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Dead Hand Proxy Puts and Shareholder

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ARTICLES

Dead Hand Proxy Puts and Shareholder Value

Sean J. Griffith† & Natalia Reisel††

We study the impact of Dead Hand Proxy Puts on shareholder value. Courts and commentators have characterized these terms as defenses against hedge fund activism that threaten to reduce firm value by entrenching underperforming managers and thereby increasing managerial agency costs. Our findings contradict this view. Using three court cases as a natural experiment, we find that shareholders do not react negatively to the inclusion of a Dead Hand Proxy Put in a firm's loan agreements. Not only do Dead Hand Proxy Puts not destroy firm value, they may even preserve it by deterring activists who would seek to extract wealth from creditors and other nonshareholder constituencies. We develop the policy implications of these findings and offer a direction for the evolution of legal doctrine in this area.

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INTRODUCTION

Hedge fund activism is now a defining force in corporate governance. Having risen sharply over the last decade,[1] hedge

[1] See John C. Coffee Jr and Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J Corp L 545, 553–56 (2016).

fund activism has entered a "second wave"[2] or "golden age."[3] Activist hedge funds, acting alone or in "packs,"[4] accumulate significant stakes in public companies[5] and then seek institutional support in putting pressure on boards.[6] Activists target firms they perceive to be undervalued and attempt to increase value through financial restructuring or through changes to management and business strategy.[7]

Shareholders benefit from hedge fund activism, at least in the short term.[8] But creditors, in general, do not. From a creditor's perspective, activist interventions threaten to increase repayment risk, either by leveraging up the firm to increase payouts to shareholders or through subtle changes in business strategy that have the effect of shifting risk to creditors and other constituencies.[9] And

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[2] C.N.V. Krishnan, Frank Partnoy, and Randall S. Thomas, *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, and Expertise*, 40 J Corp Fin 296, 299–300 (2016).

[3] Lucian A. Bebchuk, Alon Brav, and Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 Colum L Rev 1085, 1087 (2015) (noting that "the media has been increasingly referring to the current era as 'the golden age of activist investing'").

[4] See, for example, Alon Brav, Amil Dasgupta, and Richmond Mathews, *Wolf Pack Activism* *2, 11–34 (CEPR Discussion Paper No DP11507, Sept 2016), archived at http://perma.cc/D5PK-HWV7 (modeling conditions under which institutional investors may "act in groups to magnify each other's influence," forming "so-called 'wolf packs'"); Marco Becht, et al, *The Returns to Hedge Fund Activism: An International Study* *10, 18, 42 (ECGI Finance Working Paper No 402/2014, Mar 2015), archived at http://perma.cc/3UB8-Q7E2 (finding that wolf packs are disclosed in 21.7 percent of activist events and that, when they are disclosed, wolf packs hold 13.4 percent of the target stock in aggregate, compared to approximately 8 percent holdings for hedge funds acting alone). But see Yu Ting Forester Wong, *Wolves at the Door: A Closer Look at Hedge-Fund Activism* *8–11, 45–47 (Columbia Business School Research Paper No 16-11, Oct 2016), archived at http://perma.cc/LXV8-GG84 (suggesting that wolf pack activity may be inferred when not disclosed).

[5] See Lucian A. Bebchuk, et al, *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J Corp L 1, 4–5, 7–9 (2013) (analyzing activist investor 13D filings from 1994 through 2007 and finding that "hedge fund activists typically disclose substantially less than 10% ownership, with a median stake of 6.3%").

[6] Stuart L. Gillan and Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J Applied Corp Fin 55, 55 (2007) (defining activists as "investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control"). See also Part I.A.

[7] See Alon Brav, Wei Jiang, and Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 Found & Trends Fin 185, 197–202 (2009) (summarizing objectives and strategies of hedge fund activists); Robin Greenwood and Michael Schor, *Investor Activism and Takeovers*, 92 J Fin Econ 362, 368–72 (2009) (finding that excess returns from hedge fund activism are most associated with the activist strategy of forcing target firms into a takeover).

[8] See text accompanying notes 38–40.

[9] See Kevin Miller, *Food for Thought: Conflicting Views on the "Knowing Participation" Element of Aiding & Abetting Claims*, 9 Deal Lawyers 1, 1 (Mar–Apr 2015) ("From the banks' perspective, the election of a dissident stockholder's nominees as a majority of

incumbent managers, who typically lose their jobs after successful interventions, take an even less charitable view of hedge fund activism.[10] The proliferation of defensive devices aimed at hedge fund activism is therefore unsurprising. Companies have adopted structural defenses to deter activists, such as low-threshold poison pills[11] and bylaw amendments.[12] In addition to these structural defenses, but perhaps less widely noticed, firms have begun to embed defenses against activists in their ordinary business contracts.[13] This Article studies one such contractual term—the Dead Hand Proxy Put.

Dead Hand Proxy Puts trigger default and immediate repayment of corporate indebtedness in the event that a dissident slate of prospective directors wins a majority of seats on the target company's board.[14] Moreover, a Dead Head Proxy Put provides that only the creditor, not the shareholders or incumbent management, can waive the provision.[15] The provision thus threatens to

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the board of the borrower is likely to result in a material change in the business strategy and objectives of the board."). See also text accompanying notes 49–52.

10 See Alon Brav, et al, *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J Fin 1729, 1732 (2008) ("[H]edge fund activism is not kind to CEOs of target firms. During the year after the announcement of activism, average CEO pay declines by about $1 million [ ], and the CEO turnover rate increases by almost 10 percentage points.").

11 See, for example, *Third Point LLC v Ruprecht*, 2014 WL 1922029, *11–12 (Del Ch). See also *Yucaipa American Alliance Fund II, LP v Riggio*, 1 A3d 310, 359 n 254 (Del Ch 2010).

12 See Matthew D. Cain, et al, *How Corporate Governance Is Made: The Case of the Golden Leash*, 164 U Pa L Rev 649, 671–77 (2016) (describing the evolution of the golden leash bylaw, designed to prevent activists from providing incentive pay to their board nominees). Managers have also lobbied to close the ten-day 13D disclosure window in order to limit activists' accumulation of shares. See Wachtell, Lipton, Rosen & Katz, *Petition for Rulemaking under Section 13 of the Securities Exchange Act of 1934* *3–7 (Mar 7, 2011), archived at http://perma.cc/D8XP-4DYW (advocating closing the ten-day filing window under Section 13(d)). See also generally 15 USC § 78m(d) (requiring disclosure of acquisitions of block holdings over 5 percent); 17 CFR § 240.13d–1 (providing for filing within ten days of accumulation of the 5 percent block).

13 See Jennifer Arlen and Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U Pa L Rev 577, 597–605 (2003) (coining the term "embedded defenses" to describe defensive provisions that appear in ordinary contracts, such as loans and employment agreements, rather than the firm's organizational documents, thereby intertwining the interests of shareholders and managers with third-party rights). Aside from the Dead Hand Proxy Put, a recent example of an embedded defense to hedge fund activism is the "Proxy Penalty" provision of certain intragroup contracts. See, for example, *Ashford Hospitality Prime, Inc v Sessa Capital (Master), LP*, 2016 WL 7852507, *1–2, 4 (ND Tex) (describing the "Proxy Penalty" provision of a management agreement involving a publicly traded real estate investment trust (REIT) that would cost the parent company "hundreds of millions" of dollars if triggered and therefore heavily impacted a proxy contest).

