NOTES

THE SPIRIT OF *BLASIUS*: *SANDRIDGE* AS AN ANTIDOTE TO THE POISON PUT

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The poison put is a contractual innovation that grants debtholders an option to redeem their debt upon the occurrence of a predefined trigger. While certain poison puts can be justified in light of Delaware corporate law's deference to directors, one particular class of poison puts is more troubling from a corporate governance perspective: those triggered by a turnover in a majority of a company's board. These "continuing director" poison puts become problematic if a corporation with substantial outstanding debt subsequently faces a hostile challenge. In such a scenario, if the incumbent board chooses not to approve the new directors, the threat of financial distress effectively coerces shareholders to retain incumbent directors. Delaware courts have grappled with such provisions on two recent occasions: first in 2009 in San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc. *and then again in 2013 in* Kallick v. SandRidge Energy, Inc. *Both cases were brought on narrow grounds, challenging a board's failure to approve a dissident slate for the purposes of nullifying the poison put. As such, Delaware courts have yet to address whether directors breach fiduciary duties in the initial decision to agree to the inclusion of continuing director poison puts in debt agreements. This Note provides a background discussion of corporate law, before proceeding to an economic and legal analysis of continuing director poison puts. In concluding that such provisions have both the motive and effect of entrenching incumbent directors, this Note challenges Delaware courts' adoption of the intermediate* Unocal *standard of review in the context of approving a dissident slate. This Note concludes by arguing that the strict* Blasius *standard of review should apply to a board's initial decision to agree to the inclusion of continuing director poison puts in their debt agreements.*

INTRODUCTION

Delaware corporate law affords great deference to directors' business judgment.[1] Indeed, both Delaware statutes[2] and judicially created

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1. See, e.g., Stephen M. Bainbridge, The Business Judgment Rule as Abstention Doctrine, 57 Vand. L. Rev. 83, 83–88 (2004) [hereinafter Bainbridge, Abstention] (describing default standard of review for director decisions—business judgment rule—as

doctrines[3] call for nearly unfailing deference to the business decisions of directors and managers. The role of the law in regulating business activity has been summed up thusly: "With trivial exceptions, all business decisions . . . are taken by or under the supervision of th[e] board, with no substantial inquiry by anyone else."[4]

However, two recent decisions from the Delaware Court of Chancery suggest that, at least in one context, Delaware may be tightening the reins on director discretion. In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*[5] and *Kallick v. SandRidge Energy, Inc.*,[6] the Chancery Court confronted the issue of whether directors breach their fiduciary duties to a corporation's shareholders by failing to approve a slate of dissident nominees for the purpose of debt instruments containing so-called "continuing director poison puts"[7]—covenants that trigger an obligation to immediately repay a corporation's outstanding debt in the event that a majority of the board is replaced with individuals not approved by the incumbent board.[8]

"doctrine of abstention pursuant to which courts . . . refrain from reviewing board decisions unless exacting preconditions for review are satisfied"); Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 Colum. L. Rev. 1416, 1417 (1989) [hereinafter Easterbrook & Fischel, Corporate Contract] (asserting "handiwork of managers is final in all but exceptional or trivial instances" and arguing "hands-off approach" is particular to corporate law).

2. E.g., Del. Code Ann. tit. 8, § 141(a) (2011) ("The business and affairs of every corporation under this chapter shall be managed by or under the direction of a board of directors . . . .").

3. See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (defining business judgment rule as "acknowledgement of the managerial prerogatives of Delaware directors under Section 141(a)"); Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981) (describing business judgment rule as "judicial creation . . . to give recognition and deference to directors' business expertise when exercising their managerial power" under Delaware law).

4. Easterbrook & Fischel, Corporate Contract, supra note 1, at 1417; see also Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 257 (Del. Ch. 2013) (calling business judgment rule "as close to non-review as [Delaware] law contemplates").

5. 983 A.2d 304 (Del. Ch. 2009), aff'd, 981 A.2d 1173 (Del. 2009).

6. 68 A.3d 242.

7. In corporate-law literature, the terms "poison put" and "proxy put" are, for the most part, used interchangeably. See, e.g., Guhan Subramanian et al., Is Delaware's Antitakeover Statute Unconstitutional? Evidence from 1988–2008, 65 Bus. Law. 685, 709 (2010) (equating "poison put" and "proxy put" as alternative names for "change-of-control clause"). This Note employs the term poison put, except when quoting sources that use the term proxy put.

8. *SandRidge*, 68 A.3d at 247–48; *Amylin*, 983 A.2d at 310. The plaintiff in *Amylin* originally alleged that agreeing to the poison put with a continuing director provision was a breach of the fiduciary duties of care and loyalty. 983 A.2d at 310. However, following a partial settlement, the plaintiff withdrew that claim and the litigation instead focused on the trustee's contention that Amylin's board could not "approve" dissident directors and still "run its own slate in opposition." Id. at 311–14. The plaintiff in *SandRidge*, on the other hand, never pressed the issue of whether SandRidge's board breached its fiduciary duties by agreeing to a poison put with a continuing director provision. 68 A.3d at 247–48.

Both cases focused on boards' legal authority and fiduciary duties with respect to approving dissident nominees for the purposes of avoiding the triggering of a poison put, rather than deciding whether the respective boards in question breached their fiduciary duty of loyalty to shareholders by agreeing to the inclusion of a poison put in their debt instruments in the first place.[9] Despite the narrow scope of analysis, the decisions in both *Amylin* and *SandRidge* attracted significant attention from observers of Delaware law,[10] in part due to the prevalence of poison puts in debt instruments (which continues to be the case even after *SandRidge*[11]). The 2009 *Amylin* decision stirred discussion of whether shareholders would be able to curtail the use of poison puts,[12] and Chancellor Strine's 2013 opinion in *SandRidge* has raised further concern among lenders regarding the ongoing viability of the poison put.[13] The

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Nevertheless, that did not prevent Chancellor Strine from excoriating the board for failing to make itself aware of the inclusion of a poison put in the credit agreement. Id. For background on poison puts, see infra Part II.A.

9. *SandRidge*, 68 A.3d at 259–61 (deciding case based on failure to approve dissident slate because plaintiff did not raise claim that agreeing to poison put in first place was breach of directors' fiduciary duties); *Amylin*, 983 A.2d at 318–19 (applying business judgment rule and discussing duty of care, not loyalty).

10. See, e.g., Steven M. Davidoff, Icahn, Amylin and the New Nuances of Activist Investing, N.Y. Times: Dealbook (Apr. 20, 2009, 10:31 AM), http://dealbook.nytimes.com/2009/04/20/icahn-amylin-and-the-new-nuances-of-activist-investing/ (on file with the *Columbia Law Review*) (commenting on legal claims in *Amylin* and opining one should "expect lenders to keep proposing [poison puts] and issuers to avoid resisting them"); David A. Katz, Delaware Court Raises Bar for Use of "Poison Put" Provisions, Harvard Law Sch. Forum on Corporate Governance & Fin. Regulation (Mar. 15, 2013, 9:22 AM), http://blogs.law.harvard.edu/corpgov/2013/03/15/delaware-court-raises-bar-for-use-of-poison-put-provisions/ (on file with the *Columbia Law Review*) (discussing *SandRidge* and noting decision "raises serious questions about how future change-of-control provisions will be drafted and negotiated").

11. Lenders Beware: After *Kallick*, Are Proxy Puts Worth the Paper They're Written On?, Reuters: Practical Law Fin. (Oct. 31, 2013), http://us.practicallaw.com/4-542-4105?source=relatedcontent (subscription required) (on file with the *Columbia Law Review*) (finding proxy puts in approximately eighty percent of representative sample of credit agreements in immediate aftermath of *SandRidge*).

12. See, e.g., Davidoff, supra note 10 (arguing poison put in *Amylin* "likely" does not violate *Unocal*); Target, Amylin and the Peak of Proxy Season, N.Y. Times: Dealbook (May 27, 2009, 10:05 AM), http://dealbook.nytimes.com/2009/05/27/target-amylin-and-the-peak-of-proxy-season/ (on file with the *Columbia Law Review*) (dismissing poison put discussion in *Amylin* as "nonevent" and predicting ruling "will amount to . . . paperwork requirement wherein [use of poison puts] remain[s] common").

13. A range of sources has expressed the opinion that the decision in *SandRidge* signals Delaware's intention to more closely scrutinize the validity of the poison put. See, e.g., Liz Hoffman, Facing Activist, HMA Heeds Strine's 'Proxy Put' Ruling, Law360 (Aug. 2, 2013, 3:52 PM), http://www.law360.com/articles/462167 (on file with the *Columbia Law Review*) (describing *SandRidge* as "lesson sternly handed down . . . on just how far directors facing an activist challenger can go to keep their jobs"); Katz, supra note 10 (suggesting *SandRidge* raises "serious questions about how future change-of-control provisions will be drafted and negotiated"); see also Arnold & Porter LLP, Recent Trends in M&A and Corporate Fiduciary Litigation 3 (May 2013), available at http://www.arnoldporter.com/

reaction to these cases is in large part a result of the fact that the poison put touches on the shareholder franchise, one of the few areas of corporate law where Delaware courts have applied heightened scrutiny to boards' decisions.[14] Significantly, the response to *SandRidge* has focused on the fact that Chancellor Strine criticized SandRidge's directors at length for having agreed to a series of poison puts, even though the plaintiff *never raised that issue* during the trial and limited his request for relief to enjoining the board from soliciting consent revocations.[15]

In light of the central role of the shareholder franchise in Delaware law and Chancellor Strine's warning in *SandRidge*, this Note argues that the *Blasius* standard of review[16] should be applied to a board's decision to consent to the inclusion of poison puts in a company's debt instruments for theoretical, doctrinal, and policy reasons.[17]

Part I of this Note starts with a discussion of the agency relationships involved in the corporate form. In particular, it looks to Jensen and Meckling's influential work on the theory of the firm and focuses on the agency problems inherent in interactions among directors, shareholders, and debtholders. Part I then delves into background Delaware corporate law, with a focus on section 141 of the Delaware General Corporation Law ("§ 141(a)") and the various standards of review applied by the Delaware Chancery and Supreme Courts.

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resources/documents/ADV0509RecentTrendsinMAandCorporateFiduciaryLitigation.pdf (on file with the *Columbia Law Review*) ("Chancellor Strine raised significant questions about the viability of so-called 'poison puts.'").

14. Cf. Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) ("The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."); Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 851 (2005) (characterizing judicial view of shareholder franchise as "fundamental element of the corporate structure"). For a discussion of enhanced scrutiny employed in other contexts in Delaware jurisprudence, see generally Reza Dibadj, Networks of Heightened Scrutiny in Corporate Law, 46 San Diego L. Rev. 1, 3–7 (2009) (providing examples of "heightened scrutiny").

15. Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 247–48, 252, 256 (Del. Ch. 2013). Perhaps the most telling line of *SandRidge* is the following warning: "Given the obvious entrenching purposes of a Proxy Put provision, one would hope that any public company would bargain hard to exclude that toll on the stockholder franchise and only accede to the Proxy Put after hard negotiation and only for clear economic advantage." Id. at 248.

16. See *Blasius*, 564 A.2d at 661 (requiring "compelling justification" for measures whose "primary purpose" is interfering with shareholder franchise).

17. Chancellor Strine argued that "*Unocal* is the proper standard of review to examine a board's decision to agree to a [poison put] and to review a board's exercise of discretion as to the change of control provisions under such a contract." *SandRidge*, 68 A.3d at 259. However, despite this proclamation, the court only applied *Unocal* to the board's decision of whether to approve dissident nominees for the purpose of the change of control provision, because the record of the board's decision to agree to the poison put was "scarce" and the plaintiff's claim focused on the board's exercise of discretion. Id. at 247–48. For an explanation of the *Unocal* test, see infra notes 94–104 and accompanying text.

Part II begins by outlining the development of the poison put and examining economic and legal arguments regarding its legitimacy. Next, Part II catalogs the particular poison put provisions at issue in *Amylin* and *SandRidge* before moving on to discuss the Chancery Court's opinions in those cases. In addition to analyzing the reasoning of each case, Part II covers arguments made by the parties to both disputes and interpretive moves taken by Vice Chancellor Lamb and Chancellor Strine, which provide important context for how the Chancery Court views poison puts.

Part III addresses the result of the Chancery Court's application of the *Unocal* standard of review in *Amylin* and *SandRidge*, before proceeding to argue that adopting the *Blasius* standard of review would be doctrinally superior in light of the design of poison puts. Finally, Part III concludes by observing that applying *Blasius* would provide greater doctrinal clarity, reinforce the role of the shareholder franchise in Delaware law, and encourage practitioners to draft new contractual provisions.

I. CORPORATE LAW FRAMEWORK: AGENCY RELATIONSHIPS AND THE LAW'S RESPONSE

Before proceeding to a discussion of poison puts and the Chancery Court's approach in *Amylin* and *SandRidge*, it is informative to consider the general framework of Delaware's corporate law. As such, Part I.A begins with an exploration of the agency relationships that give rise to the current structure of corporate law in Delaware. A central problem that corporate law seeks to address is how best to manage conflicts that arise between people who finance a company and those who operate it.[18] The recognition of these conflicts not only influences the structure of Delaware corporate law, but has also led to important private contractual innovations such as the poison put. Consequently, Part I.B continues with a discussion of the ways in which Delaware law attempts to manage these conflicts; it focuses first on the standards of conduct imposed upon corporate directors and then on the standards of review that courts apply when evaluating directors' actions.

