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# CHANGE-IN-CONTROL CLAUSES: IS DELAWARE LAW RESURRECTING THE DEAD?

## INTRODUCTION

Change-in-control clauses are one of the most popular and innovative defensive tactics to corporate takeovers.<sup>1</sup> Commonly in the form of shareholder rights plans and often disparagingly referred to as “poison pills,”<sup>2</sup> no other defense strategy has mutated more rapidly, with every variation and innovation creating new litigation.<sup>3</sup> Target companies adopt change-in-control clauses to deter corporate raiders’ abusive tactics by making takeover attempts extremely expensive.<sup>4</sup> To encourage negotiation with raiders, the clauses are redeemable by targets’ boards for a nominal price prior to the acquisition.<sup>5</sup> Originally upheld by the Delaware Supreme Court in *Moran v. Household International, Inc.*,<sup>6</sup> change-in-control clauses defend against corporate raiders’ naked tender offers.<sup>7</sup> In response, raiders abandoned naked tender offers and began employing tender offers coupled with proxy solicitations.<sup>8</sup> By waging these proxy contests, raiders hope to unseat incumbent directors and elect a new board capable of redeeming targets’ rights plans.

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<sup>1</sup> RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 740 (2d ed. 1995).

<sup>2</sup> Wachtell, Lipton, Rosen & Katz, the firm credited with originally devising the shareholder rights plan, objects to this common characterization: “[d]espite . . . substantial evidence of the beneficial effects of rights plans, they will still be called ‘poison pills.’ This is a most unfortunate misnomer. A rights plan is neither a pill nor poisonous.” *Id.* at 741 n.7 (quoting Wachtell, Lipton, Rosen & Katz, *The Shareholder Rights Plan*, Mar. 1994).

<sup>3</sup> *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 27 (Del. Ch. 1998), *aff’d on other grounds*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

<sup>4</sup> GILSON & BLACK, *supra* note 1, at 741.

<sup>5</sup> *Id.*

<sup>6</sup> 500 A.2d 1346 (Del. 1985).

<sup>7</sup> Shawn C. Lese, Note, *Preventing Control from the Grave: A Proposal for Judicial Treatment of Dead Hand Provisions in Poison Pills*, 96 COLUM. L. REV. 2175, 2175 (1996).

<sup>8</sup> *Id.*

Faced with raiders' aggressive new tactics, targets began adding features to strengthen their change-in-control clauses.<sup>9</sup> Specifically, targets first included "dead hand," or continuing director features, which allow only the directors in office at the time the board adopted the provision (or their designated successors) to redeem a rights plan.<sup>10</sup> These features evolved into the "slow hand" variety, which preclude all directors of a newly elected board from redeeming a rights plan for a limited time.<sup>11</sup> Dead hand and slow hand features provided effective protection against proxy contests until Delaware courts invalidated both features.<sup>12</sup>

Against this background, this Comment examines continuing director provisions in light of the Delaware Court of Chancery's recent decision in *California Public Employees' Retirement System v. Coulter* ("CalPERS").<sup>13</sup> This Comment concludes that potent defenses may still be available against raiders, but CalPERS did not create one, because all that the provision at issue did was define an event which triggered additional payments to corporate executives. Part I lays a foundation by explaining Delaware's relevant statutes. Part II discusses two landmark Delaware decisions. Part III analyzes the Delaware Court of Chancery's decision in CalPERS. Part IV examines the change-in-control contractual approach.

## I. DELAWARE STATUTES

A company's board of directors can adopt change-in-control clauses without shareholder approval.<sup>14</sup> Typically, boards enact shareholder rights plans as precautionary defenses<sup>15</sup> but can quickly enact a plan when faced with a specific takeover threat.<sup>16</sup> The board retains power to remove the change-in-control clause by redeeming

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<sup>9</sup> Xueqing Linda Ji, Comment, *A New Look at Dead Hand Provisions in Poison Pills: Are They Per Se Invalid After Toll Brothers and Quickturn?*, 44 ST. LOUIS U. L.J. 223, 224-25 (2000).

<sup>10</sup> *Mentor Graphics Corp. v. Quickturn Design Sys., Inc.*, 728 A.2d 25, 28 (Del. Ch. 1998), *aff'd on other grounds*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

<sup>11</sup> *Id.*

<sup>12</sup> See *Mentor Graphics Corp.*, 728 A.2d at 52 (holding slow hand features invalid); *Carmody v. Toll Bros., Inc.*, 723 A.2d 1180, 1195 (Del. Ch. 1998) (holding dead hand features invalid).

<sup>13</sup> No. 19191, 2005 Del. Ch. LEXIS 54 (Del. Ch. Apr. 21, 2005) [hereinafter *CalPERS*].

<sup>14</sup> See Neil C. Rifkind, *Should Uninformed Shareholders Be a Threat Justifying Defensive Action by Target Directors in Delaware?: "Just Say No" After Moore v. Wallace*, 78 B.U. L. REV. 105, 111 (1998) (providing that the "great power of poison pills derives from the board's ability to adopt them without shareholder approval").

<sup>15</sup> *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1350 (Del. 1985).