14 See notes 57–58 and accompanying text.

15 See Part I.B.2.

impose a significant cost on the corporation—repayment of the company's outstanding indebtedness—if the incumbent board loses control in a proxy fight.[16]

The proxy fight is the activist's ultimate weapon.[17] Unlike bidders in a takeover battle, the activist's endgame is not to buy the company but rather to exert control with a minority ownership interest—often no more than 10 percent of the target company's outstanding shares.[18] As a result, activists, unlike would-be acquirors, do not have sufficient financial backing to replace the company's entire capital structure. The prospect of repaying the company's outstanding debt can thus have a heavy deterrent effect on hedge fund activism. Moreover, once in place, the Dead Hand Proxy Put creates a strong incentive for shareholders to vote *against* an activist's nominees in order to avoid forcing the corporation to incur the cost of repaying its debt.[19] Furthermore, because only creditors can waive the provision, the incumbent board is powerless to prevent the default from occurring.[20]

Seizing on the defensive potential of the provision, the Delaware Court of Chancery moved to restrict it in a trio of recent rulings. In the first case, *San Antonio Fire & Police Pension Fund v Amylin Pharmaceuticals, Inc*,[21] the court criticized the provision's "eviscerating effect on the shareholder franchise" which might render it "unenforceable as against public policy."[22] In the second case, *Kallick v Sandridge Energy, Inc*,[23] the court

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[16] The cost is significant, but not necessarily preclusive. See notes 175–79 and accompanying text.

[17] This is not to say that there is a proxy fight for board control in every activist intervention. There is not. But the proxy fight is the threat against which negotiated outcomes are reached. Any device, such as the Dead Hand Proxy Put, that weakens the activist's ability to take control in a proxy fight also weakens the activist's hand at the bargaining table, regardless of whether a proxy fight is ultimately launched. See Russell Korobkin, *Negotiation Theory and Strategy* 140–44 (Wolters Kluwer 3d ed 2014).

[18] Dionysia Katelouzou, *Worldwide Hedge Fund Activism: Dimensions and Legal Determinants*, 17 U Pa J Bus L 789, 800–01 (2015) (noting that "although hedge fund activism does not generally involve controlling blocks, it does involve large minority blocks with the median maximum activist blocks being around 10 percent").

[19] Even in campaigns in which the activist runs a "short slate," seeking less than a majority of the board, the provision may encourage shareholders to vote against activist nominees in order to avoid triggering default in a subsequent election. See Coffee and Palia, 41 J Corp L at 560 (cited in note 1) (noting that "most proxy contests initiated by hedge funds today are for a minority of the board").

[20] More specifically, waiver is a realistic option for bank loans, but not for bonds. See Part I.B.2.

[21] 983 A2d 304 (Del Ch 2009).

[22] Id at 315.

[23] 68 A3d 242 (Del Ch 2013).

warned that the failure to approve dissident nominees could amount to a breach of fiduciary duty.[24] Finally, in the third ruling, *Pontiac General Employees Retirement System v Ballantine*[25] ("Healthways"), the court held that the deterrent effect of Dead Hand Proxy Puts allowed them to be challenged as a breach of fiduciary duty *when adopted*,[26] thus unleashing a flood of shareholder claims aimed at eliminating the provision wherever it could be found.[27]

Commentators have likewise drawn on the analogy to takeover defense to criticize the potential of Dead Hand Proxy Puts to ward off activism and entrench underperforming managers.[28] The premise animating the view of courts and commentators alike is that defensive provisions insulate managers from the market for corporate control, thereby increasing managerial agency costs and destroying firm value.[29] Dead Hand Proxy Puts, in other

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24 Id at 261.

25 Transcript of Oral Argument on Defendants' Motions to Dismiss and Rulings of the Court, *Pontiac General Employees Retirement System v Ballantine*, Civil Action No 9789-VCL (Del Ch Oct 14, 2014) (available on Westlaw at 2014 WL 6388645) ("*Healthways* Transcript").

26 Id at 74 (emphasizing that under a rights plan with a dead hand feature "the stockholders would be deterred, they would have the Sword of Damocles hanging over them, when they were deciding what to do with respect to a proxy contest. There wasn't a requirement that an actually [sic] proxy contest be underway").

27 See Liz Hoffman, *Banks Feel the Heat from Lawsuits* (Wall St J, Apr 28, 2015), online at http://www.wsj.com/articles/banks-feel-the-heat-from-lawsuits-1430259260 (visited Feb 15, 2017) (Perma archive unavailable). See also *Plaintiffs' Firms Seek Quick Money by Challenging "Dead Hand Proxy Puts" in Debt Agreements* (Wilson Sonsini Goodrich & Rosati, June 9, 2015), archived at http://perma.cc/6653-M6WJ (referring to Dead Hand Proxy Put challenges as "the latest trend in strike suits"); T. Brad Davey and Christopher N. Kelly, *Dead Hand Proxy 'Puts' Face Continued Scrutiny from Plaintiffs Bar* (Bloomberg BNA, June 12, 2015), archived at http://perma.cc/PB98-GEBL (referring to Dead Hand Proxy Puts as the "target *du jour*" for shareholder plaintiffs).

28 See, for example, Stephen Byeff, Note, *The Spirit of* Blasius*:* Sandridge *as an Antidote to the Poison Put*, 115 Colum L Rev 375, 393–95 (2015); Danielle A. Rapaccioli, Note, *Keeping Shareholder Activism Alive: A Comparative Approach to Outlawing Dead Hand Proxy Puts in Delaware*, 84 Fordham L Rev 2947, 2982–86 (2016) (advocating banning Dead Hand Proxy Puts by analogy to dead hand poison pills); Steven Davidoff Solomon, *A Defense against Hostile Takeovers Develops a Downside* (NY Times, Nov 25, 2014), archived at http://perma.cc/7DFD-WJ8U (criticizing the transformation of proxy puts from a "well-intentioned way to protect debt holders" to a maneuver designed to "entrench existing boards").

29 See Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J Polit Econ 110, 112–13 (1965) (describing the market for corporate control and the correlation between managerial efficiency and share value). See also Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U Pa L Rev 713, 720 (2003) ("When managers have less to fear from takeovers, they fail to reduce costs and have poorer operating performance, including lower profit margins, return on equity, and sales growth."); Frank

words, function as entrenchment devices and, as such, destroy shareholder value.

We set out in this Article to test that proposition. If the prevailing view of courts and commentators is correct, the Dead Hand Proxy Put should decrease share price. We refer to this as the "entrenchment hypothesis" and devise a quasi-experimental research design to test it. Drawing on an original, hand-collected dataset of publicly traded firms that have adopted Dead Hand Proxy Puts, we analyze shareholder reactions to each of the Delaware Court of Chancery's three Dead Hand Proxy Put rulings, comparing results for companies that have adopted the provision with results for companies that have not. Because the entrenchment hypothesis predicts a negative shareholder reaction to the provision and because each ruling restricts the provision, we predicted a positive share price reaction to each decision. We fail to find this, however, regardless of whether the companies are incorporated in Delaware and regardless of whether the companies are targets of shareholder activism.[30] We find that shareholders do not react negatively to the inclusion of a Dead Hand Proxy Put in a firm's loan agreements and, in at least some instances, they react positively to the provision. Our results thus fail to support the entrenchment hypothesis.

What explains these results? First, building on our companion paper finding that creditors discount the price of debt for firms that agree to the provision, Dead Hand Proxy Puts provide an important firm-level benefit.[31] Nevertheless, our results are inconsistent with a simple story in which the benefit shareholders receive from the reduction in the cost of debt offsets the harm they suffer from the entrenchment potential of the provision.[32] Instead, more persuasive explanations for our results emerge from a close focus on the nature of the compromise underlying the provision,

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H. Easterbrook and Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 Harv L Rev 1161, 1174 (1981) ("[A]ny strategy designed to prevent tender offers reduces welfare.").

[30] See Part IV.B.

[31] Sean J. Griffith and Natalia Reisel, *Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital* *19–20 (unpublished manuscript, Sept 2016), archived at http://perma.cc/LK99-YMRX.