A. *Agency Conflicts: Managers, Shareholders, and Debtholders*

In order to appreciate the specific role that restrictive covenants play in debt agreements, one must first consider why the corporate form has developed in the manner it has. Part I.A therefore starts by addressing the threshold issue of the separation of ownership and control. This first-order level of organization creates three discrete interest groups that

18. William T. Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 102 (4th ed. 2012) [hereinafter Allen, Kraakman & Subramanian, Commentaries, 4th ed.] (citing creation "of legal rules and remedies" to resolve agency problem between management and investors as "among the foundational problems for modern corporate law").

must be considered in the context of analyzing poison puts: managers, shareholders, and debtholders.[19] Part I.A continues with a discussion of the Jensen and Meckling model of agency costs and briefly explains how those costs inform the relationships, first, between managers and shareholders and, second, between shareholders and debtholders.

1. *Separation of Ownership and Control.* — For the purposes of the following discussion, a firm is best conceptualized as a "nexus of contracts . . . among owners of factors of production and customers."[20] Since the problem addressed in this Note deals with fiduciary duties between directors and shareholders, the agency problems discussed in Part I focus on one particular type of firm: the corporation. The "nexus of contracts" in a corporation primarily serves to define the rights and obligations of three parties—owners, directors, and managers—whose relationship has been described as follows: "Owners of freely transferable voting securities elect a board of directors which, in turn, selects executive officers who, with the help of lesser employees, manage the business of the corporation."[21] In other words, the owners—who are the shareholders, or residual claimants[22]—delegate stewardship of the firm to directors, who, in

19. Although this Note is concerned primarily with assessing the fiduciary duties of directors, the framework of agency relationships applies equally to managers. The distinction between managers and directors, although meaningful in some contexts, is not particularly relevant as directors and managers share similar conflicts of interest in relation to shareholders, particularly in the poison put context.

20. Eugene F. Fama & Michael C. Jensen, Separation of Ownership and Control, 26 J.L. & Econ. 301, 302 (1983); see also Easterbrook & Fischel, Corporate Contract, supra note 1, at 1418 (defining corporation as "complex set of explicit and implicit contracts"). This is because contracts are the primary way through which various participants in an organization define and structure rights and obligations. See Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305, 306–08 (1976) (explaining "specification of individual rights determines how costs and rewards will be allocated among the participants in any organization" and concluding contract theory of firm is best for understanding "behavioral implications . . . between the owners and managers of the firm"). For an alternative treatment as to how a corporation can be conceived, see Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law, 149 U. Pa. L. Rev. 1735, 1738 (2001) ("[B]ehavioral phenomena of internalized trust and trustworthiness play important roles in discouraging opportunistic behavior among corporate participants." (emphasis omitted)).

21. Ronald J. Gilson, A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers, 33 Stan. L. Rev. 819, 833 (1981). As Professor Gilson notes, this idealized conception is inaccurate as to the actual manner in which boards are elected, since in practice boards are generally chosen by senior management. Id. at 833 n.55.

22. Shareholders are referred to as residual claimants because, as equity investors, they hold a residual interest in the assets of the firm, which is subordinated to fixed claims. Easterbrook & Fischel, Corporate Contract, supra note 1, at 1436 (describing equity investment as "claim to 'what is left over' rather than to a definable return"); cf. Frank H. Easterbrook & Daniel R. Fischel, Limited Liability and the Corporation, 52 U. Chi. L. Rev. 89, 91 (1985) (asserting fixed claimants accept lower rate of return than residual claimants because "equity claimants . . . bear the most risk").

turn, oversee the decisions of managers responsible for the day-to-day operation of the firm.

The defining aspect of this organizational form is the separation of ownership and control. From a positive standpoint, businesses have long chosen to separate the functions of ownership and management, an observation that harkens back to Adam Smith.[23] The use of organizational forms entailing the separation of ownership and control has been studied in academic literature for the better part of a century.[24] Given the wide array of off-the-rack organizational forms from which entities can choose,[25] separating the functions of the provision of capital and the management of a business appears to be, in a normative sense, the optimal way to organize many enterprises.[26]

Complicating this picture is the fact that the separation of ownership and control leads to an agency relationship—a relationship in which one person (the agent) agrees to manage the property of another (the principal).[27] As elaborated further below, agency relationships entail various kinds of costs.[28] Although individuals willingly invest in ownership shares of corporations characterized by such agency relationships (suggesting agency cost structure is efficient),[29] it is important to note, as Jensen and

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23. Adam Smith, An Inquiry into the Nature and Causes of the Wealth of Nations 700 (Modern Library ed. 1937) (1776) (describing directors as "managers rather of other people's money than of their own").

24. See Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property 84–89 (1933) (contending most public corporations separate ownership and control). Regarding the benefits of this organizational form, Berle and Means stress "[i]t is precisely this separation of control from ownership which makes possible tremendous aggregations of property." Id. at 5.

25. To name just a few, a firm may choose to be organized as a general partnership, a limited partnership, a limited liability partnership, a limited liability company, or a corporation. See generally Allen, Kraakman & Subramanian, Commentaries, 4th ed., supra note 18, at 33–39, 67, 79–81, 97–99 (discussing, respectively, those business forms).

26. E.g., Easterbrook & Fischel, Corporate Contract, supra note 1, at 1419–21 (criticizing purely ex post view of corporations and arguing widespread use of organizational form involving separation of management and control suggests it is profit maximizing); Gilson, supra note 21, at 834 (calling separation of management and ownership "desirable" due to information-cost savings, collective action problems, and development of specialized skills necessary to manage corporation).

27. Jensen & Meckling, supra note 20, at 308 ("[A]n agency relationship [is] a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent.").

28. See infra Part I.A.2–3 (exploring agency costs as between shareholders and managers, on the one hand, and shareholders and debtholders, on the other).

29. This assertion is not without controversy, as critics of Delaware law would point out. See William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663, 663 (1974) (characterizing Delaware law as "both the sponsor and the victim of a system contributing to the deterioration of corporation standards"). But see Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913, 916–17 (1982) (calling Professor Cary's criticism flawed because it is "based on a model of shareholder irrationality").

Meckling develop in their seminal work, that the effects of separation of ownership and control are not unambiguously beneficial.[30]

2. *Agency Costs Between Managers and Shareholders.* — Consider an entity owned and operated by a sole proprietor. When this owner manages his firm, he operates it so as to maximize his utility.[31] In this arrangement, the interests of the owner and manager are perfectly aligned: Actions will only be taken when the expected marginal benefit exceeds expected marginal costs, meaning that resources will be allocated efficiently.[32] By contrast, where ownership and management are separated, agency costs arise. A manager who owns less than one-hundred percent of a business does not bear the full loss when she expends resources resulting in a wealth reduction for her firm.[33]

In light of this recognition, outside owners attempt to minimize agency costs by controlling the behavior of the manager through monitoring his actions.[34] For example, shareholders often insist on auditing a

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30. Jensen & Meckling, supra note 20, at 311 (providing positivist theory of firm organization based primarily on recognition of existence of agency costs). Agency costs have been the subject of significant academic interest. See generally Armen A. Alchian & Harold Demsetz, Production, Information Costs, and Economic Organization, 62 Am. Econ. Rev. 777, 781–83 (1972) (discussing ways in which residual claimants and management can align interests to overcome agency costs); Berle & Means, supra note 24, at 4 (exploring consequences of form of corporation "in which a large measure of separation of ownership and control has taken place through the multiplication of owners"); R.H. Coase, The Nature of the Firm, 4 Economica 386 (1937) (theorizing agency costs are one reason corporations adopt top-down control structures rather than engaging in series of contracts with independent contractors); Eugene F. Fama & Michael C. Jensen, Agency Problems and Residual Claims, 26 J.L. & Econ. 327, 327 (1983) [hereinafter Fama & Jensen, Agency Problems] ("An important factor in the survival of organizational forms is control of agency problems.").

31. See William T. Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 10 (3d ed. 2009) ("[E]conomic actors are . . . utility maximizers.").

32. Where ownership and management are consolidated, the owner-manager internalizes all costs and benefits and therefore will behave socially efficiently. The foundation for this line of thinking stems from the field of welfare economics. For an introduction to welfare economics, see generally Arthur C. Pigou, The Economics of Welfare (1920).

33. See Jensen & Meckling, supra note 20, at 312–13 (contending manager owning ninety-five percent of stock will, to reap private benefit, "expend resources to the point where the marginal utility derived from a dollar's expenditure of the firm's resources . . . equals the marginal utility of an additional [ninety-five] cents in general purchasing power . . . and not one dollar"). While the foregoing example centers on an owner-manager appropriating firm resources for her own benefit, this is certainly not the sole source of agency costs and is likely not even a particularly important one in most modern corporate settings. Rather, "agency costs arise in any situation involving cooperative effort . . . by two or more people even though there is no clear cut principal-agent relationship." Id. at 309.

34. See id. at 323 (discussing monitoring activities as means to curb potential opportunistic behavior of owner-manager). Jensen and Meckling define monitoring costs as "efforts on the part of the principal to 'control' the behavior of the agent through budget restrictions, compensation policies, operating rules etc." Id. at 308 n.9.

firm's financial reports or tying the manager's compensation to the firm's performance in an attempt to align the manager's interests to their own.[35] Likewise, a manager can voluntarily tie his hands via "bonding costs," such as "contractual limitations on [his] decision making power."[36] Ultimately, agency costs will arise whenever operating a business entails cooperative effort on behalf of its proprietors.[37] Given the existence of agency costs, it is theoretically irrelevant whether a principal incurs monitoring expenses or an agent incurs bonding costs because, ex ante, prospective owners are aware of agency costs and "the price which they will pay for shares will reflect the monitoring [and bonding] costs and the effect of the divergence between the manager's interest and theirs."[38]

If selling equity in a business creates agency costs, why do firms nonetheless incur these costs and issue equity?[39] First, agency costs arise whenever multiple parties are involved in a cooperative effort[40] and, as such, alternative sources of external capital, such as debt, still entail the creation of agency costs.[41] Second, in some circumstances, diversified ownership yields benefits that outweigh agency costs and make the issuance of equity worthwhile. Selling equity can be beneficial because it spreads economic risk among a wider group of people who can individually diversify away idiosyncratic risk.[42] In the end, however, the simplest explanation for why firms might choose to employ a model of dispersed

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35. Id. at 323.

36. Id. at 325.

37. This will be the case in every business except a sole proprietorship with zero employees. In other words, agency costs exist in essentially every business and are always positive.

38. Jensen & Meckling, supra note 20, at 313.

39. Firms have a variety of options when it comes to choosing their capital structure. As Jensen and Meckling note, capital structure generally refers to "the relative quantities of bonds, equity, warrants, trade credit, etc., which represent the liabilities of a firm." Id. at 305 n.1. One caveat to this discussion, not addressed in this Note, is that firms can forgo external financing altogether. Such a situation is not covered here because this Note is concerned with firms with poison puts and the conflicts that poison puts engender among shareholders, directors, and debtholders. The firms implicated by this discussion have necessarily issued equity and debt.

40. See supra note 33 and accompanying text (explaining Jensen and Meckling's conception of agency costs).

41. See infra Part I.A.3 (covering agency costs as between shareholders and debtholders).

42. Fama & Jensen, Agency Problems, supra note 30, at 329 ("Common stock allows residual risk to be spread across many residual claimants who individually choose the extent to which they bear risk and who can diversify across organizations offering such claims."). For an introduction to modern portfolio theory stressing the benefits of diversification, see generally William Sharpe, Portfolio Theory and Capital Markets (1970); Harry Markowitz, Portfolio Selection, 7 J. Fin. 77 (1952).

equity ownership despite the existence of positive agency costs is that, relative to other options, this form is the least bad.[43]

3. *Agency Relationship Between Shareholders and Debtholders.* — Having discussed the agency relationship between managers and shareholders, it is now necessary to consider the role of debtholders.[44] With respect to managers, debtholders face similar agency costs as shareholders.[45] However, debtholders face an additional set of agency costs vis-à-vis shareholders, which stems from debtholders' position as fixed, rather than residual, claimants. Because residual claimants have limited liability and are only entitled to "what's left" after fixed claimants are made whole, they have an incentive to take on greater risk.[46] If the investment opportunity fails, shareholders risk losing their invested capital. If the investment opportunity is successful, however, shareholders are rewarded with

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43. Jensen & Meckling, supra note 20, at 328 (labeling argument that because "agency costs are non-zero . . . the agency relationship is non-optimal, wasteful or inefficient" an example of "Nirvana" fallacy). For more on the "Nirvana" fallacy, see Harold Demsetz, Information and Efficiency: Another Viewpoint, 12 J.L. & Econ. 1, 2 (1969) (criticizing "nirvana approach" as "more susceptible than is the comparative institution approach to committing . . . logical fallacies").

44. A full discussion of why firms choose to take on debt is beyond the scope of this Note. However, for two leading views, consider Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. 323, 324–26 (1986), which observes that "debt reduces the agency costs of free cash flow by reducing the cash flow available for spending at the discretion of managers," and Franco Modigliani & Merton H. Miller, Corporate Income Taxes and the Cost of Capital: A Correction, 53 Am. Econ. Rev. 433, 442–43 (1963), which highlights the importance of tax advantages of debt financing stemming from the deductibility of interest payments.

45. Morey W. McDaniel, Bondholders and Stockholders, 13 J. Corp. L. 205, 234–38 (1988) ("All outside investors are adversely affected when managers reduce the value of the firm through mismanagement or self-dealing or fail to increase the value of the firm."). Some commenters focus on the fact that fixed claimants will be made whole unless a firm defaults. See, e.g., Richard A. Posner, Economic Analysis of Law 557 (8th ed. 2011) (claiming debtholders' concern "is not that the firm be well managed, but that it not be so mismanaged that it defaults"). However, debt securities are actively traded, meaning debtholders have the opportunity to capture capital gains, creating agency concerns similar to those of shareholders. See McDaniel, supra, at 234 (contending bondholders seek capital gains and thus have interest in how firm is managed).

