REGULATING PROXY PUTS: A PROPOSAL TO NARROW THE PROPER PURPOSE OF PROXY PUTS AFTER *SANDRIDGE*

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In *Kallick v. SandRidge Energy, Inc.*, the Delaware Court of Chancery broadly characterized proxy puts in general and adopted *Unocal* to review the SandRidge board's refusal to decide whether to approve a rival proxy slate for purposes of neutralizing a proxy put in a bond indenture. However, the court failed to answer whether a board has authority to adopt a proxy put in the first place, and, if so, whether and under what circumstances triggering a proxy put is proportionate to its purpose. This Comment finds the court's adoption of *Unocal* unsatisfying doctrinally, yet recognizes that the result of subjecting proxy puts to a strict *Blasius* compelling justification review would probably be similar to subjecting a watermelon to Gallagher's sledge: lenders and borrowers would be removing pieces of proxy puts from their loan agreements for weeks. Seeking a middle path, this Comment distinguishes Identity Risk as a concern separate from Event Risk and proposes narrowing the proper purpose of proxy puts to protecting against Identity Risk. There, *Liquid Audio* emerges as a standard of review blending *Blasius*'s focus on the stockholder franchise with *Unocal*'s functionality in an Identity Risk framework that both legitimizes proxy puts and incentivizes contracting parties to document the negotiation and adoption of wealth-maximizing change of control provisions.

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INTRODUCTION

In *Kallick v. SandRidge Energy, Inc.*,[1] the Delaware Court of Chancery reviewed two primary issues: the legitimacy of proxy puts purporting to protect creditors' interests; and the appropriate standard of review for analyzing board actions that interfere with the stockholder franchise.[2] A form of change of control covenant often included in bond indentures and credit agreements, proxy puts implicate the omnipresent specter of board entrenchment addressed in *Unocal Corp. v. Mesa Petroleum Co*.[3] due to their defensive, anti-takeover effects.[4] However, proxy puts arguably also implicate the "compelling justification" standard articulated in *Blasius Industries, Inc. v. Atlas Corp*.[5] "because the effect of the [p]roxy [p]ut is to place a toll on the voting decision of the electorate[.]"[6] As demonstrated by SandRidge's debt agreements, proxy puts are triggered by a successful proxy challenge that replaces a majority of a board of directors within a specified period of time and provide

1. 68 A.3d 242 (Del. Ch. 2013).
2. *Id*.
3. 493 A.2d 946 (Del. 1985).
4. *SandRidge*, 68 A.3d at 259.
5. 564 A.2d 651, 661 (Del. Ch. 1988).
6. *SandRidge*, 68 A.3d at 258.

creditors with the right to put the company's debt back to the company at a specified price.

The core of then-Chancellor Strine's analysis in *SandRidge* considers whether the SandRidge board of directors reasonably exercised its discretion in failing to approve a change of control for purposes of a proxy put under the *Unocal* standard of review—although the court, citing the combined *Unocal-Blasius* standard created by the Delaware Supreme Court in *MM Companies, Inc. v. Liquid Audio, Inc.*, left open the possibility of a higher standard.[7] The court also drew on *Schnell v. Chris-Craft Industries*[8] to focus its good faith analysis under *Unocal* on whether the board's failure to approve the change of control was for a proper purpose.[9] Finding that the board's fiduciary duty to represent in good faith the best interests of its stockholders was consistent with its contractual duty of good faith and fair dealing owed to its creditors, the court held that "a board may only *fail* to approve a dissident slate if the board determines that passing control . . . would constitute a breach of the duty of loyalty, in particular, because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors."[10] Because the SandRidge board could not demonstrate a proper purpose for failing to approve the change of control, the court concluded the board "likely acted with an absence of good faith and reasonableness inconsistent with their fiduciary duties."[11]

However, despite deciding *SandRidge* on narrow grounds, the court left questions unanswered and created ambiguity by broadly characterizing a prior case and the proxy puts at issue. Limited facts necessarily restricted the court to a narrow holding and prevented it from conducting a broad analysis that would be useful to companies and creditors attempting to contract in the shadow of shareholder-creditor agency costs. In addition, despite that proxy puts are thought of as "event risk covenants," intuition suggests that they have nothing to do with events and everything to do with the identity of a rival slate; although not heretofore so defined, proxy puts are more accurately considered "identity risk covenants." Accordingly, this Comment attempts to narrow the court's broad characterizations to address

7. 813 A.2d 1118, 1132 (Del. 2003) (approving a unified *Unocal-Blasius* standard of review for defensive actions touching on issues of control, but maintaining that:

When the *primary purpose* of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportiona[lity].

(emphasis original)).

8. 285 A.2d 437 (Del. 1971).

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

10. *Id.* at 260 (citation omitted).

11. *Id.* at 261.

two unanswered questions, resolve ambiguity, and provide clarity to contracting parties in the future.

The court in *SandRidge* failed to address adequately two questions related to the validity of proxy puts. First, does a board of directors even have the requisite authority to bind the corporation to a change of control covenant designed to prevent stockholders from electing a new board of directors?[12] Second, under what circumstances and to what degree is a board of directors permitted to trade stockholders' right to elect the board of directors in favor of other interests? The answer to the first question may be simple: Section 141(a) of the Delaware General Corporation Law grants the board broad authority to manage the business and affairs of the corporation,[13] and Section 122(13) grants every corporation the power to make contracts.[14] But Delaware has long recognized that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."[15] Without the benefit of the court's analysis, it is unclear whether a board has authority to contract away the source of its legitimate power to enter into such a contract.

The court in *SandRidge* characterized summarily the proxy puts at issue as lacking the "sole or primary purpose" of impeding a stockholder election,[16] and stated that, "[b]y definition, a contract that imposes a penalty on . . . stockholders seeking to elect a new board[] has clear defensive value."[17] These broad characterizations enabled the court to avoid analyzing whether the board had the requisite power to adopt the proxy puts; instead, the "clear defensive value" of the proxy puts merited only heightened reasonableness review under *Unocal*.[18] However, this

12. This question is the first of two tests of corporate action proposed by Adolf A. Berle, *Corporate Powers As Powers In Trust*, 44 HARV. L. REV. 1049, 1049 (1931) ("[I]n every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a *cestui que trust* to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary"). Delaware subscribes to Berle's twice-tested approach. *See, e.g.*, *Carsanaro v. Bloodhound Techs., Inc.*, 65 A.3d 618, 641 (Del. Ch. 2013) ("Corporate acts are 'twice-tested,' once for statutory compliance and again in equity.").

13. 8 *Del. C.* § 141(a) ("The business and affairs of the corporation shall be managed by or under the direction of a board of directors . . . .").

14. 8 *Del. C.* § 122(13) ("Every corporation created under this chapter shall have power to . . . make contracts . . . .").

15. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988). *See also MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003) (finding that the board of directors could not expand the size of its membership to prevent shareholders from electing successor directors).

16. *SandRidge*, 68 A.3d at 258.

17. *Id.* at 259.

18. *Id.* at 259.

Comment recognizes that the result of subjecting proxy puts to a strict *Blasius* compelling-justification review would probably be similar to subjecting a watermelon to Gallagher's sledge: lenders and borrowers would find themselves removing pieces of proxy puts from their loan agreements for weeks.[19] But characterizing proxy puts broadly so they fit into a preferred standard of review is less helpful than developing a more nuanced understanding of their purpose, operation, and trade-offs to facilitate a more informed analysis of which standard of review ought to apply. This Comment attempts the latter with an eye toward developing a balanced outcome consistent with Delaware doctrine.

In reaching its conclusion in *SandRidge*, the court also broadly characterized a key precedent case, *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*,[20] in the following ways. First, the court stated, "*Amylin* focused on the nature of the Proxy Put as a provision giving the creditors protection against a new board that would threaten their legitimate interests in getting paid."[21] Also, "[*Amylin*] recognized that the board should take into account the interests of its creditors in deciding whether to approve the slate."[22] In addition, "as Vice Chancellor Lamb also noted, . . . it follows that 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, in particular, *because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors*."[23] The court further characterized *Amylin*, summarizing, "[i]n other words, unless the incumbent board . . . made a specific determination that the rival candidates proposed a program that would have demonstrably material adverse effects for the corporation's ability to meet its legal obligations to its creditors, the incumbent board should approve the rival slate . . . ."[24] As will be discussed in greater detail

19. *Cf.* Stephen Byeff, *The Spirit Of Blasius: SandRidge As An Antidote To The Poison Put*, 115 COLUM. L. REV. 375, 412 (2015) (arguing *SandRidge* should have applied *Blasius* to avoid creating doctrinal confusion and diminishing the primacy of the shareholder franchise); *Marcus Kai Hintze,* "If You Poison Us Do We Not Die?"—A Critical Analysis of the Legality of Poison Puts in the Wake of San Antonio Fire & Police Pension Fund v. Amylin, Inc., 2010 B.Y.U. L. Rev. 767, 793 (2010) (proposing "a rule that any time a board of directors enters into an agreement with a proxy put, it must show that it did so with a compelling justification").

20. 983 A.2d 304 (Del. Ch. 2009).

21. SandRidge, 68 A.3d at 260.

22. *Id*. at 260, fn 95. The court goes on, reading the statement "as qualifying the [*Amylin*] court's later statement, in a footnote, that 'the directors are under absolutely *no* obligation to consider the interests of the noteholders' in deciding whether to approve the new slate." Id. (citing Amylin, 983 A.2d at 316 n.37).

23. *SandRidge*, 68 A.3d at 260 (second emphasis added).

24. *Id*. at 246. The court goes on, concluding, "absent any determination by the

below, in none of these instances was the court in *Amylin* focused on creditors' legitimate interests in getting paid or on threats to the company's ability to repay its creditors.

These broad characterizations of *Amylin* raise the second question left unanswered in *SandRidge*: assuming Delaware law permits a board to bargain away some of the stockholders' fundamental right to elect directors in favor of creditors' interests in getting paid, under what circumstances and to what degree would such a trade-off be reasonable or proportionate? In other words, if proxy puts represent a legitimate trade-off between creditors' interests in getting paid and stockholders' right to elect a new board, how much of the shareholder franchise may the board trade away, and under what circumstances? By its nature, this bargain benefits both creditors and boards at the expense of "the ideological underpinning upon which the legitimacy of directorial power exists."[25] Although the *Unocal* standard of review that the court adopted in *SandRidge* would have enabled it to conduct such a proportionality analysis, the limited facts of the case narrowed the basis for its conclusion to *Unocal*'s good faith prong. And even though *Unocal* provides a functional standard of review for proxy puts, it still does not answer whether a board has the authority to adopt proxy puts without some showing that a compelling justification supports their facially disenfranchising effects.

Therefore, this Comment considers both the circumstances under which boards may validly adopt and exercise proxy puts and the proportionality of proxy puts to their purpose using *Liquid Audio*'s unified *Unocal-Blasius* standard of review. Throughout, this Comment is mindful of Professor Edward Rock's suggestion that "Delaware should worry [that investors believe it favors equity over debt], if inadequate creditor protection raises a firm's cost of capital and thereby affects the desirability of Delaware law."[26] In *Adapting to the New Shareholder-Centric Reality*, Rock surveys evidence suggesting that the classic shareholder-manager agency cost problem no longer remains significant.[27] For discussion purposes, this Comment presupposes the accuracy of Rock's suggestion that shareholder-manager agency costs have been regulated effectively and

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incumbents that the rival slate has suspect integrity or specific plans that would endanger the corporation's ability to repay its creditors, there is no harm threatened to the creditors by the election of the slate." *Id*.

25. *Blasius*, 564 A.2d at 659.

26. Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1986 (2013).

27. *See* Rock, supra note 26, at 1926 (noting that incentive compensation, board reforms, and changes in concentration of shareholdings are among the reasons why the shareholder-manager agency cost problem is no longer significant).

considers how Delaware courts can adapt existing corporate law doctrines to regulate shareholder-creditor agency costs by focusing narrowly on the proxy puts at issue in *SandRidge*.

To consider the questions left unanswered in *SandRidge*, this Comment proceeds as follows. Part II reviews the two cases interpreting proxy puts that predate *SandRidge*. Part III details the facts, analysis, and conclusions of *SandRidge* itself with the goal of confining the case as narrowly as possible. Part IV considers briefly the impact of a recent decision on the court's analysis in *SandRidge*. Part V examines the nature of proxy puts more closely and proposes to narrow the court's broad characterization of the device's purpose. Part VI proposes a framework of review for proxy puts with the goals of addressing the questions left unanswered in *SandRidge* and enabling Delaware to better regulate shareholder-creditor agency costs in the future. Part VII concludes.

I. PRECEDENT CASES ADDRESSING PROXY PUTS

The Delaware Court of Chancery decided two cases concerning proxy puts prior to *SandRidge*. In *Hills Stores Co. v. Bozic*,[28] the court reviewed change of control covenants, which the Hills board had added to managers' employment agreements during a takeover battle, under the good faith prong of *Unocal*.[29] In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals*,[30] the court interpreted a bond indenture to determine whether the Amylin board had the contractual power and right to approve a change of control and neutralize proxy puts.[31] Importantly, although both cases discussed a board's duty to consider in good faith the best interests of their company and its stockholders under *Unocal*, neither proceeded to analyze the reasonableness or proportionality of the board's action under *Unocal*'s second prong. As such, both *Hills* and *Amylin* are narrow decisions.

A. *Hills Stores Co. v. Bozic*

The dispute in *Hills* concerned the Hills board's decision to trigger change of control provisions embedded in certain senior executives' severance agreements.[32] One year after Hills had emerged from bankruptcy in 1993, Dickstein Partners, a 12% shareholder, initiated a consent

28. 769 A.2d 88 (Del. Ch. 2000).
29. *Id*. at 106–07.
30. 983 A.2d 304 (Del. Ch. 2009).
31. *Id*. at 313.
32. *Hills*, 769 A.2d 88, 89 (Del. Ch. 2000).

solicitation to replace four Hills directors and to cause Hills to conduct a share buyback using leveraged financing.[33] With the advice of outside counsel, the board opposed the buyback, believing "it was unwise to take on such substantial debt so soon after emerging from bankruptcy and that it was preferable to stick with management's existing game plan."[34] The company, among other things, entered into new employment agreements with top executives "to allow them to focus on doing their jobs without distraction by Dickstein's overtures."[35] The agreements included change of control covenants entitling the executives to severance equaling three times their annual salary (including bonuses and tax gross-ups) in the event of a change of control not approved by a majority of continuing directors.[36] After Dickstein and others filed class and derivative actions challenging the employment agreements, the parties reached a settlement agreement in which, among other things, the parties agreed to waive permanently any claims arising out of the agreements.[37]

But in 1995, Dickstein again became hostile, proposing to take over Hills by merger or proxy contest and promising to refinance Hills' existing debt, purchase Hills, and auction Hills to the highest third-party buyer.[38] At a meeting of the Hills board, the outside directors decided to reject the Dickstein proposal as inadequate for several reasons: "the company's current strategy was sound," "it was a bad time to sell a low-end retailing company," "the Dickstein leverage strategy was of the kind that had caused other retailers to descend into bankruptcy," and "Dickstein had not secured firm financing for its Proposal."[39] In addition, management expressed its view that "it would prefer not to work at Hills under Dickstein's plan, because that plan would leave the company in a highly leveraged condition."[40] The board sought reelection against Dickstein's proposed

33. *Id*. at 91.

34. *Id*.

35. *Id*.

36. *Id*. at 92. The agreement defined an Approved Change of Control as follows:

The term "Approved Change of Control" shall mean a Change of Control that has occurred with *the prior approval of a majority of the Continuing Directors* and the term "Continuing Director" shall mean any member of the Board of Directors of the Company who is not an Acquiring Person or a nominee or representative of an Acquiring Person or of any affiliate or associate of an Acquiring Person and any successor to a Continuing Director who was recommended for election or elected to succeed a Continuing Director by a majority of the Continuing Directors then on the Board of Directors of the Company.

Id.

37. *Id*. at 93.

38. *Id*. at 94–95.

39. *Id*. at 97.