[32] If the reduction in the price of debt simply offsets the entrenchment effects, we would expect a strong positive reaction to the cases from those firms with the provision in place. For such firms, any potential unenforceability of the provision would be a boon considering that they had already locked in the benefit of a lower cost of debt, now without the concomitant entrenchment burden. However, we do not find this reaction to the cases. See Part IV.B (reporting results of the event studies); Part V.D (rejecting the offset hypothesis).

from which a number of possibilities emerge. One possibility is that shareholders heavily discount the value of their votes and therefore are willing to trade their future value in exchange for an immediate discount in the cost of debt.[33] Alternatively, the Dead Hand Proxy Put may represent an arrangement that effectively deputizes creditors as gatekeepers over beneficial versus destructive forms of shareholder activism.[34]

Fortunately, these alternative explanations point in a single direction for the formulation of legal policy. We have strong evidence of firm-level benefits from Dead Hand Proxy Puts and no evidence that the provision transfers value from shareholders to creditors (or managers). The provision, in other words, may create value rather than merely redistribute it. Dead Hand Proxy Puts should therefore not be banned, and entrepreneurial lawyers should not be rewarded for pressuring firms to eliminate them.[35] Instead, courts should allow the provision to be liberally adopted. Nevertheless, due to the risk that managers will collude with creditors to use the provision for entrenchment rather than creditor protection, courts should scrutinize the conduct of boards when the provision is used in the context of a proxy fight, inquiring into whether waiver was sought, whether it was granted, and if not, whether it was validly denied.

From this Introduction, our Article proceeds as follows. Part I places Dead Hand Proxy Puts in context by reviewing the literature on hedge fund activism and private-ordering responses to it. Part II describes current judicial attitudes toward the provision. Part III presents the data used in our empirical analysis of Dead

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[33] See Part V.B.

[34] See Part V.C.

[35] Entrepreneurial lawyers are awarded fees on the basis of creating a "corporate benefit." See Sean J. Griffith, *Correcting Corporate Benefit: How to Fix Shareholder Litigation by Shifting the Doctrine on Fees*, 56 BC L Rev 1, 19–26 (2015) (describing and critiquing court practices of awarding attorneys' fees under the "corporate benefit" doctrine). See also generally John C. Coffee Jr, *Entrepreneurial Litigation: Its Rise, Fall, and Future* (Harvard 2015) (discussing the evolution of attorney-driven entrepreneurial litigation and making predictions for its future). However, our findings suggest the elimination of a Dead Hand Proxy Put produces no benefit and may in fact harm the corporation. See *The Fire and Police Pension Fund, San Antonio v Stanzione*, 2015 WL 881045, *1 (Del Ch) (awarding minimal attorneys' fees for elimination of a Dead Hand Proxy Put). See also Opening Brief in Support of Plaintiff's Application for an Order Dismissing this Action as Moot and for an Award of Attorneys' Fees and Expenses, *The Fire and Police Pension Fund, San Antonio v Stanzione*, Civil Action No 10078-VCG, *1–2 (Del Ch filed Jan 14, 2015) (available on Westlaw at 2015 WL 230365) ("*Stanzione* Fee Petition") (describing the nature of the case).

Hand Proxy Puts and supplies evidence on the effect of the provision on the price of debt. Part IV reports the results of our empirical tests on the effect of Dead Hand Proxy Puts on shareholder value. Part V evaluates possible explanations for our findings, and Part VI considers their implications for legal policy.

I. ACTIVISTS, SHAREHOLDERS, AND CREDITORS

Corporate law has long focused on the conflict between managers and shareholders, sometimes failing to recognize the equally longstanding conflict between shareholders and creditors.[36] Yet just as corporations present opportunities for managers to profit at shareholders' expense, so too do they present opportunities for shareholders to profit at creditors' expense.[37] In this Part, we present hedge fund activism as one such opportunity, to which Dead Hand Proxy Puts offer a private-ordering response. We begin by reviewing the literature on hedge fund activism, focusing in particular on how hedge fund activism creates conflict between shareholders and creditors. We then discuss the evolution of private-ordering solutions to the conflict, situating the Dead Hand Proxy Put as a contractual provision designed to mitigate the conflict between debt and equity.

A. Shareholder and Creditor Interests in Hedge Fund Activism

Debates over the effects of hedge fund activism draw a sharp distinction between short-term and long-term results. Numerous studies find that the appearance of a hedge fund activist generates significantly higher stock returns upon announcement.[38] Although there is some evidence from earlier sample periods that

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[36] See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U Pa L Rev 1907, 1910, 1926–30 (2013) (arguing that because US corporate law has shifted from a manager-centric system to a shareholder-centric one, shareholder-creditor agency costs should take the place of the longstanding focus on shareholder-manager agency costs).

[37] See, for example, Clifford W. Smith Jr and Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J Fin Econ 117, 118–19 (1979) (describing areas of stockholder-bondholder conflict).

[38] See Brav, et al, 63 J Fin at 1739, 1755–60 (cited in note 10) (analyzing data from 2001 to 2006 and finding an average abnormal return of approximately 7 percent around the announcement of hedge fund activism); Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J Corp Fin 323, 328–29 (2008) (finding a 3.39 percent shareholder return from activism for the period 1998 through 2005); April Klein and Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J Fin 187, 207–08 (2009) (finding a 10.2 percent average shareholder return from activism for the period 2003 through 2005).

returns from activism have diminished with time,[39] more recent periods of activism have shown positive abnormal returns consistent with earlier findings.[40] The longer-term effect of hedge fund activism, however, remains contested,[41] as does the question whether activists achieve shareholder gains by creating value or by merely transferring it from creditors or other constituencies.[42]

Critics of hedge fund activism argue that activists are overwhelmingly motivated by short-term goals at the expense of long-term performance.[43] According to this account, activists pursue

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39 See William W. Bratton, *Hedge Funds and Governance Targets: Long-Term Results* *19–22 (Penn Institute for Law and Economics Research Paper No 10-17, Sept 2010), archived at http://perma.cc/522K-2Y27 (showing that earlier studies of returns are less robust when sample periods are extended); Brav, et al, 63 J Fin at 1774 (cited in note 10) (noting that average abnormal returns at announcement dropped from 15.9 percent in 2001 to 3.4 percent in 2006). Compare Nickolay Gantchev, Oleg Gredil, and Chotibhak Jotikasthira, *Governance under the Gun: Spillover Effects of Hedge Fund Activism* *25 (unpublished manuscript, Aug 2016), archived at http://perma.cc/S223-PDTH (finding a cumulative abnormal return of approximately 5 percent for activist announcements through 2011), with Klein and Zur, 64 J Fin at 207–09 (cited in note 38) (finding a cumulative abnormal return of 7.2 percent for activist announcements over the period from 2003 to 2005).

40 Krishnan, Partnoy, and Thomas, 40 J Corp Fin at 299–300 (cited in note 2) (finding a 7 percent abnormal return for the entire sample period, consistent with earlier studies with significantly higher returns for some recent years, and finding a 10 percent abnormal return in 2013).

41 Compare Bebchuk, Brav, and Jiang, 115 Colum L Rev at 1098–1119 (cited in note 3) (finding improved return on assets and Tobin's Q for the five-year period following activist interventions occurring from 1994 through 2007), with K.J. Martijn Cremers, et al, *Hedge Fund Activism and Long-Term Firm Value* *14–20, 38–41, 44 (unpublished manuscript, Nov 2015), archived at http://perma.cc/UX6X-MFJU (using a matched pair analysis and finding that activist targets underperform control firms). For background on use of Tobin's Q, see Bebchuk, Brav, and Jiang, 115 Colum L Rev at 1101 & n 51 (cited in note 3) (defining Tobin's Q as "the ratio of market value of equity and book value of debt to the book value of equity and book value of debt"). For further evidence of the mixed effects of activism, see Alon Brav, Wei Jiang, and Hyunseob Kim, *The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Industry Concentration* *14, 40 (working paper, May 2013), archived at http://perma.cc/TG4K-JQE2 (finding evidence of increased CEO turnover associated with activism); Clifford, 14 J Corp Fin at 324, 330 (cited in note 38) (finding a 1.22 percent one-year target return on assets).