46. Jensen & Meckling, supra note 20, at 334. Jensen and Meckling provide an example of how this might work:

> [I]f the owner has the opportunity to *first* issue debt, then to decide which of the investments to take, and then to sell all or part of his remaining equity claim on the market, he will not be indifferent between . . . investments [with equal expected payoffs but with different variances]. The reason is that by promising to take the low variance project, selling bonds and then taking the high variance project he can transfer wealth from the (naïve) bondholders to himself as equity holder.

Id. at 335.

returns that can be multiple times the size of their initial equity investment.[47]

Of course, debtholders are aware ex ante that their interests are not perfectly aligned with those of shareholders and will take cost-justified steps to ensure that managers (who often have large equity stakes) do not act opportunistically.[48] Debtholders have several options in this regard. One choice is simply making the firm pay more to issue its debt: by increasing bonds' yield-to-maturity, for example.[49] Another option, which gives rise to the problem addressed in this Note, is that the debtholder can insist that the firm bind itself by a covenant in its debt instrument to refrain from taking certain actions.[50] By agreeing to such a covenant, the firm internalizes the agency costs of debt.[51]

Whether such cost shifting takes the form of a higher interest rate, a covenant in a debt agreement, or some other arrangement, debtholders who recognize ex ante that agency costs exist will not bear those costs: owners will.[52] As such, management's decision to agree to a restrictive covenant in a debt agreement should not necessarily raise suspicion so long as the presence of covenant protection for debtors is inversely corre-

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47. This moral hazard issue is the basic animating principle of leverage. See John C. Coffee, Jr., Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1, 61–62 & n.172 (1986) ("The standard literature on corporate finance recognizes that limited liability can give rise to moral hazard problems . . . and that this danger grows in direct proportion to the degree of leverage in the corporation's financial structure." (citing Jensen & Meckling, supra note 20, at 334)).

48. Jensen & Meckling, supra note 20, at 337–39 (noting bondholders' incentive to constrain opportunistic managerial activity). As with the agency costs of equity, the equity-owning manager will bear the agency costs of debt as long as debtholders recognize the potential agency costs up front. Id. at 337.

49. See Marcel Kahan & Michael Klausner, Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?, 40 UCLA L. Rev. 931, 938–40 [hereinafter Kahan & Klausner, Antitakeover Provisions] ("Bondholders are aware that companies may take actions that shift wealth to shareholders, and they demand a higher interest rate as *ex ante* compensation for that possibility."). Yield-to-maturity is the expected rate of return on a bond held until the end of its term. Yield to Maturity (YTM), Investopedia, http://www.investopedia.com/terms/y/yieldtomaturity.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014).

50. Kahan & Klausner, Antitakeover Provisions, supra note 49, at 938–40; see also Jensen & Meckling, supra note 20, at 337–38 ("In principle it would be possible for the bondholders, by the inclusion of various covenants in the indenture provisions, to limit the managerial behavior which results in reductions in the value of the bonds."); Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. Fin. Econ. 117, 131–35 (1979) (discussing one such covenant, a restriction on dividends).

51. Generally, a firm will internalize the agency costs of debt when it is cheaper for the firm to bear the risk by covenanting against it than to pay a higher interest rate. Cf. George Triantis, Response, Exploring the Limits of Contract Design in Debt Financing, 161 U. Pa. L. Rev. 2041, 2042 (2013) (arguing informed debtholders compel shareholders to internalize agency costs of debt).

52. Jensen & Meckling, supra note 20, at 338.

lated with the interest rate the company pays on that debt.[53] By contrast, cause for concern arises when a firm internalizes the agency costs of debt by agreeing to a covenant giving debtholders protection, but debtholders nonetheless receive an interest rate that has not been adjusted downward to reflect the reduced risk they bear. In such cases, debtholders experience a windfall.[54]

B. *Delaware Law*

The agency relationships discussed above serve as the theoretical foundation of corporate law. Corporate law adopted the fiduciary duties of loyalty and care as a response to the existence of agency problems.[55] While fiduciary duties serve as a source of protection for shareholders in Delaware, that protection is cabined significantly by the deference afforded to directors under § 141(a).[56] Moreover, judicially created doctrine has further embedded the principle of director deference,[57] except in one notable area: defensive measures,[58] particularly those that impinge on the shareholder franchise.[59]

1. *A Basic Framework: Fiduciary Duties and Directors' Discretion Under § 141(a).* — While Delaware law is fairly characterized as highly deferential to the discretion of directors,[60] such deference is not the intellectual font of corporate law. Rather, deference to directors' discretion is better read as a lens through which fiduciary duties are analyzed—in other

53. Kahan & Klausner, Antitakeover Provisions, supra note 49, at 939–40.

54. Id.

55. Robert H. Sitkoff, The Economic Structure of Fiduciary Duty, 91 B.U. L. Rev 1039, 1042–45 (2011) (conceptualizing fiduciary duties as legal solution aimed at deterring opportunistic behavior of agents).

56. Del. Code Ann. tit. 8, § 141(a) (2012).

57. See Bainbridge, Abstention, supra note 1, at 109–30 (justifying abstention doctrine view of business judgment rule as embodying deference to "board's authority"); cf. Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 Nw. U. L. Rev. 547, 559–60 (2003) (employing contractarian theory of firm and describing directors as "*sui generis* body serving as the nexus for the various contracts making up the corporation").

58. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954–55 (Del. 1985) (applying enhanced scrutiny to director approval of defensive measures "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests" in ensuring its perpetuation).

59. Stroud v. Grace, 606 A.2d 75, 91–92 (Del. 1992) (stating board action aimed at "thwart[ing] free exercise of the [shareholder] franchise" violates Delaware law); cf. David C. McBride & Danielle Gibbs, Interference with Voting Rights: The Metaphysics of *Blasius Industries v. Atlas Corp.*, 26 Del. J. Corp. L. 927, 941–43 (2001) (suggesting courts might never find compelling justification sufficient to sustain measures taken by board primarily to impinge on shareholder franchise). For a discussion of Delaware's treatment of cases involving directors' actions that impinge upon the shareholder franchise, see infra notes 99–104 and accompanying text.

60. See, e.g., supra note 1 and accompanying text (discussing standard of review for directors in Delaware).

words, deference is warranted only for those actions taken in accordance with the duties of care and loyalty.[61] As such, one must first understand directors' fiduciary obligations to shareholders before proceeding to an analysis of the interpretive methods courts apply in actions alleging a breach of those duties.

The fiduciary relationship between directors and shareholders bestows upon directors a legal obligation to direct a company for the benefit of its shareholders.[62] This responsibility takes the form of two distinct duties: the duty of care and the duty of loyalty.[63] The crux of the duty of care is a requirement that directors make informed decisions.[64] In order to fulfill this duty, directors need not clear a high bar: The standard of liability is gross negligence.[65] This is not, however, to say that

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61. Cf. Shlensky v. Wrigley, 237 N.E.2d 776, 780 (Ill. App. Ct. 1968) (concluding decision is "properly before directors" in absence of factors suggesting breach of fiduciary duty).

62. See, e.g., Stephen M. Bainbridge, In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green, 50 Wash. & Lee L. Rev. 1423, 1423–24 (1993) (calling maximization of shareholder value "fundamental norm" espoused by "mainstream of corporate law"); A.A. Berle, Jr., Corporate Powers as Powers in Trust, 44 Harv. L. Rev. 1049, 1049 (1931) (contending fiduciary powers are "exercisable only for the ratable benefit of all the shareholders as their interest appears"). For a discussion of the "shareholder primacy norm," see generally D. Gordon Smith, The Shareholder Primacy Norm, 23 J. Corp. L. 277, 280–91 (1998).

63. E.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) (citing Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)). In addition to the duties of care and loyalty, directors have an obligation to act in good faith. There has been considerable doctrinal uncertainty as to the status of this obligation within the traditional fiduciary duty framework. See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) (identifying "triad" of fiduciary duties, including good faith); Sean J. Griffith, Good Faith Business Judgment: A Theory of Rhetoric in Corporate Law Jurisprudence, 55 Duke L.J. 1, 29 (2005) ("[T]he precise meaning of good faith remains unclear."); David Rosenberg, Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach, 29 Del. J. Corp. L. 491, 496–505 (2004) (discussing doctrinal confusion as to whether good faith is separate fiduciary duty); Hillary A. Sale, Delaware's Good Faith, 89 Cornell L. Rev. 456, 494–95 (2004) (arguing good faith should be conceptualized as distinct from duties of care and loyalty). However, the Delaware Supreme Court eventually addressed this confusion and implied that the duty of good faith is a subset of the duty of loyalty. In re Walt Disney Co. Derivative Litig. (*Disney III*), 906 A.2d 27, 66–67 (Del. 2006).

64. See Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) ("[A] director's duty to exercise an informed business judgment is in the nature of a duty of care . . . ."); see also Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963) (explaining duty of care requires directors to act with same "amount of care which ordinarily careful and prudent men would use in similar circumstances").

65. See *Van Gorkom*, 488 A.2d at 873 (concluding gross negligence is appropriate standard for judging whether directors' actions conform to duty of care); cf. Strassburger v. Earley, 752 A.2d 557, 582 (Del. Ch. 2000) (holding directors not liable "for good faith business decisions, even those that turn out to be mistaken"). Note, however, that while the standard of review is gross negligence, the standard of conduct is framed in terms of ordinary negligence. See William T. Allen et al., Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of *Van Gorkom* and Its Progeny as a Standard of Review Problem, 96 Nw. U. L. Rev. 449, 451–57 (2002) [hereinafter Allen

the duty of care is totally without teeth. Directors have been found liable for violating the duty of care in a number of situations: hasty negotiation of a merger and defective process in getting board approval,[66] failure to consider the possibility that a competing hostile bid would be better for shareholders,[67] failure to monitor,[68] and conscious failure to oversee a firm's monitoring or reporting system.[69]

The duty of loyalty, on the other hand, concerns directors' actions that might be subject to conflicts of interest.[70] Perhaps the best explanation of the duty of loyalty comes from the Delaware Supreme Court in *Aronson v. Lewis*, in which it held that "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally."[71] The two paradigmatic ways to challenge a director's loyalty focus on whether a director is interested or lacks independence.[72] A director is interested in a transaction when he gets a pecuniary gain that is not shared with other shareholders.[73] Independence, by contrast, covers a broader range of situations and focuses on whether an uninterested director nevertheless might have a "sense of 'beholdenness'" to an interested director.[74]

2. *Delaware's Standards of Review: The Business Judgment Rule, Entire Fairness,* Unocal, *and* Blasius. — Delaware law imposes fiduciary duties upon directors to run the corporation for shareholders' benefit but, in

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et al., Realigning] (asserting divergent standards of conduct and review serve important policy goals).

66. See *Van Gorkom*, 488 A.2d at 875 (citing problems with board's process in light of "hastily calling [a] meeting without prior notice of its subject matter," "proposed sale of the [c]ompany without any prior consideration of the issue or necessity therefor," and "total absence of any documentation whatsoever").

67. See *Revlon*, 506 A.2d at 185 (concluding Revlon had breached its duties by playing favorites and failing to negotiate with other bidders).

68. See In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967–69 (Del. Ch. 1996) (noting breach of duty of care may exist where "loss eventuates not from a decision but, from unconsidered inaction").

69. Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (holding director oversight liability will apply even if monitoring system is in place when directors fail to make use of system, "thus disabling themselves from being informed of risks or problems requiring their attention").

70. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) ("Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests."); cf. *Van Gorkom*, 488 A.2d at 872–73 (applying duty of care and distinguishing duty of loyalty, which involves "allegations of fraud, bad faith, or self-dealing").

71. 473 A.2d 805, 812 (Del. 1984).

72. See William B. Chandler III & Leo E. Strine, Jr., The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State, 152 U. Pa. L. Rev. 953, 996–98 (2003) (discussing roles of independence and interestedness in duty of loyalty inquiry).

73. *Aronson*, 473 A.2d at 812.

74. Usha Rodrigues, The Fetishization of Independence, 33 J. Corp. L. 447, 466 (2008).

doing so, yields significant discretion to directors under § 141(a). One group, not previously considered, has added substantially to this mosaic: the Delaware judiciary. Both for doctrinal clarity and for practitioners' ex ante planning purposes, perhaps the most important role played by the Chancery Court and the Delaware Supreme Court has been establishing standards of judicial review.[75]

The default standard of review that Delaware courts employ in assessing directors' decisions is the business judgment rule[76]—a judicially created presumption that directors have acted in accordance with their fiduciary duties of care, loyalty, and good faith.[77] Business judgment deference thus represents a judicial acknowledgement of § 141(a) and the broad discretion it affords to directors.[78] While fiduciary duties legally bind directors to pursue the *end* of maximizing shareholder value, the business judgment rule gives directors significant discretion with respect to the *means* employed in pursuit of that end.[79] Thus, in order to give full effect to § 141(a), courts will generally refrain from second-guessing the wisdom of a particular business decision. Indeed, judicial review under the business judgment standard has been described as "non-review,"[80] though such a characterization may not be entirely accurate with respect to oversight of the process by which directors make decisions.[81] While there are a variety of rationales offered in defense of

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75. The Delaware judiciary plays other important roles as well. For one example, see Cary, supra note 29, at 686–88 (noting ease of bringing suit against corporate directors in Delaware and suggesting judiciary has aided by liberally construing statutes to provide enhanced rights to shareholders).

76. See, e.g., Bainbridge, Abstention, supra note 1, at 98–99 (explaining business judgment rule as default standard of review unless precondition of good faith is not met).

77. See, e.g., *Aronson*, 473 A.2d at 812 ("[The business judgment rule] is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.").

78. Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981) (describing business judgment rule as "recognition and deference to directors' business expertise when exercising" statutorily granted authority).

79. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (establishing directors' discretion as relating to "choice of means to attain [the] end" of returning profits for shareholders).

80. Lyman Johnson, The Modest Business Judgment Rule, 55 Bus. Law. 625, 628–31 (2000) ("[T]he business judgment rule is simply a policy of judicial *non-review*.").

81. See Bainbridge, Abstention, supra note 1, at 99–100 (contending, in business judgment review, courts should not reach "substantive review of the merits of the board's decision" but might still exercise review in cases with "truly egregious process failures"); Julian Velasco, Structural Bias and the Need for Substantive Review, 82 Wash. U. L.Q. 821, 828–30 (2004) ("[T]he business judgment rule focuses primarily on the directors' decision-making process."); see also In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967 (Del. Ch. 1996) (refusing director liability for "substantively wrong," "stupid," "egregious," or "irrational" decisions, so long as "process employed was either rational or employed in a good faith effort to advance corporate interests" (emphasis omitted) (internal quotation marks omitted)).

the business judgment rule—for instance, that business ventures inherently entail risk,[82] that excessive risk of liability would drive away competent directors,[83] or that value paid for the residual claim reflects the costs imposed by the corporate governance structure[84]—the crucial justification from a corporate governance standpoint is that shareholders retain discretion to elect directors and to either sell their stock or remove directors of whom they disapprove.[85]

Shareholders seeking to challenge directors' actions are best served by escaping the director-friendly confines of the business judgment rule. In order to reach heightened scrutiny, plaintiffs must be able to show that directors' actions border on fraud, illegality, or conflict of interest.[86] While the business judgment rule presumes compliance with fiduciary duties, Delaware courts apply enhanced scrutiny—entire fairness review—when that presumption is rebutted.[87] Conflict of interest is a particularly fruitful situation for shareholders seeking enhanced judicial scrutiny, because when the interests of directors and shareholders come into conflict, presuming that directors have exercised independent business judgment is no longer appropriate.[88] Under the entire fairness test, absent prior approval by independent and fully informed directors[89] or by disinterested shareholders,[90] the burden is on directors to prove the

82. Bainbridge, Abstention, supra note 1, at 117–24 (arguing "information asymmetries counsel judicial abstention from reviewing board decisions" but ultimately concluding that "cannot be a complete explanation" for deference because judges are in business of second guessing).

83. See Air Line Pilots Ass'n, Int'l v. UAL Corp., 717 F. Supp. 575, 582 (N.D. Ill. 1989) (justifying business judgment rule because it "encourages competent individuals to become directors who otherwise might decline for fear of personal liability"), aff'd, 897 F.2d 1394 (7th Cir. 1990); see also Lyman P.Q. Johnson, Corporate Officers and the Business Judgment Rule, 60 Bus. Law. 439, 455–56 (2005) (arguing one purpose of business judgment rule is "encouraging directors to serve and take risks").

84. This line of thinking stems from the efficient capital markets hypothesis, which contends that the price of a security reflects future expected cash flow, taking into account all information about a firm. See generally Myron S. Scholes, The Market for Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices, 45 J. Bus. 179 (1972) (describing efficient capital markets hypothesis and empirically confirming its predictions in context of securities issuances).

85. See Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988) (identifying those options as "only . . . protections" shareholders enjoy against directors' "inadequate business performance").

86. Shlensky v. Wrigley, 237 N.E.2d 776, 778 (Ill. App. Ct. 1968) (applying Delaware law).

87. See Velasco, supra note 81, at 827 & n.12 (stating entire fairness test applies when business judgment presumptions have been rebutted and defending importance of enhanced scrutiny in Delaware law).

88. See, e.g., Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982) (explaining business judgment deference does not apply to cases in which there is a conflict of interest); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (same).

89. Del. Code Ann. tit. 8, § 144(a)(1) (2011).

90. Id. § 144(a)(2).

transaction or decision in question was entirely fair to the corporation.[91] In a transactional context, this analysis turns on whether the transaction approximates an arm's-length deal, both substantively and procedurally.[92] In sum, the entire fairness test lies at the opposite end of the spectrum from the business judgment rule and is, consequently, the strictest standard of review in Delaware's jurisprudence.

In *Unocal Corp. v. Mesa Petroleum Co.*, the Delaware Supreme Court established an intermediate level of scrutiny for defensive measures[93] that falls somewhere between business judgment review and entire fairness review.[94] In *Unocal*, the court held that a board must make two showings to establish the validity of a defensive measure: (i) that it reasonably perceived a "danger to corporate policy and effectiveness" and (ii) that the defensive measure was a proportional response to that threat.[95] Although courts have interpreted the threat prong of *Unocal* in a relatively liberal manner,[96] both burden shifting and the proportionality requirement serve to make *Unocal* a relatively attractive option for shareholders seeking to challenge defensive measures. In order to prevail on the proportionality prong of the *Unocal* test, shareholders are required to show that a defensive measure is preclusive, coercive, or otherwise outside a range of reasonableness.[97] The principle animating the use of this intermediate standard of review is that, although the degree of conflict of interest present in defensive actions does not rise to that of self-dealing, defensive measures nevertheless carry with them an "omnipresent specter that a

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91. See Allen et al., Realigning, supra note 65, at 461 ("[L]aw imposes upon the directors the burden of showing that the transaction is entirely fair . . . .").

92. Melvin Aron Eisenberg, The Divergence of Standards of Conduct and Standards of Review in Corporate Law, 62 Fordham L. Rev. 437, 450 (1993) (describing entire fairness test as "meaning, essentially, that the terms the corporation gives or gets should be the terms it would have given or gotten if it had dealt on the market"). The entire fairness test has both substantive and procedural components. The former requires a fair price, while the latter requires that the deal have been made in the confines of a fair process. See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) ("The concept of fairness has two basic aspects: fair dealing and fair price.").

93. For a description of defensive measures and how courts respond, see, e.g., William M. Lafferty et al., A Brief Introduction to the Fiduciary Duties of Directors Under Delaware Law, 116 Penn St. L. Rev. 837, 859 (2012) (describing defensive measures as when "board takes steps to (i) lock-up or secure a favored transaction or (ii) fend off or thwart unwanted suitors or defend against a disfavored transaction"). Some types of defensive measures include staggered boards, supermajority voting requirements, stock buy-backs, and poison pills. Id. at 871–77.

94. See 493 A.2d 946, 953–55 (Del. 1985) (indicating that validity of defensive measure at issue turned on authority of board to act and calling for "enhanced duty" in light of "omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders").

95. Id. at 954–57.

96. See, e.g., Paramount Commc'ns Inc. v. Time Inc., 571 A.2d 1140, 1152 (Del. 1990) (recognizing threat to corporate culture as satisfying first prong of *Unocal*); id. at 1153 (recognizing threat in form of shareholder preference for hostile tender offer).

97. Unitrin v. Am. Gen. Corp., 651 A.2d 1361, 1386–88 (Del. 1995).

board may be acting primarily in its own interests, rather than those of the corporation and its shareholders."[98]

Within the *Unocal* framework, the Chancery Court in *Blasius Industries v. Atlas Corp.* provided an enhanced standard of review for a particular subset of defensive measures—those "designed for the primary purpose of interfering with the effectiveness of a stockholder vote."[99] Whereas most disputes in Delaware jurisprudence deal with questions relating to the propriety of directors' exercise of "*the corporation's power* over its property," when a board takes action to interfere with the shareholder franchise the question instead turns to the *allocation* of power as between shareholders and directors.[100] While directors are afforded deference as to the *means* employed to achieve legitimate corporate ends,[101] that presumption ceases to be appropriate when directors act for the primary purpose of interfering with the shareholder franchise.[102] Thus, under *Blasius*, directors must show a "compelling justification" for such actions, which is an extremely high bar.[103] Although some have criticized the workability of the *Blasius* standard, it nevertheless functions as a reminder of the importance of the shareholder franchise in Delaware law and serves as a nearly automatic bar to directors' actions that seek to diminish shareholders' ability to exercise the vote.[104]

98. *Unocal*, 493 A.2d at 954.

99. 564 A.2d 651, 659 (Del. Ch. 1988). Although *Blasius* frequently operates within *Unocal*, measures taken to abridge the shareholder franchise are not always defensive and thus in those cases *Blasius* operates independently of *Unocal*. See MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1129–30 (Del. 2003) ("[T]he same circumstances must be extant before the *Blasius* compelling justification enhanced standard of judicial review is required . . . either independently, in the absence of a hostile contest for control, or within the *Unocal* standard of review when the board's action is taken as a defensive measure.").

100. *Blasius*, 564 A.2d at 660.

101. See supra notes 76–85 and accompanying text (discussing business judgment rule).

102. See *Blasius*, 564 A.2d at 660–62 ("Action designed principally to interfere with the effectiveness of a vote . . . is not . . . a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment."); see also *Liquid Audio*, 813 A.2d at 1126–27 ("Maintaining a proper balance in the allocation of power between the stockholders' right to elect directors and the board of directors' right to manage the corporation is dependent upon the stockholders' unimpeded right to vote effectively in an election of directors.").

103. See *Blasius*, 564 A.2d at 660–62 (applying "compelling justification" standard); see also Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 258 (Del. Ch. 2013) (characterizing *Blasius* as "very high standard"); Chesapeake Corp. v. Shore, 771 A.2d 293, 323 (Del. Ch. 2000) ("In reality, invocation of . . . *Blasius* . . . usually signals that the court will invalidate the board action under examination.").

104. See *SandRidge*, 68 A.3d at 258 ("*Blasius*' importance rests more in its emphatic and enduring critical role in underscoring the serious scrutiny that Delaware law gives to director action that threatens to undermine the integrity of the electoral process, than in its articulation of a useful standard of review to decide actual cases."); William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. Law. 1287, 1311–12 (2001) [hereinafter

II. The Rise (and Fall?) of the Poison Put

In response to the agency problem between fixed and residual claimants, a variety of covenants have emerged over time in an attempt to protect debtholders. Part II begins with the protective covenant that gives rise to this Note, the poison put. Part II.A.1 discusses the arguments for and against poison puts to provide context for Part II.A.2's more detailed analysis of how poison puts function and why they appear to align more closely with directors' self-interest than to respond to debtholders' concerns. Part II.B describes the particular poison put provisions at issue in *Amylin* and *SandRidge*. Finally, Part II.C concludes with a discussion of the Chancery Court's decisions in those cases.

A. *The Poison Put*

The poison put is best conceived as a contract designed to respond to (or possibly to exploit) the agency relationships and legal framework discussed above. Consequently, this Part begins with a discussion of how poison puts function generally and the various options that companies and debtholders have in selecting the terms of a given poison put, before proceeding to the particular provisions at issue in *Amylin* and *SandRidge*.

1. *The Poison Put: An Embedded Defensive Measure.* — Antitakeover mechanisms were originally developed as tools for boards of directors facing unwanted bids.[105] The wave of leveraged buyouts and hostile takeovers during the 1980s inspired corporate directors to come up with novel ways to ward off unwanted suitors[106]—strategies such as "poison pills, greenmail, the 'Pac Man' defense, white knights, and golden parachutes" became de rigeur.[107] As new antitakeover defenses have continued to emerge, Delaware courts have analyzed these measures on a case-by-case basis in an attempt to separate valid actions that serve the best interests of the corporation from those impermissibly tainted by the self-interest of incumbent directors.[108]

Allen, Jacobs & Strine, Standards] (finding flaw in "practicality" of *Blasius* standard of review because of overlap with *Unocal* but noting *Blasius* "reaffirmed the traditional view that director actions primarily motivated to effect a disenfranchisement have a dim chance of being sustained").

105. See Martin Lipton, Corporate Governance in the Age of Finance Corporatism, 136 U. Pa. L. Rev. 1, 28–35 (1987) (describing defensive mechanisms as "legitimate responses to abusive takeover schemes").

106. See id. at 6–7 (arguing takeover boom in 1980s was spurred by "speculative, financial considerations" and "generated a host of powerful defensive responses").

107. Kahan & Klausner, Antitakeover Provisions, supra note 49, at 944; see also John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, 78 Geo. L.J. 1495, 1515–21 (1990) [hereinafter Coffee, Unstable Coalitions] (summarizing empirical studies finding bondholders lose value in leveraged buyouts and characterizing development of poison put as response thereto).

108. Cf. Stephen M. Bainbridge, The Geography of *Revlon*-Land, 81 Fordham L. Rev. 3277, 3293, 3302–04 (2013) (explaining *Unocal* as response to potential self-interest at

The poison put is a variant of an antitakeover mechanism that is embedded in a debt agreement. Taking the form of a bond indenture, poison puts provide debtholders with a contractual right to demand repayment before such debt reaches maturity. The poison put that this Note is concerned with—a continuing director poison put—acts as an antitakeover mechanism because its redemption right is triggered by a majority turnover of a company's board of directors.[109] These poison puts were introduced in the late 1980s and popularized at least in part as a response to the RJR Nabisco leveraged buyout.[110] Like all defensive measures, such poison puts are capable of serving two functions: They can protect the best interests of the company but are also capable of entrenching management and directors by shielding them from a change in control.[111] Determining which of these functions lies at the core of the poison put is subject to some controversy.

From a debtholder's perspective, these provisions are potentially beneficial based on the theory that the extensive debt accumulated by bidders attempting to mount a hostile takeover and by targets attempting to defend themselves increases the risk of prior outstanding debt, thereby decreasing the market value of the claims of existing debtholders.[112] From an agency cost framework, then, the poison put is an attempt to decrease the cost of debt by providing a contractual form of insurance—a put option[113]—for debtholders whose investment might depreciate as a result of a hostile takeover.[114] Although strong theoretical argu-

stake in defensive measures and concluding motive of target board is determinative variable). For an example of the Delaware Supreme Court performing such an analysis, consider the court's reasoning in concluding the poison pill is a valid defensive measure in Moran v. Household Int'l, Inc., 500 A.2d 1346, 1353–55 (Del. 1985).

