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An Antidote for Poison Puts: a Eulogy for a Management Entrenchment Device

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Poison puts are a type of event risk covenant commonly found in financing agreements. Lenders, both as bondholders and banks, utilize this provision as one layer of protection. However, poison puts can also be utilized to entrench a corporation’s management. The provision grew in popularity with the growth of the leveraged buyout boom of the 1980’s, but was frequently ignored during the subsequent economic growth period and merger activity that accompanied it. With the recent collapse in credit markets, companies and shareholders have challenged the provision’s interpretation and enforceability. These challenges have come in tandem with lenders taking more aggressive positions alleging the triggering of the provision. As both lenders and shareholders vie for more influence over management in formulating corporate policy, scholars have focused attention on the dynamics between these groups. Poison puts provisions are one front in this war over control.

This Comment examines recent litigation regarding poison puts. It distinguishes poison puts that are triggered through proxy contests from standard poison puts. This Comment argues that standard poison puts, drafted in their current form, do not provide either substantive protection to lenders or entrenchment benefits to management. Re-drafting standard poison puts to preserve entrenchment benefits will not correct current deficiencies without raising the same problem as proxy poison puts–thwarting the shareholder franchise. This Comment proposes a framework within Delaware corporate law, for evaluating whether proxy poison puts are enforceable so lenders can achieve similar levels of protection without constraining shareholder democracy. If the market values bonds with poison puts, then removing the ‘continuing director’ clause also achieves this goal.
INTRODUCTION

Over the last 25 years, debt has played an increasingly important role in financing business operations and takeover activity. In the late-80’s bondholders experienced significant losses when companies accumulated excessive debt to finance takeovers. To assuage investor concerns a variety of contractual protections were developed and are now incorporated into the contracts that govern these agreements. One such development is the poison put, which is now commonly used in lending agreements including bond indentures and revolving loans. In a bond indenture, a poison put provides that if a triggering event occurs, bondholders have the


2 A bond indenture is the contract that sets out the rights and obligations of the bondholders and the company issuing bonds.

3 There are three typical ways to draft poison puts: 1) single trigger puts or “Hostile Control Change Covenants” that are triggered exclusively by “takeover-related events that occur without the approval of management; 2) “Pure Rating Decline Covenants” that are triggered only by a bond rating decline; and 3) “dual trigger covenants” that are triggered by takeover-related events when a bond rating declines concurrently. See Marcel Kahan & Michael Klausner, Antitakeover
right to sell the bonds back to the issuing company at par. In revolving credit agreements, poison puts permit a lender to accelerate a company’s outstanding debt when a triggering event occurs. While poison puts protect lender investments, they can also function as entrenchment devices for a corporation’s board of directors.

This paper discusses two kinds of poison puts, which I will refer to as standard poison puts and proxy poison puts. Standard poison puts are triggered by a change in control of the majority of a company’s board of directors. A proxy poison put is triggered by the same change in control as a standard poison put, but also by actual or threatened proxy contests that can lead to changes in control of a company’s board of directors.

Recently, parties to contracts containing poison puts have challenged the enforceability of these covenants in Delaware courts. Shareholders in one case alleged that its board of directors beached their fiduciary duty of care by entering into an agreement containing a poison put provisions. The court decisions provide some clarity regarding how these provisions are interpreted and provide guidance to larger issues of corporate governance. Furthermore, these cases raise issues of the allocation of corporate power between directors, shareholders, and lenders.

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Revolving loans bear similarity to consumer credit cards. A maximum line of credit is available to the corporation, but is not necessarily used. *See William J. Carney, Corporate Finance: Principles and Practice,* Foundation Press 198–99 (2005).
This Comment argues that courts interpret standard poison puts, as they are currently drafted, in a way that fails both to protect lenders and insulate management. Re-drafting the provision, but retaining entrenchment benefits such as with a ‘continuing director’ clause will likely involve court review at a level of heightened scrutiny. Ultimately, heightened review may render such a re-drafted poison put unenforceable because a poison put that contains effective entrenchment protection likely stifles the shareholder franchise. Next, proxy poison puts are examined and this Comment suggests a method for reviewing whether a proxy poison put is enforceable under Delaware law. Finally, this Comment argues that poison puts are ineffective entrenchment devices. Even if a poison put is enforceable and effective, to protect management relevant interest rates must be high enough that the debt cannot be refinanced.

Part I of this paper provides background on poison puts, including their development and a discussion of prior research. Part II examines relevant Delaware laws and standards of scrutiny. Part III discusses recent legal challenges. Part IV argues that courts interpret the language of standard poison puts in a way that does not favor lender interests. Part V proposes a framework for determining whether proxy poison puts are enforceable.

I. BACKGROUND ON POISON PUTS

In the last twenty-five years, poison puts, a kind of change in control covenant, have become a commonplace clause in lending contracts. Part A of this section describes how poison puts function and provides the characteristics of corporations that are likely to include these covenants in lending contracts. Next, Part B provides historical background for the development of these covenants, and discusses the poison put’s subsequent popularity as a provision to protect bondholders and as an entrenchment mechanism for management. Part C discusses previous research regarding whether the market and investors value poison puts.
A. **How Poison Puts Function and Where They Occur**

The poison put, sometimes called the “super poison put,” is one kind of event-risk covenant. In the case of corporate bonds, the covenant’s provisions are triggered by a specific event or events that are stipulated in the bond’s indenture which might lower the bond’s value. When triggered, poison puts accelerate a company’s debt payments to bondholders, often providing bondholders the right to sell the bond to the company at par. These covenants are

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7 *See* Ai-Fen Cheng & Tao-Hsien Dolly King, *An Empirical Examination of Poison Puts in U.S. Corporate Debt*, Fin. Mgmt. Ass’n, available at http://69.175.2.130/~finman/Orlando/OrlandoProgram.htm (explaining that the bond indenture contains the specific triggering events, the rights of bond holders, redemption price and further explaining that, specific ratings categories are listed if a rating decline is the triggering event).


9 Malitz, *supra* note 6, at 22–23; Frederick Tung, *Leverage in the Board Room: The Unsung Influence of Private Lenders in Corporate Governance*, 57 UCLA L. Rev. 115, 151–52 (2009) (observing that in regards to credit agreements generally in practice, financial covenants are not used to force accelerated debt payment, but rather covenants “act as trip wires that signal the need for creditor attention”).
now widely included in corporate bond indentures.\textsuperscript{10} Studies suggest that corporations with particular characteristics are more likely to include poison puts in their debt instruments. Yaxuan Qi and John Wald noted that corporations incorporated in states with fewer antitakeover statutes, such as Delaware, are more likely to include poison puts and other antitakeover provisions in their bond indentures.\textsuperscript{11} Conversely, corporations incorporated in states such as New York, Texas, and California, which have statutes that restrict distributions, are less likely to utilize poison puts.\textsuperscript{12} Moreover, poison puts are more likely to be found when a low percentage of the corporation is insider-owned because of greater agency costs.\textsuperscript{13} Furthermore, in their empirical study of poison put covenants, Ai-Fen Cheng and Tao-Hsien Dolly King identified larger firm size and fixed assets and profits as factors that increase the probability of issuing bonds containing poison puts.\textsuperscript{14} Thus, poison puts are most likely to be issued by larger, profitable corporations that are incorporated in states with less stringent antitakeover laws.

\textsuperscript{10} Cheng & King, \textit{supra} note 7, at 5 (identifying 5113 bonds containing poison puts out of 134,755 public issues in the Fixed Income Securities Database from 1894 to 2003); \textit{see also} Kahan & Klausner, \textit{supra} note 3, at n.152 (1993) (observing that change in control covenants commonly occur in bonds with maturity ranging between 7 and 30 years).


\textsuperscript{12} \textit{Id.} Restrictions on distributions are important to bondholders because they ensure the company retains sufficient capital to make debt payments to bondholders before passing profits onto shareholders.

\textsuperscript{13} Ai-Fen Cheng & Tao-Hsien Dolly King, \textit{supra} 7, at 14.

\textsuperscript{14} \textit{Id.}
B. Impetus for Poison Puts

Poison puts first appeared in publicly traded bonds in 1986 in response to the increase in corporate takeovers and leveraged buy-outs. While stockholders benefited from market consolidation, bondholders lost money because large debt was utilized both to finance an acquisition and also to defend against a takeover. Thus, regardless of whether a merger succeeded, bondholders saw their debt holdings downgraded by rating agencies. The prevailing wisdom during this time suggested that significant bondholder wealth was being transferred to shareholders through these transactions. However, later studies indicated that

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17 Hertzberg, supra note 15, at 5 (noting that First Boston Corp. included poison put covenants in debt they underwrote for W.R. Grace & Co. and Sperry Co. and that “[b]oth companies have been the subject of takeover speculation”).

