hand proxy put recently has been used to ward off shareholder activists who want to make a change to the company but not acquire it.³³⁹

While dead hand proxy puts serve as a defense against shareholder activism, these change in control provisions also function as a takeover

334. See Hoffman, *supra* note 119.

335. See *supra* Part I.C.2.

336. See *supra* Part I.C.2.

337. See *supra* Part I.C.2.

338. See *supra* Part I.C.; Velasco, *supra* note 80, at 381–84.

339. See Solomon, *supra* note 99; *supra* Part I.B.2.

defense mechanism.³⁴⁰ Empirical evidence suggests that proxy puts are more prevalent in industries that are prone to takeovers, yet firms with proxy puts are less likely to be acquired.³⁴¹ Moreover, firms with proxy puts are less likely to also have poison pills.³⁴² This indicates that firms likely believe that proxy puts and poison pills serve a similar function, and management may use them interchangeably to serve the same purpose.

Traditional poison puts, as discussed above, often include language that specifically prevents a hostile takeover.³⁴³ While dead hand proxy puts generally do not include such language, these proxy puts nevertheless deter hostile takeovers, even if that is not their explicit purpose. For example, imagine a corporate raider makes a tender offer, but the company has a dead hand proxy put in place. Now imagine that the same corporate raider had the intention of changing the board of directors, by means of a proxy contest, to reflect his own strategy for the company. The dead hand proxy put, however, will increase the cost of the corporate raider's acquisition. Specifically, this is because when he or she changes the board of directors through a proxy contest, the dead hand put forces the company to repay all of its debt. If the acquirer cannot change the board of directors by means of a proxy contest, without placing this financial burden on the company, that acquirer likely will be deterred from acquiring the company in the first place. Although the dead hand proxy put does not make a hostile takeover impossible,³⁴⁴ in the event of a successful proxy challenge it will create burdensome costs to the company.³⁴⁵

2. A Similar Deterrent Effect

Continuing to compare the dead hand poison pill and the dead hand proxy put, both have the effect of deterring shareholders from bringing a proxy contest.³⁴⁶ In *Toll Bros.*, the Chancery Court expressed grave skepticism toward dead hand poison pills.³⁴⁷ The court disapproved of the negative effects the dead hand feature had on the stockholder franchise.³⁴⁸ In a takeover scenario, an acquirer often tenders an offer to buy the outstanding shares of the target, while at the same time initiating a proxy

340. See *supra* Part II.D.1; see also *Coffee Jr.*, *supra* note 102, at 1520.

341. See *supra* Part II.D.1.

342. BERESKIN & BOWERS, *supra* note 88, at 10.

343. See *supra* Part I.B.1. A poison put might be triggered by the sale of 51 percent of the company. BERESKIN & BOWERS, *supra* note 88, at 1.

344. The dead hand proxy put does not completely ban hostile takeovers. Instead, it allows the board of directors to change, but requires the company to pay back all of its debt. See *supra* Part I.B.2. By contrast, the dead hand poison pill has a stronger force. See *Coffee Jr.*, *supra* note 102, at 1520. They put a complete ban on the board's ability to redeem the poison pill. See *supra* Part I.C.1; see also *Coffee Jr.*, *supra* note 102, at 1520 (noting that while poison puts are a takeover defense, they are less preventative than poison pills because they will not stop a takeover in situations where the hostile bidder is willing to pay off the debt).

345. See *supra* Part I.B.2.

346. See *supra* Part I.B.3, C.2.

347. See *supra* Part I.C.2.

348. See *supra* Part I.C.2.

contest to nominate a slate of directors who will redeem the pill.³⁴⁹ Since only continuing directors may redeem a rights plan that contains a dead hand provision, electing a new slate of directors does not stop the poison pill from being triggered.³⁵⁰ As a result, the new board is powerless to redeem the pill, and stockholders are more likely to vote for the incumbent board, which has the ability to prevent the disastrous financial effects of the poison pill.