109. For further clarification on how poison puts function, see infra Part II.A.2.

110. Coffee, Unstable Coalitions, supra note 107, at 1519; Kahan & Klausner, Antitakeover Provisions, supra note 49, at 971. For a detailed account of the RJR Nabisco leveraged buyout, see generally Bryan Burrough & John Helyar, Barbarians at the Gate: The Fall of RJR Nabisco (3d ed. 2008).

111. See, e.g., Kahan & Klausner, Antitakeover Provisions, supra note 49, at 933–35 (presenting competing schools of thought as to whether poison puts are primarily meant to protect bondholders or instead to insulate directors); see also Coffee, Unstable Coalitions, supra note 107, at 1519–21 (suggesting confluence of interests between managers and bondholders with respect to opposing changes of control).

112. See Lipton, supra note 105, at 20–23, 26–28 (asserting accumulation of debt has been primary result of increase in hostile takeovers and contending bondholders have been "universally harmed" as a result); see also K.J. Martijn Cremers et al., Governance Mechanisms and Bond Prices, 20 Rev. Fin. Stud. 1359, 1360 (2007) ("[A]n increase in leverage can reduce the value of the outstanding bonds not only by increasing the probability and the deadweight costs of a possible future bankruptcy but also by reordering the priority of claims in bankruptcy.").

113. See Black's Law Dictionary 1204 (9th ed. 2009) (defining put option as "option to sell something (esp. securities) at a fixed price even if the market declines; the right to require another to buy").

114. See, e.g., Kahan & Klausner, Antitakeover Provisions, supra note 49, at 940–43 (arguing poison puts decrease agency cost of debt by addressing incentive shareholders

ments can be made that poison puts can maximize the value of a firm,[115] several notable commentators suggest that the primary function of poison puts is entrenching a firm's directors.[116]

In assessing whether poison puts serve the corporation-friendly purpose of decreasing the cost of debt as opposed to merely being an entrenchment tool, courts must consider the same questions as with other defensive measures: First, is the "primary purpose" of the poison put to impinge on the shareholder franchise?[117] If not, is the poison put a proportionally reasonable response to a threat to the corporation?[118]

The poison put, however, presents an additional conceptual hurdle when compared with other defensive measures. While defensive measures such as the poison pill are a "pure defense," the poison put is an "embedded defense."[119] In other words, the potential benefit of a defensive mechanism like the poison pill[120] is facially obvious: successfully

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have to prefer potentially inefficient amounts of leverage); see also Robert E. Chatfield & R. Charles Moyer, Agency Problems, Put Options, and Leveraged Buyouts, 1 J. Managerial Issues 26, 30–32 (1989) ("By promising the investor an option to redeem the bonds at par value before maturity, the ability of owners to expropriate wealth from investors is severely limited.").

115. See, e.g., Douglas O. Cook & John C. Easterwood, Poison Put Bonds: An Analysis of Their Economic Role, 49 J. Fin. 1905, 1907 (1994) (explaining "bondholder protection hypothesis" predicts positive stock price reaction in response to issuing debt with poison puts under certain circumstances); Kahan & Klausner, Antitakeover Provisions, supra note 49, at 936–50 (discussing effect of poison puts on agency costs of debt and equity and distinguishing ideal poison put protecting bondholders from one meant to entrench management).

116. See, e.g., Coffee, Unstable Coalitions, supra note 107, at 1519–21 (positing interest rate adjustments would likely provide superior protection to bondholders compared to put options and concluding "suspicion grows that those managements choosing to adopt the poison put format are utilizing the bondholders' anxiety for their own self-protective ends"); Cook & Easterwood, supra note 115, at 1905–06 (presenting "entrenchment hypothesis" that poison puts are "designed to make firms less attractive as takeover targets and thus provide an additional mechanism for strengthening managerial resistance to hostile bids").

117. See supra notes 99–104 and accompanying text (discussing *Blasius* standard of review).

118. See supra notes 93–98 and accompanying text (discussing *Unocal* standard of review).

119. See Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. Pa. L. Rev. 577, 596–99 (2003) (contending "pure defenses" are more susceptible to judicial review than "embedded defenses"). This observation stems from the fact that whereas the benefits of "pure defenses" are limited to their ability to deter inadequate hostile bids, the benefits of "embedded defenses" are more diffuse, along the lines of ordinary business decisions. Id.; see also Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 259 (Del. Ch. 2013) (describing poison put as "latent takeover and proxy contest defense").

120. See Poison Pill, Investopedia, http://www.investopedia.com/terms/p/poisonpill.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining "Poison Pill" as "strategy used . . . to discourage hostile takeovers" by allowing existing shareholders other than the potential acquirer to buy shares in either existing or acquiring company at discount).

deterring insufficient takeover bids. By contrast, the defensive effect of a poison put is embedded in what is otherwise an ordinary business decision, and the potential benefits to shareholders are twofold. The poison put might both decrease the agency cost of debt and deter inefficient takeovers. Compared to poison pills and other traditional antitakeover tools employed by corporations, poison puts present particularly difficult questions because they are, at least theoretically, bargained for at arm's length and implicate all three interest groups discussed in Part I: shareholders, directors, and debtholders.[121] As such, Delaware courts are faced with the challenge of determining how much scrutiny to apply to the inclusion of a provision in a contract with a third party—the type of ordinary business decision at the heart of § 141(a), but which nonetheless has significant antitakeover effects.[122]

2. *Remedies and Triggers.* — To assess the validity of poison puts, courts must confront the specific language of the provisions at issue. Most commonly, poison puts arise either as a covenant in a bond indenture or as a contractual term in a revolving credit facility.[123] At the greatest level of generality, the poison put grants a debtholder a remedy that is triggered by the occurrence of some predefined event.[124] While various types of event risk covenants[125] confer different remedies, as a definitional matter the remedy associated with poison puts is a put option.[126] Consequently, a company that agrees to a poison put in its debt

121. Coffee, Unstable Coalitions, supra note 107, at 1528–31 (arguing poison puts differ from poison pills because they are result of arm's-length bargaining, thereby complicating judicial task); see also Kahan & Klausner, Antitakeover Provisions, supra note 49, at 980–82 (concluding difficulty arises because restrictive covenants might benefit firm by lowering agency cost of debt but might hurt it by entrenching management and increasing agency cost of equity).

122. See, e.g., Dennis K. Berman, 'Poison Puts' Undercut Mergers, Wall St. J. (Apr. 14, 2009, 12:01 AM), http://online.wsj.com/news/articles/SB123966561891915179 (on file with the *Columbia Law Review*) (arguing poison puts have decreased merger and acquisition activity).

123. See Arlen & Talley, supra note 119, at 620–21 (highlighting range of contracts into which "penalty change of control provisions" are inserted).

124. Kahan & Klausner, Antitakeover Provisions, supra note 49, at 936–37. For the perspective of a Federal Reserve economist on how event risk covenants function, see generally Leland Crabbe, Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants, 46 J. Fin. 689, 696–700 (1991) (describing structure of event risk covenants and analyzing value based on Standard and Poor's covenant ratings).

125. The term "event risk covenant" can be best understood as a catchall term for the contractual protections given to creditors in debt instruments, subject to a variety of triggering events. See, e.g., William W. Bratton, Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process, 7 Eur. Bus. Org. L. Rev. 39, 58–62 (2006) (outlining genesis and general mechanics of event risk protections for bondholders).

126. Id. at 62. In other event risk covenants, a commonly available remedy is an increase in the yield owed on the bonds. Id. Some commenters have included within the definition of a poison put those event risk covenants whose remedy is an interest rate adjustment. See, e.g., Kahan & Klausner, Antitakeover Provisions, supra note 49, at 960–62

instruments is contractually obligated to buy back its own debt at par value (or at a premium) upon the occurrence of some event.[127] Common events that trigger the redemption right include a change in control, a merger or acquisition, a downgrading in the bond's credit rating, or a turnover of a majority of the board.[128] While poison puts undoubtedly confer protection to debtholders in certain circumstances, one must consider the full range of contractual options in order to fully appreciate why poison puts like those used in *Amylin* and *SandRidge* are the subject of debate.[129]

a. *Remedies.* — From an economic and legal standpoint, the choice of remedy is instructive as to whether the ultimate purpose of including an event risk covenant is the protection of debtholders or the entrenchment of management. From the shareholders' perspective, because shareholders bear the agency costs of debt and equity,[130] the desired event risk covenant would deter transactions that merely shift wealth from debtholders to shareholders, but would allow transactions that increase shareholder wealth more than they diminish debtholder wealth.[131] If the goal of agreeing to a poison put were to maximize firm value by protecting debtholders from opportunistic shareholder action, the ideal remedy would be one that compensates debtholders fully for actual losses incurred as a result of a subsequent transaction.[132]

If debtholders are undercompensated, shareholders might be incentivized to engage in transactions that merely shift wealth from

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(discussing remedies available under poison puts and including interest rate adjustments). From a definitional standpoint, however, the term poison put requires that the remedy be just that—a put.

127. Coffee, Unstable Coalitions, supra note 107, at 1519; see also Kahan & Klausner, Antitakeover Provisions, supra note 49, at 934 (defining poison put).

128. See, e.g., Coffee, Unstable Coalitions, supra note 107, at 1519 & n.83 (providing examples of triggering events); Kahan & Klausner, Antitakeover Provisions, supra note 49, at 950–60 (discussing and analyzing triggering events).

129. For an in-depth explanation of the poison puts at issue in those cases, see infra Part II.B.

130. See supra note 52 and accompanying text (noting shareholders bear agency costs of which parties are aware ex ante).

131. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 940–47 (arguing agency cost of debt is decreased when debtholders are fully compensated for takeover-related losses but agency cost of equity is increased by presence of poison puts). Even if a transaction shifts wealth from debtholders to shareholders, it is Pareto superior to allow these transactions if shareholders fully compensate debtholders for their losses and are still better off. Cf., e.g., Richard A. Posner, The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication, 8 Hofstra L. Rev. 487, 488 (1989) ("Pareto superiority is the principle that one allocation of resources is superior to another if at least one person is better off under the first allocation than under the second and no one is worse off.").

132. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 936–50, 962 (explaining effect of change of control covenants on agency cost of debt and equity under various circumstances and concluding full compensation can ex ante increase value of firm).

debtholders to shareholders, thereby increasing the agency cost of debt and ultimately harming the corporation.[133] On the other hand, if debtholders are overcompensated for losses, the corporation would be deterred from engaging in transactions which would have increased firm value had only full compensation been given to debtholders. Consequently, firms faced with the option of giving debtholders a remedy in the form of a put option or an interest rate adjustment should choose that remedy which provides only full compensation to debtholders. As the following example demonstrates, however, employing a put option as a remedy in a poison put is overcompensatory with respect to debtholders and therefore represents an economically inferior option to interest rate adjustments, suggesting director self-interest might be behind the use of poison puts.

The prices of outstanding bonds and market interest rates are inversely related; when interest rates go up, bond prices go down, and vice versa.[134] This relationship means that the value of a put option can fluctuate based on market interest rates in a manner that is wholly unrelated to compensating bondholders for the agency risk they face vis-à-vis shareholders.[135] Suppose a debtholder, James, owns one bond of XYZ Company, which has a par value of ten dollars and includes a put option giving him the right to sell his bond back to the company at par value in the event of a majority turnover in XYZ's board. Suppose also that during this same period, a bidder launches a hostile bid that will result in a majority turnover in XYZ's board. Suppose finally that the market interest rate goes down over the life of that bond and, as a result, the value of the James's bond increases to fifteen dollars.[136] In this case, even if the hostile bid for XYZ goes through and harms James by as much as four dollars, his put option would be valueless since he would not redeem a bond for ten dollars that still has a market value of eleven dollars. In this case, despite the fact that James's bond has lost value as a result of a takeover, he is undercompensated.

Employing a slight variation on the example from above, James will be overcompensated if market interest rates go up over the life of the bond. Supposing James's bond decreases in value from ten dollars to five dollars as a result of market interest rates increasing, James will redeem his put option even if the same hostile bid for XYZ actually *increases the*

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133. See supra Part I.A.3 (discussing agency problem between fixed and residual claimants).

134. Jonathan Berk & Peter DeMarzo, Corporate Finance 226–28 (2d ed. 2009) (explaining higher interest rates result in higher discount rates for bond's remaining cash flows, which in turn diminish their present value and results in lower price).

135. In other words, the risk that owners of the firm might take actions that would transfer wealth from debtholders to shareholders.

136. For a discussion of bond pricing mechanics, see Berk & DeMarzo, supra note 134, at 218–22. For example, the current price of a one-year bond would be equal to its future payout value divided by one plus the interest rate. Id.

value of his debt by four dollars.[137] Despite the apparent symmetry between the aforementioned situations, poison puts are systematically overcompensatory because, while downside risk is limited to zero compensation for takeover-related losses, overcompensation is potentially limitless.[138] In contrast, the remedy of adjusting interest rates in response to event risks would be more efficient because it corresponds to the change in the risk of default with respect to the particular debt at issue, rather than to broader changes in market conditions.[139] However, a pure interest rate adjustment falls short in one respect, as it fails to provide the same liquidity benefits that a put option offers.[140] Notwithstanding this shortcoming, the overwhelming frequency of using a put option as a remedy "cannot readily be explained by the interests of bondholders or shareholders."[141] By employing a remedy that is overcompensatory with respect to bondholders, the board of a potential target company increases the cost of takeovers that would trigger the poison put, thereby deterring transactions that could nonetheless increase overall firm value.

b. *Triggers.* — The event trigger that a covenant employs is instructive as to the motivation for issuing the covenant in the first place. In considering the various categories of events that might act as triggers, differences emerge between the types of event triggers that serve the corporation's best interest and those more tailored to serving the self-interest of directors. If a covenant is alleged to have been instituted for debtholder protection but is triggered by an event that typically does not harm debtholders, it is reasonable to infer that directors may have been motivated to include the covenant in order to protect themselves rather than the corporation—a critically important factor from a legal perspective.[142]

While debtholders can negotiate for covenant-based protection tied to an array of event triggers,[143] a poison put provides protection to

137. A takeover might increase the value of outstanding debt if the acquirer is financially strong or represents an upgrade in management, both of which increase the likelihood of debtholders being made whole. Cf. Henry G. Manne, Mergers and the Market for Corporate Control, 73 J. Pol. Econ. 110, 112–13 (1965) (suggesting inefficient management is primary driver of takeover activity).

138. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 964–66 (explaining "supra-compensatory" nature of put option as remedy).

139. Cf. id. (describing interest rate adjustment remedy as "more efficient").

140. See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 819 n.185 (1995) (noting pure interest rate adjustments "fail[] to provide liquidity protection").

141. Kahan & Klausner, Antitakeover Provisions, supra note 49, at 964.

142. See supra note 108 and accompanying text (suggesting motive of board in taking actions serving to entrench current directors is crucial factor in judicial review).

143. For a sampling of the types of event triggers used, see Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or "the Economics of Boilerplate"), 83 Va. L. Rev. 713, 768–69 (1997) (including share acquisitions by third parties, sale of substantially all assets, and share repurchases among list of event triggers adopted by some corporate boards).

debtholders in the event of a change in control.[144] Triggers in change of control covenants generally take one of three forms, depending on the extent of the role played by a decline in a bond's credit rating.[145] Some poison puts are triggered by an unapproved acquisition of a certain threshold of outstanding stock or a proxy contest resulting in the replacement of a majority of directors, irrespective of any change in the bond's credit rating.[146] Other poison puts are triggered when there is a hostile share acquisition or proxy contest combined with a decrease in the bond's credit rating,[147] and still others are triggered solely by a decline in the bond's credit rating.[148] From a debtholder's perspective, a particular trigger is sensible to the extent that it is likely to reflect a decrease in the value of outstanding debt.[149] Leaving aside the triggers that require a decline in a bond's credit rating,[150] it might seem that a change of control covenant triggered by a hostile share acquisition or proxy contest is a potentially desirable form of protection for debtholders, given that takeovers are often accompanied by an increase in leverage.[151] However, three factors undercut the apparent case for the event trigger satisfied merely by a hostile acquisition of shares or proxy contest.

First, the poison put's event trigger applies only to hostile takeovers. As such, although poison puts protect debtholders from losses that might accrue due to hostile takeovers, debtholders are still vulnerable to losses from director-backed transactions.[152] This trigger is both underinclusive and overinclusive. It is underinclusive because director-backed transactions might nonetheless decrease the market value of outstanding debt and overinclusive because hostile transactions do not necessarily harm

144. As such, the terms "poison put" and "change of control covenant" are considered synonymous. See, e.g., Kahan & Klausner, Antitakeover Provisions, supra note 49, at 945 (describing why change of control covenants are referred to as poison puts); Katz, supra note 10 (referring to provisions at issue in *SandRidge* alternatively as "change-of-control-triggered put right" and "poison put").

145. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 952–60 (discussing triggers for "Hostile Control Change Covenants," "Dual Trigger Covenants," and "Pure Rating Decline Covenants").

146. See id. at 952–53 (introducing "Hostile Control Change Covenants").

147. See id. at 955–58 (describing "Dual Trigger Covenants").

148. See id. at 958–60 (covering "Pure Rating Decline Covenants").

149. See supra notes 112–114 and accompanying text (explaining why debtholders seek protection from events decreasing value of outstanding debt).

150. These subtypes of poison puts were not at issue in *Amylin* or *SandRidge* and are thus beyond the scope of this Note. For a discussion of the covenants at issue in those cases, see infra Part II.B.

151. See, e.g., Aloke Ghosh & Prem C. Jain, Financial Leverage Changes Associated with Corporate Mergers, 6 J. Corp. Fin. 377, 379 (2000) (finding mean increase in financial leverage of seventeen percent for merged firms from one year prior to one year after merger).

152. This criticism also holds for poison puts that require a credit rating downgrade in their trigger, in addition to a hostile share acquisition or proxy contest.

debtholders.[153] Concededly, debtholders might think it is worth paying for protection[154] from hostile takeovers if there were a reason to believe that hostile takeovers pose a greater threat of expropriating wealth from debtholders than director-approved transactions. To some extent, such a concern was warranted in the wake of the leveraged buyout boom in the 1980s.[155] Nonetheless, while there may be some reason to believe that hostile acquirers are particularly likely to be debt financed,[156] heavily debt-financed but director-approved transactions present precisely the same risk for debtholders—and yet fall outside the protection of the poison put. Such selective protection for debtholders suggests that the poison put primarily serves directors' self-interest rather than that of debtholders.[157]

Second, the specified event—a change in control, hostile or otherwise—is an inaccurate proxy for the actual event feared by debtholders. As indicated above, the concern for those who hold outstanding debt is that an increase in leverage might decrease the market value of their claim.[158] Although there is debate as to the extent of debtholder losses as a result of leveraged buyouts,[159] employing a hostile change in control event trigger is clearly overinclusive.[160] Tying poison puts to a downgrade

153. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 954 (noting acquisitions by financially strong bidder or firm with superior management might paradoxically increase bond values and trigger poison put).

154. See, e.g., Kenneth Lehn & Annette Poulsen, Contractual Resolution of Bondholder–Stockholder Conflicts in Leveraged Buyouts, 34 J.L. & Econ. 645, 658–59 (1991) ("Bondholders generally favor more . . . [covenants] and presumably are willing to pay for these additional restrictions in the form of lower coupon payments.").

155. See, e.g., F. John Stark, III et al., "Marriot Risk": A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders, 1994 Colum. Bus. L. Rev. 503, 509 ("[E]vent risk covenants . . . were at first principally aimed at hostile acquisitions . . . .").

156. See, e.g., Lehn & Poulsen, supra note 154, at 659 ("Most hostile acquirers are heavily dependent on debt financing.").

157. See, e.g., Kahan & Klausner, Antitakeover Provisions, supra note 49, at 954 ("[T]he scope of the triggering events in Hostile Control Change Covenants reflects an unabashed pursuit of management's parochial interests."); see also Stark et al., supra note 155, at 569 ("While not explicitly adopted as an anti-takeover defense, [poison puts] appear to be more useful for that purpose rather than their purported objective of protection of the investment quality of the bonds in question . . . .").

158. See supra notes 112–114 and accompanying text (explaining why debtholders seek protection from events decreasing value of outstanding debt).

159. See, e.g., Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597, 611–12 (1989) (arguing debtholders do not lose wealth from takeovers overall and suffer only trivial losses in leveraged buyouts). But see, e.g., Crabbe, supra note 124, at 694–96 (finding net debtholder losses following leveraged restructuring resulting in credit downgrade).

160. Cf. Crabbe, supra note 124, at 690 n.3 ("Over the past decade, some bonds were upgraded after takeovers by more creditworthy issuers . . . .").

in a bond's credit rating, though imperfect,[161] provides protection for debtholders while decreasing the entrenchment value enjoyed by directors.

Third, the power to determine whether the event trigger is satisfied is vested in the board of directors.[162] As a result, the potential protective value of a poison put is left in the hands of the company's management, the very people the debtholders have purportedly sought to protect themselves from in the first place. Such a trigger renders debtholders vulnerable both to director-approved deals that might harm them and directors' failure to approve transactions that might help them. Theoretically, directors' discretion is bounded both by their fiduciary duties to shareholders[163] and their contractual duty of good faith and fair dealing to debtholders.[164] However, one must recall that directors retain significant leeway under Delaware law as to the means of fulfilling these duties.[165] Consequently, since poison puts bestow upon directors the ultimate discretion as to whether the remedy is triggered, such covenants are unlikely to provide significant protection to debtholders and therefore should draw scrutiny under Delaware law.

B. *The Poison Puts in* Amylin *and* SandRidge

Both *Amylin* and *SandRidge* involved "continuing director" poison puts.[166] The trigger in continuing director poison puts is a failure of continuing directors to make up some predetermined percentage of the board (generally a majority), though what constitutes a "continuing director" for the purpose of the covenant can change from agreement to agreement.[167] Before proceeding to a discussion of the Chancery Court's decisions in *Amylin* and *SandRidge*, this section provides an explanation of the particular poison put provisions at issue.

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161. See Stark et al., supra note 155, at 569 (describing downgrade trigger as "impractical and structurally flawed" because downgrade might precede triggering event, "render[ing] the covenant meaningless").

162. See Kahan & Klausner, Antitakeover Provisions, supra note 49, at 953 (noting poison puts "give management nearly full control over the availability of rights to bondholders").

163. For example, when the sale of the company has become inevitable, directors have a duty to get shareholders the best price. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 184 (Del. 1986).

164. See, e.g., San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 315 (Del. Ch.) (stating implied covenant of good faith and fair dealing "inheres in all contracts" including note indentures), aff'd, 981 A.2d 1173 (Del. 2009).

165. See supra Part I.B.2 (describing business judgment rule as providing deference to directors' discretion as to means used to pursue prescribed ends).

166. See Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 244–45 (Del. Ch. 2013) (discussing SandRidge's "Proxy Put"); *Amylin*, 983 A.2d at 307–09 (describing continuing director poison puts in Amylin's bonds and revolving credit facility).

167. Cf. Coffee, Unstable Coalitions, supra note 107, at 1519 & n.83 (defining continuing director trigger as "failure of a majority of the directors to remain in office").

1. *Amylin's Poison Put*.—The litigation in *Amylin* revolved around poison puts in two separate debt instruments. The first was an issuance of senior convertible notes[168] in 2007 ("2007 Notes").[169] Section 11.01 of the indenture for the 2007 Notes contained a poison put making the notes redeemable at par value upon the occurrence of a "Fundamental Change."[170] The indenture defined a "Fundamental Change" as being triggered when, among other events, "the Continuing Directors do not constitute a majority of the Company's Board of Directors."[171] The indenture further defined the term "Continuing Director" as meaning:

> (i) individuals who on the Issue Date constituted the Board of Directors and (ii) any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company 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 Issue Date or whose election or nomination for election was previously so approved.[172]

As such, the poison put associated with Amylin's 2007 Notes purported to give debtholders the option to redeem their bonds in the event of a majority turnover in Amylin's board, unless the new directors were "approved" by a majority of either the original directors at the time the 2007 Notes were issued or subsequent directors who had themselves been so approved.[173]

The second poison put appeared in Amylin's "senior secured Credit Agreement"[174] (Credit Agreement) with Bank of America, N.A.

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168. See Senior Convertible Note, Investopedia, http://www.investopedia.com/terms/s/senior-convertible-note.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining "Senior Convertible Note" as "debt security that contains an option" allowing note to be "converted into a predefined amount of the issuer's shares" and that has priority over all other debt securities issued by same firm).

169. *Amylin*, 983 A.2d at 307.

170. Verified Fourth Amended Class Action Complaint for Declaratory Relief exh. A § 11.01, at 69, *Amylin*, 983 A.2d 304 (No. 4446-VCL) [hereinafter Amylin Complaint], 2009 WL 5773342.

171. Id. exh. A § 1.01, at 7.

172. Id. exh. A § 1.01, at 4.

173. The litigation focused in large part on the correct interpretation of the word "approved" in the Indenture. See *Amylin*, 983 A.2d at 314–18 (analyzing competing arguments as to incumbent board's power and right to approve dissident nominees); see also infra Part II.C.1 (discussing court's reasoning in *Amylin*).

174. The Credit Agreement consisted of a $125 million term-credit facility and a $15 million revolving credit facility. *Amylin*, 983 A.2d at 308–09; see also Credit Facility, Investopedia, http://www.investopedia.com/terms/c/creditfacility.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining "credit facility" as type of loan made in corporate finance context); Revolving Credit, Investopedia, http://www.investopedia.com/terms/r/revolvingcredit.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining "Revolving Credit" as "line of credit . . . usually used for operating purposes"); Term Loan, Investopedia, http://www.investopedia.com/terms/t/termloan.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining

(BANA).[175] The Credit Agreement likewise contained a continuing director provision,[176] although it was more explicitly drafted and automatically accelerated the debt due under the Credit Agreement unless waived by a majority of the lenders.[177] The continuing director poison put in the Credit Agreement defined the event trigger as any "event or series of events" within a two-year period by which a majority of the board ceased to be composed of: (i) original directors, (ii) new directors approved by a board consisting of at least a majority of original directors, or (iii) new directors approved by a board consisting of at least a majority of the directors defined in (i) and (ii).[178] Additionally, the poison put in the Credit Agreement contained a provision establishing that in determining whether a majority of the incumbent board has approved new directors, the votes of any incumbent directors having been elected as a result of a threatened or actual proxy contest are excluded.[179]

2. SandRidge*'s Poison Put.* — As in *Amylin*, the existence of continuing director poison puts served as the impetus for the litigation in *SandRidge*.[180] The indentures for each of the six senior notes, totaling $4.3 billion of long-term debt,[181] that were the subject of the shareholders' complaint contained continuing director provisions that required the company to offer to purchase within thirty days of a "Change of Control" any "outstanding Notes at a purchase price equal to 101% of the principal amount plus accrued interest."[182] The indentures defined a "Change of Control" as being triggered if:

> [D]uring any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors of the Company (together with any new directors whose election to such board or whose nomination for election by the stockholders of the Company 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

"term loan" as "loan . . . for a specific amount that has a specified repayment schedule and a floating interest rate").