40. *Id*. at 96.

slate and did not erect any additional defensive measures.[41]

Considering whether to approve the Dickstein change of control for purposes of the severance agreements, the board focused on its contractual duties to the covered executives and recognized Hills faced "exactly the circumstances that had been anticipated going to contract[.]"[42] The board believed it owed a contractual duty to trigger the severance unless they "believed in good faith that the Change in Control was not harmful to the company."[43] Because the board continued to believe, as they had upon entering into the severance agreements, that "the Dickstein Change in Control would be seriously adverse to the interests of the company and its stockholders[,]" the board voted to trigger the severance package.[44] Later, after receiving complete and adequate disclosure, the shareholders elected Dickstein's slate by a large margin, thus triggering, among other things,[45] the severance packages under the employment agreements.[46]

After taking control of Hills, Dickstein caused the company to sue the former board for breaching its duty of loyalty by failing to approve the change of control for purposes of the severance agreements.[47] For our purposes, the critical question facing the court was under which standard should the change of control covenants be reviewed.[48] "Because of the defensive origins and purpose of the employment agreements, [the court applied] the *Unocal* standard of review[.]"[49] However, the court found that the previous settlement agreement, to which both Dickstein and Hills were parties, prevented the plaintiffs from challenging the board's initial decision to enter into the severance agreements in the first place, thus conceding "that those Agreements were entered into for a proper purpose and that Hills received adequate consideration[.]"[50]

This factor affected which standard of review the court chose to adopt and how that standard of review applied. First, the court refused to apply the *Blasius* "compelling justification" standard of review because the plaintiffs were "estopped from arguing . . . that the Employment Agreements were entered into for the 'primary purpose of thwarting the

41. *Id*. at 97.
42. *Id*. at 101 (citation omitted).
43. *Id*. at 101.
44. *Id*.
45. The successful proxy contest triggered several change of control provisions. In particular, "Hills's primary creditor, Chemical Bank, exercised its default rights, forcing Dickstein to refinance the company's debt." *Id*. at 101.
46. *Id*. at 101.
47. *Id*. at 90.
48. *Id*. at 103.
49. *Id*. at 90 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985)).
50. *Id*. at 102.

exercise of a stockholder vote.'"[51] The plaintiffs attempted to argue that the agreements had "the incidental effect of coercing or placing an undue toll on the free exercise of the shareholder vote[,]" but the court rejected this argument by recasting it as implicating *Unocal*'s proportionality prong instead.[52] Nevertheless, upon considering the coercion issue, the court again insisted that the plaintiffs were "estopped from making the argument that the Severance is so large as to constitute a coercive influence on a Hills stockholder vote."[53]

Second, after the court concluded that *Unocal* was the appropriate standard of review, the court reiterated the significance of the plaintiffs' previous waiver of the right to challenge the board's adoption of the employment agreements. Under *Unocal*'s two-pronged inquiry,[54] the board must first demonstrate that, "after a reasonable investigation, it determined in good faith that the corporation faced a threat warranting a defensive response" before demonstrating "the proportionality of its defensive measures to the threats it identified."[55] However, because the plaintiffs were estopped from challenging the validity of the agreements and that the agreements were disproportionate, "the first prong is of preeminent importance."[56] In other words, for the plaintiffs to prevail on their breach of loyalty claim, they would have to prove to the court that the board had failed to make "a good faith and informed judgment that the Dickstein Change in Control was a threat to Hills and its stockholders."[57] This the plaintiffs could not do.

The court concluded that the board's informed, good faith belief that the change of control posed a threat of harm to the company and its stockholders, as well as its belief that it should live up to its contractual commitment, was reasonable under the circumstances.[58] In sum, the board's decision to trigger the severance packages was not a breach of its fiduciary duty of loyalty because the plaintiff failed to produce evidence challenging the board's decision under the first prong of *Unocal* and was estopped from raising any challenges as to proportionality under *Unocal*'s second prong. Instead, the court concluded that the board's decision "to take a consistent approach to the issue of whether to approve the Dickstein

51. *Id*. at 103 (citing *Blasius*, 564 A.2d at 660).
52. *Id*. at 103.
53. *Id*. at 104.
54. As the Hills case was decided in 2000, the Delaware Supreme Court had not yet combined the *Unocal* and *Blasius* standards of review in its *Liquid Audio* decision, which was decided in 2007.
55. *Hills*, 769 A.2d at 107 (citing *Unocal*, 493 A.2d at 955–57).
56. *Id*. at 107.
57. *Id*. at 108.
58. *Id*. at 109.

Change in Control was a reasonable response in the circumstances presented."[59] In so concluding, the court endorsed the board's outside counsel's advice that because the board believed in good faith that the Dickstein Change of Control was not in the best interests of Hills and its stockholders upon entering into the employment agreements, the board's subsequent decision to trigger the severance package was justified in light of its continued belief that the Dickstein Change of Control was still, and for the same reasons, not in the best interests of Hills and its stockholders.[60]

It is important to recognize the narrow basis on which the court decided the *Hills* case. First, because of a prior settlement, the court estopped the plaintiffs from challenging any aspect of the board's initial decision to enter into the employment agreements containing change of control provisions. In the court's words, "[I] will . . . only allow them to challenge whether the [board] made appropriate decisions in 1995 regarding whether to oppose the Dickstein Change in Control and to trigger the Covered Executives Right to Severance."[61] Thus, *Hills* focuses narrowly on the board's decision to trigger the change of control provisions. Second, the plaintiffs also were estopped from challenging the proportionality of the board's decision to trigger the change of control provisions under *Unocal*'s second prong. Therefore, the court's holding in *Hills* that the board's decision to trigger the change of control provisions was reasonable in the circumstances stands only on the court's narrow analysis of the board's good faith and informed judgment that the change of control was a threat to the company and its stockholders under *Unocal*'s first prong.

B. *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*

In 2009, the court further analyzed a board's contractual power and right to approve a change of control in *Amylin*. The narrow question at issue in *Amylin* was "whether a commonplace provision found in a trust indenture governing publicly traded notes prevents the issuer's board of directors from 'approving' as 'continuing directors' persons nominated by stockholders in opposition to the slate nominated by the incumbent directors."[62] Finding that such a narrow interpretation would cause change of control covenants to "operate as improper entrenchment devices that

59. *Id.* at 108.
60. *Id.* at 100.
61. *Id.* at 103.
62. *San Antonio Fire & Police Pension Fund v. Amylin Pharms.*, 983 A.2d 304 (Del. Ch. 2009).

coerce stockholders into voting only for persons approved by the incumbent board[,]" the court held that the directors had the contractual power under the indentures to "approve" any nominee and still seek reelection.[63]

However, the court never directly answered whether the Amylin board had properly exercised that right consistent with its implied duty of good faith and fair dealing. The court said "the measure of whether the approval was in good faith was whether the board believed that the dissident slate posed a danger to the interests of the corporation and its stockholders."[64] But the court found that the record as to the board's deliberations regarding whether the dissident slate posed a threat was undeveloped[65] and held that the contractual right to approve issue was unripe.[66]

Although the *Amylin* case began as a stockholder class action against the company and its individual directors, it is a contract case, not a fiduciary duty case; the court's primary holding arose from the company's cross-claim against the trustee of its bond indentures. In March 2009, plaintiff pension fund San Antonio Fire & Police Pension Fund filed a class action complaint alleging various breaches of fiduciary duties of care and loyalty against Amylin and its individual directors.[67] In April, plaintiff added to the complaint Bank of America, N.A. ("BANA")—the Administrative Agent for Amylin's senior secured credit agreement dated December 21, 2007 ("Credit Agreement")[68]—and The Bank of New York Mellon Trust Company, N.A.—the "Trustee" under the trust indenture dated June 8, 2007 (the "Indenture") for Amylin's 3.00% convertible senior notes due 2014 (the "2007 Notes")[69]—as necessary defendants, seeking declaratory judgments as to the company's contractual rights with both.[70] Shortly thereafter, the individual directors and Amylin answered the plaintiff's complaint and included a cross-claim against the Trustee.[71]

Before trial, the plaintiff entered into a partial settlement with

63. *Id*. at 307.

64. *Id*. at 316 (citing *Hills*, at 108–09).

65. *Id*. at 317. To the extent it was, the court observed that the decision to approve may not have been the good faith exercise of the board's considered business judgment. *Id*.

66. *Id*. at 318. The court qualified its decision to treat the issue as unripe by pointing out that no result of the current election could trigger the covenants at issue and that the parties were free to replead a case after the election when the facts of the record would be more developed. *Id*. at 317.

67. *Id*. at 311.

68. *Id*. at 307.

69. *Id*.

70. *Id*. at 311.

71. *Id*.

Amylin.[72] In addition, Amylin and BANA reached a consent and waiver agreement before trial that mooted the related claims against BANA.[73] Finally, the stockholders planning proxy contests reduced the number of insurgents they had nominated such that the change of control provisions under the Indenture could no longer be immediately triggered.[74] "Thus, the central issue in [*Amylin*] is whether or not the Amylin board has both the power and the right under the Indenture to approve the stockholder nominees."[75]

The Indenture operated by declaring an event of default to have occurred upon a "Fundamental Change," which was defined to have occurred if, among other things, "at any time the Continuing Directors do not constitute a majority of the Company's Board of Directors . . . ."[76] The agreement further defined "Continuing Directors" to be:

> (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.[77]

By contrast, the Change of Control covenant in the Credit Agreement defines Continuing Directors directly within its terms and uses a narrower definition. Under the Credit Agreement, a Change of Control occurs if, among other things:

> An event or series of events by which . . . (b) during any period of 24 consecutive months, a majority of the members of the board of directors or other equivalent governing body of the Company cease to be composed of individuals
>
> (i) who were members of that board or equivalent governing body on the first day of such period,
>
> (ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body, or

72. *Id*.
73. *Id*. at 312.
74. *Id*. at 313.
75. *Id*.
76. *Id*. at 308.
77. *Id*.

> (iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body (*excluding, in the case of both clause (ii) and (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors*).[78]

Compared to the language in the bond indenture, the emphasized language in the credit agreement precludes stockholders from replacing directors pursuant to an actual or threatened proxy fight or consent solicitation. In other words, the provision precludes the stockholders from contesting the incumbency of the board without risking a default.

The court interpreted the Continuing Director provision in the bond indenture as giving the board the power to "approve" a rival slate for purposes of neutralizing the proxy put and still nominate its own candidates to contest the rivals.[79] But it also contrasted this outcome to its interpretation of the Credit Agreement, which, by comparison, it suggested "would prohibit *any* change in the majority of the board as a result of any number of contested elections, for the entire life of the notes."[80] Continuing, the court warned that "such an eviscerating effect on the stockholder franchise would raise grave concerns[,]" that the court would expect to see evidence that the board received "extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it[,] and that "the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy."[81]

Similar to the court's decision in *Hills*, it is important to recognize what the court did and did not do in *Amylin*. First, the central issue in *Amylin* is one of pure contract interpretation, namely, whether the board has the power and right under the Indenture to approve the stockholder nominees. Second, after finding the board's contractual right under the Indenture to approve stockholder nominees was limited only by its implied

78. *Id*. at 309 (emphasis added).
79. *Id*. at 314.
80. *Id*. at 315.
81. *Id*.

duty of good faith and fair dealing arising from the Indenture,[82] the court concluded that the record as to whether the board had exercised its discretion was incomplete and thus held the issue to be unripe.[83] Therefore, the court in *Amylin* held only that the board had the power under the Indenture to approve the stockholder nominees and still run its own slate against them. Accordingly, the court's discussion of the board's right under the Indenture to approve the stockholder nominees was dicta.

Nevertheless, given the court's later reliance on *Amylin* in *SandRidge*, a closer look at the *Amylin* court's interpretation of *Hills* is useful. In keeping with its contractual interpretation inquiry, the *Amylin* court found that the *Hills* court, "in considering whether the board was justified [under its contractual duties] in not approving the change in control, recognized that the measure of whether the approval was in good faith was whether the board believed that the dissident slate posed a danger to the interests of the corporation and its stockholders."[84] The court stated its rule, relying on *Hills*, to be that "the board may approve the stockholder nominees if the board determines in good faith that the election of one or more of the dissident nominees would not be materially adverse to the interests of the corporation or its stockholders."[85]

Hanging a footnote on this rule, the court qualified it, saying:

> In other words, [the board may approve the stockholder nominees if the board determines in good faith that] passing control would not constitute a breach of the directors' duty of loyalty to the corporation and its stockholders. It is important to recognize here that the directors are under absolutely *no* obligation to consider the interests of the noteholders in making this determination.[86]

Maintaining the context of the court's contractual interpretation inquiry, the second half of this footnote must be read directionally. Independent of any consideration of the interests of its creditors, a board's fiduciary duties require it to determine in good faith whether passing control to stockholder nominees would be materially adverse to the interests of the corporation or its stockholders, or in other words, whether passing control would constitute a breach of its duty of loyalty to the corporation and its stockholders. After making such a determination in the negative, a board may approve stockholder nominees without breaching its implied contractual duty of good faith and fair dealing.[87] Importantly, this

82. *Id*.
83. *Id*. at 317.
84. *Id*. at 316 (bracketed language added).
85. *Id*. at 316.
86. *Id*. at 316 n.37 (bracketed language added).
87. *Id*. at 316.

bifurcated approach comports with the *Hills* case, where the board made a determination, independent of any consideration of the interests of its contractual counterparties, that the change of control was a harmful threat to Hills and its stockholders.[88]

The court found the application of its rule to be problematic—and for good reason. First, the court acknowledged that Amylin had presented "no evidence regarding the board's deliberation with respect to the decision to approve the stockholder-nominated slate[,]"[89] and that "circumstances at least raise a question whether the board's decision to approve was made in a good faith exercise of its considered business judgment[.]"[90] For that reason, the court held that the contractual right to approve issue was unripe. Second, although unacknowledged, the court failed to recognize in its contractual duty of good faith analysis that it also had no evidence regarding the board's deliberation with respect to the decision to enter into the change of control provisions in the first place. In fact, the question was not even at issue beyond a duty of care claim that the court quickly resolved at the end of the opinion.[91]

But *Amylin*'s statement of its rule is partially inconsistent with *Hills* and in need of clarification. As discussed above, the board in *Hills* would have breached its implied duty of good faith and fair dealing by approving the Dickstein Change of Control because its good faith, informed judgment that the change of control would be harmful to the company and its stockholders that motivated the board's adoption of the employment agreements containing the change of control provisions had persisted until they reached an identical judgment and decided to trigger the provisions. In other words, because the circumstances that motivated the board's adoption of the agreement were part of the contract's consideration, the fact that those exact circumstances persisted framed the board's later decision to grant the bargained-for consideration as required by its contractual duty of good faith. The board in *Amylin* made no such determination.

The rule in *Amylin* is thus clarified as follows: A board has the contractual right under a proxy put to approve a rival slate if (1) the board determines on an informed, good faith basis that passing control to the rival slate would not be a breach of its duty of loyalty, and (2) approving the rival slate is not a breach of the board's implied duty of good faith and fair dealing under the proxy put. In *Amylin*, the court held that the facts

88. *Hills*, 769 A.2d at 108–09. *See also Hills*, 769 A.2d at 100 ("[Hills's counsel Allen Finkelson] advised the board that the obligation of the directors was to determine whether a Dickstein-led change in control of Hills was in the best interests of Hills stockholders.").

89. *Amylin*, 983 A.2d at 316.

90. *Id*. at 317.

91. *Id*. at 318.

necessary to deciding the first part of the rule were unripe and did not conduct an analysis under the second part. Also, the rule is consistent with the outcome of *Hills*; because the court held that the Hills board determined in good faith that passing control to Dickstein would be a breach of its duty of loyalty, the board had properly determined that it had no contractual right to approve the change of control under the proxy put.

Nevertheless, neither the court's analysis nor its rule provides meaningful insight into whether the board properly discharged its fiduciary duties. In other words, *Amylin*'s rule is properly limited to the narrow context of determining whether a board satisfied its contractual duty of good faith and fair dealing—especially considering the court's holding that the issue was unripe. This narrow interpretation is framed by the reality that the analysis in question arose from Amylin's cross-claim against the Trustee of the Indenture.