The dead hand proxy put has similar deterring effects and, thus, should also be found invalid.³⁵¹ In *Healthways*, the Chancery Court likened dead hand proxy puts to dead hand poison pills, stating that, in both instances, stockholders are deterred from bringing potential proxy contests.³⁵² The dead hand proxy put has the effect of disenfranchising stockholders by depriving them of any practical choice to vote for anyone other than the incumbent directors.³⁵³ Commentators argue that stockholders are not disenfranchised because the new board simply can refinance the debt if the proxy put is triggered or renegotiate with the bank to remove the proxy put.³⁵⁴ Both of these alternatives, however, can prove costly and potentially force the company to choose between refinancing the debt on unfavorable terms and suffering a liquidity crisis.³⁵⁵ Thus, the Chancery Court in *Healthways* correctly characterized the dead hand proxy put as creating a “Sword of Damocles,” whereby shareholders are deterred from threatening a proxy contest because of the dead hand provisions.³⁵⁶ The court should not uphold a defense mechanism with such strong implications on the stockholders ability to elect a new board.

3. A Similar Entrenchment Effect

Disenfranchising the stockholders has the effect of entrenching management. While the dead hand poison pill arguably has a greater entrenchment effect because it is adopted unilaterally by the board of directors for the sole purpose of preventing a hostile takeover, the dead

349. See *supra* Parts I.C.3, II.C.1.

350. See *supra* Part I.C.2.

351. See *supra* Part II.D.1. In *Amylin*, the court suggested that provisions so strongly in derogation of the stockholders’ rights could ultimately be unenforceable as a matter of public policy. See *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 315 (Del. Ch. 2009); see also *supra* Part II.A.1.

352. See *supra* Part II.C.

353. See *supra* Part II.D.1.

354. See Reindel et al., *supra* note 132. These commentators further argue that the dead hand feature of the poison pill has unknown, catastrophic implications, while the dead hand proxy put has a finite amount of debt that the board can refinance. *Id.*

355. In another recent battle for board seats where a proxy put was present, triggering the put would have required the company to repay \$2.88 billion worth of notes. At that time, the company only had \$364 million in cash and cash equivalents. In the event the company was forced to repay the \$2.88 billion, it would not have had enough cash to do so. See *UPDATE 2-Activist Investor Casablanca May Sue Miner Cliffs in Proxy Fight*, REUTERS (May 29, 2014), <http://www.reuters.com/article/cliffs-natural-investor-proxy-fighting-idUSL1N00F18G20140529> [<https://perma.cc/6ZP8-V6MB>].

356. Transcript of Oral Argument, *supra* note 15, at 74.

hand proxy put also has a similar entrenchment effect. The Delaware Chancery Court has criticized the entrenchment effects of both the dead hand poison pill and the dead hand proxy put.³⁵⁷ In the cases involving dead hand proxy puts and dead hand poison pills, the consequences of removing the incumbent board are so significant that the defense mechanisms serve to entrench the existing board members at the expense of the stockholder franchise.

In *Sandridge*, the Chancery Court explicitly stated that independent directors should “police aspects of [proxy put] agreements . . . to ensure that the company itself is not offering up these terms lightly precisely because of their entrenching utility.”³⁵⁸ There, the court made clear that where there is a proxy put present, an incumbent board must approve the new directors and neutralize the proxy put unless there is a specific and substantial risk to the corporation or its creditors.³⁵⁹ Because of the preclusive language in dead hand proxy puts, the incumbent board does not even have the opportunity to approve the new directors for purposes of neutralizing the proxy put. Therefore, the entrenching effects of the dead hand proxy put are even further reaching.