42 See Coffee and Palia, 41 J Corp L at 588–89 (cited in note 1) (summarizing studies). See also text accompanying notes 50–52 (discussing the possibility that hedge fund activists seek to transfer wealth from creditors).

43 See Iman Anabtawi, *Some Skepticism about Increasing Shareholder Power*, 53 UCLA L Rev 561, 579–83 (2006); Iman Anabtawi and Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 Stan L Rev 1255, 1290–92 (2008); Jack B. Jacobs, *"Patient Capital": Can Delaware Corporate Law Help Revive It?*, 68 Wash & Lee L Rev 1645, 1650–51 (2011); Marcel Kahan and Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U Pa L Rev 1021, 1083–87 (2007); Leo E. Strine Jr, *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 Bus Law

strategies to increase short-term payouts, such as financial restructuring aimed at increasing the company's leverage in order to pay higher dividends while also cutting research and development and other costs essential to growth.[44] By feeding market myopia, such strategies may discourage firms from pursuing longer-term goals, thereby reducing value over the long term.[45] Supporters counter that activism increases long-term value by identifying and addressing underperformance.[46] Payouts to shareholders may increase, but reducing discretionary control

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1, 9–19 (2010). But see Mark J. Roe, *Corporate Short-Termism—in the Boardroom and in the Courtroom*, 68 Bus Law 977, 987–1001 (2013) (providing theoretical and factual counterarguments to the short-term argument).

44 See Martin Lipton, *Activist Interventions and the Destruction of Long-Term Value*, *13 (remarks at Grant's Conference, Oct 21, 2014) (on file with authors) (discussing the short-term pressure US companies face "to deliver short-term results at the expense of long-term value, whether through excessive risk-taking, avoiding investments that require long-term horizons or taking on substantial leverage to fund special payouts to shareholders"); Brav, Jiang, and Kim, 4 Found & Trends Fin at 208–11 (cited in note 7) (finding that hedge fund activists tend to target firms that are ripe for financial restructuring). See also Vyacheslav Fos, *The Disciplinary Effects of Proxy Contests*, 63 Mgmt Sci 655, 662–64 (2017) (finding that proxy contests benefit shareholders when they address business strategies but do not benefit shareholders when they aim at changing capital structure).

45 See William W. Bratton and Michael L. Wachter, *The Future of Corporate Law: Trade-Offs and Private Ordering* *45–52 (unpublished manuscript, Feb 2016) (on file with authors) (summarizing studies of managerial myopia). See also Adam Brandenburger and Ben Polak, *When Managers Cover Their Posteriors: Making the Decisions the Market Wants to See*, 27 RAND J Econ 523, 524–27 (1996) (describing myopia as a result of shareholder-manager information asymmetry in which "share-price maximizers will be concerned not so much that their decisions are correct but that the market thinks these decisions are correct"); Jonathan M. Karpoff and Edward M. Rice, *Organizational Form, Share Transferability, and Firm Performance: Evidence from the ANCSA Corporations*, 24 J Fin Econ 69, 83–85 (1989) (attributing the poor financial performance of a set of corporations with restrictions on the sale of shares to shareholder preference for high dividends at the expense of the firm's long-term profitability); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q J Econ 655, 656–64 (1989) (presenting a game theoretic model of managers' incentives to manipulate market signals to enhance share price); Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J Polit Econ 61, 76–78 (1988).

46 See Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv L Rev 833, 865–69 (2005); Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 Va L Rev 675, 718–24 (2007) (disputing that shareholders would be harmed by increased control and suggesting that "[w]hile short-term insulation might induce directors to focus on long-term performance, indefinite insulation would enable boards to deviate from focusing on shareholder interests in both the short run and the long run"). For empirical support of the notion that activism increases long-term value, see, for example, Aigbe Akhigbe, Jeff Madura, and Alan L. Tucker, *Long-Term Valuation Effects of Shareholder Activism*, 7 Applied Fin Econ 567, 570 (1997) (finding average abnormal stock returns of 23 percent three years after shareholder proposals or proxy fights).

over cash flows imposes management discipline,[47] encouraging efficiency and thereby increasing firm value.[48]

Creditors, however, have a different perspective on hedge fund activism. They are indifferent to shareholder returns, either in the short or long term, and care principally about the creditworthiness of the debtor and, ultimately, repayment of the debt.[49] The prospect of hedge fund activism may increase risk for creditors by reducing the security of their loan and, ultimately, the probability of repayment. Indeed, several common activist strategies amount to transfers of wealth from creditors to shareholders. For example, activists engage in "asset dilution" by increasing firm leverage and payouts to shareholders, and they engage in "asset substitution" by pushing the firm into mergers and acquisitions.[50] Each of these strategies increases shareholder wealth only by increasing insolvency risk, thus benefiting shareholders at the expense of creditors.

Empirical studies confirm this reasoning. A prominent study of bondholder returns from hedge fund activism found a negative 3.9 percent excess bond return upon the appearance of an activist and an additional negative 4.5 percent excess bond return over the remaining year.[51] However, these results may not be consistent across all forms of activism. Another study, focused on loans rather than bonds, found *increased* interest rate spreads, indicating deterioration of credit quality, associated with activist interventions aimed at financial restructurings and forced mergers but found *decreased* spreads from interventions aimed at replacing underperforming managers.[52] In other words, while hedge

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47 See, for example, Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 Am Econ Rev 323, 324 (1986) (explaining that debt creation can enable managers to effectively bond their promises by reducing discretionary spending).

48 See Lucian A. Bebchuk, *The Myth That Insulating Boards Serves Long-Term Value*, 113 Colum L Rev 1637, 1643 (2013) (arguing that activism increases shareholder value through its ability to discipline underperforming managers).

49 See Richard A. Posner, *Economic Analysis of Law* 557 (Wolters Kluwer 8th ed 2011) (characterizing creditors' perspective as the concern "not that the firm be well managed, but that it not be so mismanaged that it defaults").

50 See Rock, 161 U Pa L Rev at 1927 (cited in note 36) (cataloging the ways in which shareholders can shift risk to creditors).

51 April Klein and Emanuel Zur, *The Impact of Hedge Fund Activism on the Target Firm's Existing Bondholders*, 24 Rev Fin Stud 1735, 1746–49, 1766 (2011).

52 See Jayanthi Sunder, Shyam V. Sunder, and Wan Wongsunwai, *Debtholder Responses to Shareholder Activism: Evidence from Hedge Fund Interventions*, 27 Rev Fin Stud 3318, 3328–30 (2014).

fund activism may increase risk to creditors, it is not quite so simple as shareholders win, creditors lose. Instead, creditors' interests appear to be harmed by some but not all forms of hedge fund activism.

In any event, creditors are not powerless in their conflict with shareholders, nor are they helpless victims of hedge fund activism. Because they are in contractual privity with the firm, creditors can negotiate for debt covenants to constrain the privileging of equity over debt.[53] In the next Section, we demonstrate how contractual provisions have evolved to address the shareholder-creditor conflict in the context of shareholder activism.

B. Event Risk Covenants and Dead Hand Proxy Puts

Dead Hand Proxy Puts are a contractual innovation to the change-of-control provision that has been standard in corporate debt agreements since the 1980s.[54] Originally designed to protect creditors from a sudden increase in credit risk associated with leveraged buyouts and hostile takeovers, change-of-control covenants also have the potential to entrench incumbent managers.[55] Dead Hand Proxy Puts respond to a gap in creditor protection under the standard change-of-control provision. The gap seems to have become apparent only with the advent of hedge fund activism.