<sup>16</sup> *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180 (Del. 1985).

the rights at a nominal price.<sup>17</sup> This power improves the board's bargaining power in merger negotiations; the board can determine whether to redeem the rights, or to retain them, threatening the raider with dilution of the target's stock.<sup>18</sup>

Change-in-control clauses can provide shareholders with several benefits in the event of a tender offer: they protect shareholders from coercive two-tiered tender offers, they give the board adequate time to consider alternatives, and they ensure that shareholders receive full value because the board can wield the pill to demand a higher price.<sup>19</sup> Critics, however, argue that such clauses entrench incumbent directors and remove control from shareholders.<sup>20</sup>

Delaware section 141 governs a company's board of directors. An understanding of this section is critical to the assessment of change-in-control clauses. Section 141(a) establishes the board's role in corporate governance. Section 141(a) provides:

The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.<sup>21</sup>

In *Moran v. Householder International, Inc.*, the Delaware Supreme Court held that section 141(a) conferred authority to adopt change-in-control clauses.<sup>22</sup> Additionally, section 141(d) allows differentiated voting powers among directors, but the company's charter must express such distinctions. Section 141(d) provides:

The directors of any corporation organized under this chapter may, by the certificate of incorporation or by an initial bylaw,

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<sup>17</sup> GILSON & BLACK, *supra* note 1, at 744 (providing a same shareholder rights plan and noting that the "rights are redeemable by the company's board of directors at a price of \$.01 per right at any time prior to the acquisition by a person or group of beneficial ownership" over the requisite threshold).

<sup>18</sup> Brian J. McTear, Comment, *Has the Evolution of the Poison Pill Come to an End?*—*Carmody v. Toll Brothers, Inc.; Mentor Graphics, Inc. v. Quickturn Design Systems, Inc.*, 24 DEL. J. CORP. L. 881, 885-86 (1999).

<sup>19</sup> *Id.* at 886.

<sup>20</sup> *Id.* at 886-87.

<sup>21</sup> DEL. CODE ANN. tit. 8, § 141(a) (2005).

<sup>22</sup> *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1353 (Del. 1985) (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953 (1985)).

or by a bylaw adopted by a vote of the stockholders, be divided into 1, 2 or 3 classes . . . [A]nd [the directors] have such voting powers as shall be stated in the certificate of incorporation.<sup>23</sup>

## II. DELAWARE CASE LAW

### *A. Dead Hand Pills: Carmody v. Toll Brothers, Inc.*

The Delaware Court of Chancery first addressed dead hand features in *Carmody v. Toll Brothers, Inc.*<sup>24</sup> Toll Brothers, a Delaware corporation, adopted a Shareholders' Rights Plan ("Rights Plan"), which contained a dead hand feature. It prevented "any directors of Toll Brothers, except those who were in office as of the date of the Rights Plan's adoption (June 12, 1997) or their designated successors, from redeeming the Rights until they expire on June 12, 2007."<sup>25</sup> The Rights Plan defined a "Continuing Director" as:

(i) any member of the Board of Directors of the Company, while such person is a member of the Board, who is not an Acquiring Person, or an Affiliate [as defined] or Associate [as defined] of an Acquiring Person, or a representative or nominee of an Acquiring Person or of any such Affiliate or Associate, and was a member of the Board prior to the date of this Agreement, or (ii) any Person who subsequently becomes a

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<sup>23</sup> The full text of section 141(d) provides:

The directors of any corporation organized under this chapter may, by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders, be divided into 1, 2 or 3 classes; the term of office of those of the first class to expire at the annual meeting next ensuing; of the second class 1 year thereafter; of the third class 2 years thereafter; and at each annual election held after such classification and election, directors shall be chosen for a full term, as the case may be, to succeed those whose terms expire. The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected separately by the holders of any class or series of stock may be greater than or less than those of any other director or class of directors. In addition, the certificate of incorporation may confer upon 1 or more directors, whether or not elected separately by the holders of any class or series of stock, voting powers greater than or less than those of other directors. If the certificate of incorporation provides that 1 or more directors shall have more or less than 1 vote per director on any matter, every reference in this chapter to a majority or other proportion of the directors shall refer to a majority or other proportion of the votes of the directors.

tit. 8, § 141(d).

<sup>24</sup> 723 A.2d 1180 (Del. Ch. 1998).

<sup>25</sup> *Id.* at 1184.

member of the Board, while such Person is a member of the Board, who is not an Acquiring Person, or an Affiliate [as defined] or Associate [as defined] of an Acquiring Person, or a representative or nominee of an Acquiring Person or of any such Affiliate or Associate, if such Person's nomination for election or election to the Board is recommended or approved by a majority of the Continuing Directors.<sup>26</sup>

Carmody, a Toll Brothers shareholder, challenged the dead hand feature on both statutory and fiduciary duty grounds. For his statutory claim, Carmody claimed that the provision created two different classes of directors—those who can redeem the pill and those who cannot.<sup>27</sup> Pursuant to sections 141(a) and (d), such restrictions or director classifications are invalid, unless set forth in the certificate of incorporation.<sup>28</sup> He also argued that adoption of the dead hand feature was a twofold breach of the board's fiduciary duty of loyalty.<sup>29</sup> First, if a raider waged a proxy contest and won, its new directors could not redeem the pill.<sup>30</sup> This made an unsolicited offer for the target unlikely.<sup>31</sup> Second, in a proxy vote, the provision eliminated all practical choice for shareholders who want to elect a new board that will redeem the provision.<sup>32</sup> From these two effects, Carmody claimed that the "only purpose that the 'dead hand' provision could serve is to discourage future acquisition activity by making any proxy contest to replace incumbent board members an exercise in futility."<sup>33</sup>

Toll Brothers responded that nothing in the Rights Plan *forced* shareholders to vote for incumbent directors; the Rights Plan did not nullify a proxy contest as a means for a raider to gain control and therefore was not invalid per se.<sup>34</sup> Noting that boards do not need special charter authority to delegate specific tasks to committees,<sup>35</sup> Toll Brothers argued that the "'dead hand' provision should be viewed as tantamount to a delegation to a special committee . . . of the exclusive power to redeem the Rights."<sup>36</sup>

Toll Brothers also argued that the Rights Plan did not violate any fiduciary duty. Because Toll Brothers was vulnerable to a hostile

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<sup>26</sup> *Id.* (quoting Rights Plan, § 1(g)).