18 Id.

wealth shifting from bondholders to shareholders through buyouts was not as significant as originally thought.\textsuperscript{20}

As buy-out activity increased, bondholders’ fears and frustrations grew accordingly, and peaked with the RJR Nabisco deal in 1988.\textsuperscript{21} The leveraged buyout of RJR Nabisco in 1988 demonstrated the severity of bondholders’ loses as well as the divergence\textsuperscript{22} of interests between bondholders and stockholders.\textsuperscript{23} During the Nabisco deal, Nabisco incurred significant additional debt, which caused the price of Nabisco’s existing bonds to drop by approximately 20\% in one night.\textsuperscript{24} The sudden drop in the bond’s price resulted in $1 billion in losses to bondholders.\textsuperscript{25} Following the Nabisco deal’s staggering losses to bondholders, investment banks sought to increase contractual protection for bondholders through the use of event risk

\textsuperscript{20} \textit{Id.}

\textsuperscript{21} \textit{See supra} note 14; Kahan & Klausner, supra note 3, at 938.

\textsuperscript{22} Kahan & Klausner, \textit{supra} note 3, at 938 (citing Michael C. Jenson & William H. Meckling, \textit{Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure}, 3 J.FIN.ECON. 305, 333–43 (1976)) (contrasting bondholders’ interests, which want companies whose debt they hold to “pursue a conservative business strategy, which would maximize the likelihood that a corporation will have sufficient funds to repay its debts”, with shareholders, whose risk of loss is limited and possible gains unlimited, “prefer higher dividends and riskier strategies”).

\textsuperscript{23} \textit{Id.} at 932; \textit{see also} Matthew Winkler, \textit{Wall Street is Devising the Takeover-Proof Bond}, WALL St. J., Feb. 13, 1986.

\textsuperscript{24} Kahan & Klausner, \textit{supra} note 3, at 932.

\textsuperscript{25} \textit{Id.}
Event risk covenants were drafted either as poison puts or as reset provisions. These covenants shielded bondholders from losses if increased debt resulted in a ratings downgrade to existing bonds. In addition to benefits for bondholders, corporate managers embraced the provision as an entrenchment mechanism.

Scholars took note of this trend, observing that poison puts create incentives for shareholders to retain incumbent management. For example, in proxy contests “[s]hareholder gains [...] are much smaller than their gains in hostile acquisitions,” thus directors can utilize poison puts as an incentive for shareholders to vote for incumbents during a proxy contest to avoid triggering the covenant. This reduces a challenger’s chances of winning a proxy

26 Winkler, supra note 23.

27 Malitz, supra note 6, at 22–24. Reset provisions provide that, upon a specified event, bondholders may “renegotiate the coupon rate.” Id. at 24.

28 Kahan & Klausner, supra note 3, at 934–35 (arguing that managers’ interests diverge with bondholders’ interests and that managers use poison puts for unrelated protection purposes); (citing John C. Coffee, Jr., Unstable Coalitions: Corporate Governance as a Multi-Player Game, GEO. L.J. 1945, 1519–21 (1990) (arguing that directors’ and bondholders’ interests in preventing takeovers overlap and that these two groups form a “coalition” whose interests are contrary to shareholders’ interests).

29 Kahan & Klausner, supra note 3, at 946.
As Lucian A. Bebchek and Marcel Kahan noted, a lower chance of success reduces the motivation to wage a proxy contest.

The poison put’s use decreased around 1991, when takeover activity dropped during the recessionary period and deals shifted from hostile to negotiated. The change in control covenants’ use increased as the next wave of corporate takeovers began, and companies “glossed over” these provisions because of surplus cash and credit availability. While poison puts have been widely used since their inception, there is not consistent empirical data to suggest these provisions provide protection to creditors.

C. Does the Market Value Poison Puts

Studies of poison puts have not provided dispositive evidence whether including these covenants in debt instruments is beneficial. Both corporations and their bondholders can benefit from poison puts depending on the covenant’s language. If these covenants reduce bondholders’ risks, the markets and investors may reduce the interest rate offered to account for

30 Id.
31 See Lucian A. Bebchuk & Marcel Kahan, A Framework for Analyzing Legal Policy Towards Proxy Contests, 78 CAL. L. REV. 1071, 1089–91 (1990) (noting that if costs of waging a proxy contest are expected to exceed the gains of winning, than contestants are unlikely to engage in this behavior).
32 Kahan & Klausner, supra note 3, at 935–36.
33 See Berman, supra note 1.
34 See Cheng & King, supra note 7, at 1–5 (collecting and summarizing prior research about the effects of poison puts on interest rates and bondholder and shareholder wealth).
35 Kahan & Klausner, supra note 3, at 937–38.
the extra security provided.\textsuperscript{36} While some benefits offered by poison puts in the late 80’s no longer exist,\textsuperscript{37} poison puts are still included and often bundled with other covenants to provide greater protection to bondholders.\textsuperscript{38}

This section provided an overview of the poison put’s history and the provision’s place in contemporary financial markets. Throughout the past decade, poison puts were included in many agreements. Available credit and low interest rates negated potential problems of poison puts until the economic collapse around 2008. Once shareholders realized the threat from poison puts, litigation ensued.

II. Delaware Law and Standards of Review for Board Actions

Under Delaware law, boards of directors are obligated to “manag[e] the corporation’s business and affairs for the benefit of the stockholders.”\textsuperscript{39} This Part examines Delaware’s

\textsuperscript{36} Id. at 937–38 (citing Leland Crabbe, Event Risk: An Analysis of Losses to Bondholders and \textit{“Super Poison Put” Bond Covenants}, 46 J. Fin. 689, 701–05 (1991) (finding a 24 basis point reduction in interest expenses due to the protection created by change in control covenants). For more detailed explanation of efficiency and agency costs associated with change in control covenants see Kahan & Klausner, supra note 3, at 936–50.

\textsuperscript{37} See Cheng & King, supra note 7, at 3 (suggesting the basis point reduction found by Crabbe ebbed along with the corporate restructuring in the early 90’s).

\textsuperscript{38} See id. at 12 (examining the frequency and percentage of various other covenants that are bundled with poison puts and arguing that, based on the data in the Fixed Income Securities Database (FISD), poison puts are most often bundled with clauses relating to the sale of assets, limiting proceeds from the sale of assets, dividend payment restrictions, and limits on indebtedness).
relevant statutory and case law regarding the fiduciary duties of boards of directors. This Part discusses the three levels of scrutiny Delaware courts use to evaluate board actions: the business judgment rule, the heightened review under Unocal, and the compelling justification review under Blasius. This Part provides the legal basis for Part IV, which argues that in San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.’s wake, standard poison puts provide little benefit to lenders or management. While re-drafting the provision may provide more force, it also likely raises new enforceability concerns.

Commentators have argued that change in control covenants cannot be regulated because of difficulties distinguishing provisions that enhance company value from those that solely entrench management. In Amylin Vice Chancellor Lamb noted in dicta that one solution could

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41 See Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. PA. L. REV. 577, 582–83, 623–28 (2003) (arguing against a strong form of shareholder choice and noting that if a shareholder choice rule that assumes shareholders were capable of making informed choices about value-enhancing firm behavior was adopted by courts, firm managers could still entrench themselves by including change in control provisions in many different kinds of contracts which would “increase both the magnitude of, and the uncertainty
be subjecting some poison puts to heightened scrutiny, depending on the provision’s effects on shareholder’s voting rights.\textsuperscript{42} Delaware law demarcates the rights of shareholder from those of a corporation’s board of directors. Additionally, Delaware law provides that courts review board actions with varying levels of scrutiny. Part A below discusses the statutory authority under Delaware General Corporation Law and the deference given to directors according to the business judgment rule. Part B discusses the 2-prong \textit{Unocal} test, and part C discusses the compelling justification standard required under \textit{Blasius}. Part IV argues that standard poison puts as they are drafted in the cases in Part III are likely reviewed under the business judgment rule or a relaxed \textit{Unocal} standard. Re-drafted standard poison puts and some proxy poison puts should be reviewed under a heightened standard.

\textbf{A. \textit{Delaware General Corporation Law and the Business Judgment Rule}}

In most instances, courts are hesitant to subject directors’ actions to heightened scrutiny. Delaware General Corporation Law § 141(e) provides a wide breadth of authority to a corporation’s board of directors when making decisions necessary to run a company,\textsuperscript{43} and this rebuttable presumption is further enhanced by through common law doctrine.\textsuperscript{44} Furthermore,

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\textsuperscript{43} \textsc{Del. Code Ann. tit. 8 §141(e)} (2010).

