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“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.*

I. INTRODUCTION

The 1980s was a decade of big hair, power suits, and hostile takeovers. While the impact of many of the decade’s trends has slowly faded, the takeover wave of the ’80s changed corporate governance in a lasting way. The increase in hostile takeover bids gave rise to new and innovative antitakeover tactics by boards of directors. Among these tactics is the infamous collection of “poison pills, greenmail, the ‘Pac Man’ defense, white knights, and golden parachutes.”¹ Despite the prevalence of these defenses, a similar, and oft-used provision—the “poison put”—had not been the subject of litigation until recently. In 2009, *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*,² a case with two poison puts at issue, broke the silence in this critical area of the law.

In *Amylin*, the provisions were a particular kind of poison put—“proxy puts.” A proxy put is a provision in a debt contract that accelerates the bondholder’s rights in a contract when a change occurs in the majority of the board of directors without the approval of the incumbent directors.³ Once a change triggers the provision, the bondholder can sell back the bonds at par value. In *Amylin*, two prominent shareholders of Amylin Pharmaceuticals nominated five-person slates for spots on the company’s board of directors.⁴ Consequently, if all ten nominees succeeded in their proxy elections and ousted the incumbent directors, the change would have affected the majority of the eleven-person board and would have triggered proxy puts in an Amylin debt indenture and credit agreement.⁵ This

1. Marcel Kahan & Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment*, 40 UCLA L. REV. 931, 944 (1993).

2. 981 A.2d 1173 (Del. 2009).

3. Appellant’s Opening Brief at 7, *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 981 A.2d 1173 (Del. 2009) (No. 268).

4. *San Antonio Fire & Police Pension Fund v. Amylin Pharms, Inc.*, C.A. No. 4446-VCL at 4 (Del. Ch. May 12, 2009), <http://law.du.edu/documents/corporate-governance/governance-cases/Antonio-Fire-Police-Memorandum-Opinion.pdf>.

5. *Id.*

possibility was problematic because, at that time, the bonds were trading so far below par value that if they were put back to Amylin the company would likely become insolvent.⁶ The plaintiff in the case, a pension fund and Amylin shareholder, sued Amylin for, among other things, injunctive relief invalidating the proxy puts.⁷ Neither Vice Chancellor Lamb of the Delaware Court of Chancery nor the Delaware Supreme Court went as far as invalidating the provisions, however, and both courts gave the Amylin board of directors the beneficial deference of the business judgment rule.⁸

In examining the Delaware courts' decisions in *Amylin*, this Note critically analyzes the legality of poison put provisions generally, and proxy puts specifically. While I do not assert that *poison* puts, or even *proxy* puts, should be per se illegal, I propose a rule that when a board of directors decides to include a *proxy* put in an agreement, it must demonstrate a compelling justification for doing so. In making this argument, I am not attempting to argue for either side of the current debate on an increased shareholder role.⁹ Rather, I argue that proxy puts infringe on "shareholders' statutorily defined role,"¹⁰ by infringing on the shareholder franchise's recognized right to vote in a contested election of directors.

This Note will bolster this proposed rule through an examination of the policy behind poison put provisions, their fiduciary duty implications, and their infringement on shareholder authority. Part II begins with a survey of poison put provisions generally, reviewing

6. *Id.* at 8.

7. *Id.* at 9.

8. See San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc., 981 A.2d 1173 (Del. 2009); *Amylin*, C.A. No. 4446-VCL.

9. See, e.g., Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833 (2005) (arguing for an alternative regime allowing shareholders a more prominent corporate governance). But see Leo E. Strine, *Toward a True Corporate Republic*, 119 HARV. L. REV. 1759 (2006) (addressing Bebchuk's article from the view of an "open-minded corporate law 'traditionalist'").

10. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 299 (2001). Like Professors Robert Thompson and Gordon Smith, I am not trying to advocate the "broad general preference for shareholder decision making that frightened judges in the aftermath of the director passivity discussions of the early 1980s." *Id.* at 46. Rather, I argue that while "directors may use defensive tactics to protect other constituencies or to gain higher returns for shareholders" and that "shareholders are capable of using their power to prefer themselves over other corporate constituencies," shareholder voting falls within the "limited and nuanced" sacred space that "emanates from the shareholders' statutorily defined role." See generally *id.*

and examining the potential benefits that poison puts can have on bondholders, shareholders, and directors respectively. Part II also considers the particular detriments that poison puts might bring to the firm through the agency cost framework. This section highlights particularly problematic aspects of proxy puts and demonstrates why they should be subjected to heightened legal scrutiny. Part III focuses on the legal standards for hostile takeovers and the implications that fiduciary duty law has on these change of control covenants. Part IV recounts the facts and analysis from *Amylin*, and Part V discusses how although the court was correct in concluding that the directors' actions would normally be safe under the business judgment rule, in the instant case, allowing proxy put provisions in the agreements should have required a compelling justification, and the provisions should have been invalidated.

II. POISON PUTS GENERALLY

Proxy puts are a form of change of control covenants (more infamously known as “poison puts”) used in debt indentures. The purported purpose of these covenants is to shield bondholders from takeover-related losses.¹¹ Because issuers are offering this protection, they can theoretically issue the bonds at lower interest rates.¹² Poison puts consist of two parts: a trigger and a remedy.¹³ The trigger is normally either a takeover-related event (e.g., an acquisition or a change in the board's majority through the proxy process), or the downgrading of a bond's credit rating, or both.¹⁴ The bondholder's remedy is either a put—the right to sell the bonds to the company at a set price—or an increased interest rate on the bonds.¹⁵ In the case of a proxy put, bondholders can sell back their bonds at par value when there is a change in the majority of the board that has not been approved by the incumbent directors—regardless of the current value of the bonds. Again, the purported purpose of poison puts is to

11. Kahan & Klausner, *supra* note 1, at 934; see Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 620 (2003) (noting that some “change of control provisions serve legitimate purposes in certain situation Penalty provisions may improve the joint welfare of contracting parties when third parties can expect to suffer losses in the event of a change of control . . .”).

12. Kahan & Kausner, *supra* note 1, at 940.

13. *Id.* at 936.

14. *Id.* at 936–37.

15. *Id.* at 937.

protect the bondholders, but, particularly with proxy puts, the board's underlying motivation is potentially problematic. Much of the debate surrounding poison puts centers on a key question: is the purpose of the covenant to protect bondholders from take-over related losses (and thus increase the value of the firm) or is it to entrench the board of directors (and thus decrease the value of the firm)?¹⁶

A. Benefits of Poison Puts

Theoretically, change of control covenants can provide value to bondholders, shareholders, and directors.¹⁷ In an excellent examination of poison puts, their effects, and the motivation for including them in debt indentures, Professors Marcel Kahan and Michael Klausner gave critical insight that assists in determining if and when poison put provisions should be legal. In this section, I will summarize their arguments and conclusions regarding the potential value of poison puts to bondholders, shareholders, and directors. First, I will address how poison puts allegedly serve bondholder interest by protecting against the increased leverage that can accompany an acquisition or recapitalization. Second, I will consider how this bondholder benefit can reduce a firm's agency cost of debt and, in turn, increase its value and benefit the shareholders. Finally, I will examine the managerial interests in these provisions.

1. Bondholder protection

Take-over related events can potentially harm bondholders by increasing a firm's leverage and therefore decreasing its ability to repay its bonds. As an issuing corporation increases in leverage, its credit rating (which measures its ability to repay its bonds) decreases.¹⁸ For instance, empirical studies show that leveraged acquisitions in the 1980s decreased the values of outstanding bonds by 5–7%.¹⁹ Bonds are considered low-risk investments, and such a

16. *See id.*; *see also* Arlen & Talley, *supra* note 11 (“Although many existing penalty change of control provisions are value enhancing, managers subject to shareholder choice could readily employ such provisions defensively, at shareholders’ expense.”).