<sup>27</sup> *Id.* at 1189.

<sup>28</sup> tit. 8, § 141(a), (d).

<sup>29</sup> *Carmody*, 723 A.2d at 1184.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> *Id.*

<sup>33</sup> *Id.*

<sup>34</sup> *Id.* at 1190.

<sup>35</sup> *Id.*

<sup>36</sup> *Id.*

takeover and a majority of its board were independent directors who reasonably perceived a threat to its business, "adopting the Rights Plan was a proportionate response that the 'dead hand' feature did not render disproportionate, because the Rights Plan does not preclude offers that are fair and noncoercive."<sup>37</sup> Finally, Toll Brothers contended that the Rights Plan did not preclude shareholders from electing a new board, and "even though that board may be unable to redeem the Rights, that violates no fiduciary duty, because [Delaware law] permits a board to interfere with the voting process in sufficiently compelling circumstances."<sup>38</sup>

The court determined that Carmody stated legally sufficient claims that the dead hand feature violated sections 141(a) and (d).<sup>39</sup> First, to create voting power distinctions, section 141(d) requires a classified board and such distinctions must be set forth in the certificate of incorporation.<sup>40</sup> Second, the board's adoption of the dead hand feature was ultra vires. Section 141(d) grants the right to elect directors to shareholders, not to the board or a special committee thereof.<sup>41</sup> The court added that, "[a]bsent express language in the charter, nothing in Delaware law suggests that some directors of a public corporation may be created less equal than other directors, and certainly not by unilateral board action."<sup>42</sup> Since the charter did not contain such "express language," the dead hand feature transgressed the shareholders' right to elect directors capable of redeeming the pill, thereby making it ultra vires.<sup>43</sup> Third, section 141(a) mandates that a corporation's board of directors manage its business "except as may be otherwise provided . . . in its certificate of incorporation."<sup>44</sup> The dead hand feature severely hindered a newly elected board's ability to achieve a business combination because the new directors would not possess the "power to redeem the pill without obtaining the consent of the 'Continuing Directors,' who (it may be assumed) would constitute a minority of the board."<sup>45</sup> Because of this, the dead hand feature interfered with the "board's power to protect fully the corporation's (and

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<sup>37</sup> *Id.*

<sup>38</sup> *Id.*; see *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661-62 (Del. Ch. 1988) (determining that a "compelling justification" must be shown for a board's interference in the voting process after the board added two new directors which prevented shareholders from electing a majority of new directors).

<sup>39</sup> *Carmody*, 723 A.2d at 1190.

<sup>40</sup> *Id.* at 1191.

<sup>41</sup> DEL. CODE ANN. tit. 8, § 141(d) (2005); *Carmody*, 723 A.2d at 1191.

<sup>42</sup> *Carmody*, 723 A.2d at 1191.

<sup>43</sup> *Id.*

<sup>44</sup> tit. 8, § 141(a).

<sup>45</sup> *Carmody*, 723 A.2d at 1191.

its shareholders') interests in a transaction that is one of the most fundamental and important in the life of a business enterprise."<sup>46</sup>

The court assessed Carmody's fiduciary duty claim under the two-prong duty of loyalty analysis. First, since Carmody alleged that the dead hand feature "purposefully disenfranchise[d] the company's shareholders without any compelling justification,"<sup>47</sup> the board needed to satisfy the more exacting standard set forth in *Blasius Industries v. Atlas Corp.*<sup>48</sup> The court found that such disenfranchisement would occur because shareholders would have to vote for incumbent directors, even if they disagree with their policies, if they want a board that is capable of redeeming the Rights Plan.<sup>49</sup> Moreover, "[a] claim that the directors have unilaterally 'create[d] a structure in which shareholder voting is either impotent or self defeating' is necessarily a claim of purposeful disenfranchisement."<sup>50</sup> Further, the court recognized "that the shareholder vote has primacy in our system of corporate governance because it is the 'ideological underpinning upon which the legitimacy of directorial power rests.'"<sup>51</sup> For these reasons, the court held that Carmody stated a cognizable claim under *Blasius* and Delaware law.<sup>52</sup>

Turning to the second prong of its duty of loyalty analysis, the court explored whether the dead hand feature was an "unreasonable defensive measure" under *Unocal*.<sup>53</sup> Claims under *Unocal Corp. v. Mesa Petroleum Co.*<sup>54</sup> and *Unitrin, Inc. v. American General Corp.*<sup>55</sup>

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<sup>46</sup> *Id.*

<sup>47</sup> *Id.* at 1193.

<sup>48</sup> In situations not involving a claim that the defensive measures purposefully disenfranchise shareholders, courts will evaluate the issue under the *Unocal/Unitrin* standard. Since Carmody alleged such purposeful disenfranchisement, the *Blasius* standard is operative. The Delaware Supreme Court articulated the *Blasius* standard as "[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.* (quoting *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992)); *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 661-64 (Del. Ch. 1988).

<sup>49</sup> *Carmody*, 723 A.2d at 1193.

<sup>50</sup> *Id.* (second alteration in original) (quoting Jeffrey N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills, and Shareholder-Adopted Bylaws: An Essay for Warren Buffett*, 19 CARDOZO L. REV. 511, 540 (1997)).

<sup>51</sup> *Id.* (quoting *Blasius Indus.*, 564 A.2d at 659).