\textsuperscript{44} \textit{See} Aronson v. Lewis, 473 A.2d 805 (Del. 1984).
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Delaware courts apply the business judgment rule when reviewing a corporate board’s actions.\textsuperscript{45} When the business judgment rule applies, the court presumes business decisions made by a board of directors “were made ‘on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.’”\textsuperscript{46} The business judgment rule applies to the board’s “exercise of [] corporation’s power over its property, or with respect to its rights or obligations.”\textsuperscript{47} Unless there is evidence that indicates a lack of good faith, self-interest, or that the board’s action was taken from an uninformed perspective, the business judgment rule’s presumption is applied and the court will not second-guess a board’s judgment.\textsuperscript{48}

In contrast to the wide scope of power and protection Delaware General Corporation Law provides a corporation’s board of directors, a corporation’s shareholders possess limited powers. Delaware General Corporation Law §141(k) allocates shareholders fewer powers, including voting for directors or for a director’s removal.\textsuperscript{49} Because shareholders have limited rights,

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\textsuperscript{46}See \textit{id.} (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).
\textsuperscript{47}Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000) (citing Blasius Ind., Inc. v. Atlas Corp., 546 A.2d 658, 659–600 (Del. 1988)).
\textsuperscript{49}Del. Code Ann. tit. 8 §141(e) (2010).
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courts apply heightened scrutiny when reviewing board actions that affect corporate control and shareholder voting rights.  

B. Scrutiny under Unocal

The 2-prong Unocal test provides an intermediate level of scrutiny for reviewing board actions. When a board “‘perceives a threat’” to control and takes defensive measures, including preemptive action, courts will apply the 2-prong Unocal analysis. First, the board must demonstrate that “the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and required a defensive response. Next, in a “proportionality test,” the court assesses whether the board’s action “was reasonable in relation

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52 Id. (citing Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).


54 Unitrin, 651 A.2d at 1375.

55 Id. at 1376.
to the threat posed.” An action is reasonable if it is not “draconian,” meaning preclusive or coercive. Furthermore, the “presence of a majority of outside, independent directors will materially enhance a board’s ability to meet this burden.”

C. **Blasius and the Compelling Justification Standard**

When a board action’s primary purpose is to interfere with shareholder voting rights for directors, *Blasius*’ “compelling justification” standard is used. In *Blasius*, Chancellor Allen addressed the issue driving the compelling justification standard:

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56 See *Stroud*, 606 A.2d at 82 (quoting Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985)).


59 See 564 A.2d 651, 659–60, 662 (Del. Ch. 1988). Atlas Corporation’s largest shareholder, Blasius Industries, suggested increasing shareholder value through selling Atlas Corporation or engaging in a leveraged recapitalization. *Id* at 553–54. Blasius also proposed to expand the Atlas board of directors from seven to fifteen directors. *Id. at 652*. After Atlas’ board of directors studied and rejected proposals to engage in a recapitalization or sale, the board voted to increase the board by two directors. *Id. at 657*. The board appointed two additional directors, which guaranteed the incumbent board would maintain a majority if the shareholders approved Blasius’ proposal to increase the board. *Id. at 655*. The court held that this board action was principally to thwart shareholders and thus was impermissible. *Id. at 662–63.*
[W]hether, in these circumstances, the board, even if it is acting with subjective good faith (which typically, if not always, be a contestable or debatable judicial conclusion), may validly act for the principal purpose of preventing the shareholders from electing a majority of new directors. The question thus posed is not one of intentional wrong (or even negligence), but one of authority as between the fiduciary and the beneficiary...  

Because issues involving shareholder-voting rights involve “internal corporate governance” that relates back to an agent’s (the director) obligations to his or her principal (the shareholder), and not the corporation’s power over property, Chancellor Allen held that the business judgment rule was not appropriate for this kind of dispute. However, if compelling justification supports the board action, the action is justified. Impermissible board actions affecting the shareholder vote include board elections and accountability. Thus, this standard may be invoked when a

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60 See Shore, 771 A.2d at 320 (citing Blasius Ind., Inc. v. Atlas Corp., 564 A.2d 651 (Del. 1988)).

61 Blasius, 564 A.2d at 658–59.

62 Shore, 771 A.2d at 320 (citing Blasius, 546 A.2d at 659–600).

63 Id.

64 Id.; see also Hollinger Int’l v. Black, 844 A.2d 1022, 1089 (Del. Ch. 2004) (noting in dicta that compelling justification is not the correct standard in this case, but if it were applied, the board had sufficient justification).

65 See Mercier v. Inter-Tel, Inc, 929 A.2d 786, 808–12 (Del. Ch. 2007) (permitting delays on merger vote, distinguishing voting in elections from voting on other matters, and discussing the evolution the compelling justification standard’s application since annunciated in Blasius).
The corporation’s board contracts with lenders, either in the form of financial institutions or bondholders, and agrees to provisions that impede shareholder democracy.

This section provided an overview of the standards courts use to review board actions. Part III describes recent challenges to poison puts. These cases only tangentially discuss the standard of review for poison puts. However, Part IV argues that the business judgment rule or a relaxed Unocal review is likely the standard to be applied when reviewing standard poison puts as they are drafted in the cases in Part III. In contrast, this Comment argues in Part V that a re-drafted standard poison puts and proxy poison puts, due to their possible impact on shareholder democracy, should receive more stringent review.

III. CHALLENGES TO ENFORCEABILITY

While poison puts are commonly included in debt instruments, they have rarely been triggered. More recently, shareholders of at least two corporations that have debt outstanding

standard, and have suggested that much of what it seeks to protect can be achieved through a stringent Unocal analysis. See id. at 805–11.

66 See Cheng & King, supra note 7, at 18 (identifying at least 5000 debt issues containing poison puts).

67 Id. (describing instances when poison puts were triggered and noting the event’s infrequency); Berman, supra note 1 (explaining fears of triggering poison puts is partially responsible for decreased merger activity). See also Law Denture Trust v. Petrohawk Energy Corp., No. Civ.A. 2422-VCS, 2007 WL 2248150 (Del. Ch. Aug. 1, 2007) (debt trustee unsuccessfully brought suit against debtor arguing technical default of the indenture); Marcel Kahan & Edward Rock, Hedge Fund Activism in the Enforcement of Bondholder Rights, 103 Nw. U. L. Rev. 281 (2009)
with poison puts have brought suit in the Delaware Chancery Court seeking declaratory judgments that the covenants are unenforceable.\textsuperscript{68} The court did not directly reach a decision on the enforceability of both variations of this covenant.\textsuperscript{69} While the court did hold that a standard poison put was enforceable, the court upheld corporation’s interpretation of the covenant over bondholders’.\textsuperscript{70} This reading reduced the scope of possible defaults.\textsuperscript{71}

Part A of this section discusses San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc, in which the court first approached the issue the enforceability and interpretation of poison puts.\textsuperscript{72} Next, Louisiana Sheriffs’ Pension & Relief Fund v. Crane is (surveying hedge fund strategy of buying deeply discounted corporate bonds and litigating technical defaults, including change in control covenants, for a profit).


\textsuperscript{71} See McLaughlin, \textit{supra} note 1.

discussed, in which the court declined to address the poison put directly.\footnote{2009 WL 1099925 (Del. Ch. Apr. 14, 2009).} Because the corporation in the dispute’s board was classified, it would take more than one election to change board control.\footnote{Id. at *2.} Thus, the court held the enforceability issue was not ripe for adjudication.\footnote{Id.}

A. \textit{San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.}

directors, 80 Amylin noted the presence of change in control provisions in its debt instruments. 81 Amaylin’s board explained the affects of the provisions in its February 27, 2009 annual report form 10-K 82:

If a majority of our Board of Directors ceases to be composed of the existing directors or to be composed of the existing directors or other individuals approved by a majority of the existing directors, we may be required to pay $575 million under our 2007 notes, $125 million under our Term Loan and any amounts that


81 2009 WL 1337150, at *4 n.7 (citing Amaylin’s 10-K at 37, 39–40 (Feb. 27, 2009).

may be outstanding under our $15 million revolving credit facility, and if a cross-default is triggered, $200 million under our 2004 Notes. . . .

Amylin further explained in its 10-K that a cross-default might require the company pay $915 million immediately to its debt holders, but the company only had $817 million in cash and cash equivalents as of 2008 year-end.

Part 1 describes how Amylin’s board adopted the debt agreements containing the contested poison puts. Part 2 describes the plaintiff’s claims against Amylin. Part 3 describes the resolution of the case.

1. **The Change in Control Provisions**

   In May of 2007, Amylin’s board adopted a resolution designating the Finance Committee as the “Pricing Committee,” which was authorized to negotiate and issue the 2007 notes. Both the 2007 notes and a senior secured credit facility contained poison puts. The Pricing Committee engaged in extensive negotiations while drafting both contracts.

   In 2006, Amylin’s board authorized officers to execute a senior secured debt facility “on terms and conditions as those officers determined to be necessary and appropriate.” Prior to approval of the credit agreement, Amylin and Bank of America, N.A. engaged in negotiations

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83 C.A. No. 4440-VCL, 2009 WL 1337150 (Del. Ch. May 12, 2009) at *4 n.7.
84 Id.
85 Id. at *2.
86 Id.
87 Id.
88 Id. at *3.
over the change in control provision. While Amylin sought to weaken the language in the covenant, Bank of America insisted and was ultimately successful in retaining the provision from the bank’s Model Syndicated Credit Agreement. A stronger covenant benefited Bank of America because it encouraged stability in the company’s leadership, and reduced the chances that Amylin would sell assets or engage in any other high-risk behavior to the detriment of Bank of America.