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[53] See Jean Tirole, *The Theory of Corporate Finance* 80–87 (Princeton 2006). See also Raghuram Rajan and Andrew Winton, *Covenants and Collateral as Incentives to Monitor*, 50 J Fin 1113, 1136–37 (1995); Natalia Reisel, *On the Value of Restrictive Covenants: Empirical Investigation of Public Bond Issues*, 27 J Corp Fin 251, 253–55 (2014) (analyzing the effects of the restrictive covenants used in their sample).

[54] The provision originated in the days of leveraged buyouts—specifically the 1988 takeover of RJR Nabisco by Kohlberg Kravis Roberts & Co (KKR)—when rather than refinancing the target's outstanding debt, KKR added layers of additional leverage, thereby reducing the value of existing bonds by 14.5 percent. See Janet Key, *$25 Billion Nabisco Sale Largest Takeover* (Chi Tribune, Dec 1, 1988), online at http://articles.chicagotribune.com/1988-12-01/news/8802210125_1_rjr-nabisco-camel-cigarettes-kohlberg-kravis-roberts (visited Mar 30, 2017) (Perma archive unavailable); Kenneth N. Gilpin, *Bid for RJR Nabisco Jolts Bonds* (NY Times, Oct 21, 1988), online at http://www.nytimes.com/1988/10/21/business/credit-markets-bid-for-rjr-nabisco-jolts-bonds.html (visited Mar 30, 2017) (Perma archive unavailable). See also George Anders, *'Recapitalizations' Are a Bonanza for Some, but Bondholders Can Take a Terrific Beating*, Wall St J 53 (June 1, 1987) (describing the growing use of debt-buying strategies in the late 1980s and their effect on bondholders).

[55] See Solomon, *A Defense against Hostile Takeovers* (cited in note 28); Daniel Hertzberg, *'Poison-Put' Bonds Are Latest Weapon in Companies' Anti-Takeover Strategy*, Wall St J 5 (Feb 13, 1986).

1. The change-of-control provision.

The standard change-of-control provision in loan agreements and bond indentures provides for default and accelerated repayment of corporate indebtedness upon the occurrence of either of two events.[56] First, default can be triggered by the outside accumulation of a control block of shares (the "control block trigger"). Second, default can be triggered by the changeover of a majority of board seats in a proxy fight (the "proxy fight trigger").[57] Nevertheless, in order to allow for ordinary board succession without triggering default, the standard provision incorporated an exception to the proxy fight trigger for new directors that are "approved" by the incumbent board.[58] The exception permits ordinary board succession while maintaining the trigger for board changeover that implies a shift in strategy or direction, thereby threatening creditor interests.

Prior work on the change-of-control provision has been preoccupied with takeovers and therefore has tended to focus on the control block trigger in bonds.[59] Studies of the wealth effects of the change-of-control provision have found that bond issuances with the provision reduce the cost of debt while also leading to declines in the debtor's share price.[60] However, these effects do not seem

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56 The enforceability of the standard change-of-control provision is well established. See Arlen and Talley, 152 U Pa L Rev at 620 n 101 (cited in note 13).

57 See Solomon, *A Defense against Hostile Takeovers* (cited in note 28) (describing the evolution of the standard change-of-control provision); Richard A. Steinwurtzel and Janice L. Gardner, *Super Poison Puts as a Protection against Event Risks*, 3 Insights 3, 7–8 (Oct 1989) (discussing first-generation change-of-control provisions to respond to the threat of hostile acquisition and other event risks, including changeovers and third-party share ownership thresholds).

58 A typical provision, without the dead hand feature, would be triggered when:

> [A] majority of the members of the board of directors . . . cease to be composed of individuals (i) who were members of that board . . . on the first day of such period, (ii) whose election or nomination . . . was *approved* by [a majority of incumbent board members] . . . or (iii) whose election or nomination . . . was *approved* by [a majority of incumbent board members or successors approved by them].

Amylin, 983 A2d at 309 (emphasis added).

59 See, for example, Marcel Kahan and Michael Klausner, *Antitakeover Provisions in Bonds: Bondholder Protection or Management Entrenchment?*, 40 UCLA L Rev 931, 951–60 (1993) (analyzing the entrenchment effect of the change-of-control provision in bond indentures). One implication of focusing exclusively on bonds is the failure to take into account differences between the ability of creditors to waive default in the context of loans. See note 126 and accompanying text.

60 See Leland Crabbe, *Event Risk: An Analysis of Losses to Bondholders and "Super Poison Put" Bond Covenants*, 46 J Fin 689, 690 (1991) (finding that issuers received a 24 to 32 basis point discount for including a change-of-control covenant but that this yield

to have survived the end of the leveraged buyout era.[61] More recent studies find that the basic change-of-control provision has become pervasive in corporate bond issuances.[62]

As for entrenchment effects, studies investigating whether change-of-control provisions are bundled with other common entrenchment provisions, such as poison pills and staggered boards, have not returned meaningful results.[63] Although one such study finds that firms with change-of-control covenants are less likely to have poison pills,[64] suggesting a substitution effect, by disregarding the "shadow pill"[65] the study undercounts the number of firms with poison pills, leading to flawed results.[66] Because a

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differential later narrowed as concern over leveraged restructurings subsided due to market conditions); Douglas O. Cook and John C. Easterwood, *Poison Put Bonds: An Analysis of Their Economic Role*, 49 J Fin 1905, 1912–18 (1994) (drawing on data from 1988 and 1989 to find that the price of outstanding bonds appreciates significantly upon a change-of-control issuance while the share price of firms issuing change-of-control bonds experiences a statistically significant negative abnormal return).

61 Greg Roth and Cynthia G. McDonald, *Shareholder-Management Conflict and Event Risk Covenants*, 22 J Fin Rsrch 207, 217–21 (1999) (testing a later sample period, 1986 through 1990, and finding that in some circumstances change-of-control provisions do not affect shareholder wealth).

62 See, for example, Frederick L. Bereskin and Helen Bowers, *Poison Puts: Corporate Governance Structure or Mechanism for Shifting Risk?* *11 (working paper, Sept 8, 2015), archived at http://perma.cc/HAZ2-F3ZM (working with a data set from 1990 through 2012); Ai-Fen Cheng and Tao-Hsien Dolly King, *An Empirical Examination of Poison Puts in U.S. Corporate Debt* *5–7, 30 (unpublished manuscript, Oct 2006), archived at http://perma.cc/6R5D-AWPT (drawing on a large sample of over 5,113 poison puts in US corporate debt from 1985 through 2003).

63 A "poison pill" is a provision protecting the firm from hostile share acquisitions and back-end mergers, in which a buyer acquires all of the target's stock after a successful tender offer. A "staggered board" is a provision preventing would-be acquirors from gaining control of the board in a single proxy contest. Poison pills can be adopted through unilateral board action, but staggered boards require an amendment of the corporate charter, and therefore a shareholder vote, in order to be effective. See Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan L Rev 887, 893–99, 904–05 (2002). See also Marcel Kahan and Edward B. Rock, *How I Learned to Stop Worrying and Love the Pill: Adaptive Responses to Takeover Law*, 69 U Chi L Rev 871, 902 (2002) (defining the poison pill as a "unilateral device").

64 See Bereskin and Bowers, *Poison Puts* at *14–15, 32 (cited in note 62).

65 John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex L Rev 271, 277–78 (2000) (noting that because "every firm has a 'shadow pill[,]' . . . adoption of an actual pill has no effect on a target's legal takeover vulnerability").