<sup>52</sup> *Id.* at 1194.

<sup>53</sup> *Id.*

<sup>54</sup> 493 A.2d 946 (Del. 1985). *Unocal* articulated the rationale and standard of review applicable to a board's adoption or retention of defensive measures, stating that "[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an *enhanced duty* which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred." *Id.* at 954 (emphasis added).

<sup>55</sup> 651 A.2d 1361 (Del. 1995). *Unitrin* restated the *Unocal* standard in the following two part test:



require enhanced scrutiny. According to *Unitrin*, a “defensive measure is disproportionate (*i.e.*, unreasonable) if it is either coercive or preclusive.”<sup>56</sup> Carmody claimed that the dead hand feature was coercive, because it forced shareholders to vote for incumbent directors or their designees.<sup>57</sup> Carmody also alleged that the dead hand feature was preclusive, because it made “an offer for the Company much more unlikely since it eliminate[d] use of a proxy contest as a possible means to gain control,” thereby rendering “future contests for corporate control of Toll Brothers prohibitively expensive and effectively impossible.”<sup>58</sup> The court agreed and held that the dead hand feature was “disproportionate and unreasonable under *Unocal*.”<sup>59</sup>

*B. Slow Hand Pills: Mentor Graphics Corp. v. Quickturn Design Systems, Inc. and Quickturn Design Systems, Inc. v. Shapiro*

Shortly after his decision in *Carmody*, Vice Chancellor Jacobs confronted the slow hand pill in *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*<sup>60</sup> Mentor made an unsolicited cash tender offer for all of Quickturn’s outstanding common shares, coupled with a proxy solicitation to replace Quickturn’s board.<sup>61</sup>

Quickturn’s board declared the offer as inadequate and advised shareholders to reject it.<sup>62</sup> The board then adopted two defenses. First, it took an existing bylaw that allowed “shareholders . . . entitled to cast not less than ten percent (10%) of the votes” to call a special meeting, and amended it. The amended bylaw allowed the board to delay the meeting for at least ninety days, but not more than one hundred days from the date of the proxy.<sup>63</sup> Second, the board eliminated the dead hand feature<sup>64</sup> from its shareholder rights plan (“Rights

First, a *reasonableness test*, which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed, and [s]econd, a *proportionality test*, which is satisfied by a demonstration that the board of directors’ defensive response was reasonable in relation to the threat posed.

*Id.* at 1373.

<sup>56</sup> *Carmody*, 723 A.2d at 1195.

<sup>57</sup> *Id.*

<sup>58</sup> *Id.*

<sup>59</sup> *Id.*

<sup>60</sup> 728 A.2d 25 (Del. Ch. 1998), *aff’d on other grounds*, Quickturn Design Sys., Inc. v. Shapiro, 721 A.2d 1281 (Del. 1998).

<sup>61</sup> *Mentor Graphics*, 728 A.2d at 33. The cash tender offer of \$12.125 was approximately a 50 percent premium over the immediate pre-offer price. *Id.*

<sup>62</sup> *Id.* at 35.

<sup>63</sup> *Id.* at 38 (emphasis added).

<sup>64</sup> Quickturn’s dead hand feature included a limited “continuing director” provision that was operative only when a raider that owned more than 15 percent of its common stock waged a

Plan”) and replaced it with a slow hand feature.<sup>65</sup> The amended Rights Plan provided that

in the event that a majority of the Board of Directors of the Company is elected by stockholder action at an annual or special meeting of stockholders, then until the 180th day following the effectiveness of such election (including any postponement or adjournment thereof), the Rights shall not be redeemed if such redemption is reasonably likely to have the purpose or effect of facilitating a Transaction with an Interested Person.<sup>66</sup>

The Rights Plan defined an “Interested Person” as

any Person who (i) is or will become an Acquiring Person if such Transaction were to be consummated or an Affiliate or Associate of such a Person, and (ii) is, or directly or indirectly proposed, nominated or financially supported, a director of [Quickturn] in office at the time of consideration of such Transaction who was elected at an annual or special meeting of stockholders.<sup>67</sup>

Quickturn’s bylaw amendment delayed a shareholder-called meeting for at least three months, while the slow hand feature prevented a new Mentor-nominated board from redeeming the Rights Plan for six months.<sup>68</sup> Taken together, the bylaw amendment and slow hand feature would have delayed Mentor’s acquisition for at least nine months.<sup>69</sup>

Mentor challenged Quickturn’s slow hand feature on three grounds. First, it interfered with the right of Quickturn shareholders to elect a board of their choice, “in derogation of the principles articulated in *Blasius*”<sup>70</sup> This interfered with the shareholders’ franchise, because even if Quickturn shareholders desired a sale to Mentor, the slow hand feature may compel them to vote for incumbent directors—directors capable of accomplishing a sale within six months—or

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proxy contest to replace a majority of Quickturn’s board. Once operative, only the “continuing directors”—the directors in office at the time the board adopted this dead hand feature—could redeem the pill. *Id.* at 43.

<sup>65</sup> *Id.* at 35 (referring to Quickturn’s slow hand feature as a Deferred Redemption Plan).

<sup>66</sup> *Id.* at 35 n.40.

<sup>67</sup> *Id.* (second alteration in original).