17. Kahan & Klausner, *supra* note 1, at 980.

18. *See, e.g., id.* at 937–50.

19. *Id.* at 940 (citing Arthur Warga & Ivo Welch, *Bondholder Losses in Leveraged Buyouts*, 6 *REV. FIN. STUD.* 959, 979 (1993)); Paul Asquith & Thierry Wizman, *Event Risk, Covenants, and Bondholder Returns in Leveraged Buyouts*, 26 *J. FIN. ECON.* 195, 203 (1990).

decrease can be problematic for bondholders. However, a poison put provision can reduce the risk of bond depreciation by assuring bondholders that the possible decrease in credit rating accompanied by a take-over will be recompensed, either by a put option at a predetermined price or an interest rate adjustment.²⁰ Because bondholders receive this insurance, corporations can theoretically issue bonds with poison puts at lower interest rates.²¹

2. *Shareholder benefits*

Shareholders benefit from change of control covenants if the provisions can succeed in increasing the overall value of the firm—i.e., “the aggregate value of the firm’s stocks and bonds.”²² In analyzing the possible benefits of poison puts, Kahan and Klausner used the Jensen and Meckling agency cost framework²³ to examine a poison put’s impact on the agency cost of debt.²⁴

At first blush, conflict arises because shareholders’ interests can be inapposite to bondholders.²⁵ Because shareholders’ claims are “unlimited on the upside and limited on the downside,” they prefer riskier strategies and higher dividends.²⁶ Conversely, bondholders prefer a conservative business strategy; if the corporation retains its earnings, it increases the probability that it will have the funds to

According to Warga’s and Welch’s studies, bond values declined by about 7% per year from 1985 to 1988. *Id.* at n.22. Asquith’s and Wizman’s study showed that from 1980 to 1988 bondholders whose bonds “were not protected by traditional bond covenants suffered abnormal returns of -5.3%.” *Id.* However, Kahan and Klausner cite earlier studies that found only minimal negative impact on bond values. *Id.* (citing Kenneth Lehn & Annette Poulsen, *Leveraged Buyouts: Wealth Created or Wealth Redistributed*, in PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 46 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988); Laurentius Marais et al., *Wealth Effects of Going Private for Senior Securities*, 23 J. FIN. ECON. 155 (1989)).

20. *Id.* at 943; *see also* Arlen & Talley, *supra* note 11 (“[T]o protect themselves from substantial potential costs associated with a change of control, third parties may reasonably insist on change of control provisions that give them the right to terminate the contract on favorable terms: terms that confer a benefit on the third party and a penalty on the contracting firm.”).

21. Kahan & Klausner, *supra* note 1, at 937–38.

22. *See id.* at 938.

23. *Id.* (“The starting point in analyzing the impact of any bond covenant on firm value is the agency cost framework developed by Jensen and Meckling.”).

24. *Id.* (“The agency cost of debt is a product of the conflicting interests of shareholders and bondholders once bonds have been issued.”).

25. *See id.*

26. *Id.*

repay its debt.²⁷ The result of these competing interests can incentivize 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.”²⁸ Such an instance would not additionally benefit bondholders if the company succeeded, but they would certainly suffer if the company failed. “The present value of the contingent losses in aggregate firm value attributable to such potential actions is referred to as an agency cost of debt.”²⁹ Under the agency cost framework, the shareholders bear the agency cost of debt.³⁰

Because bondholders are aware that companies can engage in activities that will shift wealth to shareholders, they can demand higher interest rates as *ex ante* compensation.³¹ Consequently, shareholders, who bear the cost of the increased interest rate, can have an interest in reducing the agency cost of debt, even though doing so might deny them the option of taking a potential risk-shifting action.³² Poison puts can therefore potentially increase share values—and the firm value as a whole—to the extent that they lower the interest rates on bonds and preclude wealth-reducing actions.³³ However, if the poison put protection is *not* reflected in the bond

27. *Id.*

28. *Id.* Kahan and Klausner give an example of a company implementing a leveraged recapitalization in which it pays out a large dividend to shareholders by borrowing money. *Id.* Doing so would potentially decrease the value of the firm and could even lead the business to bankruptcy. *Id.* Despite the potential for overall loss to the firm, however, shareholders could gain from the transaction while, conversely, bondholders would lose. *Id.* at 938–39.

29. *Id.* at 939 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 334–37 (1976)).

30. *Id.*

31. *Id.*

32. *Id.* However, it is worth noting that the shareholder gains from acquisitions normally greatly exceed the losses to bondholders. *Id.* at 940 (citing Asquith & Wizman, *supra* note 19, at 212).

33. *Id.*

price,³⁴ then bondholders benefit from a windfall at the shareholders' expense.³⁵

Additionally, because the benefit to shareholders in takeovers is, on average, far greater than the loss to bondholders,³⁶ takeovers can generally increase firm values.³⁷ As a result, some scholars have concluded that bondholder protections *cannot* increase the aggregate value of a firm.³⁸ While these arguments seem to weigh in favor of making a bright-line, per se rule against poison puts, the potential that a poison put brings for reducing the agency cost of debt, coupled with the chance that it could prevent wealth-reducing action, could theoretically justify a board's decision to employ these provisions in a debt indenture as a rational business decision.

Additionally, poison put provisions may increase firm value by enhancing efficiency with respect to wealth-increasing, takeover-related activity.³⁹ Although an acquisition can greatly increase firm value, it is possible that this increase is due to changes in management and operating efficiencies.⁴⁰ In fact, the increased leverage might actually have a negative impact on the firm—e.g., from inefficient investment policies.⁴¹ Despite that potential negative impact, shareholders would likely support the increased leverage if it transferred wealth from the target firm's bondholders to its shareholders.⁴² However, if a poison put provision ensures that bondholders be compensated for only their losses in a takeover

34. This would occur if the interest rates did not reflect the protection of the covenant. *Id.* at 939–40. In *Amylin*, the proxy put provision was not negotiated for, and its inclusion in the indenture was therefore not reflected in the price or interest rates of the bonds. *See infra* Parts IV–V. Thus, I argue that the bondholders would benefit from a windfall if the provisions were triggered, and the managers benefit from the entrenchment protection that they offer by deterring shareholders from voting in a way that would trigger.

35. Kahan & Klausner, *supra* note 1, at 939–40.

36. *Id.* at 940 (citing Asquith & Wizman, *supra* note 19, at 212). In Asquith and Wizman's sample, taking into account bonds with and without traditional covenant protection, bondholder losses were merely roughly 3 percent of shareholder gains. *Id.* at n.24.

37. *Id.* at 941.

38. *Id.* (citing Kenneth Lehn & Annette Poulsen, *The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts*, 15 J. CORP. L. 199, 214 (1990)). However, Kahan and Klausner acknowledge the possibility that a share value increase could reflect inaccurate pricing that often occurs prior to takeovers. *Id.* at n.25 (citing generally Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1 (1987)).

39. *Id.*

40. *Id.*

41. *Id.*

42. *Id.*

(instead of merely imposing a set price at which the bonds can be sold back), it encourages efficiency and eliminates the incentive to adopt an unnecessarily high degree of leverage—thereby increasing firm value.⁴³

Firms may also increase their value by attracting institutional investors that will only invest in low-risk bonds.⁴⁴ Such investors would also find comfort in the assurance that they can avoid paying transaction costs of selling their bonds in an illiquid market.⁴⁵ Furthermore, during times of high takeover volume, when low-risk bonds are scarce, a change of control covenant can provide an option for investors.⁴⁶ Therefore, a firm could potentially increase its value, and in turn benefit its shareholders, by issuing bonds with poison put provisions.⁴⁷

3. Managerial motivation for the board of directors

Naturally, an increase in a firm's value benefits its directors; if the company is doing well, the directors have greater job security. However, directors can use poison puts to benefit themselves in other ways. Because they have substantial control over the terms of poison put provisions, they can prevent control transactions that they oppose.⁴⁸ Thus, by insulating themselves from hostile change, they can usurp shareholder power and actually reduce firm value.