II. *KALLICK V. SANDRIDGE ENERGY, INC.*

The case of *SandRidge* involved a board of directors that refused to neutralize a proxy put by approving a rival proxy slate on the grounds that the rival slate was less qualified.[92] Plaintiff-stockholder Gerald Kallick filed a complaint against SandRidge and its individual directors in the Delaware Court of Chancery and moved for declaratory and injunctive relief, seeking

> (i) to enjoin the defendants from soliciting any consent revocations; (ii) to have any consent revocations obtained to date declared invalid; and (iii) to enjoin the defendants from taking any steps to hinder TPG's consent solicitation until they have complied with their fiduciary duties and have approved the TPG slate, or have explained in full why they will not approve it.[93]

The court applied Delaware's three-pronged standard for a preliminary injunction to grant Kallick more narrowly tailored injunctive relief than he had sought and no mandatory or declaratory relief.[94] But the court did not analyze each prong individually; instead, the court "discuss[ed] the facts in the record and the applicable law, and explain[ed] why the defendants are likely violating their fiduciary duty of loyalty to SandRidge and its

92. *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242, 245 (Del. Ch. 2013).
93. *SandRidge*, 68 A.3d at 252.
94. *Id.* at 253. The court stated the standard as follows: "To prevail on a motion for preliminary injunction, a plaintiff must prove that: (1) he is likely to succeed on the merits of his claims; (2) he will suffer imminent, irreparable harm if an injunction is not granted; and (3) the balance of equities weighs in favor of issuing the injunction." *Id.* (citing *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 173, 179 (Del. 1986)).

stockholders."[95] As to the defendants' justifications for failing to decide whether to approve the rival proxy slate, the court made "findings of fact as to them consistent with the appropriate procedural standard, which requires [the court] to determine, from the record before [the court], what would likely be the state of reality found to exist after trial."[96]

This Part will analyze and attempt to narrow *SandRidge* by tracking the structure used by the court therein. Part A sets out the background to the dispute, as well as the court's findings of fact regarding the defendants' proffered justifications for their challenged actions. Part B reviews the court's decision to adopt a *Unocal* standard of review. Part C analyzes the court's holding that the board's actions were likely a violation of its fiduciary duties. Part D notes the court's efforts to distinguish the *Hills* case.

A. *Background to the Dispute and Findings of Fact*

SandRidge Energy was an oil and natural gas exploration and production company[97] that went public in 2007.[98] In November 2012, after six years of "abysmal" performance and "lavish[ing] compensation" on its CEO, the SandRidge board became the target of a consent solicitation seeking to amend the bylaws to destagger the board, remove all directors, and install an entirely new slate.[99] TPG-Axon ("TPG"), the hedge fund seeking the consent solicitation, also sought to include stockholder representatives, replace the CEO, and investigate strategic alternatives to maximize the value of SandRidge's assets, including an asset sale.[100] TPG filed its preliminary consent solicitation statement on December 26, 2012.[101]

In response to TPG, the incumbent board adopted a poison pill, restricted stockholders' ability to act by written consent, and required an affirmative vote of more than 50% of all stockholders to amend bylaws relating to director elections.[102] In addition, on December 27, 2012, the incumbent board filed a preliminary consent revocation statement warning stockholders that replacing the board without its approval would trigger

95. *Id*. at 253.

96. *Id*. at 253 (citing *E.I. du Pont de Nemours & Co. v. Bayer CropScience L.P.*, 958 A.2d 245, 251–52 (Del. Ch. 2008).

97. *Id*. at 244.

98. *Id*. at 248–49.

99. *Id*. at 244.

100. *Id*. at 249. Another major stockholder echoed TPG-Axon's concerns with SandRidge a few days later. *Id*.

101. *Id*. at 250.

102. *Id*. at 249.

change of control covenants in the company's bond indentures and require SandRidge to offer to repurchase $4.3 billion of debt from its lenders at 101% of par.[103]

Throughout its opinion, the court refers to the change of control covenant at issue as a "Proxy Put," explaining that "the term is appropriate[] because the Proxy Put gives the noteholders the right to put back their debt after a vote that seats a new board that has not been approved by the ousted incumbents."[104] Comparing the term "Proxy Put" to "poison pill," the court emphasized that it implied "no judgment about the device's utility" and only meant to "use language that tracks the device's operation."[105] Under the indentures at issue in *SandRidge*, a Change of Control occurs if,

> during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors of the Company or any Successor Parent (*together with any new directors whose election to such board or whose nomination for election by the stockholders of the Company or any Successor Parent, as the case may be, was approved by a vote of 66 2/3% of the directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved*), cease for any reason to constitute a majority of such Board of Directors then in office.[106]

SandRidge had entered into multiple note agreements, all identical in relevant part, beginning in 2008, but the record surrounding whether the lender or SandRidge had sought to include the Proxy Puts was nonexistent.[107] From the outset, the court noted that, consistent with *Moran v. Household International, Inc.*,[108] a plaintiff could challenge both a board's decision to agree to a change of control covenant and whether the board properly used its discretion under the covenant to approve a change

103. *Id.* at 250.
104. *Id.* at 244, n. 8.
105. *Id.* Despite the court's comparison of the terms, proxy puts and poison pills differ in one doctrinally significant respect: the supreme court validated poison pills in part upon the recognition that they do not materially interfere with the stockholder franchise. *See Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 96 (Del. Ch. 2011) ("Notably, the pill in *Moran* was considered reasonable in part because the Court found that there were many methods by which potential acquirors could get around the pill. One way around the pill was the 'proxy out'—bidders could solicit consents to remove the board and redeem the rights.") (citing *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1354 (Del. 1985). In other words, proxy puts are not like poison pills because unapproved proxy fights do not trigger poison pills.
106. *Id.* at 250 (emphasis added by court).
107. *Id.* at 247–48.
108. 500 A.2d 1346 (Del. 1985).

of control.[109] Here, however, because no record of negotiations existed, both the plaintiff and the court were limited to attacking and analyzing the board's exercise of discretion required by the Proxy Put. Accordingly, the court assumed the "provisions were accepted by management without resistance and without any input from the board."[110]

On January 15, 2013, TPG filed its definitive consent solicitation statement with the SEC.[111] The board then filed its definitive consent revocation statement on January 18, reiterating the potential harm to stockholders if the Proxy Puts were triggered, but also admitting that "if the Board takes actions to approve the TPG-Axon Group Nominees that are permitted by the Indentures, such refinancing would not be required."[112] However, the board stated that it had not yet decided whether it would approve TPG's slate.[113]

A month later, the board stated in an 8-K that because the debt at issue was trading above 101% of par, the bondholders were "unlikely" to redeem them, but that the company could obtain any financing necessary if notes were redeemed.[114] Accordingly, the board changed its position on the threat posed by an unapproved slate, suggesting that the election of an unapproved slate might have no impact on the company.[115] Nevertheless, the board continued to refuse to decide whether to approve TPG's proposed slate for purposes of the Proxy Put.[116]

In support of their refusal to approve TPG's slate for purposes of the Proxy Put, the defendants proffered the following justifications: (1) "that the TPG slate does not consist of directors with sufficient energy experience[,]"[117] and (2) granting approval "would compromise the company's ability to obtain financing because . . . such lenders would charge a higher price for credit, perceiving SandRidge as a company that 'circumvents' change of control provisions."[118] As to the defendants' first argument, the court found that "[n]othing in this record indicates that any incumbent board member or incumbent board advisor has any reasonable basis to dispute the basic qualifications of the TPG slate."[119] As to the

109. *SandRidge*, 68 A.3d at 247.
110. *Id*. at 248.
111. *Id*. at 251.
112. *Id*. (citing Pl.'s Ex. P (SandRidge Energy, Inc., Definitive Consent Revocation Statement (Jan. 18, 2013) at 8 [hereinafter Definitive Consent Revocation Statement]).
113. *Id*.
114. *Id*. at 251–52.
115. *Id*. at 252.
116. *Id*. at 257.
117. *Id*. at 253.
118. *Id*. at 255.
119. *Id*.

defendants' second argument, the court found that "[t]he incumbent board has identified no specific threat that the TPG slate's plans have on the ability of SandRidge to repay its creditors."[120]

To support this conclusion, the court noted that

> the incumbent board and its financial advisors have failed to provide any reliable market evidence that lenders place a tangible value on a Proxy Put trigger—not a change in a board composition accompanying a merger or acquisition or another type of event having consequences for the company's capital structure, but a mere change in the board majority.[121]

In addition, in his deposition, one of SandRidge's independent directors admitted that the company derives no benefit from the Proxy Puts.[122] According to the court, "[t]his testimony implies that the board gave little or no consideration to the adoption of the Proxy Put."[123]

B. *The Standard of Review*

The defendants argued that the correct standard of review should be Delaware's business judgment rule, under which the court would defer to the incumbent board's decision not to approve TPG's slate if it was supported by a rational business purpose.[124] The plaintiff, on the other hand, argued that the court should apply the "compelling justification" standard "because the effect of the Proxy Put is to place a toll on the voting decision of the electorate [and] the primary purpose of such a provision is disenfranchising within the meaning of the *Blasius* standard."[125] To trigger *Blasius*, "the challenged action had to be 'taken for the sole or primary purpose of thwarting a shareholder vote.'"[126]

The court rejected a stand-alone *Blasius* standard because it "does little to address situations like this, where a contractual provision cannot be said to have the 'sole or primary purpose' of impeding the stockholders' vote[.]"[127] Instead, the court chose to focus its *Unocal* analysis using "*Schnell*'s generalized insistence that any director action be in fact taken for a proper purpose."[128] In adopting a *Unocal* standard of review, the

120. *Id*. at 257.
121. *Id*. at 256.
122. *Id*. at 257.
123. *Id*.
124. *Id*.
125. *Id*. at 258.
126. *Id*. at 258 (citing *Blasius*, 564 A.2d at 662).
127. *Id*. at 258.
128. *Id*. at 259 (citing *Schnell v. Chris-Craft Indus., Inc*., 285 A.2d 437, 439 (Del.

court reasoned that "*Unocal* is the proper standard of review to examine a board's decision to agree to a contract with [change of control provisions] and to review a board's exercise of discretion as to the change of control provisions under such a contract."[129] To support its decision, the court broadly characterized Proxy Puts as "a contract that imposes a penalty on the corporation [and stockholders seeking to elect a new board]" that has "clear defensive value."[130]

Although a reliable shoehorn to invoking a preferred standard of review, this broad characterization of proxy puts is neither precise nor desirable. By characterizing proxy puts as contracts with clear defensive value, the court sidestepped silently the question of whether the SandRidge board had the authority to adopt the proxy puts in the first place. The court was able to do so in part because the plaintiff's claim focused narrowly on whether the board exercised its contractual discretion under the proxy puts consistent with its fiduciary duties and not whether the board's decision to adopt the Proxy Puts was valid, and also in part because the record surrounding the board's negotiation of the Proxy Puts was nonexistent.[131] Without a record as to the purpose or intended design and effect of the Proxy Puts, the court exercised its discretion to broadly characterize the device as a contract with clear defensive value that "cannot be said to have the 'sole or primary purpose' of impeding the stockholders' vote[,]"[132] instead assuming that they "might have a legitimate purpose of protecting creditors who in fact insisted on its inclusion for their own good-faith reasons[.]"[133] This Comment considers a more precise characterization of proxy puts in Part V.

Meanwhile, it is interesting to note that the court partially supported its decision to apply the *Unocal* standard of review by citing to the Delaware Supreme Court case *MM Companies, Inc. v. Liquid Audio, Inc.*,[134] which the court characterized as "provid[ing] a responsible form of review that smokes out self-interest and pretext[] by requiring boards that face the omnipresent specter of *Unocal* to justify their actions as reasonable in relationship to a threat faced by the corporation."[135] However, in *Liquid Audio*, the supreme court held that

> [t]o invoke the *Blasius* compelling justification standard of

1971)).

129. *Id*. at 259 (citing *Moran v. Household Int'l., Inc*., 500 A.2d 1346 (Del. 1985).
130. Id. at 259.
131. *Id*. at 247–48.
132. *Id*. at 258.
133. *Id*.
134. *Liquid Audio, Inc.,* 813 A.2d at 1129.
135. *SandRidge*, 68 A.3d at 259.

> review *within* an application of the *Unocal* standard of review, the defensive actions of the board only need to be taken for the primary purpose of interfering with or impeding the effectiveness of the stockholder vote in a contested election for directors.[136]

Thus, despite the court's clear statement in *SandRidge* that it was applying *Unocal*, one could argue that it was applying *Liquid Audio*'s unified standard of review. Given the narrow basis for the court's decision in *SandRidge*, this Comment considers the application of the *Liquid Audio* standard to proxy puts in Part VI.

Finally, the court framed its *Unocal* analysis as whether "the directors [complied] with their *Unocal* duties by identifying a circumstantially proper and non-pretextual basis for their actions[.]"[137] According to the court, "[b]y smoking out the directors' reasons, *Unocal* surfaces the issues at stake, including the possibility of bad faith."[138] In a footnote, the court reiterated the standard, stating, "the first prong of the *Unocal* test is 'designed to ensure that a defensive measure to thwart or impede a takeover is indeed motivated by a good faith concern for the welfare of the corporation and its stockholders[;]'"[139] and "a board that takes defensive measures in response to a hostile offer must show, under the first prong of the *Unocal* test, that 'it determined in good faith [] that the [offer] presented a threat . . . that warranted a defensive response[.]'"[140] Importantly, the court made clear that its holding was based only on its analysis under *Unocal*'s first prong.

C. *The Court's Analysis and Conclusion*

Based on the facts and the court's view of the record, the court concluded, "the directors have failed to demonstrate a reasonable justification for their refusal to consider whether to approve the TPG slate for purposes of the good faith standard in *Unocal*."[141] In other words, the court held that the board's decision to simply remain silent as to whether it approved of the rival slate for purposes of the Proxy Put was in bad faith. Accordingly, the court enjoined the board from soliciting consent revocations, voting any proxies it had received, and otherwise impeding TPG's consent solicitation in any way until the board approved the TPG

136. *Liquid Audio*, 813 A.2d at 1132 (emphasis original).
137. *SandRidge*, 68 A.3d at 259.
138. *Id*. at 259.
139. *Id*. at 259 n.90 (citing *Unocal*, 493 A.2d at 955).
140. *Id*. at 259 n.90 (citing *Unitrin*, 651 A.2d at 1375).
141. *Id*. at 259–60.

slate.[142]

To reach its conclusion, the court relied heavily on its previous decision in *Amylin*.[143] As detailed above, the court in *Amylin* interpreted similar change of control provisions and made clear that a board's "only duty to the creditors [under the contracts] was to honor the implied covenant of good faith and fair dealing."[144] The court in *SandRidge* read *Amylin* as holding that "the board could approve the new slate if 'passing control would not constitute a breach of the directors' duty of loyalty to the corporation and its stockholders.'"[145] In other words, "the duty of loyalty requires the incumbent board to exercise their contractual discretion with the best interests of SandRidge and its stockholders firmly in mind, to the extent that it can do so without breaching the very limited obligations it owes to its noteholders."[146]

This analysis is sufficient to reaching the court's conclusion in *SandRidge*: the board had made no determination that the rival slate posed a threat to the company, much less a good faith determination, and *Amylin* made it clear that the board had the contractual right to approve the rival slate. Therefore, the board's refusal to approve the rival slate was likely not motivated by a good faith concern for the welfare of the corporation and its stockholders and was thereby in breach of its duty under *Unocal*'s first prong. Yet the court continued its analysis and began to recharacterize *Amylin* as having been concerned with creditors' legitimate interests in getting paid:

> Because, as Vice Chancellor Lamb also noted [in *Amylin*], the failure to approve a new slate might "impinge on the free exercise of the stockholder franchise," and because a board that acts in good faith must seek to protect the stockholders' ability to make an uncoerced choice of directors, it follows that 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, *in particular, because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors*.[147]

This aspect of the court's opinion in *SandRidge* broadens the court's prior opinion in *Amylin* without justification. And broadly characterizing *Amylin* has the effect of broadening the basis for the court's holding in

142. *Id*. at 247.
143. *Amylin*, 983 A.2d at 304.
144. *SandRidge*, 68 A.3d at 260 (citing *Amylin*, 983 A.2d at 314–16).
145. *Id*. at 260 (citing *Amylin*, 983 A.2d at 316 n. 37).
146. *Id*. at 261.
147. *Id*. at 260 (citing *Amylin*, 983 A.2d at 319) (second emphasis added).