<sup>68</sup> *Id.* at 36.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.* at 44.

abstain entirely from the vote.<sup>71</sup> Second, Mentor claimed the slow hand feature violated *Unocal/Unitrin's* fiduciary principles because it "was a disproportionate response to any threat reasonably perceived by the Mentor bid."<sup>72</sup> Third, Mentor argued that the slow hand feature violated section 141(a), because it prevented a newly elected board from redeeming the rights plan, even if the board's fiduciary duty required it to do so.<sup>73</sup> This improperly denied "any newly elected board of its core authority to manage the corporation."<sup>74</sup>

The Court of Chancery did not reach Mentor's *Blasius* or statutory claims.<sup>75</sup> Instead, the court held that Quickturn's board violated its fiduciary duties under *Unocal* and *Unitrin* by adopting the slow hand feature.<sup>76</sup> The court determined that the board acted from fear that "Quickturn shareholders might mistakenly, in ignorance of Quickturn's true value, accept Mentor's inadequate offer, and elect a new board that would prematurely sell the company."<sup>77</sup> Analyzing the first prong of *Unocal/Unitrin*, the court found that the tender offer and proxy contest constituted a legally cognizable threat.<sup>78</sup> Next, the court evaluated the slow hand feature's proportionality to that threat—the second prong of *Unocal/Unitrin*. Although the court rejected Mentor's arguments that the slow hand feature was coercive and preclusive, it held that the slow hand feature was disproportionate for two reasons: (1) it delayed a new board's sale of Quickturn for six months only when such transaction involved an Interested Person (i.e., Mentor), and (2) pursuant to Quickturn's bylaw amendment, if shareholders can inform themselves in three months, it is unreasonable to conclude that a board requires six months.<sup>79</sup> For these reasons, the court held the slow hand feature invalid.<sup>80</sup>

The Delaware Supreme Court affirmed the decision, but based its conclusion on section 141(a).<sup>81</sup> The court stressed that "[o]ne of the most basic tenets of Delaware corporate law is that the board of directors has the ultimate responsibility for managing the business and

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<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

<sup>74</sup> *Id.*

<sup>75</sup> The court acknowledged that, "a disposition of this issue on fiduciary, rather than upon statutory, grounds may appear counterintuitive . . . . [But] the statutory argument . . . was not adequately developed by the parties." *Id.* at 44 n.73.

<sup>76</sup> *Id.* at 44.

<sup>77</sup> *Id.* at 46.

<sup>78</sup> *Id.* at 45-46.

<sup>79</sup> *Id.* at 50-52.

<sup>80</sup> *Id.* at 52 (holding the slow hand feature invalid, but upholding the bylaw).

<sup>81</sup> *Quickturn Design Systems, Inc. v. Shapiro*, 721 A.2d 1281, 1291-93 (Del. 1998).

affairs of a corporation.”<sup>82</sup> Section 141(a) requires that a company’s charter explicitly state any limitation on the board’s authority;<sup>83</sup> Quickturn’s charter had no such limitation.<sup>84</sup> The court determined that the slow hand feature would prevent the board from performing its fundamental duties for six months.<sup>85</sup> The court admitted that the slow hand feature would only limit the board’s authority in one respect—contracting for the sale of Quickturn—but noted that this is an “area of fundamental importance to the shareholders.”<sup>86</sup>

The court found that the slow hand feature would “prevent[ ] a newly elected board of directors from completely discharging its fiduciary duties to protect fully the interests of Quickturn and its stockholders.”<sup>87</sup> Since “no defensive measure can be sustained which would require a new board of directors to breach its fiduciary duty,” the slow hand feature was invalid under Delaware law.<sup>88</sup>

### III. OVERBLOWN FEARS?: *CALIFORNIA PUBLIC EMPLOYEES’ RETIREMENT SYSTEM V. COULTER*

Some feared that *Carmody* and *Mentor Graphics Corp.* would forbid a board from executing contracts that limit its discretion. Vice Chancellor Noble’s ruling in *CalPERS* suggests such fears are overblown.<sup>89</sup> This case involved an agreement by Lone Star Steakhouse & Saloon, Inc. to pay additional compensation to its senior management in the event of a change-in-control in order to encourage senior management to stay with Lone Star, despite any threat of such change.<sup>90</sup>

The change-in-control contracts (“Contracts”) provided senior management with additional compensation in the case of (1) a shift in shareholder voting power, (2) a change in the composition of the board, (3) a merger or similar transaction, or (4) liquidation.<sup>91</sup> Only Lone Star’s founder and largest shareholder, Defendant Coulter, however, would receive his “golden parachute”<sup>92</sup> solely upon the occur-

<sup>82</sup> *Quickturn Design Systems*, 721 A.2d at 1291.

<sup>83</sup> DEL. CODE ANN. tit. 8, § 141(a) (2005).

<sup>84</sup> *Quickturn Design Systems*, 721 A.2d at 1291.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* at 1291-92.

<sup>87</sup> *Id.* at 1292.

<sup>88</sup> *Id.* at 1292-93.

<sup>89</sup> *Cal. Pub. Emp. Retirement Sys. v. Coulter*, No. 19191, 2005 Del. Ch. LEXIS 54, at \*21 (Del. Ch. Apr. 21, 2005) (holding that a contractual clause which entitled corporate executives to payments, if a majority of the company’s directors were displaced, to be legal).

<sup>90</sup> *Id.* at \*3.