66 Because the poison pill can be adopted on a moment's notice through unilateral board action, surveying the number of firms that have adopted the provision undercounts the number of firms that would have the provision at their disposal in the event of a hostile offer. See id at 291–97. For additional research suggesting that poison pills have minimal economic effects, see Emiliano M. Catan, *The Insignificance of Clear-Day Poison Pills* *20–25, 29 (NYU School of Law: Law & Economics Working Paper No 16-33, Sept 2016) (on

staggered board can be adopted only with a shareholder vote, its presence or absence is far more indicative of potential entrenchment than a poison pill is.[67] The study finds no relationship between change-of-control covenants and staggered board provisions.[68]

2. The dead hand feature.

The standard change-of-control provision may adequately protect creditor interests in the context of leveraged buyouts and hostile takeovers, but the provision has a serious weakness in the context of hedge fund activism. Debtors can effectively waive the standard provision's proxy fight trigger by "approving" a dissident's slate.[69] Approval, in this context, amounts to formally confirming that the dissident nominees are qualified to serve, but not necessarily endorsing or recommending those nominees for election.[70] As a result, the debtor's board can avoid default simply by confirming the qualifications of the dissident's nominees. Moreover, the board's fiduciary duties may require them to approve qualified nominees.[71] The standard provision, in other words, gives the debtor's board de facto waiver authority that they may be required to exercise.[72]

The potential defect in the provision—that "approval" might mean something less than "endorsement"—may not have been apparent in the takeover era, because in those days proxy fights were typically paired with tender offers as a means of dismantling

file with author) (attributing the relationship between poison pills and firm value to reverse causality).

[67] The staggered board provision is arguably the single most powerful entrenchment provision and has been shown in numerous studies to reduce shareholder value. See Lucian A. Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, 78 J Fin Econ 409, 412–13, 418–30 (2005); Lucian Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?*, 22 Rev Fin Stud 783, 791, 803–05 (2009). But see K.J. Martijn Cremers, Lubomir P. Litov, and Simone M. Sepe, *Staggered Boards and Long-Term Firm Value, Revisited*, J Fin Econ *9–13, 45–47 (forthcoming), archived at http://perma.cc/XDZ2-F967 (finding positive long-term association between staggered boards and firm value).

[68] Bereskin and Bowers, *Poison Puts* at *14–15, 32 (cited in note 62). Consistent with this finding, we find no relationship between the Dead Hand Proxy Put and staggered board provisions. See Part IV.A.

[69] See note 58 and accompanying text (discussing the "control share" and "proxy fight" triggers under the standard change-of-control provision).

[70] See *Amylin*, 983 A2d at 314–15 (interpreting the meaning of "approve" under a change-of-control provision in a bond contract).

[71] This is the holding of *Sandridge*, 68 A3d at 261. See also Part II.B.

[72] For a discussion of the resulting failure of the standard provision to protect managers in the context of hedge fund activism, see Part V.E.

the target company's poison pill.[73] As long as the proxy fight was paired with an offer to purchase shares, there would have been no gap in creditor protection; in the unlikely event that the target board "approved" the dissident slate, creditors remained protected by the control share provision, which would have been triggered upon consummation of the tender offer. Only in the context of hedge fund activism, in which proxy fights are *not* paired with tender offers, would the gap in creditor protection have become apparent. Because victory in a proxy fight, not acquisition, is the hedge fund activist's ultimate objective, creditors remain vulnerable under the standard provision. The Dead Hand Proxy Put responds to this gap in protection.

The Dead Hand Proxy Put expressly disempowers the debtor's board from approving dissident nominees in the context of a proxy fight.[74] The contractual innovation of the provision is thus to reset the waiver mechanism of the change-of-control provision, updating it to the era of stand-alone proxy fights. Previously, waiver authority was shared by the creditor and, through the approval mechanism, the debtor. By eliminating the approval mechanism, the Dead Hand Proxy Put strips the debtor of de facto waiver power, allocating waiver authority exclusively to the creditor.

The reallocation of waiver authority empowers creditors to protect their own interests in the context of a proxy fight. This is a crucial innovation in the era of hedge fund activism. Activists

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73 The buyer's strategy was to win a board majority in order to redeem the poison pill and thus to allow the tender offer to proceed. Buyers therefore typically launched proxy fights at the same time as tender offers, conditioned the tender offer on success in the proxy fight, and committed in the solicitation materials to consummate the tender offer if the proxy fight was successful. See Robert J. Klein, Note, *The Case for Heightened Scrutiny in Defense of the Shareholders' Franchise Right*, 44 Stan L Rev 129, 138 (1991):

> Strategic acquirors have often been forced to wage a proxy fight concurrently with a tender offer to combat . . . the poison pill. The acquiror hopes that if the incumbent board refuses to redeem the target's poison pill, the acquiror can convince the shareholders to elect a new board that will remove the pill.

74 The dead hand feature is typically included by appending the following exclusion to the change-of-control provision quoted in note 58:

> excluding, in the case of both clause (ii) and clause (iii), any individual whose initial nomination for, or assumption of office as, a member of that board . . . occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors.

Amylin, 983 A2d at 309. For the meaning of "approval" in this context, see notes 70–73 and accompanying text.

use proxy fights to gain control of target companies.[75] And activists, once in control, frequently seek changes that threaten creditor interests.[76] Hence, a creditor that does not control waiver authority under the proxy fight trigger remains vulnerable to loss through hedge fund activism.

The Dead Hand Proxy Put brings the creditor back to the bargaining table. Once the provision is in place, an activist cannot proceed without replacing the company's outstanding debt unless the creditor waives the provision. An event of default thus gives the creditor three options: (1) waive the default, (2) renegotiate the terms of the debt, or (3) demand immediate repayment. The debtor, having lost the ability to avoid acceleration by approving dissident nominees, no longer has any choice in the matter. The Dead Hand Proxy Put thus represents a private-ordering solution to creditor vulnerabilities in the era of hedge fund activism.

II. THE JURISPRUDENCE OF DEAD HAND PROXY PUTS

Although the discussion above portrays the provision as a bargained-for response to a gap in creditor protection, the judicial response to Dead Hand Proxy Puts has focused principally on the conflict between managers and shareholders. This Part describes the current jurisprudence of Dead Hand Proxy Puts as revealed by three recent decisions of the Delaware Court of Chancery. Emphasizing the deterrent effect of the provision, the court has clearly and consistently portrayed Dead Hand Proxy Puts as potentially harmful to shareholders, ultimately going so far as to hold that mere adoption of the provision may constitute a breach of fiduciary duty. A common thread underlying each of these decisions is the court's suspicion of devices that disempower shareholders and entrench managers. It remains to be seen, however, whether this is the correct lens through which to view the provision.

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[75] See Ronald J. Gilson and Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 Colum L Rev 863, 897 (2013) (describing hedge fund activists as "governance entrepreneurs, arbitraging governance rights that become more valuable through their activity monitoring companies to identify strategic opportunities and then presenting them to institutional investors for their approval—through a proxy fight, should the portfolio company resist the proposal"). There is not a proxy fight in every activist intervention—indeed, most activist interventions end without one. But the proxy fight is a hedge fund activist's ultimate recourse (and threat) if management cannot be persuaded to capitulate by other means. See note 19.

[76] See text accompanying notes 50–52.