SandRidge. To narrow *SandRidge*, this Comment attempts to scale back the court's characterizations of *Amylin* therein.

The court in *Amylin* did not discuss a company's legal duty to repay its creditors. Nevertheless, the court in *SandRidge* continued to recharacterize *Amylin* as such, stating, "this court in *Amylin* focused on the nature of the Proxy Put as a provision giving the creditors protection against a new board that would threaten their legitimate interests in getting paid."[148] *Amylin* did no such thing. To the contrary, the *Amylin* court stated clearly in a footnote its view that "directors are under absolutely *no* obligation to consider the interests of the noteholders in making this determination."[149] Then, the court in *SandRidge* listed three situations that would threaten creditors' legitimate interests in getting paid: (1) "the proposed new board consists of 'known looters[,]'" (2) "persons of suspect integrity[,]" or (3) "the insurgent slate could have plans for the company posing a genuine and specific threat to the corporation and its ability to honor its obligations to its creditors that prevent the incumbent board from approving them in good conscience for purposes of the Proxy Put."[150] Regarding this third situation, the court recharacterized explicitly the *Amylin* court's determination that "the directors are under absolutely *no* obligation to consider the interests of the noteholders" as having meant instead that "the directors are under no obligation to place any greater emphasis on the interests of the noteholders in making their decision as to the Proxy Put than as to any other decision that implicates the noteholders' contractual rights."[151] To the contrary, *Amylin* made clear that a board's good faith, informed judgment as to whether a change of control was not in the best interests of the company or its stockholders is independent from any subsequent determination of whether to approve the change of control for purposes of discharging its contractual duties—and even then the court's analysis focused on the board's power and rights under the contract and not the interests of its counterparty.[152] At minimum, this portion of *SandRidge* characterizes *Amylin* as placing a greater emphasis on creditors' interests, when in fact *Amylin* insisted that a board had no such duty.

Between *Amylin*'s bifurcated approach and *SandRidge*'s

148. *Id*. at 260 (citing *Amylin*, 983 A.2d at 307 ("[C]onstrued in accordance with generally applied standards, the provision is properly understood to permit the incumbent directors to approve as a continuing director any person, whether nominated by the board or a stockholder, as long as the directors take such action in conformity with the implied covenant of good faith and fair dealing and in accordance with their normal fiduciary duties.")).

149. *Amylin*, 983 A.2d at 316 n.37 (emphasis original).

150. *SandRidge*, 68 A.2d at 260.

151. *Id*. at 260 n.95 (citing *Amylin*, 983 A.2d at 316 n.37).

152. *Amylin*, 983 A.2d at 316 n.37.

recharacterization of *Amylin* as a unified approach, the bifurcated approach is the better of the two. The board's initial determination is binary—either the board believes in good faith that the change of control is a threat to the company and its stockholders or it does not—and has nothing to do with the counterparty's interests under the contract. If the board determines in good faith that the change of control is not a threat to the company and its stockholders, then the company has no duty to trigger a remedy under the contract. The court stated as much in *SandRidge*.[153] Alternatively, if the board determines in good faith that the change of control is a threat to the company and its stockholders, it is an exercise of bad faith to approve the change of control simply to avoid payment under the contract.[154] The court reached this conclusion in *Hills*, not *Amylin*, and did so on a different record and under different circumstances.[155]

As discussed previously, a critical distinction between *Hills* and *Amylin* is the record of the circumstances under which the respective companies agreed to the contracts containing the change of control provisions. In *Hills*, the record demonstrated that the Hills board agreed to the severance packages precisely because it believed in good faith that the Dickstein Change of Control posed a threat of harm to Hills and its stockholders.[156] Thus, its decision to trigger the promised remedy was reinforced by its belief that it had a contractual duty to trigger the bargained-for remedy under the exact circumstances contemplated by the contract.[157] To the contrary, in *Amylin* there was no such record. First, the

153. *See SandRidge*, 68 A.3d at 260 ("[W]here an incumbent board cannot identify that there is a specific and substantial risk to the corporation or its creditors posed by the rival slate, and approval of that slate would therefore not be a breach of the contractual duty of good faith owed to noteholders with the rights to the Proxy Put, the incumbent board must approve the new directors as a matter of its obligations to the company and its stockholders[] . . . .").

154. *Hills Stores Co. v. Bozic*, 769 A.2d 88, 109 (Del. Ch. 2000).

155. The court also reached this conclusion in *SandRidge*, but expressly included consideration of creditors' rights in doing so:

> [W]here an incumbent board cannot identify that there is a specific and substantial risk to the corporation or its creditors posed by the rival slate, and approval of that slate would therefore not be a breach of the contractual duty of good faith owed to noteholders with the rights to the Proxy Put, the incumbent board must approve the new directors as a matter of its obligations to the company and its stockholders, even if it believes itself to be better qualified and have better plans for the corporation that the rival slate.

SandRidge, 68 A.2d at 260–61.

156. *Hills*, 769 A.2d at 101.

157. *Id.* at 100–01. "The outside directors felt that the company had a contractual obligation to the Covered Executives to trigger their right to Severance, unless the board believed in good faith that the Change in Control was not harmful to the company." *Id.*

stockholder-plaintiff's duty of care claim was based on the fact that the board failed to learn of the change of control provisions before agreeing to the Indenture.[158] Second, the court held that whether the board had made an informed, good faith determination that the rival slate posed a threat to the company and its stockholders was unripe given the underdeveloped state of the record.[159] A final distinction between *Hills* and *Amylin* is that, unlike in *Hills* (or even *SandRidge*), the central dispute in *Amylin* concerned the contractual rights and duties between the company and a creditor.[160] Critically, the court in *Amylin* failed to emphasize or even recognize a contractual duty owed by the board to consider its creditors' legitimate interests in getting paid pursuant to a change of control provision. Thus, the court in *SandRidge* purports to find in *Hills* and *Amylin* an emphasis on creditors' legitimate interests in getting paid that simply are not there.

As demonstrated, this broad characterization of proxy puts as giving creditors "protection against a new board that would threaten their legitimate interests in getting paid" appears throughout the court's analysis in *SandRidge*.[161] The effect is to imply a broad validation of proxy puts as an ordinary contractual device properly adopted both to protect a company's creditors' legitimate interests in getting paid and to enable the company to defend against threats posing a danger to the company's ability to honor its legal duty to repay its creditors. Framed as such, the *SandRidge* court's broad characterization of proxy puts appears reasonable. However, the court inadequately considers the cost of broadly validating a device that only accomplishes its intended purposes by either deterring stockholders from replacing an incumbent board or triggering enormous penalties against the company and its stockholders upon their electing to do so.

Accordingly, this Part has attempted to narrow the *SandRidge* court's broad characterizations of the *Amylin* case and suggest that the court's broad characterizations of proxy puts enabled it to avoid reviewing both the proper purpose of the device and a board's statutory authority to adopt the device. However, the court's attempt in *SandRidge* to narrow its own analysis by distinguishing its prior decision in the *Hills* case assists the furtherance of this Comment's purpose.

158. *Amylin*, 983 A.2d at 318.
159. *Id.* at 317.
160. *Id.* at 313.
161. *SandRidge*, 68 A.3d at 260.

D. *Distinguishing the* Hills *Case*

Notwithstanding the court's previous analysis as discussed at length above, *SandRidge* includes an informative discussion drawing sharp distinctions between this case and the *Hills* case.[162] In particular, the court focused on (1) the nature of the contracts at issue in *Hills* compared to those at issue in *SandRidge*,[163] and (2) the nature of the threats identified by the board in *Hills* compared to those (not) identified by the board in *SandRidge*.[164]

The court points out that the severance agreements at issue in *Hills* "involve considerations that are distinct from credit agreements."[165] Although both lenders and employees want to get paid, an employee's "concerns about the identity of her boss [] are far more extensive, and legitimately so."[166] Elaborating, the court explains,

> A lender, such as the noteholders in this case, can protect itself by financial covenants, such as coverage and leverage ratios. The reality is that the debt, in this context, issued by the company is impersonal . . . . An employee cannot protect herself against a fundamental shift in managerial approach, and has an obvious interest in knowing who her boss is.[167]

The court objects to lumping different contracts including change of control provisions together, emphasizing that "the contractual obligation that the corporation owes to its contractual partner in exercising discretion to approve a change in control is [] influenced by the contractual expectations of that partner."[168] The court then distinguishes between changes of control under credit agreements: "Critical for lenders are changes in control that directly affect capital structures in a way that could impair the lenders' ability to get repaid, such as mergers or leveraged equity acquisitions."[169] Second, the court distinguishes the *Hills* case on the basis of the Hills board's determination that the Dickstein Change of Control threatened the company's fundamental ability to honor its legal obligations.[170]

Nevertheless, the court fails to distinguish expressly the circumstances

162. *Id*. at 261.
163. *Id*. at 262.
164. *Id*. at 263.
165. *Id*. at 262.
166. *Id*.
167. *Id*.
168. *Id*.
169. *Id*. at 263.
170. *Id*.

of the *Hills* case from its invocation in *SandRidge* of the legitimacy of a board's determination that a rival slate's plans pose a threat to the company's ability to honor its obligations to its creditors.[171] Even though the court uses qualifying phrases like "demonstrably material adverse effects"[172] and "specific and substantial risk"[173] throughout its opinion, it fails to characterize accurately the proper threat in *SandRidge* as bankruptcy. Unlike SandRidge, Hills had recently emerged from bankruptcy and was already in financial distress; thus, the board determined that Dickstein's proposal to take on enormous leverage threatened the ability of the company to continue as a going concern.[174] Although far narrower than the court's characterization in *SandRidge*, the facts of *Hills* suggest proxy puts might be construed as narrowly as protecting creditors from a rival slate threatening to put the company in bankruptcy.

III. UPDATE: THE *HEALTHWAYS* CASE

Recently, the Delaware Court of Chancery issued a transcript ruling concerning a proxy put in *Pontiac General Employees Retirement System v. John Ballantine, et al. and Healthways, Inc*.[175] The relevant facts of *Healthways* arose in May 2012 when Healthways stockholders voted by an overwhelming margin to approve a precatory proposal to declassify the board over the board's objections.[176] Nearly eighteen months later, the board amended its articles of incorporation to phase out its classified structure. Yet, immediately after the May 2012 proposal and long before its adoption in October 2013, the board entered into a fifth amended and restated revolving credit and term loan agreement.[177] Unlike its predecessor, this agreement contained what the plaintiffs characterized as a "dead hand proxy put."[178] In 2013, Healthways issued additional debt without the "dead hand proxy put" provisions; but the new debt included cross-default provisions triggering default if the company defaulted on at

171. *See id*., at 246, 260.
172. *Id*. at 246.
173. *Id*. at 260.
174. *Id*. at 263.
175. C.A. No. 9789-VCL, transcript (Del. Ch. Oct. 14, 2014) [hereinafter *Healthways Transcript*] (on file with author).
176. *Healthways Transcript*, at 69.
177. *Id*.
178. *Id*. at 70. *See also Pontiac General Employees Retirement System v. John W. Ballantine, et al. and Healthways, Inc*., C.A. No. 9789-VCL, redacted compl. (Del. Ch. June 24, 2014), at 18 [hereinafter, *Healthways Complaint*](claiming the "dead hand proxy put" would cause enormous economic harm to the plaintiffs).

least $10 million of its other debt.[179]

Stockholder pressure on the Healthways board continued. The board rejected an 11% stockholder's public demand to remove the CEO, but eventually resolved to grant the stockholder representation on the board in January 2014 after the stockholder threatened to wage a proxy fight.[180] The "dead hand proxy put" provision at issue in *Healthways* operates identically to the one in the credit agreement appearing in *Amylin*.[181] Thus, because the new directors assumed office as a result of a threatened proxy fight, they were not considered continuing directors for purposes of the "dead hand proxy put."[182] Before filing its complaint in *Healthways*, the plaintiff served the company with a books and records request under Section 220 "seeking documents and records relating to the dead hand proxy put."[183] However, according to the plaintiff, "the company failed to produce documents showing that there was substantive negotiation about the proxy put and no documents that suggested, to use the language of Amylin, that the company received 'extraordinarily valuable economic benefits' that might justify the proxy put."[184]

In *Healthways*, the plaintiff brought breach of fiduciary duty claims against the individual directors; a claim for aiding and abetting against SunTrust, the administrative agent for the bank group that extended the credit agreement to Healthways; and a declaratory judgment that the dead hand proxy put is unenforceable.[185] The court denied a motion to dismiss by the individual directors and the company on ripeness grounds and a motion to dismiss for failure to state an aiding and abetting claim by SunTrust. The court determined that the plaintiff's claim was ripe due to two present injuries: the deterrent effect of the proxy put and an ongoing Section 141(d) violation.[186] In addition, the court determined that the plaintiff pled facts supporting the knowing participation requirement for aiding and abetting liability by demonstrating that SunTrust became "a party to an agreement containing an entrenching provision that creates a conflict of interest on the part of the fiduciaries on the other side of the negotiation" long after *Amylin* and *SandRidge* put parties on notice that the

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179. *Healthways Transcript*, at 70. The cross-default provisions were included on issuances totaling $145 million in debt that would go into default if the company defaulted on any other loans in excess of $10 million. *Id*.

180. *Id*.

181. *Compare Healthways Complaint*, at 15, *with Amylin*, 983 A.2d at 309. *See also* text accompanying note 78 (citing the credit agreement).

182. *Healthways Transcript*, at 70–71.

183. *Id*. at 71.

184. *Id*.

185. *Id*.

186. *Id*. at 72–74, 75.

proxy puts were questionable.[187]

Healthways contributes two new bases for narrowing the court's prior decisions in the previous three cases: statutory claims under Section 141 and an aiding and abetting claim. The § 141(d) claim in *Healthways* takes its support from two cases considering poison pills. In *Carmody v. Toll Brothers, Inc.*, the Delaware Court of Chancery ruled on a motion to dismiss that the "complaint states legally sufficient claims that the 'dead hand' provision of the Toll Brothers Rights Plan violates 8 Del. C. §§ 141(a) and (d)."[188] Because the statute requires restrictions on a board's authority to manage the business and affairs of a corporation to be in the statute itself or the corporation's certificate of incorporation and requires the creation of different classes of directors with unequal voting powers to be stated in the certificate of incorporation, the plain language of the "dead hand" provisions that restricts Continuing Directors' authority to manage the company's business and affairs and denies non-Continuing Directors equal voting power gives rise to cognizable statutory invalidity claims.[189]

In addition, in *Quickturn Design Systems, Inc. v. Shapiro*, the Delaware Supreme Court held invalid a "slow hand" poison pill because it "impermissibly circumscribes the board's statutory power under Section 141(a) and the directors' ability to fulfill their concomitant fiduciary duties."[190] Importantly, the supreme court in *Quickturn* emphasized that "to the extent that a contract, or a provision thereof, purports to require a board to act or not act in such a fashion as to limit the exercise of fiduciary duties, it is invalid and unenforceable."[191]

As to the aiding and abetting claim in *Healthways*, the court did not provide a detailed analysis, but noted merely that the court's previous decisions in *Amylin* and *SandRidge* put the parties on notice that proxy puts were of questionable validity and recognized the conflict of interest

187. *Id.* at 80–81.

188. 723 A.2d 1180, 1190 (Del. Ch. 1998). In relevant part, Section 141(d) states:

The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors.

8 Del C. § 141(d). In addition, Section 141(a) states, in relevant part:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

8 Del. C. § 141(a).

189. Id. at 1190–91.

190. 721 A.2d 1281, 1293 (Del. 1998).