Just as shareholders' and bondholders' interests do not perfectly align, directors and shareholders can have conflicting interests.⁴⁹ Kahan and Klausner discuss directors' parochial interests, which might be their true motivation to institute poison put provisions.⁵⁰ When directors take actions, in pursuit of their personal interests, that are not in the shareholders' best interest, the resulting losses are

43. *Id.* “[Poison puts] may be especially effective in deterring inefficient leveraged recapitalizations.” *Id.* at 942.

44. *Id.*

45. *Id.* at 942–43.

46. *Id.* at 943.

47. *Id.*

48. *Id.*; see also Arlen & Talley, *supra* note 11, at 620 (explaining how managers can use poison put type provisions to significantly increase the cost of acquisitions, insulating themselves at the shareholders' expense).

49. Kahan & Klausner, *supra* note 1, at 944. Directors are concerned with “compensation, work conditions, job security, reputation, and power,” while shareholders are primarily interested in the maximization of share values. *Id.*

50. *See id.*

termed the agency cost of equity.⁵¹ Shareholder action in the market for corporate control—e.g., through hostile takeovers and proxy contests—can be an important mechanism for reducing the agency cost of equity.⁵² Not only can hostile takeovers and proxy contests remove failing directors and replace them with more effective counterparts, but the mere threat of those actions also incentivizes directors to work for the shareholders' interests.⁵³ Thus, to the extent that hostile control changes promote efficient management and move corporate assets to their highest value uses, they increase the firm's value.⁵⁴ Conversely, when defense mechanisms like poison puts insulate directors from the corporate control market, the agency cost of equity may rise and thereby potentially decrease the value of the firm.⁵⁵

In many instances the cost imposed by poison puts is nominal in comparison to the gains of an acquisition.⁵⁶ If a poison put only calls for compensation to bondholders for their takeover related losses, it may not be much of a deterrent to takeover-related events and therefore not significantly affect the agency cost of equity.⁵⁷ Such provisions could thus lower bondholder risk without harming shareholders if the bondholder benefit is reflected in the price or interest rates of the bonds. Directorial decision to include such a

51. *Id.* (citing Jensen & Meckling, *supra* note 29, at 327–28).

52. *Id.*

53. *Id.*

54. *Id.* (citing Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169–74 (1981); Ronald J. Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819, 841–45 (1981); Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 113 (1965)). *But see* Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789 (2007) (arguing that director accountability to shareholders may increase agency costs). In addition, Kahan and Klausner cited to Lipton, *supra* note 38, at 20–25, as an example of an argument that “takeover threat induces undesirable responses.” Kahan & Klausner, *supra* note 1, at 944 n.38.

55. Kahan & Klausner, *supra* note 1, at 944. However, Kahan and Klausner acknowledge that “some antitakeover devices allow management to protect shareholders from underpriced or coercive tender offers, or help create an auction among potential acquirors that may increase the price received by target shareholders.” *Id.* at n.40 (citing Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1054–56 (1982); Lipton, *supra* note 38, at 26). However, they also refer again to Easterbrook & Fischel, *supra* note 54, which argues that “such tactics are not in the *ex ante* interest of shareholders or society.” Kahan & Klausner, *supra* note 1, at 944 n.40.

56. *Id.* at 945; *see supra* text accompanying notes 36–38.

57. *Id.*

provision could then conceivably be protected by the business judgment rule.⁵⁸ However, in other provisions, the triggered remedy can exceed the loss suffered by bondholders.⁵⁹ This is particularly true in the case of proxy puts, which highlights why proxy puts are a more troublesome entrenchment mechanism and the decision to implement them in an indenture should be subjected to heightened scrutiny.

Proxy puts are more troublesome than other poison puts for two reasons. First, shareholders' gains in proxy contests are far less than their gains in hostile takeovers.⁶⁰ Therefore, even if the triggered remedy is modest, it can have significant deterrent effect in preventing shareholders from voting against incumbent management.⁶¹ Second, in a change of control through proxy election, bond values are likely to be unaffected.⁶² Because proxy elections do not directly increase the leverage of the firm or affect the bond's credit rating—and thereby increase the agency cost of debt—preventing them will not decrease the agency cost of debt. Hence, allowing bondholders to sell back their notes at par value has catastrophic potential, which would have been the case in *Amylin*. Market changes can greatly decrease the value of bonds (while the actual change of control does not affect them), and so when a put is triggered after market conditions have lowered the value of a bond, paying the bondholders could bankrupt the firm. Because shareholders would naturally want to avoid this outcome, the entrenchment effect of the puts greatly increases the agency cost of equity.

Moreover, managers' substantial control over the terms of poison put provisions enables them to omit management buyouts and other friendly acquisitions from the covenant while including

58. While this is certainly a logical possibility, this Note does not attempt to make a detailed, bright-line rule for when the decision to employ poison put provisions should be protected by the business judgment rule. Rather, this Note focuses on defining a rule for proxy puts specifically.

59. *Id.*

60. *Id.* at 946 (citing Peter Dodd & Jerold B. Warner, *On Corporate Governance: A Study of Proxy Contests*, 11 J. FIN. ECON. 401 (1983)).

61. *Id.* (citing Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1091–93 (1990)). Kahan and Klausner refer to the Bebchuk and Kahan's point that the "reduced likelihood of winning decreases incentives by potential challengers to initiate a proxy contest." *Id.* at n.48.

62. *See id.* at 945–46.

hostile takeovers and proxy elections.⁶³ In entering debt indentures, managers are not required to obtain shareholder approval, and the complexity of the provisions make it easy for directors to design them in a self-serving manner without shareholder review.⁶⁴ Hence, management can provide incomplete bondholder protection in a way that increases the agency cost of equity and has no effect on bondholder interests.⁶⁵ If a poison put type covenant were to offer full protection to a bondholder, it would grant full compensation for any loss that bondholders incur from acquisitions generally—hostile or friendly—and it could thereby decrease the agency cost of debt.⁶⁶ However, directors' primary concern with control changes stems from the threat of the loss of employment in hostile changes, which management usually protects against when writing poison put provisions.⁶⁷

Management protects itself against hostile changes in three main ways. First, directors can restrict a poison put's coverage to transactions that they disfavor (leaving bondholders at risk for director favored acquisitions).⁶⁸ Consequently, this could lower the firm value by achieving only a nominal reduction of the agency cost of debt, while at the same time creating an uneven playing field for hostile acquirers and increasing the agency cost of equity.⁶⁹ Second, directors can design a provision that increases the costs of control changes that threaten their job security but do not threaten the bondholders.⁷⁰ This category seems to encompass proxy puts and would also include non-leveraged hostile acquisitions.⁷¹ These provisions would increase the firm's agency cost of equity.⁷² Finally, a

63. *Id.* at 947.

64. *Id.*

65. *Id.* at 948.

66. *Id.*

67. *Id.* at 949.

68. *Id.*

69. *Id.* Because friendly bidders would not face the hurdle of the put provision, they would be at an incredible advantage over hostile bidders, who would have to deal with the increased costs associated with triggering the put. *See id.* at 947.

70. *See id.* at 949.

71. *See id.* at 949–50. Kahan and Klausner also considered that bondholders may actually favor proxy contests and non-leveraged hostile acquisitions because new management could increase performance without increasing bondholder risk. *Id.* at n.57. In such a case, there would be no sense in awarding any compensation to the bondholders after the transaction.

72. *Id.* at 950.

third category includes poison puts that provide for a supra-compensatory remedy to bondholders in the event that unwanted acquisitions occurred.⁷³ This increases the company's agency cost of equity without a reduction in its agency cost of debt.⁷⁴ Proxy puts may also fall into this category because of their potential to compensate far in excess of bondholder loss.