The change in control covenant operated on a rolling 24 month basis. Moreover, the covenant provided that a change in control occurred if, within those 24 months, a majority of the board consisted of individuals that were not the directors when the Credit Agreement was executed, or approved by those directors. Additionally, the agreement included provisions for proxy contests:

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 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.

89 Id.
90 Id.
91 Id. at *2 (citing Indenture § 1.01) (quoting opinion at *7).
92 Id. at *2 (citing Indenture § 1.01).
93 Id. at *3.
By including directors that were nominated or assumed office as a result of a threatened or actual proxy contest in the definition of what constitutes a change in control, Bank of America provided very strong protection for itself.\(^{94}\)

In contrast, during the Pricing Committee’s negotiations over the 2007 notes, Amylin and Bank of New York Mellon did not discuss the bond indenture’s change in control language.\(^{95}\) Unlike the Credit Agreement’s Change in Control provision, the Change in Control covenant in the bond indenture did cover proxy contests and defined Continuing Directors as directors who composed the board of directors the day the notes were issued.\(^{96}\) Additionally, no change in control occurred if the individual director was approved by a majority of the directors still on the board from the notes’ issue date.\(^{97}\) Prior to authorizing the notes, the Pricing Committee conferred with their counsel regarding whether the indenture contained any unusual provisions.\(^{98}\) Amylin’s counsel assured the Pricing Committee that the indenture’s terms were satisfactory.\(^{99}\)

2. **Plaintiff’s Claims**

In response to Amylin’s February 27, 2009 10-K disclosure, the plaintiffs argued that by adopting the debt agreements, Amylin’s directors breached their fiduciary duties of care and

\(^{94}\) *Id.* at *3. Amylin argued that the change in control language should be similar to the same provision in the bond’s indenture, which they believed to be weaker. The indenture did not contain language similar to clause (iii) of the credit agreement regarding proxy contests.

\(^{95}\) *Id.* at *2.

\(^{96}\) *Id.* at *2* (quoting Indenture § 11.01).

\(^{97}\) *Id.*

\(^{98}\) *Id.* at *2 n.4.

\(^{99}\) *Id.*
loyalty to the company.\textsuperscript{100} The plaintiffs sought declaratory judgments that the continuing director provisions were unenforceable and that the directors had breached their fiduciary duties.\textsuperscript{101}

Amylin’s board interpreted the Bank of New York Mellon indenture’s language as permitting the board to approve dissident nominees “at any time up to the election” and the board disclosed their opinion in Amylin’s Preliminary Proxy Statement.\textsuperscript{102} The board also noted that under the contract’s terms, if six or more dissident nominees were elected, the poison put would be triggered.\textsuperscript{103} After the defendants filed their answer, the plaintiff moved for summary judgment arguing that the Credit Agreement’s Continuing Director provision is unenforceable as

\begin{footnotesize}
\textsuperscript{100} Id. at *4.
\textsuperscript{101} Id. at *4. The plaintiff argued that the Amylin directors breached their fiduciary duties of care and loyalty in 3 ways: 1) including the Continuing Director Provisions in the debt instruments; 2) failing to approve the dissident nominees; and 3) misleading and coercive method of disclosing the risks presented by the Continuing Director Provision in the company’s 10-K. Moreover, the plaintiff later sought an injunction that required the directors to approve the dissident nominees. Additionally, Amylin, when filing their answer, included a cross-claim against Bank of New York Mellon Trust seeking a declaratory judgment that the board can approve any stockholder nominees at any time.
\textsuperscript{103} Id. at *4 (quoting Amylin’s March 30, 2009 Preliminary Proxy Statement Schedule 14A).
\end{footnotesize}
a matter of law and that the board’s interpretation of the Bank of New York Mellon indenture was the correct reading.\(^{104}\)

3. **Post Script**

Before the court resolved the question of the Credit Agreement’s proxy poison put, the parties settled.\(^{105}\) Bank of America waived any possible default triggered by the Continuing director covenant in exchange for increased payment by Amylin.\(^{106}\) Similarly, the pension fund and Amylin reached partial settlement, and the plaintiff amended its complaint to remove claims against Amylin and its board for breaches of fiduciary duty, duty of loyalty, and duty of good faith.\(^{107}\)

Following the partial settlements of claims, the court addressed Amylin’s claims regarding the interpretation of the 2007 Indenture’s change in control provision.\(^{108}\) Bank of New York Mellon Trust Company argued that the word “approve” in the change in control provision was synonymous with “endorse or recommend.”\(^{109}\) Conversely, Amylin argued that “approve” means “to give formal sanction to; to confirm authoritatively.”\(^{110}\) Amylin’s interpretation allows its board to approve dissident nominees for the purposes of not triggering the Indenture’s change

\(^{104}\) *Id.* at *5*.

\(^{105}\) *Id.* at *6*.

\(^{106}\) *Id.* at *6* (providing details of the parties’ settlement agreement).

\(^{107}\) *Id.* at *5*.

\(^{108}\) *Id.* at *6* (noting that both Eastbourne and Icahn filed definitive proxy statements stating that they reduced their slates to 3 and 2 nominees respectively).

\(^{109}\) C.A. No. 4440-VCL, 2009 WL 1337150 (Del. Ch. May 12, 2009) at *7*.

\(^{110}\) *Id.* at *7* (quoting BLACKS LAW DICTIONARY 111 (8th Ed. 2004)).
in control covenant.\footnote{C.A. No. 4440-VCL, 2009 WL 1337150 (Del. Ch. May 12, 2009) at *7.} Concurrently, the board may actively campaign to its shareholders to vote for incumbent directors.\footnote{Id.}

The court upheld the Amylin board’s interpretation of the indenture.\footnote{Id.} Moreover, the Court held that Bank of New York Mellon Trust’s interpretation would trigger the change in control covenant if the majority of the board changed before the bonds matured.\footnote{C.A. No. 4440-VCL, 2009 WL 1337150 (Del. Ch. May 12, 2009) at *7.} Vice Chancellor Lamb held that Bank of New York Mellon Trust’s reading could entrench Amylin’s board.\footnote{Id.}

Furthermore, the court suggested that boards might breach fiduciary duties by agreeing to contracts containing poison puts with strong restrictions on stockholder voting.\footnote{Id. at *8.} But, if there is evidence that the board had a good faith belief that the company received “extraordinarily valuable economic benefits” in exchange for entering into the contract, no breach may exist.\footnote{Id. at *8.} The court noted that if the board’s conduct was motivated by “extraordinarily valuable economic benefits.”
benefits” the burden would be lesser than under *Blasius Indus., Inc. v. Atlas Corp.* 118, in which the board intentionally acted to impede stockholder voting. 119

B. *Louisiana Sheriffs’ Pension & Relief Fund v. Crane*

In *Louisiana Sheriffs’ Pension & Relief Fund v. Crane*, 120 Exelon Corporation made an unsolicited offer to buy all NRG Energy’s outstanding common stock shares in a stock-for-stock exchange. 121 Three weeks later, NRG Energy’s board rejected the offer. 122 In response, Exelon posed the same offer to NRG’s stockholders. 123 The offer was a premium of 37% over NRG’s stock price the day before the offer was presented. 124 The majority of NRG’s stockholders accepted and tendered their shares to Exelon. 125 Moreover, Exelon provided notice that it planned to nominate nine directors to NRG’s board. 126 It also proposed an amendment to NRG’s by-laws that would enlarge NRG’s board from 12 to 19 directors. 127 Exelon avoided nominating


123 *Id.*

124 *Id.* at *1 n.1.

125 *Id.* at *1.

126 *Id.*

127 *Id.*
a majority of the board to prevent triggering approximately $4 billion debt acceleration through poison puts in NRG’s debt agreements.\textsuperscript{128}

The plaintiff, a stockholder in NRG Energy, Inc., moved for expedited proceedings for its claim against the company that its board breached its fiduciary duty by rejecting Exelon Corporation’s offer without first fully informing themselves of the transaction’s potential benefits for NRG’s shareholders.\textsuperscript{129} The plaintiff unsuccessfully argued that the poison puts would discourage stockholders from voting for Exelon’s directors.\textsuperscript{130} The court rejected the plaintiff’s argument for expedited proceedings.\textsuperscript{131} Less than a majority of board positions were contested during the election, so there was no immediate chance of triggering the covenant.\textsuperscript{132} Additionally, the court noted that, like in Amylin, the current board could approve nominees to the board and reduce the possibility of triggering the poison put.\textsuperscript{133} Thus, the court held that the plaintiff could move for expedited proceedings at a later point, such as before an election that might trigger the change in control covenant.\textsuperscript{134}

\textit{Crane} and \textit{Amylin} provide two important points on the judicial treatment of poison puts. First, classified boards, which discourage proxy contests by increasing costs by requiring an


\textsuperscript{129} Id. at *2–3; NO. CIV. A. 4193-VCL, 2008 WL 5359701 (Del. Ch. Apr. 14, 2009) (Compl. at ¶5).