191. *Id.* at 1292 (citing *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 51 (Del. 1994)).

between the company's board and its stockholders created by the proxy put.[192] Nevertheless, and even though *Healthways* is only a transcript ruling decided at the pleading stage, as of March 1, 2015, the firm representing the plaintiff who filed the complaint had successfully targeted and caused numerous other companies to remove "dead hand proxy puts" in their debt agreements.[193]

The *Healthways* case narrows the court's previous decisions in the following ways. First, the Continuing Director provisions in the Employment Agreement at issue in *Hills*[194] and the Credit Agreement appearing (though not directly at issue) in *Amylin*[195] are subject to direct attack and review under the supreme court's binding precedent in *Quickturn* and the chancery court's persuasive precedent in *Carmody*. Given the similarity with which the Continuing Director provisions operate in the proxy put and poison put cases, it is difficult to imagine the court reaching a different conclusion in future proxy put cases. Second, although the Indenture in *Amylin*[196] and the Indenture in *SandRidge*[197] do not operate by defining Continuing Directors directly, the provisions nevertheless operate by creating two classes of directors with unequal voting rights indirectly. As before, it is difficult to imagine the court determining that these provisions are not invalid solely because they do not define Continuing Directors expressly. Third, given the court's now-demonstrated willingness to recognize aiding and abetting claims against third-parties entering into agreements with these provisions, the proxy puts at issue in *Hills*, *Amylin*, *SandRidge*, and *Healthways* will probably be

192. *See Healthways Transcript* at 79–80 ("There was ample precedent from this Court putting lenders on notice that these provisions were highly suspect and could potentially lead to a breach of duty on the part of the fiduciaries who were the counter-parties to a negotiation over the credit agreement.").

193. *See, e.g.*, *San Antonio Fire & Police Pension Fund v. Stanzione, et al. and Arris Group Inc.*, C.A. No. 10078-VCG, proposed order & notice (Dec. 5, 2014) ("In this case, defendant Arris Group, Inc. . . . removed from a bank loan agreement the 'continuing director' provision which plaintiff alleged was invalid and a product of fiduciary duty breaches by the Company's board of directors."); *Ironworkers Local No. 25 Pension Fund v. Donehy and Joy Global Inc.*, C.A. No. 10341-VCP, letter (Jan. 28, 2015) ("[N]ominal defendant Joy Global Inc. and defendant Bank of America, N.A. have eliminated the "Dead Hand Proxy Put" in the debt agreement that gave rise to this action."); *Ironworkers Local No. 25 Pension Fund v. Khoury, et al. and B/E Aerospace, Inc.*, C.A. No. 10342-VCN, letter (Dec. 24, 2014) ("[D]efendant B/E Aerospace, Inc. and defendant JPMorgan Chase Bank, N.A. have terminated the Dead Hand Proxy Put and refinanced the debt under the debt agreement that is the subject of this action.").

194. *See supra* note 36 (citing the text of the Continuing Director provision).

195. *See supra* text accompanying note 78 (citing the text of the Continuing Director provision).

196. *See supra* text accompanying note 77 (citing the text of the Indenture).

197. *See supra* note 106 (citing the text of the Indenture).

amended or eliminated.[198]

However, none of this is to say that the court's ruling in *Healthways* (i.e., the plaintiffs there merely stated a legally cognizable claim) will have the effect of eliminating proxy puts entirely. It is more likely that contracting parties will instead draft and adopt proxy puts that trigger upon the unapproved stockholder election of a new board majority where all directors have equal voting power. Including delay provisions risks running afoul of *Quickturn*'s invalidation of "slow hand" poison pills, but parties still may implement provisions requiring approval by a supermajority vote.

Accordingly, following this Comment's attempt to narrow Delaware's cases interpreting proxy puts and the likelihood that the court's recent decision in *Healthways* will fundamentally affect the nature of proxy puts in the market, there is ample room to consider how Delaware should regulate proxy puts in the future.

IV. RECHARACTERIZING PROXY PUTS

This Part considers how to regulate proxy puts by exploring the device's components and operation.[199] Then, this Part questions the limited extent to which proxy puts provide unique protection to creditors and proposes narrowing the proper purpose of proxy puts to Identity Risk as a concern distinct from Event Risk.

A. *Understanding the Components and Operation of Proxy Puts*

As an initial matter, it must be noted that change of control covenants are not the only covenants protecting lenders. Debt covenants cover a wide range of circumstances and can be divided into several categories:

> restrictions on the firm's production/investment policy (including restrictions on disposition of assets); restrictions on distributions (including restrictions on the payment of dividends, share purchases, and other forms of distribution); restrictions on

198. *See supra* text accompanying note 193.

199. For an argument that "embedded" change of control provisions like proxy puts in bond indentures are unregulable, *see* Jennifer Arlen & Eric Talley, *Precommitment and Managerial Incentives: Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 602 (2003) ("[I]t is also neither desirable nor feasible to regulate such defenses by allowing shareholders or courts (or both) to decide their fate ex post, once a tender offer has emerged."). However, as *Amylin* and *SandRidge* demonstrate, it is well within the expertise of Delaware courts to regulate board decisions made in the ordinary course of business that have an entrenching effect or touch on issues of control.

> subsequent financing (including limitations on issuing higher-priority debt and guarantees); modification of payoffs (including sinking funds, conversion rights, and callability); and bonding activities (including required reports, specification of accounting standards, and officer certificates of compliance).[200]

However, as exemplified by the RJR Nabisco buyout discussed below, traditional covenants alone proved inadequate to protecting lenders from certain changes of control. An early generation of change of control covenants, characterized as "poison puts" because they were intended to make the company "indigestible for a hostile bidder", triggered upon a change of control not approved by the board of directors.[201] But because these covenants failed to protect against management-friendly transactions, such as the RJR Nabisco buyout, a second generation of more comprehensive "super poison puts" emerged,[202] including limitations on beneficial ownership, stock repurchases and special dividends, the transfer or lease of assets, certain mergers or acquisitions, and significant changes in board composition.[203] The last of these most closely captures the proxy puts that are the subject of this Comment.

To better understand the operation and impact of proxy puts, this Comment turns to the scholarship of Professors Kahan and Klausner. In *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, Kahan and Klausner examined the development of change of control covenants protecting bondholders in the wake of the 1988 RJR Nabisco buyout.[204] Despite the variety of covenants already protecting bondholders in the event of certain changes in control, the buyout announcement caused RJR Nabisco bondholders to suffer catastrophic losses because the protections did not include management buyouts or friendly mergers.[205] As a result, lenders and corporations expanded the scope of the change of control covenants protecting bondholders from takeover-related losses. However, the expanded change of control covenants also functioned as antitakeover measures that protected

200. *See* Rock, *supra* note 26, at 1930 (citing Clifford W. Smith, Jr. & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. FIN. ECON. 117, 118-19 (1979)).

201. F. John Stark et al., "Marriott Risk": A New Model Covenant to Restrict Transfers of Wealth from Bondholders to Stockholders, 1994 COLUM. BUS. L. REV. 503, 568 (1994).

202. *Id*. at 569.

203. *Id*. at 573.

204. Marcel Kahan & Michael Klausner, Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?, 40 UCLA L. REV. 931 (1992/1993).

205. *See id*. at 980 (discussing the narrow change of control covenants in substantially all bonds issued prior to the RJR Nabisco buyout).

management at the expense of stockholders.[206] Given the mixed efficiency of these devices, Kahan and Klausner examined whether change of control covenants in bond indentures enhance firm value and the potential for management to use these provisions for entrenchment purposes. This Comment relies on Kahan and Klausner's description of how change of control provisions operate and affect a firm's agency costs of debt and equity rather than the results of their empirical analysis.

Kahan and Klausner discussed two issues critical to understanding proxy puts: a corporation's agency costs of debt and equity, and the triggers and remedies that define the way change of control covenants operate. First, the authors situated change of control covenants in Jensen and Meckling's agency cost framework.[207] There, a corporation's agency cost of debt "is a product of the conflicting interests of stockholders and bondholders once bonds have been issued."[208] More specifically, risk-averse bondholders prefer the corporation to pursue a conservative business strategy to maximize the likelihood of paying off its debt; in contrast, stockholders prefer the corporation to pursue a riskier strategy to maximize the unlimited gains on their investment. Thus, agency costs arise from the "incentives for a company to engage in transactions that lower the value of the firm but nevertheless increase shareholder wealth by shifting wealth from bondholders to shareholders."[209]

Importantly, these transactions include the debt-financed acquisitions or leveraged recapitalizations that surround takeover-related activity. When a company takes on high levels of debt, existing bondholders "bear a large part of the company's [increased] risk of failure, but . . . receive no additional benefit if the company succeeds."[210] As a result, new bondholders incorporate the risk of this additional leverage into the cost of the company's debt by either requiring higher interest rates or including certain other restrictive covenants. To the extent that higher interest rates fully compensate bondholders ex ante for the risk of harm flowing from increased leverage associated with certain changes in control, bondholders are indifferent as to whether a change occurs. However, since a higher cost of debt decreases the value of the company, companies face an incentive to

206. *See id*. at 934–35 (discussing the differing view that the change of control covenants are designed and implemented by management without shareholder approval to protect management from hostile takeovers).

207. *Id*. at 938 (citing Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 333–43 (1976)).

208. *Id*. at 938.

209. *Id*.

210. *Id*. at 939.

give up their right to engage in takeover-related activities associated with higher leverage by entering into restrictive, protective covenants in exchange for debt with lower interest rates. The authors state, "So long as bondholders are paid interest rates that reflect the presence or absence of covenant protection, they are indifferent to the extent of protection they are given."[211]

Kahan and Klausner also examined the impact of change of control covenants on a company's agency cost of equity. Agency costs of equity arise from the conflict between stockholders' sole interest in maximizing the value of their shares and the personal interests of management to retain control of the company.[212] Generally, the market for corporate control decreases a company's agency cost of equity by both disciplining managers to act in the best interest of stockholders by maximizing share value, and replacing managers who fail to do so through hostile takeovers and proxy contests.[213] However, the market for corporate control primarily consists of the same takeover-related, leverage-increasing events as those covered by the change of control provisions protecting bondholders. Accordingly, change of control covenants that protect not only bondholder interests but also managements' interests represent a trade-off between decreasing agency costs of debt and increasing agency costs of equity.[214] Kahan and Klausner contrasted the boundaries of this trade-off as follows:

> the bondholder-protective covenant that minimizes the agency cost of debt and equity would cover all leveraged acquisitions and recapitalizations and would provide compensation for no more than the actual loss in bond values that occurs as a result of the transaction. The ideal management-protective covenant, in contrast, would cover only hostile acquisitions and proxy challenges, and it would provide for a supra-compensatory remedy in the event that either of these control changes occurs. This covenant would both increase the firm's agency cost of equity and fail to achieve potential reductions in the agency cost

211. *Id*. at 939. *See also* Rock, *supra* note 26, at 1932 ("At issuance, many studies find a negative relationship between the ex ante pricing of debt and the presence of covenants.") (citing Vidhan K Goyal, Market Discipline of Bank Risk: Evidence From Subordinated Debt Contracts, 14 J. FIN. INTERMEDIATION 318, 334 (2005)); Natalia Reisel, On the Value of Restrictive Covenants: An Empirical Investigation of Public Bond Issues 5–7 (Dec. 2004) (unpublished manuscript), available at http://ssrn.com/abstract-644522).

212. *Id*. at 944 (citing Michael C. Jensen & William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. FIN. ECON. 305, 327–28 (1976)).

213. *Id*.

214. *Id*.

of debt.[215]

Importantly, Kahan and Klausner noted that, because bondholders are indifferent to changes in control when interest rates reflect the presence or absence of protection, "[t]he underlying conflict regarding the terms of a change of control covenant is thus the familiar one between managers and shareholders."[216] Thus, managers draft change of control covenants to benefit themselves in the following ways. First, managers who draft covenants that fail to protect bondholders from harmful, management-favored transactions (like management buyouts or leveraged recapitalizations) fail to efficiently reduce the company's agency cost of debt.[217] Since bondholders protect themselves by requiring higher interest rates to account for the additional risk of harmful, management-favored transactions, stockholders ultimately carry this additional cost through higher costs of borrowing. Second, managers draft covenants to compensate bondholders for takeover-related events that cause no harm whatsoever, but nevertheless threaten management's interests and control of the company.[218] Finally, managers draft covenants to significantly overcompensate bondholders for certain disfavored transactions in order to deter takeover-related events that threaten their job security.[219]

The second issue critical to understanding proxy puts is the terms that define change of control covenants generally. Change of control covenants consist of a trigger and a remedy. Kahan and Klausner divided change of control covenants into the following categories: Hostile Control Change Covenants, Dual Trigger Covenants, and Pure Rating Decline Covenants.[220] Additionally, the authors observed two remedies: the right to put debt back to the company at par or at a premium and an adjustment on the interest rate payable to the bondholder.[221]

Hostile Control Change Covenants are triggered by one of two takeover-related events: an unapproved acquisition of a specified percentage of the company's shares; or an unapproved proxy challenge replacing a majority of the company's directors.[222] In both cases, approval typically can be given "by the directors in office at the time the bonds were

215. *Id*. at 950.
216. *Id*. at 948.
217. *Id*. at 949.
218. *Id*.
219. *Id*. at 950.
220. *Id*. at 951.
221. *Id*. at 960.
222. *Id*. at 952–53. Although not described as such by Kahan and Klausner, an unapproved proxy challenge replacing a majority of the company's directors is a Proxy Put.

issued or successors they have chosen . . . ."[223] Because these covenants only apply to transactions not approved by management and omit management-favored, leveraged recapitalizations, "[t]he scope of bondholder protection is thus narrowly limited to hostile acquisitions and proxy challenges, the two ways in which stockholders can wrest control from management."[224] When triggered, Hostile Control Change Covenants typically provide the right to put the debt back to the company at par or at a premium.[225] However, this remedy does not compensate bondholders for harm arising from the triggering event: if market interest rates had declined enough prior to the event, the put would undercompensate a bondholder; alternatively, if market interest rates had increased enough prior to the event, the put would overcompensate a bondholder.[226] In either case, intervening market events, not bondholder protection against harm arising from an unapproved acquisition of shares or a proxy challenge, will largely determine the size of the remedy triggered by a Hostile Control Change Covenant. Thus, despite the stated intent, Hostile Control Change Covenants appear to protect directors more from the market for corporate control than bondholders from harm arising from hostile changes of control.

Dual Trigger Covenants, on the other hand, are triggered only when a decline in a bond's credit rating[227] accompanies one of the following events: (1) the acquisition of a specified percentage of the company's stock; (2) a successful proxy challenge replacing a majority of an incumbent board by individuals not nominated by management; (3) a merger, consolidation, or sale of substantially all of the corporation's assets; or (4) the payment of dividends or the repurchase of shares exceeding a specified percentage of the company's equity, or both, over the course of one year.[228] Kahan and Klausner found that most Dual Trigger

223. *Id*. at 952.
224. *Id*. at 954.
225. *Id*. at 960.
226. *Id*. at 963. Kahan and Klausner further explain the managerial interests reflected by including puts in change of control covenants, stating:

> This skewing of compensation under a put at par is particularly evident in the case of a proxy challenge or a hostile acquisition by a financially strong acquirer – two transactions that are unlikely to reduce bond values substantially, if at all. Because bondholders rarely suffer losses as a result of these transactions, the predominant potential impact of a put at par is to provide overcompensation (that is, if market rates have risen).

Id. at 965.
227. *Id*. at 955–56. To contribute to a trigger, a bond's rating must fall either from investment grade or a full rating category. *Id*.
228. *Id*. at 955. Kahan and Klausner note that sometimes a successful proxy challenge

Covenants included a put at par, although some included an interest rate adjustment determined by a schedule in the covenant relating specific interest rates to changes in credit ratings.[229] According to Kahan and Klausner, because Dual Trigger Covenants protect against most takeover-related events, they "offer substantially more complete coverage to bondholders than do Hostile Control Change Covenants."[230] Also, even though the put remedy is less efficient than the interest rate adjustment, Dual Trigger Covenants "relate the availability of a remedy more closely to transactions that actually cause a reduction in bond values[.]"[231] Nevertheless, these covenants still reflect managerial interests by including proxy contests, which alone merely remove management and cause little harm to bondholders.[232]

Finally, Pure Rating Decline Covenants automatically adjust the interest rate payable to bondholders upon an increase or decrease in the bond's credit rating, regardless of whether the change corresponds with a takeover-related event.[233] Pure Rating Decline Covenants "contain the most direct link between the remedy and losses in bond values" and reflect no influence of management interests.[234] However, they also "impose on a corporation the risk of credit quality deterioration that is completely outside the control of corporate management, such as problems attributable to increased competition."[235] Kahan and Klausner suggest these covenants are rare because they create management inflexibility that is adverse to both stockholders and bondholders.[236]

Kahan and Klausner's analysis of antitakeover provisions in bonds illustrates two issues critical to understanding proxy puts. First, the agency cost of debt arising from takeover-related transactions provides opportunities for companies to reduce their cost of debt and increase stockholder value by utilizing change of control covenants. However, because change of control covenants concern management's exposure to the market for corporate control, managers are incentivized to draft these covenants in their best interest rather than in the company's best interest, resulting in both a failure to decrease their company's agency cost of debt

replacing a majority of the incumbent board is not included in a Dual Trigger Covenant, and sometimes a major asset acquisition by the company is included.