175. *Amylin*, 983 A.2d at 308–09.

176. See Amylin Complaint, supra note 170, exh. B § 8.01(k), at 92, § 8.02, at 92–93, 2009 WL 5773346 (providing, respectively, change of control as an event of default and corresponding remedies).

177. *Amylin*, 983 A.2d at 309.

178. Amylin Complaint, supra note 170, exh. B § 1.01, at 6–7, 2009 WL 5773346.

179. See id. (excluding directors taking office by actual or threatened proxy contest from calculation of whether change of control has occurred).

180. See Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 244–45 (Del. Ch. 2013) (noting potential triggering of poison put led to shareholder Kallick's motion for injunctive relief).

181. See Verified Amended Class Action Complaint ¶¶ 58–59, at 15–16, *SandRidge*, 68 A.3d 242 (No. 8182-CS) [hereinafter SandRidge Complaint], 2013 WL 419884 (cataloging notes constituting outstanding debt and corresponding indentures governing such notes).

182. Id. ¶ 60, at 17.

> reason to constitute a majority of such Board of Directors then in office . . . .[183]

Thus, much like in *Amylin*, the poison puts in SandRidge's note indentures purported to require the company to repurchase more than $4.3 billion in long-term debt should a majority of the board cease to consist of either the original directors or new directors approved by two-thirds vote of original directors or like-approved directors.

C. *The Chancery Court's Approach in* Amylin *and* SandRidge

Neither *Amylin* nor *SandRidge* decided whether the respective boards of directors of those companies breached their fiduciary duty of loyalty[184] by authorizing their companies to agree to indentures that contained poison puts. Instead, both cases turned on the issue of incumbent boards "approving" a dissident slate of directors in order to avoid triggering poison puts in the context of consent solicitations.[185] By focusing on boards' approval of dissident nominees and greatly cabining directors' discretion in that realm, the Chancery Court avoided the question of whether issuing debt with continuing director poison puts constitutes a breach of a board's fiduciary duties. In doing so, however, the court neutralized both the legitimate corporate purposes and illegitimate entrenching effects of the poison put.

1. San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals. — *Amylin* concerned two separate poison puts—one in the company's 2007 Notes and another in its Credit Agreement.[186] The dispute arose when two large shareholders, Icahn Partners and Eastbourne Capital Management, launched a proxy contest.[187] Fearing that the election of both dissident slates would trigger the poison put, Eastbourne requested that Amylin assemble an approved slate of directors that was to include a number of both Eastbourne's and Icahn's candidates.[188] Amylin responded by warning shareholders in its annual

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183. Id.

184. This is the much more significant fiduciary duty for litigation purposes, in light of a statutory provision allowing a Delaware corporation to, in its certificate of incorporation, eliminate a director's personal liability for breaches of the duty of care. Del. Code Ann. tit. 8, § 102(b)(7) (2012).

185. See *SandRidge*, 68 A.3d at 247 ("Kallick's focus . . . is on whether the SandRidge board has properly used the contractual discretion left to it by the stockholders to approve the [dissident] slate for purposes of relieving the corporation of any duty to offer to repurchase SandRidge's debt if that slate is elected."); San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 313 (Del. Ch.) ("[T]he central issue in this case is whether or not the Amylin board has both the power and the right under the Indenture to approve the [dissident] stockholder nominees."), aff'd, 981 A.2d 1173 (Del. 2009).

186. See 983 A.2d at 307–09 (outlining history of debt instruments); see also supra Part II.B.1 (discussing Amylin's poison puts).

187. *Amylin*, 983 A.2d at 309.

188. Id.

report of the potentially disastrous consequences of triggering the continuing director provisions.[189]

The litigation commenced when a third shareholder, the San Antonio Fire & Police Pension Fund ("Pension Fund"), filed suit in March 2009 alleging Amylin's board breached its fiduciary duties of care and loyalty by: (i) agreeing to the poison puts in the note indenture and in the credit facility, (ii) failing to approve the dissident nominees so as to avoid triggering the poison puts, and (iii) disclosing the risks associated with the poison puts in a misleading and coercive manner.[190] By April, the parties reached a partial settlement whereby the Pension Fund agreed to drop the duty of loyalty claims, to not seek damages against the board, and to forgo the claim pertaining to the allegedly faulty disclosure.[191] In return, Amylin agreed to "approve" the dissident nominees for the purposes of the poison put.[192] Soon after, both Eastbourne and Icahn agreed to reduce their slates to three and two candidates respectively, meaning their election would not trigger the poison put since at least a majority of the twelve-member board would consist of continuing directors.[193] Amylin subsequently entered into an agreement with BANA, whereby BANA agreed to waive any event of default in the Credit Agreement resulting from the 2009 elections in exchange for a fifty basis point fee on the outstanding balance should the trigger be met.[194]

In response to the above, Vice Chancellor Lamb determined that the claims relating to the poison put in the Credit Agreement were moot.[195] The indenture trustee[196] argued that the claims regarding the indenture for the 2007 Notes were likewise not ripe for determination, since the revised proxy contest could not result in a majority turnover of the board and thus could not trigger the poison put embedded in those notes.[197] However, Vice Chancellor Lamb sided with both the Pension Fund and Amylin, who recognized the issue would likely require resolution before the next year's annual meeting.[198] Because Amylin had agreed to approve the dissident nominees if it had the power and right to

189. See Amylin Pharm., Inc., Annual Report (Form 10-K), at 37, 39–40, 59 (Feb. 27, 2009) (providing detailed description of magnitude of effect poison put would have on Amylin if triggered and exercised).

190. *Amylin*, 983 A.2d at 310.

191. Id. at 311–12.

192. Id.

193. Id. at 312–13.

194. Id. at 312.

195. Id. This was significant in part because of the lack of an "approval out" in the Credit Agreement poison put. Davidoff, supra note 10.

196. See Bond Trustee, Investopedia, http://www.investopedia.com/terms/b/bond-trustee.asp (on file with the *Columbia Law Review*) (last visited Oct. 17, 2014) (defining trustee as "financial institution with trust powers . . . given fiduciary powers by a bond issuer to enforce the terms of a bond indenture").

197. *Amylin*, 983 A.2d at 313.

198. Id.

do so, Vice Chancellor Lamb focused on the board's authority to "approve" dissident nominees instead of whether the board had breached its duty of loyalty in agreeing to the poison puts in the first place.[199]

Vice Chancellor Lamb framed the issue as whether, as a matter of contract interpretation, incumbent directors could "approve" dissident nominees for the limited purpose of neutralizing the poison put while not formally endorsing those candidates.[200] The indenture trustee argued that "approve" meant to "endorse or recommend," and consequently contended a board could not approve dissident nominees while simultaneously running its own slate.[201] The court disagreed with that reading, noting it would prohibit "*any* change in the majority of the board . . . for the entire life of the notes."[202] Vice Chancellor Lamb reasoned that the board must have the power to approve dissident nominees for the limited purpose of neutralizing a poison put, because a contrary interpretation would have "such an eviscerating effect on the stockholder franchise" as to "raise grave concerns."[203] Likewise, the court declared that incumbent directors have the right to approve dissident nominees as long as they have a good faith belief that their election "would not be materially adverse to the interests of the corporation or its stockholders."[204]

2. Kallick v. SandRidge Energy. — In 2013, the Chancery Court handled another case revolving around continuing director poison puts in a series of notes issued by SandRidge Energy.[205] Frustrated with SandRidge's performance, TPG—a hedge fund holding a seven percent stake in the company—launched a consent solicitation for the purpose of amending the company's bylaws to destagger the board as well as to remove and replace the incumbent board.[206] SandRidge's board responded in turn, adopting a poison pill and amending its bylaws to try to block the activists.[207] SandRidge's board then issued a consent revocation statement, warning shareholders that electing the TPG slate would trigger a series of poison puts, requiring SandRidge to repurchase $4.3 billion of its debt at one-hundred-one percent of par value.[208] Following

199. Id. Vice Chancellor Lamb did assess whether the directors had violated their duty of care (by issuing the notes with a continuing director poison put) based on the fact that the Pricing Committee (who had responsibility for negotiating and issuing the 2007 Notes) never discussed the poison put. Id. at 318–19. Ultimately, he ruled the board was not grossly negligent, citing their use of "highly-qualified counsel." Id.

200. Id. at 313.

201. Id. at 314.

202. Id. at 315.

203. Id.

204. Id. at 316.

205. See supra Part II.B.2 (describing poison puts issued in SandRidge's notes).

206. Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 244 (Del. Ch. 2013).

207. Id. at 249.

208. Id. at 250.

this back and forth, Gerald Kallick, a shareholder who supported TPG, sued SandRidge for injunctive relief, asking the Chancery Court to enjoin the company from doing anything to hinder TPG's consent solicitation until SandRidge approved the dissident nominees in order to neutralize the poison puts.[209]

In determining the appropriate standard of review, Chancellor Strine rejected the plaintiff's argument that *Blasius* should apply.[210] He reasoned that poison puts do not have the "'sole or primary purpose' of impeding the stockholders' vote," since they "might have a legitimate purpose of protecting creditors."[211] Nonetheless, recognizing both the defensive value and the potential entrenching effect of SandRidge's poison puts, Chancellor Strine applied the *Unocal* standard of review to SandRidge's failure to approve TPG's slate of nominees, making reference to Delaware's "special sensitivity towards the stockholder franchise."[212] In noting SandRidge's board had likely violated its fiduciary duty of loyalty, Chancellor Strine determined that the board's justification for not approving the TPG slate—that the dissident nominees were less qualified than the incumbent board[213] and that doing so would damage its relationship with current and future debtholders[214]—was "redolent more of the pursuit of an incremental advantage in a close contest . . . than of any good faith concern for the company, its creditors, or its stockholders."[215]

In addition to the Chancery Court's decision to apply *Unocal* instead of *Blasius*, *SandRidge* contains three particularly noteworthy developments. First, Chancellor Strine built on Vice Chancellor Lamb's observation that failing to approve a new slate might inhibit the stockholder franchise[216] and concluded that in order to comply with *Unocal*, "a board may only *fail* to approve a dissident slate if the board determines that passing control to the slate would constitute a breach of the duty of loyalty."[217] As such, in the face of a poison put, an incumbent board cannot withhold its approval merely because it thinks itself better qualified or

209. Id. at 245, 252.

210. Id. at 258.

211. Id.

212. Id. at 257–59.

213. See id. at 253–55 (summarizing SandRidge's argument as "we are better than the new guys and gals, so keep us in office" and rejecting it as "not . . . close to a reasoned conclusion that the electoral rivals lack the integrity, character, and basic competence to serve in office").

214. See id. at 255–57 (pointing to SandRidge's shifting arguments regarding whether triggering poison puts would be detrimental and finding lack of "reliable market evidence that lenders place a tangible value on a [poison put] trigger").

215. Id. at 261.

216. San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 319 (Del. Ch.), aff'd, 981 A.2d 1173 (Del. 2009).

217. *SandRidge*, 68 A.3d at 260.

having better plans for the company.[218] Rather, the incumbent board can resist approving a dissident slate only if that slate poses a "specific and substantial risk to the corporation or its creditors"—such as if the dissident nominees are looters or of suspect integrity.[219]

Second, Chancellor Strine clarified that a board has "very limited obligations" to consider creditors in deciding whether to approve a dissident slate in the face of a poison put.[220] Significantly, the board's obligation to creditors is no different when deciding to neutralize a poison put than otherwise inheres in any decision that might touch on debtholders' rights.[221]

Third, to a far greater extent than Vice Chancellor Lamb in *Amylin*, Chancellor Strine broadly criticized the inclusion of poison puts in SandRidge's debt agreements. Noting doubt may exist as to whether a change of control poison put was actually bargained for by creditors or voluntarily inserted by incumbent management,[222] Chancellor Strine warned that a company should "bargain hard" to avoid poison puts in light of their impact on the shareholder franchise and should only agree to such measures in return for "clear economic advantage."[223] Going further, Chancellor Strine posited that companies could avoid such covenants when credit markets are healthy[224] and found no evidence in this case that poison puts were of value to the debtholders.[225] Taken together, these statements highlight the Chancery Court's skepticism of poison puts.

III. THE CHANCERY COURT'S FLAWED END RUN ON THE POISON PUT

The Chancery Court's decision in *SandRidge* served as an end run on the poison put. Rather than confronting the entrenching purpose of issuing debt with poison puts in the first place, the Chancery Court skirted the issue by instead focusing its decision on the change of control trigger for poison puts. By severely limiting the circumstances under which a board can fail to "approve" dissident director nominees for the purposes of triggering a poison put, Chancellor Strine effectively ended the legitimate use of the poison put. Part III.A begins by first explaining the practical effect of *Amylin* and *SandRidge* on the future use of poison puts. It then continues by arguing that the Chancery Court in *SandRidge*

218. Id. at 260–61.

219. Id. at 260.

220. Id. at 260–61.

221. Id. at 260 n.95; see also, e.g., McDaniel, supra note 45, at 273–74 (defining duty of good faith and fair dealing as directors' "duty to prevent stockholders from enriching themselves at bondholder expense").

222. *SandRidge*, 68 A.3d at 259.

223. Id. at 248.

224. Id.

225. Id. at 256.

should have directly confronted the question of whether issuing debt with poison puts improperly interferes with the shareholder franchise. Part III.B contends that the appropriate standard of review for an analysis of issuing debt with poison puts is the *Blasius* "compelling justification" standard. Finally, Part III.B concludes with a brief discussion of the future of contractual protection for creditors.