\textsuperscript{131} Id.

\textsuperscript{132} Id.

\textsuperscript{133} Id.

\textsuperscript{134} Id.
additional election to gain control of a board, limiting poison puts. Just as a dissident shareholder cannot gain majority control of a classified board in one election, a standard poison put drafted like the provisions in *Crane* and *Amylin* requires two elections to be triggered when the board is classified. Second, standard poison puts offer narrow protection to bondholders. Regardless of board structure, when drafted like the provisions in *Crane* and *Amylin*, bondholder protection is reliant upon the continuing directors in an incumbent board. Because the board can always approve nominees to prevent the trigger, failure to do so may result board liability for breach of fiduciary duty of care.

**IV. STANDARD POISON PUTS HAVE BEEN DE-FANGED**

While the parties in *Amylin* settled most disputes without a judicial ruling, the court’s holding on the contested matters provided more flexibility to the company’s directors than bondholders wanted. The Delaware court interpreted away the legally troublesome provision, rather than directly holding that the standard poison put was unenforceable. Because a board of directors may now ‘approve’ opponents in a proxy contest simply to avoid triggering a covenant, it is almost certain that the provision will never be triggered. In fact, an incumbent board’s failure to approve opponents would likely result in triggering the put and a claim by shareholders against the board for breach of fiduciary duty of care.

This Part argues that standard poison puts as drafted in Part IV are likely reviewed under the deferential business judgment rule or a relaxed *Unocal* standard. Moreover, when reviewing the provisions, courts interpret these covenants strictly according to the provision’s text. As standard poison puts were drafted in *Amylin* and *Crane*, a strict literal reading provides the debtor corporation flexibility to avoid claims that a poison put provision has been triggered. This approach significantly reduces situations where a creditor may exercise the poison put. Because
a toothless standard poison put fails to provide incentives to shareholders to re-elect incumbent directors, it fails to provide security to management.

In light of the Amylin court’s interpretation of standard poison put provisions, challenges to the provision would likely fail because boards are protected by a more lenient standard of review and the authority provided by Delaware General Corporation Law §141. The court’s opinion in Amylin did not suggest an identifiable takeover threat existed when the corporation chose financing strategies. The Delaware Supreme Court evaluated an analogous situation in Moran v. Household Int’l. Inc., in which a company’s board authorized a preemptive defensive plan where no identifiable or imminent threat existed.

In Moran, the defendants adopted a Preferred Shareholder Rights Plan, a poison pill, to defend against possible takeovers. Under the plan, each common share receives one Right that is activated by two possible triggering events: the announcement of a tender offer for 30% of Household’s shares or when a single entity or group acquires 20% of Household’s shares. Once triggered, the rights, which are non-redeemable, allow for the purchase of 1/100 of a share of preferred stock. The plan also contained a “flip-over” provision. This provision

\[ \begin{align*}
135 & \text{ Del. Code Ann. tit. 8 §141 (2010).} \\
136 & \text{ C.A. No. 4440-VCL, 2009 WL 1337150 (Del. Ch. May 12, 2009).} \\
137 & \text{ 500 A.2d 1346 (Del. 1985).} \\
138 & \text{ Moran v. Household Int’l. Inc., 500 A.2d 1346, 1350 (1985).} \\
139 & \text{ Moran, 500 A.2d at 1349. Household’s board was particularly concerned with “bust-up” mergers, where the acquisition is financed by selling off pieces of the acquired company. Id.} \\
140 & \text{ Moran, 500 A.2d at 1348.} \\
141 & \text{ Id. at 1349.}
\end{align*} \]
provided that if a merger occurred, and a Right holder did not exercise his or her Right, then the
Right holder can exercise each Right to purchase $200 worth of the tender-offeror’s stock for
$100.\textsuperscript{143} The plaintiff, a Household director and also the chairman of a company that was the
single largest holder of Household’s stock, brought an action in the Chancery court arguing that
the Rights Plan was in invalid.\textsuperscript{144} The Chancery court held the plan was valid.\textsuperscript{145}

While the Delaware Supreme Court affirmed the Chancery’s court’s application of the
business judgment rule, it also applied a relaxed \textit{Unocal} analysis.\textsuperscript{146} The court distinguished
\textit{Moran} from \textit{Unocal}, explaining there was no specific threat when Household’s board adopted
the rights plan, and the plan was utilized to enhance shareholder value rather than solely to
maximize management entrenchment.\textsuperscript{147} Moreover, the court held that the poison pill did not
prevent Household’s stockholders’ ability to receive tender offers, and that the rights plan
imposed less change than other defensive measures.\textsuperscript{148} For example, if the rights plan is
triggered, then the company maintained its assets, protected financial flexibility from excessive

\textsuperscript{142} \textit{Id.}

\textsuperscript{143} \textit{Id.}

\textsuperscript{144} The plaintiff’s company briefly studied the possibility of engaging in a leveraged buyout of
Household Int’l, but quickly abandoned the idea. Household’s board was aware of this fact. \textit{Id.}

\textsuperscript{145} \textit{Moran}, 500 A.2d at 1350.

\textsuperscript{146} \textit{Id.} While the court affirmed the application of the business judgment rule, it applied a lenient
\textit{Unocal} analysis to the Rights Plan, and concluded that the action was permissible. \textit{Id.} at 1356–
57.

\textsuperscript{147} \textit{Id.}

\textsuperscript{148} \textit{Moran}, 500 A.2d at 1354.
cash outflows, and did not dilute earnings per share. While the court noted that the rights plan would dissuade some proxy contests, the plan did not affect stockholder voting since dissident stockholders owning 10% of stock were able to win corporate control through actual or threatened proxy battles.

Under Moran, the business judgment rule or a relaxed Unocal review would apply to standard poison puts that are drafted like the provisions in Part IV and interpreted according to Amylin, Petrohawk, and Crane. Additionally, both the ubiquity of these provisions and board use of teams of attorneys and financial experts to negotiate and execute debt instruments containing these provisions provide evidence that inclusion of such a provision was in good faith. The Delaware Supreme Court noted these factors when affirming the Chancery court’s

\[\text{149 Id.}\]


\[\text{151 Following the bondholders’ interpretation of standard poison puts would likely face scrutiny under Blasius because the provision directly effects the election of directors. See Quickturn Design Systems v. Shapiro, 721 A.2d 1281 (Del. 1998); Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998) (invalidating delayed rights plan, or no hand, and dead hand poison pills respectively due to the plan’s affects on shareholder voting and impeding the ability to allow newly elected directors to exercise full judgment and authority for corporation and shareholder’s best interests); see infra Part V.A for discussion.}\]

\[\text{152 See DEL. CODE ANN. tit. 8 §141(e) (2010); San Antonio Fire & Police Pension Fund v Amylin Pharm., Inc., C.A. No. 4440-VCL, 2009 WL 1337150, at *2 (Del. Ch. May 12, 2009) (discussing the use of professionals in the negotiation of debt instruments).}\]
Amylin decision.\textsuperscript{153} Like in Moran, these debt instruments are often negotiated when no identifiable takeover threat exists, and are utilized primarily for financing business activities.

Despite these factors, two issues may change this analysis: 1) how a re-drafted standard poison put operates; and 2) who initiates the provision’s inclusion in an agreement. In response to Amylin it is likely that standard poison puts will be re-drafted to explicitly express bondholder’s desired protection.\textsuperscript{154} Under Moran, standard poison puts as drafted in Part IV and similar defensive mechanisms are presumptively permissible\textsuperscript{155} because they do not thwart changes to a board of directors through shareholder votes.\textsuperscript{156} However, to provide effective lender and corporate management protection, a re-drafted standard poison put would necessarily

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\footnotesize

\textsuperscript{154} The entrenchment aspect of poison puts is not found in every covenant in the current ‘booming’ corporate bond market. See Adobe Systems, Inc. Supplement to Prospectus dated January 15, 2010, S-15–17, available at http://www.sec.gov/Archives/edgar/data/796343/000104746910000331/a2196146z424b2.htm#da49502_risk_factors. This indenture utilizes a duel trigger poison put without a ‘continuing director’, instead relying on a reset provision and a ‘change of control’ which is not dependant on impeding shareholder democracy.

\textsuperscript{155} But see Moran v. Household Int’l. Inc. 500 A.2d 1346, 1350 (1985). A lenient Unocal analysis may still be appropriate before the provision is presumptively fair.

\textsuperscript{156} The Moran court emphasized that the Rights Plan did not impede the shareholders’ ability to receive tender offers or engage in proxy contests. See Moran v. Household Int’l. Inc., 500 A.2d 1346, 1354–55 (1985).
\end{flushleft}
depart from its current form with respect to its effect on changes to board control. Furthermore, the question of which party initiated the provision’s inclusion in an agreement is relevant when a more restrictive standard poison put is used. If lenders insist on the provision, the poison put may be enforceable; yet, a board of directors may be liable to shareholders for agreeing to the provision. Conversely, the provision appears suspect if management insists on including the provision. Board insistence suggests entrenchment purposes rather than lender protection.