The effects poison puts have on the agency cost of debt and equity should have great bearing on their legality. Using these effects to draw a definitive line is difficult, but the ideal "bondholder-protective covenants"—in which all leveraged acquisitions and recapitalizations are covered and bondholders are only compensated for the actual decrease in bond values resulting from the transactions⁷⁵—should be legal, and their use should be within directorial discretion. Such transactions can minimize the agency cost of debt and equity, and a board's decision to employ them could therefore reasonably be within the protection of the business judgment rule.⁷⁶ Such a provision should probably not be the limit for legal poison put provisions. There is probably room for directorial discretion beyond that, and while this Note does not attempt to define the boundaries, it does contend that proxy puts should be beyond them. They constitute a form of the "ideal management protective covenant" that Kahan and Klausner describe.⁷⁷ They are triggered by proxy challenges and provide for a supra-compensatory remedy, increasing the firm's agency cost of equity without reducing the agency cost of debt.

III. LEGAL STANDARDS

Since the mid '80s, the Delaware courts have presided over many influential cases that now govern Delaware law in hostile takeover contexts. Before 1985, the courts merely applied the business

73. *Id.*

74. *Id.*

75. *Id.*

76. *See id.*

77. *See id.* ("The ideal management-protective covenant, in contrast, would cover only hostile acquisitions and proxy challenges, and it would provide 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 of debt.").

judgment rule to director conduct even in defense of hostile takeovers.⁷⁸

Under this deferential standard, hope was bleak for challenging directorial defensive measures. Once directors were under that protection, shareholders would have to show by a preponderance of the evidence that the “directors’ [defensive actions] were primarily based on perpetuating themselves in office, or some other breach of duty such as fraud, overreaching, lack of good faith, or being uninformed”⁷⁹

In 1985, however, the Delaware Supreme Court applied an innovative and aggressive new standard for reviewing board defensive action against hostile offers. *Unocal Corp. v. Mesa Petroleum Co.* introduced a new, “intermediate” standard of review,⁸⁰ which—although it perhaps has not been the innovative change that it was originally anticipated to be⁸¹—has led to interesting and controversial judicial decisions and scholarly works.

A. The Unocal Test: “Intermediate” Scrutiny for Hostile Takeovers

In *Unocal*, Mesa, Inc., (a 13 percent Unocal shareholder) commenced a two-tier “front loaded” tender offer for 37 percent of Unocal’s shares in an effort to gain majority control of the company.⁸² The Unocal board rejected the offer and, to defend against it, instituted a self-tender offer (a form of “poison pill”).⁸³ According to the terms of the self-tender, if Mesa acquired its intended shares then Unocal would buy the remaining 49 percent of

78. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (explaining that “the business judgment rule, including the standards by which director conduct is judged, [was] applicable in the context of a takeover” (citing *Pogostin v. Rice*, 480 A.2d 691, 627 (Del. 1984))). In *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), the Delaware Supreme Court defined the business judgment rule as a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” *Id.* at 812.

79. *Unocal*, 493 A.2d at 958.

80. Thompson & Smith, *supra* note 11, at 281.

81. See *id.* at 293. “Regardless of one’s predilections about the initial decision, however, the subsequent development of the Unocal standard has failed to live up to its early billing.” *Id.* Included in the initial fanfare was Chancellor Allen, calling it “the most innovative and promising case in our recent corporation law.” *Id.* (citing *City Capital Assocs., L.P. v. Interco, Inc.*, 551 A.2d 787, 796 (Del. Ch. 1988)).

82. *Unocal*, 493 A.2d at 949.

83. *Id.* at 951.

the outstanding shares—excluding Mesa from the proposal.⁸⁴ Mesa sued the Unocal Board in the Court of Chancery and won.⁸⁵

When the case reached the Delaware Supreme Court on appeal, however, the court was prepared to establish a new standard for takeover situations. The issue on appeal was whether the Unocal board had “the *power* and *duty* to oppose a takeover threat [that] it reasonably perceived to be harmful to the corporate enterprise, and if so, [was] its action here entitled to the protection of the business judgment rule?”⁸⁶

In its analysis, the court opined that “[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests [in takeover situations], rather than those of the corporation and its shareholders,” the board is subject to an “enhanced duty.”⁸⁷ This “enhanced duty” requires directors to meet a two-part test before they can receive the benefit of the business judgment rule. First, directors must demonstrate that they did not act “solely or primarily out of a desire to perpetuate themselves in office;” they must have reasonably perceived a threat to the company.⁸⁸ Second, they must show that their actions were proportional, or “reasonable in relation to the threat posed.”⁸⁹ Interestingly, despite the heightened scrutiny, the court determined that the directors in *Unocal* satisfied the two-part test and were, therefore, entitled to the protection of the business judgment rule.⁹⁰

B. Liquid Audio *and* Blasius: A Compelling Justification Standard

Chancellor Allen of the Delaware Court of Chancery addressed directorial defensive tactics in a somewhat different vein than *Unocal* in *Blasius Industries, Inc. v. Atlas Corp.*⁹¹ In *Blasius*, the plaintiff—a 9% shareholder of Atlas, Corp.—challenged the Atlas directors’

84. *Id.*

85. *Id.* at 951–52.

86. *Id.* at 953 (emphasis added).

87. *Id.* at 954.

88. *Id.* at 955 (citing *Cheff v. Mathes*, 199 A.2d 548, 556 (Del. 1964); *Kors v. Carey*, 158 A.2d 136, 140 (Del. Ch. 1960)). With this prong, the court required that defense measures be motivated by a good faith concern for the welfare of the corporation and its stockholders—i.e., *not* entrenchment. *Id.* (citing *Cheff*, 199 A.2d at 554–55).

89. *Id.* at 955. This prong requires directors to analyze “the nature of the takeover bid and its effect on the corporate enterprise.” *Id.*

90. *Id.* at 956–58.

91. 564 A.2d 651 (Del. Ch. 1988).

action to add two new members to its seven member board.⁹² The addition was controversial because the board's motivation was to preclude Atlas's shareholders from electing a majority of new directors through the plaintiff's consent solicitation.⁹³ The issue then facing Chancellor Allen was whether a board can act "consistently with its fiduciary duty when it acts, in good faith and with appropriate care, for the primary purpose of preventing or impeding an unaffiliated majority of shareholders from expanding the board and electing a new majority."⁹⁴

The interesting aspect of the case was that Chancellor Allen determined that, in adding the board members, the directors "acted on their view of the corporation's interest and not selfishly,"⁹⁵ and, therefore, apparently under the protection of the business judgment rule. However, the Chancellor qualified the question posed as not one of fiduciary duty, but one of authority "*as between the fiduciary and the beneficiary.*"⁹⁶ In Allen's eyes, this question of authority distinguished acts that interfere with the effectiveness of stockholder voting from other *Unocal* type claims.⁹⁷ He reasoned that the "central importance of the [shareholder] franchise to the scheme of corporate governance, requires that, in this setting, [the *Unocal* intermediate scrutiny] rule not be applied and that *closer* scrutiny be accorded."⁹⁸

In reaching that conclusion, Chancellor Allen reasoned, in language now famous in corporate law, that "[t]he shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."⁹⁹ He elaborated that the only two protections afforded shareholders against inadequate board business performance are selling their stock and voting to replace board members.¹⁰⁰ The chancellor opined:

[W]hether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is

92. *Id.* at 652.

93. *Id.* at 655.

94. *Id.* at 652.

95. *Id.*

96. *Id.* at 658.

97. *Id.* at 659.

98. *Id.* (emphasis added).

99. *Id.*

100. *Id.*

critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus . . . matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.¹⁰¹

In sum, infringing on the shareholder franchise's right to vote would be an inappropriate usurpation of shareholder authority by the board of directors.