229. *Id*. at 961.
230. *Id*. at 956.
231. *Id*.
232. *Id*. at 957.
233. *Id*. at 958–59.
234. *Id*. at 959.
235. *Id*.
236. *Id*. at 960.

and ultimately an increase in their company's agency cost of equity.[237] Second, managers draft change of control provisions to benefit their interests and harm stockholders in several ways. In particular, managers design triggers to protect against changes of control that are not likely to harm bondholders, like successful proxy challenges, and to exclude management-favored transactions that will harm bondholders. To deter unfriendly changes of control, managers also design remedies that either compensate bondholders who have not been harmed or overcompensate bondholders for harm actually suffered.

Importantly, the price of bonds reflects the extent of protective covenants.[238] In other words, a bondholder seeks to make themselves indifferent between either receiving lower interest rates ex ante and a remedy equal to harm suffered in the event of a triggering change of control or receiving higher interest rates ex ante with no remedy in the event of a change of control. Thus, while bondholders might receive a windfall from an overbroad or overcompensatory provision, there is little reason to assume a bondholder would accept a lower interest rate ex ante in exchange for the mere chance at a windfall remedy—and no reason to assume a bondholder would accept a lower interest rate ex ante in exchange for a provision that fails to protect against other genuinely harmful takeover events.

Kahan and Klausner's analysis leaves the benefit of proxy puts to agency costs of debt and equity, and thus to stockholders, on narrow ground. Without an accompanying decline in credit rating, proxy puts are Hostile Control Change Covenants. When proxy puts are included in debt agreements, successful proxy challenges trigger proxy puts and provide debt holders the remedy of putting their debt back to the company. But as

237. *See supra* text accompanying note 215 (illustrating the poor incentive structures that lead managers to draft covenants in their own best interests as opposed to the company's best interest).

238. *Id*. at 939 (arguing that "So long as bondholders are paid interest rates that reflect the presence or absence of covenant protection, they are indifferent to the extent of protection they are given."); *see also*, Rock, *supra* note 26 at 1932 (stating "(1) creditor protection is associated with lower promised yields at issue; and (2) there is a significant negative relation between credit spreads and the degree of covenant protection, controlling for issuer and bond issue characteristics") (citing Chenyang Wei, Covenant Protection, Credit Spread Dynamics and Managerial Incentives 13–18 (Nov. 29, 2005) (unpublished manuscript), *available at* http://pages.stern.nyu.edu/~cwei/JobMarket_CovenantsSpreadCEOIncentive_ChenyangWei.pdf); Rock, *supra* note 26 at 1934 (citing Matthew T. Billet, Zhan Jiang & Erik Lie, *The Effect of Change-in-Control Covenants on Takeovers: Evidence from Leveraged Buyouts*, 16 J. CORP. FIN. 1, 6 tbl.2, 11 (2010) (providing evidence that in the 2000s, change of control covenants used in 41% of bonds were associated with gains to bondholders of 2.3% compared to losses to bondholders of 6.8% in bonds without change of control covenants).

Kahan and Klausner point out, successful proxy challenges alone pose little threat to debt holders for which they would require protection.[239] Instead, the larger risk to debt holders associated with successful proxy challenges arises from the newly elected board's later decision to engage in debt-financed or takeover-related activity. But since proxy puts do not provide debt holders with direct protection from harm arising from leverage-increasing events subsequent to successful proxy challenges, debt holders protect themselves from these events with higher interest rates or other restrictive covenants.[240]

By implication, because debt holders benefit only marginally, if at all, from additional takeover-related protection in proxy puts, it is unlikely that companies derive substantial benefits from granting them.[241] In this respect, stockholders do not benefit from proxy puts because proxy puts exact a toll on stockholders' voting rights without a corresponding decrease in the company's cost of borrowing and agency cost of debt. Furthermore, by providing an overcompensatory put remedy, proxy puts tend to shield managers from the market for corporate control and thereby increase the company's agency cost of equity. It is evident that entrenchment may be the primary purpose of proxy puts.

To better illustrate how limited the protective value of a proxy put is to a lender, compare two extremes: debt protected only by a proxy put and no other covenants; and debt protected by a wide range of protective covenants but no proxy put. First, in the absence of additional protective covenants, a proxy put provides no creditor protection from nearly any action the incumbent board could take, including engaging in management-

239. *Id.* at 950. This is explained by Kahan and Klausner's observation that bondholders will protect themselves by pricing any unprotected risk of harm into the interest rate on bonds. *Id.* at 939. Because proxy puts do not provide bondholders with additional protection from takeover-related events, bondholders have no incentive to reduce the interest rate. Thus, broad proxy puts tend to benefit bondholders at the expense of stockholders. Instead, the benefit flows to management by shielding them from the market for corporate control. *Id.* at 949.

240. In fact, the RJR Nabisco buyout itself illustrates the risk of harm to bondholders that Hostile Control Change Covenants (like proxy puts) leave unprotected: because the RJR Nabisco buyout resulted from a bidding war between a highly-leveraged management-led buyout and a highly-leveraged friendly acquisition, neither non-hostile buyout triggered a bondholder-protective remedy. Similarly, a proxy put alone would not compensate bondholders for harm suffered if incumbent management themselves decided to leverage the company and buy back shares or distribute a cash dividend to defend against a proxy challenge.

241. Debt holders undoubtedly benefit when proxy puts compensate them despite a lack of harm. *See supra*, text accompanying note 213. However, this benefit is an unbargained-for windfall to the debt holder representing a direct transfer of wealth from stockholders to bondholders.

friendly changes of control. For example, the board could dilute the value of the creditor's fixed claim on the assets of the company by spinning off a subsidiary or distributing assets to shareholders or by substituting more risky assets for less risky assets; alternatively, the board could decide to change the capital structure of the company by increasing leverage.[242] Given that this list likely includes nearly everything that could happen in the life of a company, other than the shareholders choosing to elect a new board majority without the incumbent board's approval, the creditor faces an enormous risk of harm that the proxy put cannot prevent. By way of analogy, a proxy put protects creditors from harm to the same extent the front door insulates a home from the cold: it doesn't matter how tightly you bolt it shut if all the other doors and windows are left open. It is difficult to imagine a creditor conferring a material benefit on a company in exchange for this kind of protection.

In the alternative, consider a creditor that is concerned about its borrower dramatically changing its capital structure, significantly diluting its assets, taking too many risks, or becoming the target of a leveraged buy-out. Instead of a proxy put, this creditor negotiated with its borrower for covenants restricting its ability to materially change its capital structure by increasing leverage, decreasing equity, spinning-off or selling all or substantially all of its assets, and for protection against both a credit rating downgrade and the company reporting an interest coverage ratio below a negotiated threshold. By design, the creditor is protected from just about any foreseeable event that would materially reduce the likelihood that its borrower will repay its debt. In addition, the borrower was able to obtain a lower interest rate as consideration for agreeing to the covenants protecting the lender; thus, both parties benefit from the covenant. However, seeking to refinance its debt with the creditor, presumably for the purpose of further reducing its cost of borrowing, the company proposes to add the only protection the creditor doesn't already have: a proxy put. How would the proxy put increase the creditor's protection from harm? Any new board majority would be just as subject to the creditor's existing protection as the incumbent board is. As such, the creditor is already protected from any material increase in the risk that the company would not be able to repay its debt arising from stockholders electing a new board majority.

This hypothetical is not meant to reflect current market trends, but rather that the amount of protection uniquely provided by proxy puts is limited, notwithstanding the Delaware Court of Chancery's analysis in *SandRidge*. Nevertheless, there is evidence suggesting that lenders in fact

242. *See* Rock, *supra* note 26, at 1927 (describing how shareholders externalize risk onto creditors and other fixed claimants).

place no value on proxy puts.[243] The next section of this Comment proposes a distinction designed to enable Delaware to better regulate proxy puts.

B. *Distinguishing Identity Risk From Event Risk*

The "proxy put" label can be characterized broadly or narrowly. Under the court's broad characterization of proxy puts in *SandRidge*, the "proxy" label most accurately captures the device's duplicative function as a distant proxy for protection against multiple possible harms arising from leverage-increasing or takeover-related events taking place after stockholders elect a new board majority by directly and substantially interfering with the shareholder franchise itself. Instead, the "proxy put" label could be narrowly characterized as a description of the device's operative provisions and an honest recognition of its purpose of protecting against unique risks arising from proxy fights. Adopting a narrow characterization, as this Comment proposes, suggests the clearest answer to whether a board has the authority to bind the corporation to a change of control provision designed to prevent stockholders from electing a new board of directors: as the court held in *Blasius*, a board has no such authority absent a compelling justification.[244] Because the limited protection that a proxy put uniquely provides contrasts with the potentially unlimited cost of the device to the stockholder franchise, this Comment proposes defining the proper purpose of proxy puts to be as narrow as the limited protection that a proxy put uniquely provides. More precisely, this Comment proposes (1) defining the proper purpose of proxy puts to be providing protection against Identity Risk and (2) attaching a rebuttable presumption that proxy puts are disenfranchising.

Kahan and Klausner define "Event Risk" as "the risk that an event will occur that results in a sudden change in a corporation's credit quality

243. *See, e.g.*, Joseph A. Fields, David S. Kidwell & Linda S. Klein, *Coupon Resets Versus Poison Puts: The Valuation of Event Risk Provisions in Corporate Debt*, 3 FIN. SERV. REV. 143 (1994); Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 J. FIN. 689 (1991) (attributing 24 basis points in value primarily to a change in beneficial ownership and a credit rating decline); MOODY'S REP. NO. 98985, REQUEST FOR COMMENT ON MOODY'S INDENTURE COVENANT RESEARCH & ASSESSMENT FRAMEWORK (2006) (omitting proxy puts as a relevant or valuable form of creditor protection); Moody's Rep. No. 108526, CREDIT ROUNDTABLE ADOPTS A CONTRACT-BASED APPROACH TO MITIGATING RISK, (2008), at 5 n. 15 (describing proxy puts as "[d]esigned to address hostile takeovers, this 'event' prong is not particularly useful."). These reports are in stark contrast to the court's consistent characterization of proxy puts in *SandRidge* as protecting creditors' legitimate interests in getting paid.

244. *Blasius Industries v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988).

but that cannot be predicted using the tools of credit analysis."[245] This definition "includes not only financial transactions such as leveraged buyouts, spin-offs and restructurings but also a variety of other extraordinary events such as major litigations, casualty losses and the like."[246] For present purposes, Event Risk might as well be defined so broadly that it includes the risk that any event will occur resulting in a sudden change in a corporation's credit quality. The only thing that Event Risk should not include is Identity Risk.

As defined here, Identity Risk arises from proxy fights, but contrasts with Event Risk in that it is not concerned with what legitimate actions a newly elected board majority might take. It is instead narrowly concerned with risks related to the identity of the individuals in question.[247] By way of example, the court in *SandRidge* identified several risks to creditors posed by a rival proxy slate: "the proposed new board consists of 'known looters' or persons of suspect integrity[;]" or "the insurgent slate could have plans for the company posing a genuine and specific threat to the corporation[.]"[248] Although Event Risk likely encompasses "plans for the company," Identity Risk carves out the risk of harm arising from stockholders electing a new board majority consisting of "known looters" or persons of suspect integrity.[249]

Distinguishing Identity Risk from Event Risk is consistent with Delaware law. In Delaware, the stockholders of a corporation elect its directors.[250] According to *Blasius*, this continues to be true even when a rival slate's "proposal was or is unrealistic and would lead to injury to the corporation and its shareholders if pursued."[251] Critically, the court clarified that while it may be true that "the board knows better than do the shareholders what is in the corporation's best interest[] . . . for any number of matters, it is irrelevant . . . when the question is who should comprise the board of directors."[252] Thus, notwithstanding the Event Risk posed by a rival slate's proposal, a board may not interfere with the shareholder franchise without a compelling justification.[253] Even without the proposed

245. *See* Kahan & Klausner, *supra* note 204, at 934 n.5 (defining "event risk").

246. *See* Stark et al., *supra* note 201 (describing a broad definition of "event risk").

247. For the avoidance of doubt, Identity Risk is concerned with the identity of nominees on a rival slate, not the stockholder nominating the rival slate.

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

249. The substance of this proposed definition is intentionally limited to one of the strongest justifications for interfering with the stockholder franchise, but experience will no doubt permit the definition to expand.

250. 8 *Del. C.* § 211(b).

251. *Blasius*, 564 A.2d at 663.

252. *Id.* at 663.

253. *Id.* at 659.

presumption that proxy puts are disenfranchising, a broadly framed proxy put characterized as being concerned with Event Risk is arguably disenfranchising on its face, notwithstanding the chancery court's prior decisions to the contrary.[254] By contrast, a proxy put concerned only with Identity Risk, that is, the narrow risk of harm arising from a new board majority consisting of known looters or persons of suspect integrity, arguably satisfies *Blasius*'s compelling justification standard with ease. Because of this, attaching a disenfranchising presumption is both consistent with *Blasius* and easily rebutted by a board defending a narrow proxy put.

In addition to being consistent with Delaware law, separating Identity Risk from Event Risk as the proper purpose of proxy puts is useful in several ways. First, it provides a clear signal to the market that the court is willing to presume a proxy put is disenfranchising on its face. This will put boards on notice that they will have to demonstrate a compelling justification for triggering proxy puts in order to satisfy their fiduciary duties. Plus, the threat of being subject to compelling justification review will incentivize boards to amend the proxy puts to which their company is a party in order to decrease the extent to which they are concerned with Identity Risk. For example, a dual trigger covenant providing a creditor with an interest rate adjustment remedy upon the reduction in the credit rating of its borrower shortly after a change in board majority is arguably more concerned with the credit rating Event Risk than the proxy fight risk and thus not likely to reviewed under *Blasius*. This contrasts with a provision that automatically triggers a put remedy above par upon the election of an unapproved new board majority, which would probably be a facially invalid abdication of a board's fiduciary duties or, at minimum, subject to *Blasius* review in all circumstances. Thus, the threat of being subjected to compelling justification review will encourage directors to focus change of control provisions on the best interests of the company and its stockholders instead of their own.

Second, separating Identity Risk from Event Risk will provide clarity not only as to the proper standard of review for proxy puts, but also as to the proper standard of review for broader change of control covenants. Even though the court has reviewed proxy puts under *Unocal* "with a

254. *See, e.g.*, *Hills Stores Co. v. Bozic*, 769 A.2d 88, 90 (Del. Ch. 2000) ("The plaintiffs are estopped from arguing and have produced no evidence that the Employment Areements were entered into for the 'primary purpose of thwarting the exercise of a stockholder vote.'"); *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242, 258 (Del. Ch. 2013) ("But the standard of review *Blasius* offers does little to address situations like this, where a contractual provision cannot be said to have the 'sole or primary purpose' of impeding the stockholders' vote . . . .").

special sensitivity towards the stockholder franchise[,]"[255] the simple fact is that *Blasius* and *Liquid Audio* still create ambiguity as to when the court might adopt a higher standard. Thus, carving out Identity Risk would increase clarity as to the circumstances under which the court will conduct a compelling justification review.