A. *Amylin*

Amylin is, at its core, a contract interpretation case. The dispute arose out of a proxy contest in which two activists each sought five seats on Amylin's twelve-member board.[77] Amylin had change-of-control provisions both in its bond indenture and its credit agreement, but only the credit agreement contained the dead hand feature.[78] Had either provision been triggered, the result would have been accelerated repayment of $915 million in total debt at a time when the company had only $817 million in cash and cash equivalents.[79] After the company warned its shareholders of dire financial consequences should the activists win, the activists and a group of shareholder plaintiffs sued the company to force it to remove any obstacle to the proxy contest.[80] After a partial settlement of the litigation,[81] which included an amendment to the credit agreement eliminating the dead hand feature,[82] the only live dispute in the case was whether the terms of the bond indenture permitted the board to "approve" dissident directors, thereby avoiding acceleration.[83]

In holding that the bond indenture did indeed permit the board to approve dissident nominees, the court compared the language of the credit agreement, which plainly restricted such approval, to the language of the indenture, which did not.[84] Thus

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77 *Amylin*, 983 A2d at 309.

78 See id at 307–09.

79 See id at 310 n 7. Due to cross-default provisions, a default under either form of indebtedness would have triggered default under the other. See Stephen R. Kruft, *Cross-Default Provisions in Financing and Derivatives Transactions*, 113 Bank L J 216, 216 (1996) ("A cross-default is a contractual provision that establishes an Event of Default under the agreement if a party defaults under other specified agreements. . . . These provisions appear in most credit-related agreements.").

80 The company's 10-K emphasized, "We may not have the liquidity or financial resources to [pay off or refinance the debt] at the times required or at all." *Amylin*, 983 A2d at 310 n 7.

81 As part of the settlement, the company agreed to approve the dissident nominees if entitled under the indenture to do so. See id at 311–12.

82 The lender received a 50 basis point fee for the waiver. See id at 312.

83 See id at 313. The indenture trustee argued that this dispute was not ripe because the provision would not in any event have been triggered by the current proxy contest. However, both the shareholder plaintiffs and Amylin argued that the issue was ripe because whether dissident directors constitute "Continuing Directors" under the provision could have a significant effect on shareholder voting in subsequent years. Id.

84 See *Amylin*, 983 A2d at 315 n 30 (noting that the negotiating history showed that the bank lenders insisted on the dead hand feature in the credit agreement in spite of the company's attempt to substitute the language of the indenture, presumably because they viewed the credit agreement's language as more, not less, restrictive).

finding the indenture trustee's reading of the provision to be overly restrictive, the court then went beyond this narrow holding to assert that the presence of a dead hand feature in a bond indenture would have an "eviscerating effect on the stockholder franchise."[85] However, the court also noted that the presence of the provision in a credit agreement might be less problematic because it could be more easily waived.[86] Finally, the court concluded by recalling the shareholder-bondholder conflict and the risk that corporations may agree to contract terms that "impinge on the free exercise of the shareholder franchise."[87] Because the right to vote belongs "first and foremost to the stockholders," boards must carefully consider fiduciary duty when restricting that right in favor of another corporate constituency, especially debtholders, "whose interests at times may be directly adverse to those of the stockholders."[88] All of this language, because it was not necessary to arrive at the actual holding, is technically dicta. Yet it is instructive in revealing the court's approach to Dead Hand Proxy Puts, which clearly echoes the concerns of the famous *Blasius Industries, Inc v Atlas Corp*.[89]

B. *Sandridge*

If *Amylin* was fundamentally a contract interpretation case with dicta touching on issues of fiduciary duty, *Sandridge* was a fiduciary duty case that squarely confronted the question whether and when a board might be required to approve a dissident slate. Although the answers to these questions plainly have some bearing on Dead Hand Proxy Puts, the change-of-control provision in *Sandridge* did not include a dead hand feature. Moreover, the holding—that fiduciary duty may, under some circumstances, require a board to approve a dissident slate—was resolutely fact specific, resting principally on the manifest lack of good faith of the target board.

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[85] Id at 315.

[86] See id at 315 n 30.

[87] Id at 319.

[88] *Amylin*, 983 A2d at 319.

[89] 564 A2d 651, 661 (Del Ch 1988) (holding that boards must offer a "compelling justification" for any act or device with the primary purpose of infringing on shareholders' voting rights). See also Part VI.B (discussing *Blasius* in the context of the evolution of corporate-law doctrine).

In *Sandridge*, an activist hedge fund sought to replace a majority of the Sandridge board.[90] As in *Amylin*, the Sandridge board warned its shareholders that voting in favor of the activist might cause material harm to the company by triggering the provision and thereby allowing the holders of $4.3 billion in notes to put the indebtedness back to the company.[91] A shareholder plaintiff sued, arguing that because approval of dissident nominees was, as in *Amylin*, permitted under the terms of the indenture, failure to do so amounted to breach of the board's fiduciary duties.[92]

The *Sandridge* court confronted the fiduciary duty issue under the *Unocal Corp v Mesa Petroleum Co*[93] standard, after considering and then rejecting as an alternative the *Blasius* "compelling justification" standard in light of the ability of change-of-control provisions to serve creditors' good-faith interests.[94] Under *Unocal*, the *Sandridge* court stated the question would not be the reason for which the provision was adopted but rather the reasonableness of its effect in light of the threat facing the corporation.[95] Boards must identify "a circumstantially proper and non-pretextual basis for their actions, particularly when their actions have the effect of tilting the electoral playing field against an opposition slate."[96] Because the board had failed to articulate a legitimate threat to bondholder interests from the dissident slate,[97]

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90 *Sandridge*, 68 A3d at 244.

91 See id at 250. Interestingly, however, because the existing debt was trading well above par, the board later reversed course and informed creditors that the change of control created no risk to the company because shareholders were not likely to put their debt back to the company at below-market prices. See id at 251–52.

92 See id at 250–51.

93 493 A2d 946 (1985).

94 See *Sandridge*, 68 A3d at 258 (emphasizing that *Blasius* applies only when an action is "taken for the sole or primary purpose of thwarting a shareholder vote"), quoting *Blasius*, 564 A2d at 662.

95 See *Sandridge*, 68 A3d at 259 (noting that the standard requires boards to prove their actions were "reasonable in relationship to a threat faced by the corporation" and that the test is applied with "special sensitivity towards the stockholder franchise").

96 Id.

97 The court found no threat to noteholder interests because the hedge fund activist had not proposed measures, such as increasing leverage or payouts to shareholders, that would legitimately increase noteholder risk. See id at 263. In the absence of

> a specific determination that the rival candidates proposed a program that would have demonstrably material adverse effects for the corporation's ability to meet its legal obligations to its creditors, the incumbent board should approve the rival slate and allow the stockholders to choose the corporation's directors without fear of adverse financial consequences.

Id at 246.

the court found that the board's likely motive in refusing to approve the dissident slate was merely to entrench itself, therefore failing under *Unocal*.[98]

Sandridge is thus one of the relatively few cases to apply *Unocal* and find a violation of the standard, suggesting perhaps that the test will be applied more stringently to defenses that block activism than it has been to defenses that block hostile takeovers.[99] Ultimately, the case stands for the proposition that fiduciary duty may require the target board to approve an apparently qualified dissident slate. But what if the defensive provision does not allow approval to avoid the trigger? Is that provision automatically void as against public policy? Does the board violate its fiduciary duties in agreeing to it? And is the creditor complicit in aiding and abetting the breach in negotiating for and then enforcing the provision? The answers to these questions would have to await the court's ruling in *Healthways*.

C. *Healthways*

Unlike the Amylin and Sandridge boards, the Healthways board was not in the midst of a proxy contest at the time of litigation. However, the company had been under shareholder pressure, initially to destagger its board, a demand to which the company ultimately acceded after amending its credit agreement to include a Dead Hand Proxy Put.[100] Not long thereafter, an activist hedge fund with an 11 percent stake sent a public letter to the board expressing concern over the company's leadership and recommending removal of the CEO.[101] The company eventually accommodated the activist, offering the fund three seats on the

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[98] See id at 263–64 (holding that the board's failure under *Unocal* entitled the shareholder plaintiffs to a preliminary injunction).