Chancellor Allen further reasoned that the ordinary considerations that implicated the business judgment rule were not involved in the shareholder voting context.¹⁰² He argued that rather than exercising the corporation's power over its property, or respecting its rights, every time "an incumbent board seeks to thwart a shareholder majority" it will involve the question of who has authority regarding a matter of internal corporate governance.¹⁰³ In such a situation, a court may not leave to the "agent finally to decide so long as he does so honestly and competently"; therefore, the business judgment rule cannot apply.¹⁰⁴ Although the corporate law theory gives directors power as agents of the shareholders, "it does not create Platonic masters."¹⁰⁵ Instead of the deferential business judgment rule, in a *Blasius*-type case the board of directors must "bear[] the heavy burden of demonstrating a compelling justification for such action."¹⁰⁶

The *Blasius* case did not reach the Delaware Supreme Court on appeal, but its holding was adopted by the court in a later case, *MM Companies, Inc. v. Liquid Audio, Inc.*¹⁰⁷ In *Liquid Audio*, the plaintiff shareholders ("MM") sued for injunctive relief against the Liquid Audio board's action to expand its board members from five to seven.¹⁰⁸ The board enacted this expansion after MM had nominated two directors for an upcoming election to Liquid Audio's staggered board.¹⁰⁹ The court, in an opinion written by Justice

101. *Id.*

102. *Id.*

103. *Id.* at 660.

104. *Id.*

105. *Id.* at 663.

106. *Id.* at 661.

107. 813 A.2d 1118 (Del. 2003).

108. *Id.* at 1121.

109. *Id.* at 1123.

Holland, found that the board had taken this action “for the primary purpose of interfering with and impeding the effectiveness of the shareholder franchise in electing successor directors.”¹¹⁰ Justice Holland concluded that the board’s actions implicated the *Blasius* compelling justification standard *within* the *Unocal* test.¹¹¹ The Holland court held 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 proportionately.¹¹²

In sum, the court fully adopted and integrated the *Blasius* compelling justification standard into the *Unocal* test as a condition precedent to the reasonableness and proportionality prong.

110. *Id.* at 1131. The board members testified that they were concerned that the two of the incumbent directors may resign if MM’s nominees were elected, due to the “acrimonious relationship between MM and Liquid Audio.” *Id.* at 1126. Because they felt that if either one or two of the incumbent directors resigned it could jeopardize an impending merger that the incumbent directors favored and “run an undue risk to the shareholders,” they acted to “minimize the impact of the election of MM’s nominees.” *Id.* at 1125–26.

111. *Id.* at 1131 (“This case presents a paragon of when the compelling justification standard of *Blasius* must be applied within *Unocal*’s requirement that any defensive measure be proportionate and reasonable in relation to the threat posed.”). Earlier in the opinion, Justice Holland recounted that both the supreme court and the chancery court had recognized the “substantial degree of congruence” between the rationale for the heightened *Blasius* standard and the “logical extension of that rationale *within* the context of the *Unocal* enhanced standard of judicial review.” *Id.* at 1129 (citing *Stroud v. Grace*, 606 A.2d 75, 91 (Del. 1992); *Chesapeake Corp. v. Shore*, 771 A.2d 293, 320 (Del. CH. 2000)). He summarized *Gilbert v. El Paso Co.* as holding that the *Unocal* standard must be applied “whenever a board . . . adopts any defensive measure ‘in response to some threat to corporate policy and effectiveness which touches upon issues of control.’” *Id.* (quoting 575 A.2d 1131, 1144 (Del. 1990)). He then interpreted *Stroud* to show how the *Blasius* compelling justification standard fit into *Unocal*: “A board’s unilateral decision to adopt a defensive measure touching upon ‘issues of control’ that purposefully disenfranchises its shareholders is strongly suspect under *Unocal*, and cannot be sustained without a ‘compelling justification.’” *Id.* at 1130 (quoting *Stroud*, 606 A.2d at 92 n.3).

112. *Id.* at 1132. Important to note in the holding is that the defensive actions taken by the board do not actually need to succeed in preventing the shareholders from gaining a seat on the board, and the contested election does not need to involve an competition for outright control of the board. *Id.* All that is required is that the board’s defensive actions were taken with the *primary purpose* of “interfering with or impeding the effectiveness of the stockholder vote.” *Id.*

IV. *SAN ANTONIO FIRE & POLICE PENSION FUND V. AMYLIN PHARMACEUTICALS*

The legality of two poison put provisions was at the heart of *San Antonio Fire and Police Pension Fund v. Amylin Pharmaceuticals*.¹¹³ In *Amylin*, San Antonio Fire & Police Pension Fund (the “Pension Fund”) sued Amylin Pharmaceuticals, Inc., (“Amylin”) and its board members to enable the board to disable the change of control provisions in both a bond indenture for notes and a credit agreement for a senior secured credit facility¹¹⁴—both proxy puts.

A. Facts of the Case

In 2007, the Amylin board’s Finance Committee approved the issuance of 3.00% convertible senior notes (“2007 Notes”).¹¹⁵ The indenture for the 2007 Notes (“Indenture”) contained a change of control covenant that is the central piece to this lawsuit.¹¹⁶ The change of control provision is in § 11.01 of the Indenture and “gives the noteholders the right to demand redemption of any or all of their notes at face value upon the occurrence of certain events, including a Fundamental Change, as defined in the Indenture.”¹¹⁷ The Indenture provides that a “Fundamental Change” occurs if, “at any time the Continuing Directors do not constitute a majority of the Company’s Board of Directors,” defining “Continuing Directors” as:

- (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

113. 981 A.2d 1173 (Del. 2009).

114. *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, C.A. No. 4446-VCL at 2–3 (Del. Ch. May 12, 2009), *available at* <http://law.du.edu/documents/corporate-governance/governance-cases/Antonio-Fire-Police-Memorandum-Opinion.pdf>.

115. *Id.* In May 2007, the board had adopted resolutions that authorized certain members of senior management to negotiate the terms and conditions of the 2007 Notes. *Id.* at 2. The board also made the Finance Committee the “Pricing Committee” for the notes, giving them full board authority to negotiate and issue the notes. It was the Pricing Committee that ultimately approved the notes’ issuance. *Id.*

116. *Id.* at 3–4.

117. *Id.* (citing Fourth Am. Compl. Ex. A § 11.01).

who were directors on the Issue Date or whose election or nomination for election was previously so approved.¹¹⁸

Although the Pricing Committee had extensive discussions about various terms of the notes before authorizing their issuance, the proxy put was never brought to the attention of the board of directors.¹¹⁹

In addition to the provision in the Indenture, this case also involved a proxy put in Amylin's senior secured credit facility (the "Credit Agreement"), which Amylin entered into with Bank of America, N.A., ("BANA") shortly after issuing the 2007 Notes.¹²⁰ The proxy put in the Credit Agreement was more explicitly confining than the provision in the Indenture, as it accelerated the debt due under the agreement if a Change of Control occurred.¹²¹ Although counsel for Amylin tried to define a Change of Control

118. *Id.* at 4 (quoting Fourth Am. Compl. Ex. A § 1.01). At all times relevant to this case, and at the time this case was tried, the Amylin board consisted of twelve Continuing Directors. *Id.*

119. *See id.* at 4–5. The drafting history reveals that the originally circulated drafts of the description of the 2007 Notes and the of the Indenture contained the Continuing Directors provision. *Id.* Prior to issuing the notes, the Pricing Committee worked extensively with its management, legal advisors, and underwriters to structure them, after which it consulted outside counsel on various terms. *Id.* at 4. During that process, the proxy put provision was not brought up, even after the directors asked counsel if there was anything "unusual or not customary" in the Indenture. *Id.* (citing Bradbury Dep. Tr. 77).

120. *Id.* at 5–6. Although Amylin entered into the Credit Agreement after it issued the 2007 Notes, the Finance Committee authorized Amylin officers to enter the agreement almost one year prior to the notes' issuance. *Id.* at 5.