<sup>91</sup> *Id.*

<sup>92</sup> A golden parachute is a very popular tactic employed by targets that “award[s] very favorable employment contracts to its senior management which become effective only in the event of a change in control.” GILSON & BLACK, *supra* note 1, at 768.

rence of one of these events.<sup>93</sup> The Contracts required the happening of a second trigger, such as a change in their duties, before anyone else received such payment.<sup>94</sup> The Contracts provided that a change-in-control occurred if

[t]he individuals who, as of January 3, 2001, are members of the Company's Board of Directors (the "Existing Directors"), cease, at or prior to January 3, 2003, for any reason, to constitute at least a majority of the number of authorized directors of the Company as determined in the manner prescribed in the Company's Certificate of Incorporation and Bylaws; *provided, however, that if the election, or nomination for election, by the Company's stockholders of any new director was approved by a vote of at least a majority of the Existing Directors, such new director shall be considered an Existing Director*; provided further, however, that no individual shall be considered an Existing Director if such individual initially assumed office as a result of either an actual or threatened election contest or other actual or threatened solicitation of proxies by or on behalf of anyone other than the Board of Directors (a "Proxy Contest"), including by reason of any agreement intended to avoid or settle any election contest or Proxy Contest.<sup>95</sup>

The votes of new directors not approved as existing directors (effectively "continuing directors") were not counted in determining whether subsequent new directors would be considered continuing directors. If continuing directors voted to approve the new directors, then the new directors became continuing directors and the change-in-control payments would not occur.<sup>96</sup>

Ten Contracts were involved. Although their terms varied, the definition of "change of control" was constant. All Contracts were effective January 3, 2001, and, by their terms, expired on January 3, 2003.<sup>97</sup> The Contracts would have likely cost the company between \$10 and \$30 million,<sup>98</sup> but Lone Star never made any payments and the Contracts were not renewed. The California Public Employees'

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<sup>93</sup> *CalPERS*, 2005 Del. Ch. LEXIS 54, at \*5 n.3.

<sup>94</sup> *Id.*

<sup>95</sup> *Id.* at \*3-4.

<sup>96</sup> *Id.* at \*18.

<sup>97</sup> *Id.* at \*6.

<sup>98</sup> *See id.* at \*5 n.2 (noting that Lone Star claimed "its exposure was less than \$10 million" while CalPERS argued that payments to two defendants alone "could have exceeded \$30 million").

Retirement System (CalPERS), however, contended that the Contracts damaged Lone Star by causing Bruckmann, Rosser, Sherrill & Co. to abandon a plan to acquire Lone Star.<sup>99</sup>

CalPERS moved for summary judgment, arguing that the continuing director provision in the Contracts violated both section 141(d) and the board's fiduciary duty because it granted individual directors differential voting powers based on classifications not present in Lone Star's certificate of incorporation, thereby conflicting with *Carmody*.<sup>100</sup>

The Court of Chancery recognized that the board would "not vote on the specific question of whether the new director will be an 'Existing Director'"; rather, the continuing director provision provided "an after-the-vote measure for ascertaining whether there is continuity within the Board even though its membership has changed."<sup>101</sup> The Contracts referenced the board's vote simply to determine the managers' rights to payments and did not deny voting rights to any new, noncontinuing directors.<sup>102</sup> Ultimately, the court ruled that the continuing director provision contravened neither section 141(d) nor *Carmody* since it did not limit or expand directors' voting powers.<sup>103</sup>

Although the court determined that the Contracts were a reasonable means to avoid change-in-control payments, they may not be the only acceptable approach.<sup>104</sup> While the court held that Lone Star's Contracts did not pose the corporate governance defects present in *Carmody*, it stated that "incumbent directors may not employ a similar device, in a different context, to deprive various directors of their voting power or to deprive them of the capacity to exercise that power when necessary."<sup>105</sup> The court emphasized that every decision depends upon its factual context; under certain circumstances, a provision comparable to Lone Star's could constitute a breach of the board's obligations to shareholders.<sup>106</sup> The court, however, did not provide specific examples.

The court highlighted that the Contracts had a limited, two-year duration, while the challenged dead hand provision in *Carmody* had a ten-year term.<sup>107</sup> This difference, however, is not crucial. For example, even if the Rights Plan in *Carmody* had a two-year limit, the

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<sup>99</sup> *Id.* at \*6 n.5.

<sup>100</sup> *Id.* at \*15.

<sup>101</sup> *Id.* at \*19-20.

<sup>102</sup> *Id.* at \*20.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at \*21-22.

<sup>105</sup> *Id.* at \*22 n.25; see, e.g., Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437 (Del. 1971).

<sup>106</sup> CalPERS, 2005 Del. Ch. LEXIS 54, at \*22 n.25.

<sup>107</sup> *Id.*; Carmody v. Toll Brothers, Inc., 723 A.2d 1180, 1184 (Del. Ch. 1998).

board would not have full power to manage the corporation. Moreover, assuming the two-year limit in *CalPERS* made a difference, nothing would stop a corporation from adopting such an agreement and then extending it every year. The real difference between the two provisions lies in their effects.

#### IV. RESURRECTING THE DEAD?

Viewed together, *CalPERS*, *Carmody*, and *Mentor Graphics Corp.* seem to signal that defensive measures making a change-in-control impossible demand higher judicial scrutiny than other measures that contain continuing director provisions such as ERAs (employee retention agreements).<sup>108</sup> But is the effect not the same? All three cases involved devices that deterred raiders from taking control of targets.<sup>109</sup> The difference is that *CalPERS* did not entail a coercive or preclusive defense.