Third, despite limiting the proper purpose of certain proxy puts, the proposed distinction is not a per se invalidation of the device. This is consistent with Delaware's preference against per se rules.[256]

Finally, juxtaposing Identity Risk and Event Risk will focus both the court and boards of directors on a more thorough consideration of the broad contractual context in which proxy puts appear. For example, a board determining for purposes of a proxy put whether to approve a rival slate planning to conduct a leveraged share repurchase like in *Hills* might reasonably choose not to do so because the creditor is better protected by a covenant restricting the rival slate's ability either to change the company's capital structure after its election or to repurchase a substantial amount of shares. And because neither party expected the proxy put to protect from leveraged share repurchases, declining to trigger the remedy would not be a breach of the proxy put.

V. DEVELOPING A FRAMEWORK OF REVIEW FOR PROXY PUTS

In *Hills*, *Amylin*, *SandRidge*, and *Healthways*, Delaware began laying the foundation for a framework of review, but more work is necessary to achieve clarity and utility in future cases concerning proxy puts. This Comment set out to address two primary questions left unanswered in *SandRidge* by narrowing the court's characterizations of both *Amylin* and proxy puts. After exploring the components and agency costs of change of control provisions, this Comment questioned the extent to which proxy puts add unique protection to creditors and proposed narrowing the proper purpose of proxy puts to Identity Risk as a concern distinct from Event Risk. In this Part, this Comment develops the structure of a framework of review assuming Identity Risk is the proper purpose of proxy puts with the goal of exploring the extent to which the framework provides a means to regulating shareholder-creditor agency costs related to proxy puts.

Distinguishing Identity Risk from Event Risk parallels distinguishing *Blasius* from *Unocal*: as the court recognized in *Blasius*, it is irrelevant

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

256. *See, e.g.*, *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS, transcript (Del. Ch. Dec. 17, 2012) ("Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be.").

whether a board's actions are proportionate to a threat conceived in good faith when it comes to deciding who should comprise the board of directors. And the supreme court was just as clear in *Liquid Audio* when it held that demonstrating a compelling justification for action taken with the primary purpose of interfering with a stockholder election is a condition precedent to any determination of the action's reasonableness.[257] Yes, actions taken to protect against Identity Risk are by their nature defensive; but because protecting against that risk requires interfering with the stockholder franchise, the primary purpose of those defensive actions is presumptively disenfranchising. By implication, then, distinguishing Identity Risk from Event Risk attaches the presumption of a primary purpose to disenfranchise and suggests some form of compelling justification review. Therefore, this Comment adopts the *Liquid Audio* standard of review for proxy puts as a means to considering both the disenfranchising presumption and the proportionality of a board's actions in relation to Identity Risk.

As will be shown, incorporating Identity Risk into a *Liquid Audio* standard of review simplifies the analysis of proxy puts by focusing narrowly on whether a proxy put was adopted to protect against Identity Risk, whether its trigger is limited to protecting against Identity Risk, and whether the board demonstrates a good faith belief informed by compelling evidence that a rival slate poses a threat arising from Identity Risk before triggering the device. Within this framework, the validity of a board's decisions to adopt and exercise a proxy put has a firm basis in Delaware corporate law, both in terms of the board's authority to adopt the device and the proportionality of the device's trade-off between the stockholders', creditors', and company's interests under the circumstances. Finally, creditors also benefit from the framework's clear demarcation of a board's authority to adopt and exercise proxy puts.

This Part proceeds as follows. Section A considers a board's possible responses to a disenfranchising presumption. Section B outlines how fiduciary duty claims would be reviewed and Section C outlines how contract claims would be reviewed, both with a focus on Identity Risk. Section D explores extending the framework. Section E looks back at prior cases.

A. *Satisfying Identity Risk's Disenfranchising Presumption*

The *Blasius* standard incorporated into *Liquid Audio* has two parts: primary purpose and compelling justification. Thus, a board attempting to

257. *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003).

satisfy the disenfranchising presumption can attack both parts. First, a board that adopted a proxy put for the primary purpose of protecting against Identity Risk should concede that the proxy put is disenfranchising and instead focus on demonstrating that the proxy put provides protection against known looters or persons of suspect integrity that might take over the board through a proxy fight. Second, a board could also seek to rebut that the primary purpose of adopting the proxy put was disenfranchising. For example, the primary purpose of the Severance agreements in *Hills* was to prevent the covered executives from quitting in the face of Dickstein's hostile takeover attempts. In either case, the board is best served by clear evidence of its purpose in adopting the proxy put. Rebutting the presumption is not meant to be difficult, but to incentivize boards to document their negotiations and deliberations leading up to their adoption or exercise of a proxy put.

However, the path that the board chooses impacts the subsequent analysis. By rebutting the presumption, the ordinary *Unocal* standards would apply. Alternatively, by conceding that the primary purpose of the proxy put is disenfranchising, certain portions of the analysis would be influenced by *Blasius*'s compelling justification standard, as demonstrated below.

B. *Reviewing Fiduciary Duty Claims*

As established in *Moran* and recognized in *SandRidge*, both a board's decision to adopt a change of control provision and a board's decision to trigger the change of control provision are challengeable.[258] In addition, as stated above, this Comment adopts the *Liquid Audio* standard of review for proxy puts.

1. Challenging A Board's Decision to Adopt a Proxy Put

A board's decision to adopt a proxy put would be reviewed under *Liquid Audio*'s unified standard. Under *Liquid Audio* review, rebutting the disenfranchising presumption satisfies the standard's condition precedent to questions of proportionality and reasonableness. Afterwards, the familiar two-prong *Unocal* standard applies. As an initial matter, by narrowing the proper purpose of a proxy put to protecting against Identity Risk, the grounds on which a board may validly defend its decision to adopt a proxy put are similarly narrow. A board would support its decision to adopt the

258. *SandRidge*, 68 A.3d at 259 (citing *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985)).

proxy put one of two ways. Either the board would rebut the disenfranchising presumption by demonstrating that the proxy put was adopted for a purpose other than protecting against Identity Risk and thereafter demonstrate that the proxy put's components are proportionate to its purpose. Or the board would concede that the proxy put was adopted for the primary purpose of disenfranchising and instead demonstrate that the proxy put's components are proportionate to a compelling justification—something it should be able to do with ease as protecting against Identity Risk justifies a much larger remedy.

A stockholder challenging the validity of the board's decision to adopt the proxy puts would only be able to do so by demonstrating that the proxy put is not proportionate to the purpose for which it was adopted. However, a stockholder would be able to argue against the board's purported purpose for adopting the proxy put in order to challenge its proportionality against a different standard: a proxy put adopted to protect against Identity Risk would be disproportionate if its trigger prevents more than the election of known looters or persons of suspect integrity or if its remedy provides a creditor with significantly more than the basic right to put its debt back to the company at par.

Unocal review would proceed as follows. Applying the first prong to a board's decision to adopt a proxy put is simple: did the board have an informed, good faith belief that the proxy put protects against Identity Risk?[259] Alternatively, if the board rebutted the disenfranchising presumption by demonstrating that protecting against Identity Risk was not the primary purpose of the challenged proxy put, the board would only have to demonstrate that it had an informed, good faith belief that something posed a threat to the company, even if the threat does not arise from Identity Risk.

Second, the board would have to demonstrate that the proxy put operates in proportion to its proper purpose. Kahan and Klausner's description of a proxy put's operative provisions, as well as the *Amylin* court's insistence that a board receive extraordinary consideration for granting a proxy put, identify three components that inform *Unocal*'s proportionality review: the proxy put's trigger and remedy, and the consideration the company received. Notwithstanding the court's comments in *Amylin*, however, the clear protection a proxy put also gives the company against Identity Risk suggests that a proxy put has defensive

259. This would also satisfy *Schnell*'s concern that board action be taken for a proper purpose; in this case, protecting against Identity Risk is a proxy put's only proper purpose. *See Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (finding against board actions taken for "inequitable purposes [and] contrary to established principles of corporate democracy").

value independent of any bargained-for benefit negotiated from a creditor. In other words, because both a company and its creditors benefit from a proxy put's protection against Identity Risk, the board need not necessarily extract additional concessions from its counterparty.

If a board seeks to include a proxy put, the board's informed, good faith belief that it is in the best interest of the company and its stockholders to give itself a lever to deter known looters or persons of suspect integrity from winning a board majority would alone be a compelling justification. When the board adopts a proxy put for its independent value, this trade-off between protecting the company from Identity Risk and the stockholder's fundamental right to elect the board can only be proportionate if the trigger is narrowly tailored to protecting against Identity Risk, because only when protecting against Identity Risk is the put remedy reasonable in relation to the threat posed. Thus, a proxy put adopted in good faith and on an informed basis for its independent defensive value satisfies *Liquid Audio*'s condition precedent to *Unocal* review if its trigger is narrowly tailored to protecting against Identity Risk and similarly satisfies *Unocal*'s proportionality review. Alternatively, if a creditor seeks to include a proxy put, the board should consider whether its independent value is worth the cost to the stockholder franchise and attempt to negotiate for additional concessions as urged by the court in *Amylin*.

Notwithstanding a proxy put's independent value, as suggested previously and discussed by Kahan and Klausner, a proxy put might also be adopted for mixed purposes exceeding Identity Risk and be structured to trigger under circumstances other than the unapproved election of a new board majority. Even though related to Identity Risk, the proportionality of these mixed-purpose proxy puts is discussed in greater detail in Section D below.

As an additional claim, the court acknowledged in *Healthways* its willingness to consider a device's deterrent effect on the stockholder franchise to be an ongoing, actionable harm.[260] This analysis would closely follow the adoption analysis with a focus on whether the remedy's deterrent effect is disproportionate to the proxy put's purpose. However, assuming the board reserved discretion to approve a rival slate that does not consist of known looters or persons of suspect integrity, a stockholder arguably could not be deterred from nominating a rival slate unless and until the board acts to disapprove the slate (in which case the stockholder's claim would relate to the board's exercise of its approval), or refuses to act one way or another (in which case the stockholder's claim would be that the board is acting in bad faith as demonstrated by *SandRidge* itself). In

260. *Healthways Transcript,* at 78–80.

any event, narrowing the proper purpose of proxy puts to Identity Risk would also narrow the court's deterrence analysis in *Healthways* by narrowing the circumstances under which a stockholder might be deterred. Finally, a proxy put with an automatic trigger would have a much stronger deterrence effect and, as discussed above, is arguably a facially invalid abdication of a board's fiduciary duties or, at minimum, would require the board to rebut the disenfranchising presumption in all circumstances.

2. Challenging a Board's Decision to Trigger a Proxy Put

A board's decision to exercise its discretion under a proxy put would be similarly reviewed under a *Liquid Audio* standard, but the framework differs in two respects: the good faith prong should be ratcheted up by the compelling justification standard[261] and the proportionality prong would necessarily require an adoption analysis. First, considering the narrow basis for validly adopting a proxy put, the only unique board action separating its contractual duty to its creditors and its fiduciary duties to the company and its stockholders is its informed, good faith belief that the rival slate consists of known looters or persons of suspect integrity. As suggested above, the board's burdens of production and persuasion here would be influenced by the compelling justification standard. Given the potentially staggering consequences of triggering a validly adopted proxy put, a board's informed, good faith belief that electing the rival slate would pass control of the company to known looters or persons of suspect integrity should be supported by compelling evidence. In other words, in order to rebut the disenfranchising presumption after conceding primary purpose, the board should have to demonstrate that it formed its good faith belief based on compelling evidence justifying the magnitude of its decision to trigger the put remedy. As demonstrated in Section C below, this determination also relates to a counterparty's potential claim that the board breached its duty of contract. In either case, requiring compelling evidence provides the board with a strong basis for defending against fiduciary duty claims and creates a high hurdle for creditors suing in contract to overcome.

Second, a board cannot validly exercise an invalidly adopted proxy put. Thus, assuming the board demonstrated that it had reached an informed, good faith belief based on compelling evidence that the rival slate posed a threat to the company arising from Identity Risk, the proportionality analysis would necessarily shift its focus to the board's

261. For mixed-purpose proxy puts, discussed *infra* part VI.D., the good faith prong is not ratcheted up by the compelling justification standard.

decision to adopt the proxy put in the first place. As an initial matter, the board would already have shown that the threat posed is proportionate to the trigger itself by demonstrating its informed, good faith belief that the threat arises from Identity Risk. Beyond that, however, whether the remedy and consideration are proportionate to the proper purpose of protecting against Identity Risk necessarily requires a record of the board's negotiations and deliberations leading to the proxy put's adoption. Because a board's decision to trigger a proxy put after satisfying the good faith prong is a contractual duty, it is thus independent from a contemporaneous conclusion that the remedy and consideration are disproportionate. In order for the remedy and consideration to be proportionate at exercise, they must have been proportionate at adoption.[262] The contours of this analysis are set forth above and thus not repeated here.

The trade-off between stockholder, company, and creditor interests by its nature places the board under enormous pressure. Upon considering whether to trigger a proxy put, a board should recognize that it will probably be sued, either by stockholders or by creditors, regardless of its conclusion. The goal of this Identity Risk framework, however, is not to create a jump ball scenario in which it would never be clear to creditors or stockholders when proxy puts may be validly adopted or exercised. Instead, the goal is to incentivize boards to adopt and exercise proxy puts for the (proposed) proper purpose of protecting against Identity Risk and to document both negotiations and deliberations leading to their decision to do so. If negotiated, deliberated, and documented appropriately, a board reduces the risk of liability to either party. First, as the counterparty to the proxy put, a creditor should never have any doubt as to why the proxy put was adopted and should have the same evidence as the board as to whether a rival slate poses a threat arising from Identity Risk. A mere difference of opinion is resolved in favor of the board, both in contractual and fiduciary terms.[263]

262. Incidentally, this follows from *Hills*, where the court estopped the plaintiff from challenging the proportionality of the board's decision to trigger the Severance agreements because the plaintiff had contractually waived its right to challenge the proportionality of the board's decision to adopt the agreements in the first place. *See Hills Stores Co. v. Bozic*, 769 A.2d 88, 107 (Del. Ch. 2000) ("The plaintiffs cannot in good faith claim that the Severance is a disproportionate response in a situation when the Hills board, on a good faith and informed basis, concluded that a Change in Control was adverse to the interests of Hills and its stockholders. To find otherwise would be to say that the plaintiffs waived nothing when they agreed not to challenge the adoption of the Employment Agreements.").

263. That is, the contract expressly grants the board the right to exercise its discretion as to whether the rival slate poses Identity Risk. Furthermore, a board arguably lacks authority to adopt a proxy put that grants the creditor its fiduciary duty to determine whether a rival slate poses an Identity Risk to the company and its stockholders.

Second, a board should disclose to its stockholders that it adopted a proxy put, its narrow purpose for doing so, and the narrow circumstances in which the board would be required to trigger the proxy put. Fundamentally, however, when facing competing fiduciary and contract claims, the board's contractual duty to trigger the proxy put would be consistent with its fiduciary duties to the company and its stockholders. Such is the purpose of narrowing the validity of proxy puts to protecting against Identity Risk: the stockholders', creditors', and company's interests under the circumstances would be aligned. Whether a board has breached its contractual duty to trigger a proxy put is discussed in the following Section.

C. *Reviewing Contract Claims*

A creditor's claim that the company breached its contractual duty under a proxy put will only arise from a board's decision to approve a rival slate and neutralize the creditor's put remedy. Determining whether a board exercised its discretion under a proxy put in breach of its contractual duties turns first on whether the proxy put actually grants the board such power. As suggested in *Amylin* and *Healthways*, a board's adoption of a proxy put with an automatic trigger denying the board power to neutralize the remedy is arguably a facial abdication of its fiduciary duties to the company and its stockholders or, at minimum, is invalid without a compelling justification.[264] For present purposes, however, this Comment considers only proxy puts that grant power to the board to exercise its discretion and determine whether to trigger the proxy put's remedy.

The test in *Amylin* for whether a board has the contractual right to approve a proxy put was clarified above.[265] The test has two parts: A board has the contractual right under a proxy put to approve a rival slate if (1) the board determines on an informed, good faith basis that passing control to the rival slate would not be a breach of its duty of loyalty to the company or its stockholders, and (2) approving the rival slate is not a breach of its implied covenant of good faith and fair dealing. Defining Identity Risk as the proper purpose of proxy puts would also attach the disenfranchising presumption to whether the board has the right to approve a rival slate. The disenfranchising presumption focuses the first part of this test on whether the board's informed, good faith belief was based on compelling evidence and the second part of this test on whether the board

264. *Amylin*, 983 A.2d 304, 315 nn. 31–32 (Del. Ch. 2009); *Healthways Transcript* at 75, 80–81.