A. *The Chancery Court Two-Step: How* Amylin *and* SandRidge *Avoided (and Ultimately Voided) the Poison Put*

Due to the posture of the claims brought in *Amylin* and *SandRidge*, the Chancery Court has yet to assess a board's initial decision to authorize the issuance of debt with continuing director poison puts. However, in light of the extremely limited circumstances under which a board is free to deny approval to dissident nominees and the resulting lack of protection afforded to debtholders, the effect of the Chancery Court's jurisprudence is that adopting poison puts will constitute a breach of a board's fiduciary duties in almost all cases, even under the *Unocal* standard as applied in *SandRidge*.

1. *A Broad Reading of "Approve."* — In *Amylin*, the Chancery Court read the language regarding the board's ability to "approve" nominees in the 2007 Notes indentures to mean that a board could simultaneously approve dissident nominees while endorsing its own slate.[226] Had the court interpreted the term "approve" to mean "endorse" as the indenture trustee suggested,[227] the poison put in the 2007 Notes almost certainly would have run afoul of a *Unocal* analysis. As elucidated in *Unitrin, Inc. v. American General Corp.*, defensive measures are invalid under *Unocal* to the extent that they are coercive—depriving shareholders of a free choice in an election—or preclusive—making a change of control "realistically unattainable."[228] Similar to the "dead hand" poison pill invalidated in *Carmody v. Toll Bros.*,[229] a covenant that did not allow directors to approve dissident nominees for the limited purpose of neutralizing a poison put would be coercive. In such a case, shareholders would be effectively forced to vote in favor of incumbent directors or their designees because triggering a poison put could force the company into severe financial distress—a death knell for the value of securities

226. San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 314–15 (Del. Ch.), aff'd, 981 A.2d 1173 (Del. 2009); see also supra Part II.C.1 (discussing proceedings in *Amylin* and Vice Chancellor Lamb's reasoning).

227. *Amylin*, 983 A.2d at 314–15; see also supra notes 200–203 and accompanying text (presenting arguments by opposing parties in *Amylin* with respect to meaning of "approve").

228. Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1388–89 (Del. 1995).

229. See 723 A.2d 1180, 1194–95 (Del. Ch. 1998) (holding "dead hand" poison pill is preclusive and coercive).

held by residual claimants.[230] Correspondingly, a poison put lacking an approval out would be coercive to the extent that it would make a change in control via a proxy contest prohibitively costly for shareholders.[231]

Recognizing the problems with reading the term "approve" as suggested by the indenture trustee, Vice Chancellor Lamb interpreted it in a way that largely eviscerated debtholders' protection from a poison put in the face of a hostile takeover attempt. Based on the outcomes in *Amylin* and *SandRidge*—and the text of the poison put provisions at issue in those cases, which are typical of such provisions generally—a poison put can only be triggered if, first, directors deny approval to dissident nominees and, second, those nominees are still able to garner sufficient votes in a proxy contest to take over a majority of the board. Notably, directors can deny approval only to those nominees who are "known looters," have "suspect integrity," or otherwise pose a "genuine and specific threat to the corporation."[232] Therefore, a poison put's protective value for creditors rests solely in those cases where a proxy contest leads to a new board majority consisting of directors who are looters, who have otherwise suspect integrity, or whose plans pose a genuine threat to the corporation. While the court conceded that withholding approval of dissident nominees could be consistent with a board's fiduciary duties in some circumstances, it is hard to conceive of a situation in which a board would be within its right to fail to approve a dissident slate and yet shareholders would vote that slate into office.

2. *Adopting Poison Puts Now Likely Violates* Unocal. — Because poison puts now provide such little value to creditors, issuing debt with poison puts will almost always constitute a violation of *Unocal*. In both *Amylin* and *SandRidge*, the Chancery Court cautioned that boards must not agree to poison puts lightly. Vice Chancellor Lamb suggested that in assessing a board's agreeing to poison puts, "[t]he court would want, at a minimum, to see evidence that the board believed in good faith that . . . it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it."[233] Similarly, Chancellor Strine stated that poison puts should be resisted and only

230. *SandRidge*, 68 A.3d at 260; cf. *Toll Bros.*, 723 A.2d at 1195 (finding threat of being represented by board without full statutory rights sufficient to constitute coercion under *Unitrin*).

231. Cf. *SandRidge*, 68 A.3d at 257 (noting triggering poison put could lead to mandatory refinancing of $4.3 billion worth of debt). Whether or not a poison put lacking an approval out might be *preclusive* is a more fact-dependent question than the coercion prong of the *Unitrin* analysis. See *Unitrin*, 651 A.2d at 1386–89 (explaining and applying "coercive" and "preclusive" standards). Factors such as how much debt is involved, the creditworthiness of the acquiring company, and the strength of debt markets would be instructive. Cf. id. at 1388–89 (defining "preclusive" measures as those making proxy fight "mathematically impossible or realistically unattainable").

232. *SandRidge*, 68 A.3d at 260.

233. San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc., 983 A.2d 304, 315 (Del. Ch.), aff'd, 981 A.2d 1173 (Del. 2009).

conceded to in return for "clear economic advantage," and that independent directors have a duty to ensure the company is not agreeing to poison puts "precisely because of their entrenching utility."[234]

By severely limiting the circumstances under which dissident nominees might be denied approval for the purposes of neutralizing a poison put, the decisions in *Amylin* and *SandRidge* guarantee that poison puts will be of little practical value to creditors. Not only would a poison put be triggered in extremely rare circumstances (if ever),[235] the poison put does not afford debtholders any special consideration of their interests.[236] One must consider that the Chancery Court began by warning that a board could only adopt poison puts in return for an economic benefit—for example by securing a lower yield on the debt the company issues. Creditors, in turn, would only be incentivized to forego a higher interest rate on their investment in exchange for a poison put if they valued that poison put marginally more than the corresponding decrease in their return. The decisions in *Amylin* and *SandRidge* significantly diminished the value that creditors should place on a poison put, due to the fact that poison puts can be triggered in only rare circumstances. Together, these developments ensure that a board will almost always violate its fiduciary duties by agreeing to poison puts. Importantly, though, this does not constitute a categorical invalidation of the poison put, since *Unocal* analyses are inherently fact intensive.[237]

B. *Why the Chancery Court Should Have Applied* Blasius

Although Part III.A argues that the practical effect of the decisions in *Amylin* and *SandRidge* is to make the issuance of debt with poison puts nearly uniformly invalid under a *Unocal* analysis, a similar outcome could—and should—be achieved by applying *Blasius* to a board's initial decision to agree to poison puts. Despite the fact that the outcome would be largely the same on a case-by-case basis, the Chancery Court's reasoning in *Amylin* and *SandRidge* is troubling for two reasons. First, it further confuses the already muddied doctrinal distinction between *Blasius* and *Unocal*.[238] Second, although even *Blasius* does not offer a per se rule invalidating board actions taken for the "primary purpose" of interfering

234. *SandRidge*, 68 A.3d at 248.

235. See supra Part III.A.1 (arguing triggering of poison puts is largely implausible following *SandRidge*).

236. *SandRidge*, 68 A.3d at 260 n.95; see also supra note 221 and accompanying text (discussing good faith and fair dealing).

237. See, e.g., Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1915 (1998) (describing *Unocal* as "fact-intensive legal standard[]").

238. See Allen, Jacobs & Strine, Standards, supra note 104, at 1311–16 (arguing for elimination of *Blasius* standard of review because of alleged overlap between *Blasius* and *Unocal*). Unfortunately, Chancellor Strine's view of *Blasius* ultimately led to *SandRidge* further confusing, rather than clarifying, the unique role of *Blasius* in Delaware.

with the shareholder franchise, the "compelling justification" standard nonetheless almost always "signals that the court will invalidate the board action under examination."[239] Consequently, because it diminishes Delaware's otherwise strong endorsement of the primacy of the shareholder franchise, the reasoning in *SandRidge* constitutes a significant doctrinal shortcoming.

Chancellor Strine declined to apply *Blasius* in *SandRidge* based on his view that poison puts "might have a legitimate purpose" and because *Blasius* applies only to those actions taken for the "primary purpose of thwarting" the exercise of the shareholder franchise.[240] Concededly, as discussed in Part II.A, poison puts could be valuable to debtholders. However, the fact that a contractual provision might provide a benefit to a company is not responsive to the threshold question of whether the contractual provision was agreed to for the primary purpose of interfering with the shareholder franchise. In *Blasius*, Atlas—the company that Blasius was targeting for a hostile takeover—increased the size of its board in order to impede Blasius's attempt to replace a majority of the Atlas board through a proxy contest.[241] Then-Chancellor Allen's decision noted that Atlas's board had acted with "subjective good faith"—meaning he found credible the board's claims that they believed their actions to be in the best interest of the company.[242] As such, the issue in determining whether to apply *Blasius* is *not* whether the directors' action "might have a legitimate purpose."[243] Instead, courts should apply *Blasius* notwithstanding a concurrent legitimate purpose so long as the board's action results in the proscribed effect of preventing the election of a new majority of directors.[244]

Moreover, considering the structure and functioning of the poison put,[245] there can be little doubt that the purpose of the poison put is to thwart the exercise of the shareholder franchise. Although the corporation may benefit from a poison put's restriction on shareholders' ability

239. Chesapeake Corp. v. Shore, 771 A.2d 293, 323–24 (Del. Ch. 2000).

240. *SandRidge*, 68 A.3d at 258 (quoting Blasius Indus. v. Atlas Corp., 564 A.2d 651, 662 (Del. Ch. 1988)).

241. *Blasius*, 564 A.2d at 654–57.

242. Id. at 658.

243. See McBride & Gibbs, supra note 59, at 930–34 ("When assessing whether the *Blasius* standard applies to an individual case, lawyers are often consumed by the question of the defendant's motive or purpose. They sometimes fail to appreciate that courts make an equally important inquiry into whether the defendant's action, whatever its purpose, had the proscribed effect.").

244. Id.; see also *Chesapeake Corp.*, 771 A.2d at 320 (noting, in determining board's primary purpose, "[a]bsent confessions of improper purpose, the most important evidence of what a board intended to do is often what effects its actions have"); Carmody v. Toll Bros., 723 A.2d 1180, 1193 (Del. Ch. 1998) (finding "purposeful disenfranchisement" when unilateral director action impedes effective shareholder vote).

245. See supra Part II.A.2 (describing functioning of poison puts and questioning their validity).

to vote via reduced agency cost of debt,[246] it accomplishes this potentially desirable end through the illegitimate means of blocking the free exercise of the shareholder franchise. As was the case in *Blasius* itself, the *allocation of power* between directors and shareholders dictates that boards cannot take an action "designed principally to interfere with the effectiveness of a vote,"[247] even though it might serve some additional purpose such as decreasing agency costs. In other words, the very design of poison puts—accelerating debt when shareholders vote to replace the incumbent board without its consent—thwarts the free exercise of the shareholder franchise; such a goal is not made more legitimate because it in turn is employed to achieve a reduction in the agency cost of debt.

Additionally, the case for applying *Blasius* to a board's decision to concede to poison puts is strengthened when considering the decision in *SandRidge*. To the extent that one might have previously been tempted to agree with Chancellor Strine's assertion that poison puts "might have a legitimate purpose of protecting creditors,"[248] his decision in *SandRidge* has rendered poison puts useless from a creditor's perspective.[249] Thus, even accepting *SandRidge*'s reasoning in declining to apply *Blasius* at that point in time, such reasoning would no longer be valid for the next poison put case that arises. Indeed, Chancellor Strine's prior decision in *Chesapeake Corp. v. Shore*[250] helps highlight this point. In that case, Chancellor Strine noted: "In reality, invocation of the *Blasius* standard of review usually signals that the court will invalidate the board action under examination," while "[f]ailure to invoke *Blasius*, conversely, typically indicates that the board action survived (or will survive) review under *Unocal*."[251] However, given the foregoing analysis, it is clear that the adoption of a poison put would almost never survive *Unocal* as applied in *SandRidge*. If one accepts Chancellor Strine's explanation in *Chesapeake Corp.*, then, courts faced with poison puts are likely to invoke the *Blasius* standard of review.

Going forward, no matter what standard of review Delaware courts apply to a board's agreeing to poison puts in a company's debt agreements, the poison put has been stripped of both its potential value to debtholders as well as its entrenching value to incumbent directors. Taken together, the decisions in *Amylin* and *SandRidge* have weakened the efficacy of the poison put to the point where a novel contractual innovation will be needed if creditors and issuers believe it economically

246. See supra Part II.A.1 (discussing possible corporate benefits flowing from agreeing to poison puts).

247. *Blasius*, 564 A.2d at 660.

248. Kallick v. SandRidge Energy, Inc., 68 A.3d 242, 258 (Del. Ch. 2013)

249. See supra Part III.A.2 (noting extremely limited circumstances under which poison put might be triggered).

250. 771 A.2d 293 (Del. Ch. 2000).

251. Id. at 323.

efficient to provide protection against a change in control of the issuing company.

CONCLUSION

Unlike some other areas of law, Delaware corporate law is notable for its ability to grow and change in response to "evolving concepts and needs."[252] The development of, and eventual judicial response to, the poison put exemplifies this ever-changing nature. While the agency-framework conception of corporate law suggests that continuing director poison puts can theoretically benefit a corporation issuing debt, the particular manner in which poison puts came to be used suggested that board entrenchment purposes had trumped potential agency cost reduction. The decisions in *Amylin* and *SandRidge* have set the stage for Delaware to invalidate poison puts going forward—either through the doctrinally inferior route of applying *Unocal* or the better option of applying the *Blasius* standard of review. In light of the primacy of the shareholder franchise in Delaware's corporate law, the latter route would be a welcome doctrinal development.

252. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 957 (Del. 1985) ("[O]ur corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs.").