##### *A. Lone Star's ERAs: Neither Preclusive nor Coercive*

The difference is relevant because of Delaware sections 141(a) and (d). According to Delaware law, defenses that are neither preclusive nor coercive must only be reasonable.<sup>110</sup> The arrangements in *Carmody* and *Quickturn*, found to be preclusive and coercive, severely limited their boards' ability to govern the corporation. The dead hand and slow hand features prevented a newly elected board from redeeming the defenses for at least six months; they left shareholders only one choice if they wanted to elect directors with authority to redeem the pills. A newly elected board, therefore, could not sell the company—the most significant transaction in a company's existence. This violated section 141(a).<sup>111</sup>

Nothing in the Lone Star ERAs had this effect; all directors were capable of taking any actions that were in the best interests of the

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<sup>108</sup> Stephen Fraidin, *Continuing Director Provisions Revisited*, M&A NOTES (KIRKLAND & ELLIS LLP), May 2005, at 1; see *All "Dead Hands" Are Not Created Equal*, NEWSL. OF THE ABA SEC. TASK FORCE ON DIR. & OFFICER LIAB., <http://www.abanet.org/buslaw/committees/CL9960000pub/newsletter/20050728000000.html> (last visited Jan. 21, 2006) (noting the difference in judicial treatment in the context of employee retention agreements from shareholder rights plans).

<sup>109</sup> *CalPERS* alleged the ERA led to the expiration of Bruckmann Rosser's letter of intent to acquire all the shares of Lone Star. *CalPERS*, 2005 Del. Ch. LEXIS 54, at \*6 n.5.

<sup>110</sup> See *Unitrin Corp. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995) (providing that "[i]f a defensive measure . . . is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to [reasonableness]").

<sup>111</sup> Additionally, the *Carmody* court determined that the dead hand feature violated section 141(d), but neither the Delaware Court of Chancery in *Mentor Graphics* nor the Delaware Supreme Court in *Quickturn* addressed this section.

corporation. The continuing director provision was in the ERAs between Lone Star and senior management, not a shareholder rights plan. The court acknowledged that the ERAs required the board's vote to determine the rights of senior managers to payments.<sup>112</sup> Even though the votes counted for only continuing directors, this did not differentiate the directors' voting powers because the question answered by such vote does not require board action.<sup>113</sup> Therefore, unlike *Carmody*, the ERAs did not violate section 141(d).

CalPERS claimed that the ERAs were coercive and preclusive because the election of certain directors could trigger the ERAs, thereby making Bruckmann Rosser's acquisition of Lone Star prohibitively expensive. But the ERAs, though increasing the cost of the acquisition, did not make it *impossible*. The potency of the Lone Star ERAs was in their potential cost—\$10 million to \$30 million.<sup>114</sup> The non-binding letter of intent between Lone Star and Bruckmann Rosser provided for the acquisition of Lone Star's common stock for \$20.50.<sup>115</sup> As of April 26, 2002 (just over a week before the letter of intent expired), Lone Star had 24,754,980 common shares outstanding.<sup>116</sup> The ERAs represented possible payments between 1.97 percent and 5.91 percent of the deal value. This may have dissuaded Bruckmann Rosser from acquiring Lone Star,<sup>117</sup> but it did not make it *impossible*; the ERAs simply made it more costly.

If the provision in *CalPERS* were invalid, then all ERAs should be invalid. This is not the case; instead, ERAs are common and often upheld by courts in Delaware and other states.<sup>118</sup> Further, many other common arrangements (e.g., termination fees in acquisition agreements) impose costs on competing bids. For example, for canceling Johnson & Johnson's agreement to acquire Guidant Corporation for

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<sup>112</sup> *CalPERS*, 2005 Del. Ch. LEXIS 54, at \*20.

<sup>113</sup> *Id.* at \*20 n.23.

<sup>114</sup> *See id.* at \*5 n.2 (providing that Lone Star claimed "its exposure was less than \$10 million" while CalPERS argued that payments to certain defendants "could have exceeded \$30 million").

<sup>115</sup> Press Release, Lone Star Steakhouse & Saloon, Inc., Letter of Intent for Sale and Merger of the Company for \$20.50 Per Share in Cash (Apr. 2, 2002), available at [http://sec.gov/Archives/edgar/data/883670/000092189502000175/form8k01657\\_04022002.htm](http://sec.gov/Archives/edgar/data/883670/000092189502000175/form8k01657_04022002.htm).

<sup>116</sup> Lone Star Steakhouse & Saloon, Inc., Quarterly Report (Form 10-Q), at 1 (May 3, 2002), available at [http://sec.gov/Archives/edgar/data/883670/000092189502000240/form10q01657\\_03192002.htm](http://sec.gov/Archives/edgar/data/883670/000092189502000240/form10q01657_03192002.htm).

<sup>117</sup> *See* Press Release, Lone Star Steakhouse & Saloon, Inc., Expiration of the Letter of Intent for Sale of the Company and Projected Revenue, EBITDA and Earnings Per Share for 2002 (May 6, 2002), available at [http://sec.gov/Archives/edgar/data/883670/000092189502000247/form8kex991\\_0165705042002.htm](http://sec.gov/Archives/edgar/data/883670/000092189502000247/form8kex991_0165705042002.htm) (announcing that the letter of intent expired).

<sup>118</sup> *See* GILSON & BLACK, *supra* note 1, at 768 (providing a description of golden parachutes and summarizing an analysis of a sample of ninety firms that adopted ERAs).



\$24.2 billion,<sup>119</sup> Guidant must pay Johnson & Johnson a \$705 million termination fee.<sup>120</sup> This represents 2.91 percent of the deal. Delaware courts have upheld termination fees ranging 2 percent to 4 percent.<sup>121</sup> Even if a court determined that the guidelines for termination fee agreements also apply to ERAs, Lone Star's ERAs were probably within the acceptable range. Of course, a court would need more information to assess the actual cost, but even if the ERAs were valued at \$20 million, they would only represent 3.94 percent of the deal.<sup>122</sup>

Courts, however, should not extend to ERAs the amount guidelines applicable to termination fees. The purposes of these two arrangements are different. Delaware courts view termination fees as liquidated damages, meant to cover fees and expenses,<sup>123</sup> whereas ERAs seek to retain managers faced with the instability of hostile takeover situations.<sup>124</sup> Because of this, judicial review of ERAs should focus solely on what amount is reasonably necessary to keep valued managers.