Thus, for standard poison puts such as the provisions in Part IV, the business judgment rule or a relaxed Unocal review is likely the standard of review. Delaware General Corporation Law §141(a) provides that a company’s board of directors manages the company’s business affairs. Securing capital is necessary for a company to continue functioning. Provided that the board of directors demonstrates the good faith efforts used to obtain financing, the deference of the business judgment rule or a relaxed Unocal will likely continue. However, standard poison puts offer little protection to lenders or corporate management.

A. When the Dispute is Reduced to Contract Interpretation, Courts Review these Provisions to Provide Flexibility to the Debtor Corporation

Bond indentures containing standard poison puts provide little protection to creditors. In two instances where poison put provisions were enforceable, courts, relying on basic contract

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158 See supra Part II.A.
interpretation, held that defaults were not triggered.\textsuperscript{160} Part 1 describes this aspect of \textit{Amylin}.

Part 2 describes \textit{Law Debenture Trust Co. of New York v. Petrohawk Energy Corp}. In both these cases the court focused on the practical needs of each party’s interpretation of its indenture.

1. \textit{San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.}

As described above in Part III.A, in \textit{Amylin}, two separate dissident shareholders ran uncoordinated and independent proxy campaigns against the incumbent board.\textsuperscript{161} The board of directors argued that, for the purposes of the indenture, it could ‘approve’ dissident slates, and thus avoid triggering the poison put.\textsuperscript{162}

Bondholders argued that the text of the disputed bond indenture\textsuperscript{163} prevented Amylin’s directors from formally ‘approving’ a dissident slate of candidates for election to the board of

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\textsuperscript{162} \textit{See supra} part III.A.
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\textsuperscript{163} The indenture defined “Continuing Director” in a manner to avoid the board ‘approving’ dissident nominees:

(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.”

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directors without triggering the poison put. Relying on basic principles of contract
interpretation, the court disagreed. The court embraced the board’s interpretation of the text
over the bondholders’ view, even though the bondholders drafted the provision. While this
interpretation avoids entrenchment and enforceability concerns, it significantly reduces the
scope of the creditor protection provision.


*Law Debenture Trust Co. of New York v. Petrohawk Energy Corp.* followed after the
merger of KCS Inc. with Petrohawk Energy. Prior to the merger, KCS had outstanding bonds
with an indenture providing that if there was a change in control, the bondholders could redeem
their bonds for 101% of the principal plus any accrued and unpaid interest. The parties
structured the merger to avoid triggering the change in control provision, which included
satisfying the definition of a “Continuing Director.” The language used to define a
“Continuing Director” was very similar to the language used later by Amylin:

any member of the Board of Directors of the Company who (1) was a member of
such Board of Directors on the [date the Notes were issued]; or (2) was nominated
for election or elected to such Board of Directors with the approval of a majority

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164 Id. at *7.
165 Id.
166 Id.
168 Id. at *1.
169 Id. at *2.
170 Id. at *3.
of the Continuing Directors who were members of such Board at the time of such nomination or election.\textsuperscript{171}

But unlike most other indentures, “Company” was defined only as KCS energy and did not include successor entities.\textsuperscript{172} The surviving company in this merger was Petrohawk.\textsuperscript{173}

Following the merger, KCS’s bondholders’ Trustee, acting on behalf of the bondholders, brought suit arguing that the indenture’s poison put was triggered by a default of two of five terms in the bond indenture:\textsuperscript{174} 1) the change in control provision was violated; and 2) the indenture stipulated that KCS stockholders own at least 50.06% of any post-merger entity.\textsuperscript{175}

\textsuperscript{171} Id. at *2.

\textsuperscript{172} Id. at *3.

Bondholders used this fact in to argue that that Petrohawk is not the “Company” under the indenture. The court rejects this argument noting that the bondholders are suing Petrohawk to redeem the notes. \textit{Id.} at 8.


\textsuperscript{174} Id.

\textsuperscript{175} Id. at *1. Before the Merger the entities possessed stock in amounts that would leave KCS with 49.88% of the post-merger voting, and in breach of the indenture. \textit{Id.} To avoid default, Petrohawk redeemed 509,271 shares of its preferred stock so these shares would not be counted in determining stockholder voting shares.\textsuperscript{175} \textit{Id.} Petrohawk completed its preferred share redemption two days before the Merger was consummated, and KCS stockholders had 50.06% of voting shares. \textit{Id.}

The plaintiffs argued that the Petrohawk redemption was defective. \textit{Id.} According to the plaintiff, this redemption did not comply with either the applicable Certificate of Designation or
The plaintiffs argued that the continuing director provision was breached and triggered the change in control provision. The plaintiff’s argument focused on the procedure by which the post-merger board was composed and seated. Because the post-merger directors were not relevant Securities and Exchange Commission rules regarding tender offers. The court rejected this argument and held that even if Petrohawk’s redemption procedure was flawed, the voting shares are included in determining voting shares of each entity. Furthermore, the court held that the bondholders had no standing to challenge how the shares were redeemed, because pre-merger Petrohawk was not a party to the relevant indenture.

176 No. Civ.A. 2422-VCS, 2007 WL 2248150 (Del. Ch. Aug. 1, 2007), at *1. 177 Id. at *5. The plaintiffs also argued that “Company” only referred to KCS and not successor entities. KCS’s pre-merger board consisted of seven directors, Petrohawk’s pre-merger board consisted of nine directors, and no directors served on both companies’ board. The merger agreement provided that the post-merger Petrohawk board would have a nine-member board: five directors nominated by Petrohawk and four directors nominated by KCS. Furthermore, a joint proxy statement filed by the companies listing the nine nominees stated “when the merger is consummated, it is anticipated that four members of Petrohawk’s board of directors will resign and the remaining Petrohawk board members will appoint [the four KCS Designees] to the Petrohawk board.”

Five days before the merger, KCS’s board adopted a resolution that “confirm[ed] and approv[ed] the nomination and election of each of the [Post-Merger Directors] as members of the Board of Directors of the surviving corporation.” Unlike the merger agreement and proxy statement, the Certificate of Merger listed the post-merger directors, but did not discuss
“nominated for election or elected,” plaintiffs argued that the post-merger directors cannot be deemed “Continuing Directors” and that the KCS board approval did not satisfy the indenture’s requirement.\(^\text{178}\)

The court rejected both arguments by the bondholders as “technical defects”\(^\text{179}\) and held that no change of control occurred for the indenture’s purpose. Furthermore, the court held the bondholders had no standing to challenge either the redemption of the preferred shares or the methods by which the post-merger board was seated.\(^\text{180}\)

\[\text{additional steps required to seat the post-merger directors, stating “[t]he directors of the surviving corporation shall be [the Post-Merger Directors] until their successors are duly elected or appointed and qualified or until their earlier death, resignation, or removal in accordance with the Certificate of Incorporation and Bylaws of [Petrohawk].”}\] Id. at *4. No other steps were taken and after the merger was executed, departing directors no longer acted in their director capacity, while the post-merger directors assumed their positions. Id. at *5. Upon the merger’s completion, the pre-merger directors stopped acting and the post-merger directors assumed office. Id. at *5. Without a formal board meeting, the post-merger board, through unanimous written consent, “identif[ed] each of th[e] nine Petrohawk board, placing them in various classes of the classified board, and designating the committees on which they would serve among other routine Merger-related matters.” Id. at *5. The first post-merger board meeting occurred approximately one month later and the post-merger board conducted business in a “routine manner.” Id. at *5.

\(^\text{178}\) Id. at *10.


\(^\text{180}\) Id. at *11.
In both Amylin and Petrohawk, bondholders alleging default lost challenges in the Delaware courts. Both cases involved standard poison puts, and the courts did not directly opine on each provision’s enforceability. The courts’ respective interpretations resulted in a covenant that offered reduced protection to bondholders. After these cases, unless board and lender interests are aligned, it seems unlikely this kind of poison put provides either entrenchment for boards of directors or protection to bondholders. In contrast, the court’s commercially reasonable interpretation provides maximum flexibility to the debtor corporation since the literal words in the covenant’s text confines them. While this section described how the literal words of standard poison puts offer a limited scope of lender protection, the next section argues that the literal words of proxy poison puts may present the opposite problem: in some instances these covenants may constrain shareholders too much, and thus may not be enforceable. Moreover, attempts to re-draft standard poison puts are likely to face a similar problem. Part V proposes a method for determining whether such poison puts are enforceable.