121. *Id.* at 6. A Change of control in the Credit agreement is defined as including:
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
(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 clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors).

using the same language as the Indenture, BANA's counsel insisted on the version that ended up in the agreement.¹²²

The proxy puts became relevant when, on consecutive days, two stockholders independently notified Amylin of their intention to each nominate a slate of five directors to the twelve-person Amylin board.¹²³ First, Icahn Partners LP ("Icahn"), an approximately 8.8% stockholder, notified Amylin, and the following day, Eastbourne Capital Management, LLC ("Eastbourne"), a 12.5% stockholder, followed suit.¹²⁴ While neither stockholder's nominated slate would change a majority of the board alone, if both succeeded without the board's approval, the proxy puts would be triggered.

A few days later, Eastbourne sent a letter to Amylin asking for the board to take the necessary action to prevent the Continuing Directors provision from being triggered.¹²⁵ However, Eastbourne requested that the board assemble an approved combination of directors that included a large number from each of Icahn's and Eastbourne's nominees.¹²⁶

Amylin responded to the dissident slates in its 10K filing—explaining the proxy put provisions and highlighting the potential adverse consequences the company would face if they were triggered.¹²⁷ Just over one week later, Eastbourne mailed a letter to the board in which it questioned the legitimacy of the proxy put provisions.¹²⁸ Eastbourne encouraged the board to still "approve" the dissident slates, but to do anything necessary to remove any obstacles to the stockholder franchise.¹²⁹

B. Litigation

The Pension Fund filed suit against Amylin and its individual directors on March 24, 2009. In its original suit, the Pension Fund requested declaratory and injunctive relief, alleging three claims of breach of fiduciary duties:

122. *Id.* at 7.

123. *Id.* at 4, 7.

124. *Id.* at 7.

125. *Id.* at 7–8.

126. *Id.* at 8.

127. *Id.*

128. *Id.* at 8–9.

129. *Id.*

(1) [B]reaches of the fiduciary duties of care and loyalty by the board of Amylin in the adoption of the Credit Agreement and the Indenture, insofar as they both contained Continuing Directors provisions, (2) breaches of the fiduciary duties of care and loyalty by Amylin's board in failing to approve the dissident nominees in order to defuse the Continuing Directors provision of the Indenture, and (3) breaches of the fiduciary duties of care and loyalty in the allegedly misleading and coercive manner in which Amylin's board chose to disclose the risks presented by the Continuing Directors provisions in the company's Form 10-K.¹³⁰

Additionally, Eastbourne requested a mandatory injunction forcing the directors to approve the shareholders' nominees.¹³¹ Shortly after the Pension Fund filed suit, Amylin filed its preliminary proxy statement, followed by a proxy "fight letter" stating:

While we believe that the Board has the ability to approve any nominees proposed by Icahn or Eastbourne at any time up to the election in order to nullify the debt acceleration provision, we cannot ensure that our bondholders will concur with that view. In fact, we requested confirmation of our view from the trustee of the [2007] notes and the trustee has refused to confirm our view. To protect the company and its shareholders, this issue will need to be resolved in court.¹³²

Subsequent to the "fight letter," the Pension Fund filed two amended complaints, adding BANA and the trustee of the 2007 Notes (the "Trustee") as defendants and seeking declaratory relief establishing the board's sole right and power to "approve" stockholder nominees.¹³³ After Amylin and its directors filed an answer,¹³⁴ the Pension Fund moved for partial summary judgment that the Credit Agreement's proxy put was unenforceable as a matter of law.¹³⁵ Further, the Pension Fund moved for summary judgment giving the board "the right and power to approve the stockholder nominees for the purpose of the Indenture."¹³⁶

130. *Id.* at 9.

131. *Id.* at 9–10.

132. *Id.* at 10.

133. *Id.* at 10–11.

134. The answer also contained a cross-claim by Amylin against the Trustee. *Id.* at 11. The claim against the Trustee sought declaratory relief that the board had the right to approve the election of any of the dissident nominees at any time prior to the election. *Id.*

135. *Id.*

136. *Id.*

C. The Pension Fund and Amylin Reach a Partial Settlement

About three weeks after the Pension Fund filed its complaint, Amylin and the Pension Fund announced that they had reached a partial settlement.¹³⁷ The board released a public statement summarizing the terms:

[T]he Board has determined, subject only to the entry of a final, non-appealable order prior to May 27, 2009 declaring that the Board possesses the contractual right to do so, that the Board will “approve” the Icahn Capital LP and Eastbourne Capital management L.L.C. nominees for [the purpose of the Continuing Directors provision of the Indenture].¹³⁸

In return for that released statement, the Pension fund agreed to drop its loyalty claim, to refrain from seeking damages against Amylin or the board, dismiss its claim of coercive disclosure in the Form 10-K without prejudice, and dismiss the fiduciary duty claim for the board’s failure to approve the stockholder nominees.¹³⁹ Following the settlement, Amylin moved for partial summary judgment for its cross-claim against the Trustee.¹⁴⁰

After the settlement, Amylin and BANA entered into a consent waiver agreement that waived any event of default that would result if the Credit Agreement’s proxy put was triggered.¹⁴¹ The court was therefore satisfied that the claims against BANA were moot, but determined that the resolution of the BANA claims did not affect the claims concerning the Indenture.¹⁴² Soon after the BANA claims were resolved, Eastbourne and Icahn both reduced the number of their nominees in their definitive proxy statements—Eastbourne from five to three, and Icahn from five to two.¹⁴³ Consequently, the Trustee argued that the issue was not ripe because there was no longer potential for a change in the majority of the board.¹⁴⁴ However, both the Pension Fund and Amylin contended that even if only five nominees were elected whether or not they were

137. *Id.*

138. *Id.* at 12.

139. *Id.* at 11–12.

140. *Id.* at 12.

141. *Id.* at 13.

142. *Id.* at 12–13.

143. *Id.* at 14.

144. *Id.*

Continuing Directors would be critical in the following year's stockholder meeting.¹⁴⁵

D. The Court's Analysis

The court first addressed “whether or not the . . . board [had] both the power and the right under the Indenture to approve the stockholder nominees.”¹⁴⁶ Considering the matter one of contract interpretation, the court first looked to the language of the Indenture.¹⁴⁷ The language was not clearly unambiguous as both parties argued for differing meanings of the word “approve.”¹⁴⁸

First, the Trustee argued that “approve” should be interpreted as synonymous with “endorse or recommend.”¹⁴⁹ The court took issue with this argument because, under the Trustee's logic, the board would never be able to approve a shareholder-nominated slate of directors—for the purposes of the Indenture—while, simultaneously, endorsing its own slate.¹⁵⁰ Conversely, Amylin argued that the court should adopt the *Black's Law Dictionary* definition of “approve”: “to approve’ means ‘to give formal sanction to; to confirm authoritatively.’”¹⁵¹ According to that definition, “while endorsement or recommendation may necessarily imply approval, the reverse is not true.”¹⁵² Thus, the board could sanction the nomination of a dissident slate without endorsing its candidacy, and,

145. *Id.*

146. *Id.* at 15. At this point, the Amylin board had already agreed that it would approve the insurgent parties' nominees if the court determined that it had the power. *Id.*

147. *Id.* at 17. “Indentures are to be read strictly and to the extent they do not expressly restrict the rights of the issuer, the issuer is left with the freedom to act, subject only to the boundaries of other positive law.” *Id.* (citing *In re Loral Space & Commc'ns, Inc. Consol. Litig.*, 2008 WL 4293781, at *35 (Del. Ch.)).

148. *Id.*

149. *Id.* The Board recounted the Trustee's argument:

[t]he Board's determination not to recommend the election of any of the Dissident Nominees, to recommend its own competing slate, and that the election of the Dissident Nominees would not be in the best interests of the Company—determinations that have not changed as a result of the Partial Settlement—simply cannot be reconciled with the plain meaning of the term “approval.” To the contrary, such determinations by the Board clearly indicate *disapproval*.