### B. ERAs Are Not "Defenses"

Classifying ERAs as defenses is debatable for two reasons.<sup>125</sup> First, ERA payments are rarely large enough to deter raiders.<sup>126</sup> Second, companies adopt ERAs to eliminate potential conflicts between target shareholders and target managers.<sup>127</sup> Managers faced with a possible change-in-control are often uncertain of their future with the company and therefore about their financial security.<sup>128</sup> ERAs reduce such concerns by providing financial security, thereby allowing managers to focus on their company's shareholders' best interests during

<sup>119</sup> Press Release, Johnson & Johnson, Guidant Corporation and Johnson & Johnson Announce New Definitive Acquisition Agreement (Jan. 13, 2006), available at <http://www.sec.gov/Archives/edgar/data/200406/000095012306000395/y16559exv99w1.htm>.

<sup>120</sup> Press Release, Johnson & Johnson, Johnson & Johnson Statement Regarding Guidant Corporation (Jan. 25, 2006), available at <http://www.sec.gov/Archives/edgar/data/200406/000095015706000071/ex99-1.htm>.

<sup>121</sup> See *Brazen v. Bell Atlantic Corp.*, 695 A.2d 43, 50 (Del. 1997) (upholding a \$550 million termination fee that represented about 2 percent of Bell Atlantic Corp.'s market capitalization); *Goodwin v. Live Ent'mt, Inc.*, No. 15765, 1999 Del. Ch. LEXIS 5, at \*69 (Del. Ch. Jan. 25, 1999), *aff'd*, 741 A.2d 16 (Del. 1999) (upholding termination fee of 3.125 percent).

<sup>122</sup> In an analysis of ninety firms that have ERAs, one firm had a payout of approximately 11.23 percent of its equity's market value. GILSON & BLACK, *supra* note 1, at 768 n.43.

<sup>123</sup> See *Brazen*, 695 A.2d at 49.

<sup>124</sup> Dennis J. Block, *Public Company M&A: Recent Developments in Corporate Control, Protective Mechanisms and Other Deal Protection Techniques*, in *CONTESTS FOR CORPORATE CONTROL 2005*, at 9, 89 (Dennis J. Block & Merideth M. Brown eds., Practising Law Inst. 2005).

<sup>125</sup> See GILSON & BLACK, *supra* note 1, at 768.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> Block, *supra* note 124, at 9, 89.

merger negotiations.<sup>129</sup> The company retains valued managers rather than deterring or thwarting takeovers.

Of course, there are risks associated with ERAs. An ERA could tempt managers to pursue takeovers that are adverse to shareholders' interests in order to collect their payments, or could deter companies from pursuing friendly transactions (as it may have in the Bruckmann Rosser deal).<sup>130</sup> Companies considering whether to provide ERAs to senior management should consider their purpose and risks. Under no circumstances, however, should the company view ERAs as a defense; only in small deals could the aggregate of payments be large enough to deter a raider.<sup>131</sup> Although Lone Star's ERAs may have grown large enough to torpedo Bruckmann Rosser's acquisition of Lone Star, this neither changed their ostensible purpose nor rendered them invalid.

The whole point of ERAs is to provide payments in the event of a change-in-control. All the "existing directors" provision did in *CalPERS* was define a change-in-control that would trigger such payments. Not all changes-in-control, however, create adverse consequences. For example, directors may change, but their replacements could have the same policies. Lone Star recognized this and gave original directors the power to deprive managers of their payments if the original directors approved enough new directors so that the combination of the two represented a majority of the board.<sup>132</sup> This lessened the severity of the provision and provided a technique for the board to reduce managers' temptation to solicit takeovers that were adverse to shareholders' interests. This definition does not seem arbitrary, much less nefarious. Therefore, Lone Star's ERAs were reasonable and valid under Delaware law.<sup>133</sup>

#### CONCLUSION

ERAs are popular; by 2000, 70 percent of America's largest one thousand corporations had ERAs.<sup>134</sup> Lone Star simply added a con-

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<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.*

<sup>132</sup> See *Cal. Pub. Emp. Retirement Sys. v. Coulter*, No. 19191, 2005 Del. Ch. LEXIS 54, at \*4 (Del. Ch. Apr. 21, 2005).

<sup>133</sup> See *id.* at 21-22 ("It is reasonable that a change of control agreement have some mechanism by which the corporation's obligation to make such payments can be avoided if the composition of the Board has changed in name only.").

<sup>134</sup> Michael C. Jensen, Kevin J. Murphy & Eric G. Wruck, *CEO Pay . . . And How To Fix It* 31 (Harvard Bus. Sch. Negotiation, Org. and Mkt. Research Paper Series, Research Paper No. 04-28, 2005) (providing that "70 percent of the largest 1000 companies had change-in-control agreements in place in 2000, up from 41 percent in 1988 and 57 percent in 1996").

tinuing director provision to its ERAs. Those ERAs reached an amount that may have sunk a takeover, but that amount was not affected by the change-in-control provision. Moreover, Lone Star was not looking for a potent defense when it adopted the ERAs; rather, it sought to retain valued managers during challenging times. In sum, the ERAs did not involve a dead hand feature thereby leaving such features where they ought to be—buried under Delaware case law. The *CalPERS* court correctly determined that Lone Star's change-in-control contractual approach was valid under Delaware law. Investors should consider this good news.

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