Moreover, the dead hand proxy put is correctly categorized as an embedded defense masked as serving a legitimate purpose, when instead it functions to entrench management.³⁶⁰ The legitimate purpose, in the case of proxy puts, is arguably the protection of the creditors.³⁶¹ While creditors do have an interest in putting dead hand proxy puts in their credit agreements to protect against the risk associated with a change in control, creditors can achieve risk reduction without using mechanisms that both eviscerate the stockholder franchise and entrench management.³⁶²

Creditors argue that proxy puts are needed protection against shareholder activists because activists take control only to issue large dividends or issue more debt to afford large share buybacks.³⁶³ Creditors, however, can protect against activist actions in a less entrenching way. For instance, they can include other covenants in their debt agreements, such as covenants that specifically restrict the payment of excessive dividends, limit an increase in the company’s outstanding debt, or prevent sale of the company’s assets

357. *See supra* Parts I.C.2, II.C.

358. *Sandridge v. Kallick*, 68 A.3d 242, 248 (Del. Ch. 2013).

359. *Id.* The court also explained that directors are under no obligation to place any greater emphasis on the interest of noteholders in making their decision as to the proxy put.

360. *See supra* Part II.B.1.

361. Commentators argue that dead hand poison pills and dead hand proxy puts are fundamentally different because dead hand proxy puts involve third party creditors, while dead hand poison pills do not. *See supra* Part II.D.2; Coffee Jr., *supra* note 102, at 1528 (explaining that poison puts are distinguishable from poison pills because poison puts are bilateral contracts and not unilateral actions of management).

362. In *Healthways*, the Delaware Chancery Court suggested that there were other ways for creditors to get protection that do not involve entrenchment management or inhibiting stockholders’ rights. *See supra* notes 283–85 and accompanying text.

363. *See supra* Part II.D.2.

above a certain threshold.³⁶⁴ Thus, creditors can still protect themselves from excessive dividends or reduced liquidity using covenants other than dead hand proxy puts. Covenants addressing the specific actions taken by a new board once an activist campaign is successful, as opposed to the change in control itself, can provide adequate protection for creditors, without entrenching management or limiting stockholders' ability to bring a proxy contest.

4. A Similar Limiting Effect on the Board of Directors' Duties Under DGCL Section 141(a)

Not only do dead hand proxy puts have similar effects on shareholders and management, but, like dead hand poison pills, they also prohibit the board of directors from fulfilling its fiduciary duties in accordance with DGCL section 141(a). In *Quickturn*, the Delaware Supreme Court used this antidisablement principle to invalidate dead hand poison pills.³⁶⁵ When considering that dead hand proxy puts have the same impact on a board in that they prevent the directors from taking actions that are in the best interest of the shareholders, the Delaware courts should outlaw dead hand proxy puts.

Section 141(a) provides the board of directors with the authority to manage the "business and affairs" of the corporation.³⁶⁶ The Delaware court has upheld the corporate board's statutory authority to manage the corporation and has expressed its "concomitant fiduciary duty pursuant to that statutory mandate."³⁶⁷ As a result, any defense mechanism that prevents the board from "exercise[ing] [its] own best judgment on matters coming before the board" violates the duty owed to each director.³⁶⁸

In *Quickturn*, the Delaware Supreme Court ultimately concluded that the no hand poison pills were invalid because they prevented the newly elected board of directors from managing and directing the business and affairs of the corporation.³⁶⁹ There, only continuing directors could redeem the poison pill, and only the incumbent directors were considered continuing directors for purposes of redeeming the poison pill.³⁷⁰ As a result, the defense mechanism required the new board to breach its fiduciary duty any time it was in the best interest of the company to have the board redeem the pill.³⁷¹ The court held that "no defensive measure can be sustained when it represents a breach of the directors' fiduciary duty."³⁷²

364. They also can include ratings decline covenants as a means of protection, whereby interest rates increase upon a decrease in a bond rating. *See supra* note 101 and accompanying text.

365. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291 (Del. 1998).

366. *See supra* Part I.C.2; *see also* DEL. CODE ANN. tit. 8, § 141(a) (2012).

367. *Quickturn*, 721 A.2d at 1291.