Id. (citing Trustee's Br. In Opp'n to Pl.'s and Amylin's Mot. for Summ. J. 31–32 (emphasis in original)).

150. *Id.*

151. *Id.* (citing BLACK'S LAW DICTIONARY 111 (8th ed. 2004)).

152. *Id.* at 17–18.

meanwhile, still recommend and support its own slate of nominees.¹⁵³ The court agreed with Amylin, cautioning that a provision incorporating the Trustee's proposed meaning, with "such an eviscerating effect on the stockholder franchise[,] would raise grave concerns."¹⁵⁴

Although the court determined that the board had the power to approve the nominees, the question remained as to their *right* of approval. Did the board properly exercise that right in this case? The court articulated the issue, "[t]he key question is whether approval by the board, under the given circumstances, comports with the company's implied duty of good faith and fair dealing which inheres in all contracts, including the Indenture."¹⁵⁵ The court looked to the rule from *Hills Stores Co. v. Bozic*,¹⁵⁶ which allows the board to approve stockholder nominees if it determines in good faith that the election of at least one of the dissident nominees would "not be materially adverse to the interests of the corporation or its stockholders."¹⁵⁷ While the court identified the appropriate rule for the instant case, it found the application of that rule to be problematic.¹⁵⁸

The court concluded that there was not sufficient evidence before it to apply the *Hill Stores* test.¹⁵⁹ Although the court acknowledged that two "sets of circumstances" cast some light onto the board's decision-making process, it disregarded them as "less than helpful."¹⁶⁰ First, the court recognized that the board's proxy fight letters potentially demonstrated that the board's actions failed the *Hill Stores* test.¹⁶¹ Yet, the court dismissed the fight letters as mere "election puffery," insufficient to show the board's true

153. *Id.* at 18.

154. *Id.* at 19. The court reasoned that Trustee's reading was far too restrictive, essentially making the provision an entrenchment mechanism. *Id.* at 18. More specifically, the Indenture would prohibit any change whatsoever in the board's majority as a result of contested elections, throughout the lifetime of the note. *Id.* at 18–19. Were such a meaning incorporated, the court would require that the board demonstrate that it at least had a good faith belief that it was "obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it." *Id.*

155. *Id.* at 19–20.

156. 769 A.2d 88 (Del. Ch. 2000).

157. *Amylin*, C.A. No. 4446-VCL at 21.

158. *Id.*

159. *Id.* at 21–22.

160. *Id.* at 22.

161. *Id.* at 22–23.

deliberations.¹⁶² Second, the court conceded that “the posture in which the board appears to have made its decision to approve” also was problematic.¹⁶³ Namely, the board waited more than one month after the insurgent stockholders nominated the dissident slate to approve them, and when it did approve them, it was as part of its partial settlement with the Pension Fund.¹⁶⁴ However, the court concluded that while these “circumstances at least raise[d] a question whether the board’s decision to approve was made in a good faith exercise of its considered business judgment,” the “underdeveloped state of the record” coupled with the post-trial developments—i.e., the dissident slates decreasing from ten nominees to five—demonstrated that the issue was not yet ripe and should be relitigated in the future, if necessary.¹⁶⁵

Finally, the court considered the Pension Fund’s claim that the Amylin board breached its duty of care by adopting the Indenture in the first place, in light of the proxy put provision.¹⁶⁶ The Pension Fund’s main assertion was that the Pricing Committee breached its duty of care by failing to discover the proxy put during its approval process for the Indenture.¹⁶⁷ However, because it was a care claim, the court concluded that the board was entitled to the deferential treatment of the business judgment rule.¹⁶⁸ The court reasoned that the board’s failure to ascertain and reject the presence of this provision was *not* “the sort of conduct generally imagined when considering the concept of gross negligence, typically defined as a

162. *Id.*

163. *Id.* at 23.

164. *Id.*

165. *Id.* at 23–24.

166. *Id.* at 25–26.

167. *Id.* at 25. The Pension fund further argued that Amylin’s CEO and CFO both admitted that they were entirely unaware of the existence of the proxy put provisions until they read about them once the proxy contest began. *Id.* The court dismissed this information as unhelpful to the Pension Fund’s claim, because the CFO was not a director and there was no evidence that the CEO was on the Pricing Committee. *Id.*

168. *See id.* at 25. The court reasoned that the duty of care requires that in making business decisions, directors must consider all material information reasonably available, and that the directors’ process is actionable only if grossly negligent [T]he standard for judging the informational component of the directors’ decisionmaking does not mean that the Board must be informed of *every* fact. The Board is responsible for considering only *material* facts that are reasonably available, not those that are immaterial or out of the Board’s reasonable reach.

Id. at 25 (citing *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000)).

substantial deviation from the standard of care.”¹⁶⁹ Because “the board retained highly-qualified counsel . . . , sought advice from [its] management and investment bankers as to the terms of the agreement . . . , [and] asked its counsel if there was anything ‘unusual or not customary’ in the terms of the Notes,” the court was satisfied that the board did not act grossly negligent and held in favor of the defendants.¹⁷⁰

Nevertheless, in dicta, the court recognized that “[t]his case does highlight the troubling reality that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise.”¹⁷¹ The court gave two reasons why this is particularly troubling when negotiating a debt instrument.¹⁷² First, few events “have the potential to be more catastrophic for a corporation than the triggering of an event of default under one of its debt agreements.”¹⁷³ Second, when the board is negotiating these instruments, it is dealing “with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise),” and it “must be especially solicitous to its duties both to the corporation and to its stockholders.”¹⁷⁴ The truth of this notion is particularly relevant concerning transactions with debtholders—whose interests “may be directly adverse to those of the stockholders.”¹⁷⁵ Particularly, terms that may limit the stockholders’ discretionary range in exercising the franchise should be highlighted to the board, thereby enabling the board “to exercise its fully informed business judgment.”¹⁷⁶

Ironically, though the court’s holding grants the directors the benefit of the business judgment rule, the court’s cautionary dicta recounts some of the key public policy reasons for not immediately granting directors that privilege in the case of proxy puts and why, instead, the directors should be subject to the *Blasius* standard of showing a compelling justification.

169. *Id.* at 26.

170. *Id.* The court reasoned that “[c]ertainly, no one suggests that the directors’ duty of care required them to review, discuss, and comprehend every word of the 98-page Indenture.” *Id.*

171. *Id.*

172. *Id.*

173. *Id.* at 27.

174. *Id.*

175. *Id.*

176. *Id.*

E. Appeal to the Delaware Supreme Court

The case reached the Delaware Supreme Court on appeal of several issues.¹⁷⁷ The Pension Fund appealed the Court of Chancery's decisions to refrain from validating the directors' approval of the stockholder slates, not invalidate the proxy put in the Credit Agreement, and dismiss the care claim.¹⁷⁸ However, five days after the arguments concluded, the court adopted the Chancery Court's opinion and surmised its decision in one sentence and one footnote. The opinion, in its entirety stated:

This 5th day of October 2009, upon consideration of the briefs of the parties, and their contentions in oral argument, it appears to the Court that the order and judgment of the Court of Chancery should be affirmed on the basis of and for the reasons set forth in its decision dated May 12, 2009.¹⁷⁹

The footnote that accompanied the opinion was slightly longer.

The Court of Chancery determined . . . that [the] board . . . did not breach its duty of care in authorizing the corporation to enter into the Indenture Agreement, with its "proxy put" provision. That determination was correct, not only for the reasons made explicit in the Court's opinion, but also for one that is implicit: no showing was made that approving the "proxy put" at that point in time would involve any reasonably foreseeable material risk to the corporation or its stockholders. That risk materialized only months later, and was aggravated by the unexpected, cataclysmic decline in the nation's financial system and capital markets beginning in the Spring of 2008.¹⁸⁰

And at that, the board rejected the Pension Fund's arguments and affirmed the Chancery Court's decision.