265. *See* discussion, supra part II.B.

has deprived the creditor of its bargained-for protection.

In contrast to a fiduciary duty claim, here a board would defend its decision to approve the rival slate and neutralize the proxy put one of two ways. First, the board would argue that the proxy put was adopted to protect against Identity Risk, but that it lacks compelling evidence to believe in good faith that the rival slate poses a threat arising from Identity Risk. For example, a board may have determined in good faith that passing control to the rival slate would be a breach of its duty of loyalty to the company—yet also determine in good faith that the threat posed by the rival slate does not relate to the creditor's bargained-for protection from Identity Risk. In such a situation, a board has the right to approve the rival slate for purposes of the proxy put without frustrating the device's purpose of protecting the creditor from Identity Risk.[266] Signaling the likelihood of this outcome would incentivize creditors to protect themselves from Event Risk with covenants more narrowly designed to do so. Second, the board may have compelling evidence that the rival slate poses a threat arising from Identity Risk, but argue that it has no duty to trigger the put remedy because it was not adopted to protect against such a risk. Because this Comment proposes that protecting against Identity Risk should be the only proper purpose of a proxy put, this second argument depends on the device in question being something other than a proxy put. As such, discussion of that possibility is reserved to Section D below.

A creditor would make the opposite arguments: either the proxy put was adopted to protect against Identity Risk and the board acted in bad faith by ignoring compelling evidence that the rival slate posed such a threat; or, the device in question was not adopted to protect against Identity Risk so the board's duty to trigger the device does not require compelling evidence, and thus the board acted in bad faith by denying the creditor otherwise valid bargained-for protection. Again, this second argument depends on the device in question being something other than a proxy put and is discussed in greater detail below.

This contractual analysis purposefully mirrors the fiduciary duty analysis above. In order for the board to validly trigger a proxy put without breaching its fiduciary duties, the proxy put must have been designed and adopted for the primary purpose of defending against Identity Risk and the board must have compelling evidence to support an informed, good faith belief that the rival slate in fact poses a threat arising from Identity Risk,

266. Although dicta, the court in *Hills* recognized that if the board had approved the Dickstein Change of Control, it would have denied the Covered Executives of the exact protection the Employment Agreements were designed to provide and thereby breached its implied duty of good faith and fair dealing. *See Hills Stores Co. v. Bozic*, 769 A.2d 88 (Del. Ch. 2000).

among other things. Without meeting these requirements, the board arguably lacked authority to grant the protection in the first place, rendering the creditor's interest in the proxy put's exercise unenforceable. Therefore, within an Identity Risk framework, a creditor would have no reasonable expectation of protection absent the board's satisfaction of the above requirements. In other words, a creditor cannot prove a breach of contract without also proving that the board breached its fiduciary duty of loyalty by passing control of the company to a rival slate of known looters or persons of suspect integrity notwithstanding compelling evidence in support of such a determination. The potency of proxy puts would thus require both parties to believe in good faith that they are each agreeing to it for a proper purpose and recognize that for the board to have the authority to grant the protection, its ability to trigger the remedy must be circumstantially narrow. As emphasized above, this framework would allow boards and creditors to confidently adopt valid, enforceable proxy puts by aligning stockholders', companies', and creditors' interests in Identity Risk protection. That the framework of review of contract claims would mirror the framework of review of fiduciary duty claims in maintaining the alignment of those interests is self-evident.

D. *Extending the Framework*

By now, one might validly question whether the adoption of proxy puts would continue if subject to this Identity Risk framework. As stated previously, the purpose of this framework is not to discourage the use of proxy puts, but to limit the device's validity to legally and equitably defensible circumstances and to incentivize parties to adapt devices to protect against Event Risk without interfering with the stockholder franchise to the extent proxy puts do. This Section explores extending the framework to devices resembling proxy puts but that reach beyond the narrow, primary purpose of protecting against Identity Risk and to devices that are arguably not proxy puts at all.

Adopting this Identity Risk framework would probably have the following effect on proxy puts. First, the validity of existing proxy puts would be narrowed by the presumption that their only valid primary purpose is to protect against Identity Risk. Such proxy puts would arguably remain valid, subject to their exercise under compelling circumstances. Second, new proxy puts adopted for the primary purpose of protecting against Identity Risk would be adapted to this framework. Finally, for existing or new proxy puts whose primary purpose is arguably not to protect against Identity Risk, the device's components would be drafted to be proportionate to that purpose. This Section considers this final category of mixed-purpose proxy puts, which resemble proxy puts that arguably serve a primary purpose other than protecting against Identity Risk, and other devices, which are neither triggered by a proxy fight replacing a majority of the board nor provide a put remedy.

As discussed previously, a board may seek to rebut the disenfranchising presumption by arguing that a mixed-purpose proxy put was adopted for a primary purpose other than protecting against Identity Risk. Consistent with this Comment's argument that a creditor's only valid interest in a proxy put should be avoiding the harm arising from Identity Risk, a board would only grant a creditor a proxy put for a different purpose by narrowing the proxy put's components to be proportionate to that purpose. Furthermore, a board's failure to demonstrate that the components of a mixed-purpose proxy put are proportionate to its purpose would be strong evidence that the primary purpose of the device was in fact disenfranchising. For example, in *Healthways*, SunTrust argued that as a lender, it had a legitimate interest in knowing the identity of its borrower:

> [I]t's really designed to sort of give the creditors an opportunity to evaluate the credit situation and the risk situation if either within a one-year period or a two-year period there suddenly is a change in the composition of the board so that the majority is all of a sudden different.[267]
>
> . . .
>
> [I]f you have a fundamental change, where a majority of your board turns over, it just gives the borrower the ability to completely clean house, change management, change business direction, which obviously may show up in the form of other covenants, or may not.[268]

There, the stated risk to SunTrust was not that a new board would consist of known looters or persons of suspect integrity, but that a new board might change the direction of the business without triggering any of the creditor's other protective covenants. Even assuming SunTrust's interest in such protection was legitimate and non-pretextual, both SunTrust and Healthways failed to demonstrate how a put remedy above par was proportionate to any harm that might arise from a new board simply taking the company in a different direction. In this scenario, the SunTrust proxy put would have been more defensible had it drafted a double trigger requiring not only an unapproved election of a new board majority, but also a decline in Healthways' credit rating within a reasonable

267. *Healthways Transcript* at 26.
268. *Healthways Transcript* at 27.

period of time.[269] And even with a narrower trigger, it is not clear how an enormous put remedy would be proportionate to harm arising from a mere change in credit rating. Alternatively, under the facts of *Healthways*, a dual trigger proxy put providing an interest rate adjustment upon a credit rating decline occurring within a reasonable period of time after a change in board majority would probably have been proportionate to SunTrust's stated purpose. Additionally, since neither Healthways nor its stockholders would benefit from this protection the same way they would from protection against Identity Risk, the board probably would have to have negotiated for a proportionate concession from SunTrust. But because the proxy put's components were so disproportionate to SunTrust's stated purpose, the court could have reasonably concluded that the proxy put's primary purpose was disenfranchising.

This example is not comprehensive, but highlights two facts. First, very few compelling justifications, if any, support a creditor's interest in putting its debt back to the company at a premium above par upon the stockholders' election of a new board majority. This Comment suggests that the only compelling justification for such an extreme toll on the stockholder franchise is when the creditor's interests are aligned with those of the company and the stockholders, namely, in order to protect against Identity Risk. Second, because a creditor's valid interest in a proxy put is so limited, a board that grants a creditor the protection of a device resembling a proxy put, but for the primary purpose of protecting against something other than Identity Risk, may only do so if the device's components are narrowly proportionate to another valid purpose. Here, relating the device's trigger to the stockholder franchise is arguably justified, but providing a put remedy is probably not. Thus, it is possible that the only valid proxy put purporting to protect a creditor from something other than Identity Risk is one whose trigger and remedy are adapted so that the device no longer in fact operates as a proxy put.

Although this Comment has primarily focused on proxy puts in lending agreements, the Identity Risk framework explored herein is reasonably extended to proxy puts adopted in other types of agreements. For example, in *Hills*, the board entered into Severance agreements with certain covered executives that included large buy-out provisions that triggered upon the unapproved election of the Dickstein slate.[270] Within an

269. Consistent with SunTrust's argument, this dual trigger differs from a pure rating decline trigger in that it protects against the risk of a new board on whom SunTrust was unable to conduct due diligence. In other words, SunTrust contracted for the risk that the direction of the business under the current board might lead to a credit rating decline, but not for such a risk under the leadership or direction of a new board.

270. *Hills Stores Co. v. Bozic*, 769 A.2d 88, 91–92 (Del. Ch. 2000).

Identity Risk framework, the Hills board probably would have rebutted the disenfranchising presumption because, as the court in *Hills* concluded, the board entered into the Severance agreements for the primary purpose of retaining the covered executives at a time when they were likely to resign their positions.[271] These agreements are materially different than the debt agreements containing proxy puts considered throughout this Comment. Unlike creditors, the covered executives in *Hills* had the power and the right to protect themselves from any perceived risk of harm by terminating their agreements and walking away.[272] And after the company granted the Severance agreement, the covered executives avoided harming the company and any perceived risk of harm to them arising from the change of control by staying at Hills until the triggering event. Importantly, the threat of harm to Hills in the Dickstein Change of Control did not arise from Dickstein's identity, but instead from his plans to dramatically increase leverage after winning board control. Thus, the board could not have adopted the Severance agreements for the primary purpose of disenfranchising the stockholders because Dickstein posed a threat of harm to the company arising from Event Risk, not Identity Risk, and protecting against Event Risk is not a compelling justification.

This example highlights the fact that boards enter into agreements with other parties whose interests in the identity of a new board majority may not be as limited as a creditor's interest is. Employment agreements are one such example. A license agreement is another. Consider a company whose business relies heavily on a license agreement granting it an exclusive right to use patented technology. There, the licensor is probably unconcerned with the identity of a new board majority under most circumstances, but is probably very concerned about a direct competitor taking control of the board and gaining access to the licensed technology. A provision that protects the licensor from such a change in board majority, rather than a change in ownership or control of the company itself, by requiring the company to terminate its use of the licensed technology at no cost to the licensor is arguably disenfranchising by virtue of penalizing the stockholders for exercising their franchise. Yet the board's primary

271. *Id.* at 102.

272. Even though the court in *SandRidge* pointed out that the covered executives in *Hills* did have an interest in the identity of the board that differed in kind and degree from a creditor's interest, *SandRidge,* 68 A.3d at 262, the covered executives' interests in the Severance agreements did not arise from any exposure to Identity Risk as defined in this Comment. As stated, the covered executives could have avoided any such risk by quitting. Instead, the Severance agreements arose from the company's exposure to harm upon the covered executives' mass departure. Though subtle, this distinction clarifies that the Identity Risk framework is concerned with the company's primary purpose, not that of its counterparty.

purpose in adopting the provision was not to disenfranchise the stockholders, but to secure the rights to the patented technology upon which its business heavily relies in the first place. Thus, a board would only have to rebut the disenfranchising presumption and demonstrate the device's proportionality rather than a compelling justification. Again, this is because the licensor's interest in protection against a new board majority arose from the narrow risk that its patented technology would fall into a competitor's hands, not the risk that a new board majority would consist of known looters or individuals of suspect integrity.

As the above examples demonstrate, reviewing proxy puts, mixed-purpose proxy puts, and other devices related to the shareholder franchise within this Comment's Identity Risk framework is advisable because boards will probably continue including them in various agreements. In fact, the framework specifically contemplates boards doing so by defining Identity Risk narrowly and making clear both how to validly adopt and exercise a proxy put and how to avoid compelling justification review for mixed-purpose proxy puts and other devices. Accordingly, reviewing the adoption and exercise of these devices within an Identity Risk framework regulates a board's ability to do so validly by attaching the disenfranchising presumption. Anticipating the need to rebut the presumption, a board will either adopt proxy puts for the primary purpose of protecting the company from Identity Risk or document its negotiations and deliberations in support of the primary purpose of protecting the company from a threat falling outside the scope of Identity Risk. Finally, the disenfranchising presumption also signals to the market that devices closely resembling proxy puts are more likely to require compelling justification review and encourages the development of more narrowly tailored change of control provisions. These modifications would not only increase the value of these devices to companies and to creditors by more efficiently reducing agency costs of debt and equity, but also increase the ability of the court to conduct its compelling justification and proportionality reviews by incentivizing thorough recordkeeping.

E. *Reconsidering Prior Cases*

This framework would not have materially altered the outcomes of *Hills* and *SandRidge*, but may have had an impact on the outcome in *Amylin*. First, the court in *Hills* still would have concluded that the board did not adopt the Severance agreements for the primary purpose of disenfranchising the stockholders, held that the board made an informed, good faith determination that the Dickstein Change of Control posed a threat to the company, and estopped the plaintiff from arguing that the remedy under the agreements was disproportionate to its proper purpose. Second, assuming the SandRidge board conceded that the proxy put was disenfranchising because it was adopted for the narrow purpose of protecting against Identity Risk, the court in *SandRidge* still would have concluded that the SandRidge board had failed to exercise its fiduciary duties in good faith by failing to neutralize the proxy put and that its fiduciary duty to do so did not breach its contractual duty to its creditor. Accordingly, the court in *SandRidge* still would never have reached a proportionality analysis.

By contrast, if the court in *Amylin* had faced the same record, the court probably would have concluded that the board had the contractual right to trigger the proxy put in the absence of compelling evidence that the rival slate was composed of known looters or persons of suspect integrity. However, the court in *Amylin* could have reached any conclusion with a complete record had this framework incentivized the parties to document their negotiations and deliberations thoroughly.

CONCLUSION

This Comment began by identifying two questions left unanswered in *SandRidge*. First, does a board of directors have the requisite authority to bind the corporation to a proxy put designed to prevent stockholders from electing a new board of directors? Second, under what circumstances and to what degree is a board of directors permitted to trade its stockholders' right to elect the board of directors in favor of other interests? Finding the broad characterization of proxy puts in *SandRidge* to be of dubious validity under both the first and second questions, this Comment interpreted narrowly *SandRidge* and other cases addressing proxy puts and explored the components and operation of proxy puts in order to establish a stronger legal basis for upholding them. Given the limited extent to which proxy puts provide unique protection, this Comment suggested that a board of directors should only have the authority to adopt a proxy put for the limited purpose of protecting against Identity Risk—a concern distinct from Event Risk proposed herein—and even then may only adopt and exercise proxy puts that are narrowly tailored to that limited purpose. In order to regulate shareholder-creditor agency costs arising from proxy puts, this Comment adopted a *Liquid Audio* standard of review in order to account for both a disenfranchising presumption that attaches to proxy puts comporting with Identity Risk and a subsequent proportionality and reasonableness analysis consistent with *Unocal* review.

This Comment found that adopting an Identity Risk framework provides boards and creditors with a reasonable amount of clarity regarding the circumstances under which they will be subject to *Blasius*'s compelling justification review, the circumstances under which they will be subject to *Unocal*'s heightened reasonableness review, and the requirements for staying within either and satisfying both. This clarity is valuable especially in light of the recent *Healthways* case, which demonstrated the court's willingness to find a creditor liable for aiding and abetting a board's breach of its fiduciary duties in adopting a proxy put for an improper purpose—even if the case was only decided on a motion to dismiss. Finding the navigation of this framework to be relatively simple, this Comment concludes that narrowing the validity of proxy puts to protecting against Identity Risk would probably reduce creditor-shareholder agency costs by discouraging, but not prohibiting, boards and creditors from adopting proxy puts in favor of less disenfranchising devices that are more narrowly tailored to other purposes and also by incentivizing boards and creditors to document negotiations and deliberations relating to change of control provisions by attaching a disenfranchising presumption to devices resembling proxy puts. Taken together, this approach aligns a company's interests in proxy puts with those of its creditors' and stockholders' and makes Delaware more creditor-friendly by recognizing legitimate creditor interests and framing clearly the circumstances under and extent to which a board of directors may validly protect those interests through contract provisions.