368. *Id.* at 1292.

369. *See supra* Part I.C.2.

370. *Quickturn*, 721 A.2d at 1289.

371. *See id.* at 1292.

372. *Id.* at 1291-92.

The *Quickturn* Court further emphasized that “[t]o the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable.”³⁷³ Dead hand proxy puts are precisely such a contract. They are provisions, embedded in contracts, that prohibit a board from exercising its fiduciary duties. When a dissident slate of directors is elected through a threatened or actual proxy contest, the incumbent board is powerless to stop the dead hand proxy put, even if it is in the best interest of the corporation.³⁷⁴

Commentators argue that the incumbent board can renegotiate the debt or trigger the proxy put and then later refinance corporation’s debt.³⁷⁵ However, as discussed above, these costly alternatives will not always be in the best interest of the company. Directors have the authority to exercise their own judgment regarding the corporation’s business matters³⁷⁶ and thus should not be prevented from approving new directors to the board if doing so is in the corporation’s best interest. As a result, precluding their ability to approve the new directors for purposes of neutralizing the dead hand proxy put prevents them from fulfilling their fiduciary duties to the corporation under section 141(a).

While commentators argue that the use of the dead hand feature is necessary to make the proxy put effective,³⁷⁷ this argument lacks merit. The Delaware Chancery Court has provided a fair standard for when a board must approve directors for purposes of a proxy put without a dead hand feature.³⁷⁸ Based on the Chancery Court’s rulings in *Amylin* and *Sandridge*, a traditional proxy put, with no dead hand feature, will be effective in preventing a change in control only when it is in the best interest of the corporation and the creditors.³⁷⁹

Moreover, the court’s decision to review traditional proxy puts under *Unocal*’s intermediate standard of review is appropriate given the defensive nature of the proxy puts and the entrenching effects that they have on management.³⁸⁰ The incumbent management, under this standard, does not always have to approve the new directors, but must do so if failure to approve them would constitute a breach of a fiduciary duty.³⁸¹ In the event that approving the new directors creates a substantial risk to the corporation

373. *Id.* at 1292 (citing *Paramount Commc’ns, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (1994)).

374. *See supra* Part I.B.3. Approving the new slate of directors when there is a dead hand proxy put in place is meaningless because the new directors will remain noncontinuing for purposes of the proxy put.

375. *See* Reindel et al., *supra* note 132.

376. *See Quickturn*, 721 A.2d at 1292.

377. *See supra* Part I.C.2.

378. *See supra* Part II.A.3, B.3. The dead hand feature eliminates the need for this standard because the incumbent board may never approve the new slate of directors.

379. *See supra* Part II.A.3, B.3.

380. *See* *Kallick v. Sandridge*, 68 A.3d 242, 258 (Del. Ch. 2011).

381. *Id.* at 260; *see supra* Part II.B.3.

or the creditors, the board of directors is not obliged to approve them.³⁸² This provides an adequate remedy for the board without allowing it to use the dead hand feature of the proxy put solely for entrenchment purposes. Thus, allowing the use of traditional proxy puts, without the dead hand feature, gives effect to change in control provisions, without violating DGCL section 141.

CONCLUSION

With the rise in shareholder activism, dead hand proxy puts are playing a more significant role in corporate debt agreements. Recent Delaware litigation is indicative of the debate among shareholders, management, and creditors as to provisions' legality. The Delaware Chancery Court has recognized the harmful nature and effect of dead hand proxy puts. The Chancery Court should, however, go one step further and outlaw dead hand proxy puts in Delaware. Ultimately, the Chancery Court should condemn dead hand proxy puts as both overdetering on shareholders and overentrenching on management, while upholding traditional proxy puts as valid under Delaware law.

382. See *Kallick*, 68 A.32 at 260; *supra* Part II.B.3 The board is, however, required to substantiate a risk that goes beyond distaste for the new directors or wanting to keep their own position.