177. *See, e.g.*, *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 981 A.2d 1173, 1173 n.2 (Del. 2009).

178. *See, e.g.*, Appellant's Opening Brief at 7, *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 981 A.2d 1173 (Del. 2009) (No. 268).

179. *Id.* at 1173. The decision is outlined above in Part III.4.

180. *Id.*

V. DIRECTORS WHO APPROVE AGREEMENTS WITH PROXY PUTS
SHOULD BE SUBJECTED TO THE COMPELLING JUSTIFICATION
STANDARD

Chancellor Allen's profound language from *Blasius* provides the proper framework for analyzing the legality of the proxy puts in *Amylin*, and all proxy puts generally: "The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests."¹⁸¹ He further reasoned that "it is clear that [the shareholder vote] is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own."¹⁸² Because the proxy puts in *Amylin* infringed on the shareholder franchise's authority in a contested election, I contend that the Delaware courts should have required the Amylin board to show a compelling justification for including them in the Indenture and the Credit Agreement. Moreover, I propose 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.

My proposed rule aligns with the policy underlying the Delaware courts' opinions in *Blasius* and *Liquid Audio*. In criticizing the *Amylin* opinions, I do not contend that Vice Chancellor Lamb's answer to the Pension Fund's care claim was necessarily wrong, but I do assert that, in addressing it, he answered the wrong question. As Chancellor Allen reasoned in *Blasius*, the ordinary considerations that implicate the business judgment rule are not present in the shareholder voting context and were not present in *Amylin*.¹⁸³ Even though, similar to the board in *Blasius*, the Amylin board likely did not breach its duty of care,¹⁸⁴ the proxy puts' infringement on shareholder voting posed a question of authority "as between the fiduciary and the beneficiary," not a question of fiduciary duty.¹⁸⁵

181. *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659 (Del. Ch. 1988).

182. *Id.*

183. *Id.* at 659.

184. As the court noted, by retaining sophisticated counsel, working intensely with management and investment bankers, and asking its counsel if there was anything unusual in the agreement, the board easily cleared the low gross negligence. Moreover, directors should not be expected to review every page of an agreement. *See San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, C.A. No. 4444-VCL, at 26-27 (Del. Ch. May 12, 2009), available at <http://law.du.edu/documents/corporate-governance/governance-cases/Antonio-Fire-Police-Memorandum-Opinion.pdf>.

185. *See Blasius*, 564 A.2d at 658.

Because the proxy puts enabled the incumbent board to “thwart a shareholder majority,” they implicated a question of who had authority regarding a matter of internal corporate governance.¹⁸⁶ According to Chancellor Allen’s reasoning, the business judgment rule cannot apply in such circumstances, and the board must “bear[] the heavy burden of demonstrating a compelling justification for such action.”¹⁸⁷

My rule is also supported by the *Liquid Audio* interpretation of *Blasius* and its adoption into the *Unocal* test. The *Liquid Audio* holding fits *Blasius* into *Unocal* by requiring directors to demonstrate a compelling justification for any defensive measure that has the primary purpose of interfering with or impeding “the effective exercise of the shareholder franchise in a contested election for directors,” as a condition precedent to the *Unocal* reasonableness and proportionality inquiries.¹⁸⁸ Proxy puts absolutely interfere with and impede the shareholder franchise’s right to participate in the proxy election of directors. In *Amylin*, because the company could not afford to pay off the 2007 notes at face value or handle the acceleration of the debt in the Credit Agreement, the two dissident slates were unable to run successful proxy campaigns. In fact, they eventually reduced their slates to a number that would not constitute a majority. The Delaware courts should not have had to answer questions of the board’s power and right to approve the slates, because the provisions themselves should not have been valid without a showing of compelling justification to include them in the agreements.

While the facts of *Blasius* and *Liquid Audio* do not perfectly align with *Amylin*, the reasoning and underlying policy of the cases support my rule for proxy puts and its application in *Amylin*. The notable factual distinction in *Amylin* from both *Liquid Audio* and *Blasius* is that the *Amylin* directors allegedly approved of the Indenture and the Credit Agreement without knowing about the proxy put provisions, while the directors in the other cases acted intentionally, but in good faith.¹⁸⁹ This distinction is of little consequence, however, to my proposed rule and to the underlying policy rationale from *Blasius* and *Liquid Audio*. Whether or not the

186. *See id.* at 660.

187. *See id.* at 661.

188. *MM Companies, Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1132 (Del. 2003).

189. *See id.* at 662.

directors knew that they were acting outside their authority does not change the fact that they were doing so. Directors should not have authority to approve a provision that would “thwart a shareholder majority,”¹⁹⁰ “interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors,”¹⁹¹ and ultimately entrench an incumbent board. Shareholders have only two key protections against inadequate business performance—selling their shares and voting.¹⁹² The Amylin board, by approving the Indenture and the Credit Agreement (both of which contained proxy puts) took one of those protections away. Therefore, their decision to do so must have been made with a compelling justification.

The agency cost framework also demonstrates public policy reasons for requiring a compelling justification to employ proxy puts.¹⁹³ As Kahan and Klausner’s analysis demonstrates, proxy puts are the “ideal management protective covenant,” and they almost assuredly increase the agency cost of equity without decreasing the agency cost of debt.¹⁹⁴ While they likely give no additional protection to bondholders, they do provide them a supra-compensatory remedy if the puts are triggered.¹⁹⁵ It is difficult to imagine a scenario where proxy puts should be allowed, and, like Chancellor Allen in *Blasius*, I see the advantage of clarity and predictability in a bright-line, per se rule invalidating proxy puts.¹⁹⁶ However, as Chancellor Allen finally concluded,¹⁹⁷ I recognize that it is impossible to foresee all scenarios in which a board could implement a proxy put. Therefore, I am satisfied with the high burden of requiring a board that uses a proxy put to show a compelling justification.

Applying the compelling justification standard makes *Amylin* an easy case. The fact that the board did not even know that the provisions were in the agreements cuts against them in this test. How could they have had a compelling justification to put the provisions in when they were not even aware of their existence?

190. *Id.* at 660.

191. *Liquid Audio, Inc.*, 813 A.2d at 1132.

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

193. *See supra* Part II.

194. Kahan & Klausner, *supra* note 1, at 950.

195. *See id.* at 934–50.

196. *See Blasius*, 564 A.2d at 661.

197. *See id.* at 662.

There is no evidence that they used the proxy puts as negotiating leverage to obtain more favorable interest rates, or anything at all, in return. They were merely included as parts of long agreements. The board clearly had no compelling justification to include the proxy puts, and they therefore should have been invalidated.

VI. CONCLUSION

The hostile takeover craze of the 1980s has slightly abated in the past twenty years, but the lasting effects of the decade are still felt. The antitakeover defenses that the '80s spawned have affected corporate governance in complex and intriguing ways. Poison puts are no exception.

In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, Amylin's board of directors employed a particular kind of poison put—a proxy put. Both Delaware courts refrained from truly confronting the legality of the proxy puts, as they deferred to the board's business judgment in failing to identify and remove the provisions. I contend that the court erred in not requiring the board of directors to demonstrate a compelling justification for implementing the proxy puts.

In this Note, I do not attempt to craft a comprehensive rule for all poison put provisions, but I do propose a rule for proxy puts. Because of the unique infringement that proxy puts impose on the shareholder franchise, any directors who enter into an agreement with a proxy put provision must show that they did so with a compelling justification. In *Amylin*, the board did not demonstrate a compelling justification, and, therefore, the proxy puts at issue should have been invalidated.

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* J.D. candidate, April 2011, J. Reuben Clark Law School, Brigham Young University. The quotation in the title is taken from William Shakespeare's *The Merchant of Venice* act 3, sc. 1. I would like to thank Professor D. Gordon Smith for his encouragement, help, and friendship. I also need to thank the women in my life: Kris and Hailey Jane, you two are my all.