V. REVIEW AND ENFORCEMENT OF PROXY POISON PUTS

In Amylin, the court suggested that covenants drafted to achieve the bondholders’ interpretation are subject to a standard somewhere between the compelling justification standard and the business judgment rule. However, the court declined to provide guidelines. Part V predicts that proxy poison puts are likely to face review under a more stringent standard because of their resemblance to dead hand poison pills. Finally, this part proposes a methodology for reviewing proxy poison puts.
Proxy poison put provisions like the credit agreement in *Amylin* expressly prohibited the seating of directors through actual or threatened proxy fights. In later legal challenges, a provision with such an impact on shareholder voting rights now likely requires review at a level less than the *Blasius* compelling justification standard, but still more stringent than the business judgment rule. Delaware courts have noted the difficulty of determining where *Unocal* ends and *Blasius* begins. To avoid this problem, Vice Chancellor Strine suggested in the dicta of Chesapeake Corp. v. Strine that if courts apply *Unocal* with particular attention to electoral manipulations “or for subjectively well-intentioned board action that has preclusive or coercive effects,” then the need for a compelling justification is reduced. Furthermore, the Delaware Supreme court articulated how *Blasius* review fits within *Unocal* review:

> 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 proportionality . . . .To invoke the *Blasius* compelling justification standard of review *within Unocal* standard of review, the defensive actions of the board only need to be taken for the primary purpose of interfering

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Proxy battles between incumbent directors and dissident nominees triggered the credit agreement’s provision:

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 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.

182 See Mercier v. Inter-Tel Inc., 929 A.2d 786, 810 n.72 (Del. Ch. 2007).

183 771 A.2d 293 (2000).

184 *Shore*, 771 A.2d at 323.
with or impeding the effectiveness of the stockholder vote in a contested election for directors.\textsuperscript{185}

Vice Chancellor Lamb suggested in \textit{Amylin} that creditors have constructive notice that strong poison puts containing exceedingly onerous covenants might be unenforceable.\textsuperscript{186} Yet because the controversy about the proxy poison put settled, Vice Chancellor Lamb declined to offer a framework to evaluate poison puts that are challenged due to the provision’s affect on shareholder-voting rights.

This section argues that to be enforceable, a proxy poison put must 1) avoid preclusive effects as defined by the \textit{Unocal} proportionality test; and 2) offer lenders unique investment protection that cannot be achieved by bundling other covenants. This test seeks to prevent the stifling of shareholder-voting rights and can also be applied to a re-drafted standard poison put that utilizes a continuing director clause or provision with similar effects.\textsuperscript{187} Part A argues that proxy poison puts must not impede shareholder voting rights to elect the board of directors and compares these provisions to variations of the poison pill. Part B argues that if a lender can protect investments through utilizing a combination of other covenants, without impacting

\textsuperscript{185} MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003).


\textsuperscript{187} I am heavily indebted to Professor William J. Carney for suggesting this line of inquiry and proposed framework. \textit{See also} Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1386–90 (Del. 1995) (distinguishing categories of takeover defenses that expressly effect director elections with other takeover defenses)
shareholder voting, than a poison put maybe an unnecessary restriction whose absence only harms incumbent directors.

A. **Preclusive Effects**

Under the second prong of a *Unocal* analysis, the court determines if a board of directors’ action was reasonable based on the existing threat. According to the court, an action is reasonable if it is not “draconian,” meaning preclusive or coercive.

Proportionality review began under *Unocal*, and has since been applied to assess whether takeover defenses are reasonable. While the proportionality test has often been applied to poison pill in its many variations, this measure may provide some analogous guidance in reviewing proxy poison puts. Under the proportionality test, “‘directors may not [...] act[...]* solely or primarily *out of a desire to perpetuate themselves in office’ (preclusion of the stockholders’ corporate franchise right to vote). . . .” Proxy poison puts may produce preclusive or draconian affects on shareholder voting rights. As an analogue to the proxy poison put, this Part

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188 *See* Stroud v. Grace 606 A.2d 75, 82 (Del. 1992) (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985)).


190 *See supra* Part II.B; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956–57.


will discuss how Delaware courts have addressed the dead hand poison pill. Dead hand poison pills are analogous because both mechanisms can be used to thwart shareholder-voting relating to the election of directors, entrench boards, and discourage takeovers.

In Carmody v. Toll Brothers, Inc.\(^{193}\) the defendant Toll Brothers, a homebuilding company, adopted a dead hand poison pill\(^{194}\) in response to widespread consolidation in the company’s industry, but with no particular threat identified.\(^{195}\) The plaintiff, a shareholder in the company, brought suit arguing that the dead hand poison pill was invalid as *ultra vires* and a breach of the directors’ fiduciary duty of loyalty.\(^{196}\)

The court, denying the company’s motion to dismiss,\(^{197}\) held that the dead hand provision violates Delaware General Corporation Law and that the plaintiff had sufficient claims.\(^{198}\) The court held that the dead hand provision violates the shareholder rights to elect directors with more voting power, and that directors cannot unilaterally usurp this power.\(^{199}\) Additionally, because the plaintiff’s complaint argued that the dead hand feature of the rights plan limits the

\(^{193}\) 723 A.2d 1180 (Del. Ch. 1998)

\(^{194}\) Under the plan, each outstanding share of common stock as of July 11, 1997, received one preferred stock purchase right, which allowed the holder to buy one thousandth of a share of preferred stock for $100. *Id.* at 1183. Under the plan, the rights are exercisable for 10 years after the plan is triggered, unless they are redeemed by Toll Brothers. *Id.*


\(^{196}\) *Carmody*, 723 A.2d at 1185.

\(^{197}\) *Id.* at 1190.

\(^{198}\) *Id.*

\(^{199}\) *Id.*
power of future boards of directors, the plaintiff’s claim was sufficient.\textsuperscript{200} The court held that if the shareholders replaced the board, it would not be possible for the board to redeem the pill.\textsuperscript{201} This would impede the ability of future boards to manage the company, including possible mergers that may be in the shareholders’ and corporation’s best interest.\textsuperscript{202}

When addressing the plaintiff’s claims that the board breached its fiduciary duty of loyalty, the court applied both \textit{Blasius} and \textit{Unocal}, and held that the board’s approval of the dead hand provision would not receive the presumption of the business judgment rule.\textsuperscript{203} Under \textit{Blasius}, the court held that the dead hand provision interfered with shareholder voting without compelling justification.\textsuperscript{204} Similarly, under \textit{Unocal} the court held that the provision was disproportionately preclusive.\textsuperscript{205}

The \textit{Carmody} court contrasted the dead hand pill with the plan evaluated in \textit{Moran},\textsuperscript{206} which had “minimal” affect on proxy contests and allowed shareholders, if dissatisfied with the board’s refusal to redeem the plan, to remove and replace the board.\textsuperscript{207} The court held that the plaintiff’s claim was sufficient under \textit{Blasius} because shareholders, regardless of their thoughts about potential purchase offers or board policies, are forced to vote for Continuing Directors due

\textsuperscript{200} \textit{Id.}

\textsuperscript{201} \textit{Id.}

\textsuperscript{202} \textit{Id.}

\textsuperscript{203} \textit{Carmody}, 723 A.2d at 1192–93.

\textsuperscript{204} \textit{Id.}

\textsuperscript{205} \textit{Id.}

\textsuperscript{206} See \textit{supra} Part IV.

\textsuperscript{207} \textit{Carmody v. Toll Bros.}, 723 A.2d 1180, 1193 (Del. Ch. 1998).
to their power to redeem the rights plan. Moreover, applying similar logic as the court’s *Blasius* analysis, the court held that the plaintiff’s *Unocal/Unitrin* claim was valid. Because the dead hand provision “ma[de] a bidder’s ability to wage a successful proxy contest and gain control either ‘mathematically impossible’ or ‘unrealistically unattainable,’” the court held that the plan was preclusive.

Similarly, *Quickturn Design Systems, Inc. v. Shapiro*, the plaintiff, a hardware and software manufacturer, targeted the defendant, a competitor, for a takeover. In response to the threat, the defendant adopted two defenses: 1) it amended its by-laws to require three months before holding a special meeting; and 2) the board changed its dead hand poison pill to a no hand poison pill, or delayed rights plan. Under the delayed rights plan, a newly elected board could not redeem the poison pill to conduct a transaction with an interested party until six months after the new board’s served in office. The plaintiff brought suit and seeking declaratory judgment that the defendant’s takeover defenses were invalid. The Chancery court held that the by-law

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208 *Carmody*, 723 A.2d at 1193.
209 *Id.* at 1194.
211 721 A.2d 1281 (Del. 1998).
212 721 A.2d at 1283.
213 *Id.* at 1287.
214 *Id.*
215 *Id.* at 1287–88.
amendment did not violate any fiduciary duties articulated in the *Unocal* case line, but held that the delayed rights plan could not pass the proportionality test.\textsuperscript{216}

The Delaware Supreme Court affirmed Chancery court’s decision, holding that the delayed rights plan violated §141(a) because newly elected directors were restricted in authority for the first sixth months of their service.\textsuperscript{217} The Court held the delayed rights plan also violated the fiduciary duties of the directors and 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.’”\textsuperscript{218}

Like the dead hand poison pill and delayed rights plan adopted in *Carmody* and *Quickturn*, proxy poison puts may prevent shareholders from conducting meaningful voting and serve to entrench directors.\textsuperscript{219} The court held in *Carmody* that a Toll Brothers shareholder that was dissatisfied with corporate leadership could not vote for an alternative board under the dead

\textsuperscript{216} *Id.* at 1289–90.

\textsuperscript{217} *Id.* at 1292.

\textsuperscript{218} 721 A.2d at 1292 (quoting Paramount Commc’n, Inc. v. QVC Network, Inc., 637 A.2d 34, 51 (Del. 1994)).

\textsuperscript{219} *Carmody* v. Toll Bros, 723 A.2d 1180, 1193 (Del. Ch. 1998); *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (Impeding newly elected directors to on a takeover offer for 6 months may encourage shareholders to vote for incumbent boards, whose actions are not restricted). However the effects of proxy poison puts may not make takeovers or proxy contests as futile as a dead hand poison pill; futility may ultimately depend on factors such as the company’s liquidity and access to credit. Furthermore, applying these covenants in boards with classified structures may avoid enforceability problems.
hand poison pill and expect the remaining continuing directors to agree to redeem the pill. \textsuperscript{220} Similarly, reviewing proxy poison puts for a preclusive effect on shareholder voting distinguishes provisions that impede shareholder voting.

Unlike the poison pills in \textit{Carmody} and \textit{Shapiro}, a board of directors might be able to justify entering into a financing agreement that included a proxy poison put. Because the proxy poison put is tangential to the purpose of the actual board action--obtaining the necessary capital to manage the company’s operations--a court may find this provision acceptable. However, such a decision would also focus on factors including which party insisted on the provision, how long the provision constrains the shareholder franchise, whether the board is classified, and whether the board made any good faith attempts to remove or lessen the burdens of the proxy poison put during negotiations. Because the proxy poison put accompanies necessary financing agreements, rather than occurring in defensive shareholder rights plans, the proxy poison put is better assessed under \textit{Unocal}'s proportionality review. In the next section I argue that if a proxy poison put is held to be preclusive under \textit{Unocal}, than it must serve a protective function that cannot be achieved through the use of other contractual mechanisms.

\textbf{B. Bundling}

If a proxy poison put is held to be preclusive in accordance with \textit{Unocal}, then the court should determine whether the goals of the provision are achievable by other means. This section argues that if the protective goals of a preclusive proxy poison put can be achieved through the use of other covenants, than the provision should not be enforced. In most instances, lenders are adequately protected through other contractual mechanisms. In contrast, incumbent boards of

\textsuperscript{220} \textit{Carmody v. Toll Bros}, 723 A.2d 1180, 1191 (Del. Ch. 1998).
directors have significantly more at stake with the proxy poison put. Thus, under this test, the proxy poison put’s entrenchment benefits would be significantly narrowed, if not eliminated.

Because the preclusive effects of proxy poison puts depend on particular facts, looking at other covenants utilized in the debt instruments may provide further guidance whether the proxy poison put is required to protect lenders. In evaluating takeover defenses, courts have not expressed concern about a board adopting a myriad of protective measures. Similarly, bond indentures and other lending agreements often contain sets of bundled covenants to ensure the borrower acts financially prudently.

A dual trigger option may also retain some useful effects of the proxy poison put, but it also aids in entrenching management. One possibility would be to link a proxy poison put with a reset provision. Under this provision, bondholders would be granted the right to put the bonds back to the corporation only after a bond is both downgraded and a change in control occurs. Linking the bond’s rating and the control minimizes the possibility that the covenant


222 See Cheng & King, supra note 38 and accompanying text; Tung, supra note 9 at 120–21 (discussing the unique position lenders occupy and the influence lenders have on dictating corporate policy, which, in many cases, is more effective and potent than shareholder power).

223 Kahan & Klausner, supra note 3, at 959–60 (suggesting a pure ratings decline covenant would better protect lender interests).

224 Adobe Systems, Inc. used this approach when it recently issued two series of bonds. See prospectus at S-15–17, available at
will be held unenforceable in a legal challenge. However, Marcel Kahan and Michael Klausner observed that the dual trigger provision enables managerial entrenchment and noted its increased agency costs.\textsuperscript{225}

Lenders already utilize a combination of covenants including anti-dilution provisions and negative pledge covenants to protect against leveraged buy-outs.\textsuperscript{226} Because lenders have a bolstered framework of covenants constraining a debtor corporation’s actions, shareholders have a strong argument that proxy poison puts do not add significant protection. However, the situation is slightly different in the case of revolving loans; these covenants provide means through which lenders can influence corporate decisions.\textsuperscript{227}

The bundling prong of the proxy poison put analysis is useful because it balances the parties’ freedom to contract with a corporation’s shareholders’ voting rights. If the goals of some proxy poison puts can be achieved through other means, then they provide no justification

\textsuperscript{225} Kahan & Klausner, \textit{supra} note 3, at 966, 980.

\textsuperscript{226} \textit{See} Tung, \textit{supra} note 9, at 136–39, 153–59 (discussing covenants used to monitor corporate borrowers and discussing empirical data showing lender influence on corporate investment policy decisions). Tung argues that lenders might be in a better position to review a corporation’s performance than directors due informational, incentive, expertise, and enforcement advantages. \textit{Id.} at 132–33

\textsuperscript{227} \textit{See generally} Tung, \textit{supra} note 9 (describing how, through credit agreements and borrowing, lenders often exude significant influence on corporate policy)
for impeding shareholder democracy. However, there may be circumstances when other covenants cannot achieve the same results. In such instances, these provisions should be enforced to provide lender protection. Thus, this test reduces the utility of the proxy poison put as an entrenchment device for incumbent boards.  

Because some circumstances may exist where poison puts will provide unique protection, a *per se* ban on the provision is not advocated.

**CONCLUSION**

This Comment discussed the development of the poison put as a contractual provision to protect creditors from risks that grew out of the leveraged buy out boom of the 1980’s.  

In addition to protecting lender’s investments, in some instances boards of directors also utilized poison puts to entrench their positions in a company. These provisions continued to grow in popularity, and any possible problems associated with the covenants were ignored during the most recent period of economic growth. Cheap and readily available credit allowed for the refinancing if the provision was triggered.  

Now that financing is no longer easily obtained, provisions have been challenged. 

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228 This test only reduces the proxy poison put and a possible re-drafted standard poison put as an entrenchment device. As Jennifer Arlen and Eric Talley noted, incumbent management can still utilize other change in control provisions in a myriad of other contracts for entrench purposes. *See* Jennifer Arlen & Eric Talley, *supra* note 41.

229 *See supra* notes 15–16.

230 *See* Kahan & Klausner, *supra* note 29.

231 *See* Cheng & King, *supra* note 67.

232 *See id.*

233 *See id.*
Part IV argued that standard poison puts are likely reviewed under the deferential business judgment rule or a lenient Unocal review. Based on Amylin, Crane, and Petrohawk, this Comment argued that when courts review standard poison puts, they read the covenants strictly according to the provision’s text, which narrows the scope of the standard poison put and limits the provision’s protective function. Under Amylin, incumbent boards may ‘approve’ opponents in a proxy contest to avoid triggering a covenant, while simultaneously seeking to retain their position managing the company’s affairs. Thus, even if a change in control occurs, the new board is ‘approved’ by the old board, and no default occurs. This interpretation provides little benefit to either lenders seeking protection or management seeking entrenchment. However, re-drafting the standard poison put to retain protections for both bondholders and corporate management will likely create similar problems to those faced by the proxy poison put.

In contrast to the reduced scope of the standard poison put in the cases discussed in this Comment, the proxy poison put may place onerous constraints on shareholders. This Comment argued that courts should review these covenants using a two-part test to determine whether these provisions are enforceable. First, through the application of the second prong of a Unocal analysis, the court should determine whether the covenant is preclusive. If this question is answered in the affirmative, the burden should lie with the board to rationalize why goals of the covenant could be achieved through other contractual means such as bundling other covenants.

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If lenders can protect their investment without thwarting shareholder democracy, courts should encourage this method of contracting. This test will not constrict lender protections because lenders already use a variety of covenants in these agreements to reduce risky behavior by debtor corporations. This approach also reduces entrenchment under proxy poison puts because the first prong specifically aims to protect shareholders voting rights.

This test is beneficial because it provides predictability for parties entering financing agreements. If a poison put’s enforceability is in doubt, it may appear less frequently. However, only the provision’s entrenchment clause is questionable; if bondholders value the poison put, a corporate board will likely remove this language to obtain lower interest rates on debt. Additionally, recent calls by the Securities & Exchange Commission for increased shareholder access to proxy ballots may also precipitate the poison put’s decline as entrenchment device. While long-term consequences of the poison put’s likely demise as an entrenchment device are not clear, shareholders appear to be the victors in this battle.

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237 See Tung, supra note 226.