[99] See Robert B. Thompson and D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 Tex L Rev 261, 284–94 (2001) (analyzing application of the *Unocal* standard over a fifteen-year period and finding that the standard very rarely resulted in the invalidation of board action). See also *Air Products & Chemicals, Inc v Airgas, Inc*, 16 A3d 48, 57–58, 92 (Del Ch 2011) (approving a board's use of a poison pill but noting that a "preclusive or coercive" defensive action would violate the second step of *Unocal* review).

[100] See *Healthways* Transcript at *69–71 (cited in note 25). The New York State Common Retirement Fund submitted a precatory proposal to destagger the Healthways board, which the company's shareholders approved on May 31, 2012. Id at *69. Healthways amended its credit agreement to insert the Dead Hand Proxy Put on June 8, 2012. Id at *69–70. The company amended its articles of incorporation on October 10, 2013, to phase out the staggered board. Id at *69.

[101] Id at *70.

board.[102] A group of shareholder plaintiffs nevertheless sued, alleging that the board had breached its fiduciary duty in agreeing to the Dead Hand Proxy Put and that the lenders had aided and abetted the breach of fiduciary duty by including the provision in the loan agreement.[103] The defendants moved to dismiss, arguing that the claim was not ripe for adjudication because the provision, unlike those in *Amylin* and *Sandridge*, had not been invoked in the context of a proxy fight.[104]

The *Healthways* court disagreed, denying the motion to dismiss and ruling that the claim was indeed ripe for adjudication due to the potential deterrent effect of the Dead Hand Proxy Put.[105] In addressing the claims against the director defendants, the court relied on *Carmody v Toll Brothers, Inc*,[106] a case involving a dead hand version of the poison pill,[107] which the court treated as indistinguishable from the present case.[108] A dead hand feature, whether in a poison pill or a poison put, the *Healthways* court reasoned, chilled proxy contests regardless of whether the proxy contest was in fact underway.[109] Moreover, any directors elected under the dead hand provision and thereby deemed "noncontinuing" suffer the injury of being treated differently from every other member of the board, regardless of whether the number of noncontinuing directors ever triggered acceleration of the debt.[110] In addition to *Toll Brothers*, the court cited *Moran v Household International, Inc*[111] for the proposition that defensive provisions would be subject to scrutiny both when adopted *and* when invoked.[112] Having thus laid the framework of its analysis, the court pointed to the fact that no evidence had surfaced to suggest that the board had carefully considered the provision in the

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[102] Id at *12. Because these nominees were proposed by the activist, however, they would constitute noncontinuing directors for purposes of the company's Dead Hand Proxy Put. See id at *70–71.

[103] Id at *71.

[104] *Healthways* Transcript at *71–72 (cited in note 25).

[105] Id at *72–73 ("As with other defensive devices, such as rights plans, one necessarily bargains in the shadow of a defensive measure that has deterrent effect. A truly effective deterrent is never triggered.").

[106] 723 A2d 1180 (Del Ch 1998).

[107] Id at 1184.

[108] *Healthways* Transcript at *74 (cited in note 25).

[109] Id.

[110] Id at *75.

[111] 490 A2d 1059 (Del Ch 1985).

[112] *Healthways* Transcript at *73–74 (cited in note 25). See also *Moran*, 723 A2d at 1074–75.

credit agreement or sought to negotiate it away. The central focus of the court was the absence of the shareholder interest in this negotiation and the joint interest of management and creditors in perpetuating the incumbent management team.[113] Likewise, the court viewed the creditor's knowing participation in agreeing to the potentially entrenching provision, especially in the wake of *Amylin* and *Sandridge*, as sufficient to deny the motion to dismiss the aiding and abetting claim against the creditors.[114]

The *Healthways* court was at pains to emphasize that it did not hold Dead Hand Proxy Puts to be a per se breach of fiduciary duty.[115] Nevertheless, in holding boards to a heightened standard of review upon adoption, the ruling creates a clear pathway for plaintiffs to challenge the provision. Unless persuasive evidence surfaces that a board carefully considered the Dead Hand Proxy Put before agreeing to it, suits challenging the provision as an infringement of the shareholder franchise would likely survive a motion to dismiss. The ability to survive a motion to dismiss means, as a practical matter, that defendants will settle, often for nonpecuniary relief—in this context an amendment to the credit agreement eliminating the dead hand provision—along with the payment of plaintiffs' attorney's fees.[116] The predictable result of

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113 The court emphasized this point:

> [Poison Puts] are great for the two sides of the negotiation who are at the table. So, I mean, that's what we know from the history of the '80s. These things come out of the '80s. And both sides of the negotiation at the table, . . . both the lender and the fiduciaries, had benefit from the entrenching effect. It's a win-win for them. The person for whom it's not a win is the person not at the table, who then has to actually expend resources to monitor, to bring suit, etc.

Healthways Transcript at *35 (cited in note 25).

114 Id at *80.

115 Id at *76 ("This is not a per se analysis. . . . Nor does the denial of the motion to dismiss depend on any theory that entering into an agreement that contains a proxy put is a per se breach of fiduciary duty."). The court repeated this in a subsequent ruling approving settlement of the case. See Transcript of Settlement Hearing, *Pontiac General v Ballantine*, Civil Action No 9789-VCL, *35–36 (Del Ch May 8, 2015) (available on Westlaw at 2015 WL 3658647) (stating that the court's prior ruling on the motion to dismiss "was a contextual ruling based on the facts" and that "the facts in the complaint suggested that this [Dead Hand Proxy Put] provision was inserted in the shadow of a control contest").

116 See *Solomon v Pathe Communications Corp*, 1995 WL 250374, *4 (Del Ch) ("It is a fact evident to all of those who are familiar with shareholder litigation that surviving a motion to dismiss means, as a practical matter, that economical [sic] rational defendants . . . will settle such claims, often for a peppercorn and a fee."). The other route to fees for plaintiffs' attorneys comes into play when defendants amend their credit agreement after suit has been filed, mooting the claim, and entitling attorneys to a "mootness fee." See *Swomley v Schlecht*, 2015 WL 1186126, *1 (Del Ch) (setting forth the conditions of a mootness fee when "(i) the defendants have taken action sufficient to render a class or

this combination of incentives has been a wave of actual or threatened litigation against companies with Dead Hand Proxy Puts and strong incentives, on the part of companies and lenders, to eliminate the provision.[117] In this way, although *Healthways* did not in fact hold that Dead Hand Proxy Puts are per se illegal, the effect of the ruling, given the incentives of the parties at settlement, may have been much the same.

The jurisprudence on Dead Hand Proxy Puts thus clearly portrays the provision as a burden on shareholders. But is this an accurate characterization of the role and function of Dead Hand Proxy Puts? This is the subject of our empirical analysis in the next two Parts.

III. Empirical Evidence on the Incidence and Effect of Dead Hand Proxy Puts

We set out to study Dead Hand Proxy Puts empirically and to analyze, in particular, their effect on creditor and shareholder interests. To do so, we began by searching SEC filings for loan agreements and bond indentures containing the Dead Hand Proxy Put provision.[118] Using Intelligize, an online platform that allows efficient searching of SEC filings and exhibits, we ran searches on the two forms of the provision we had encountered.[119]

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derivative action moot and (ii) the defendants agree . . . to pay a fee to plaintiffs' counsel in light of the benefits the litigation conferred by contributing to the action taken by the defendants"), citing *In re Advanced Mammography Systems, Inc Shareholders Litigation*, 1996 WL 633409, *1. See also, for example, *Stanzione* Fee Petition at *1–3 (cited in note 35) (describing mootness fee dispute involving the amendment of a credit agreement to eliminate a Dead Hand Proxy Put).

117 See text accompanying note 27. In addition to claims actually filed, plaintiffs' firms have allegedly contacted companies demanding that they remove their Dead Hand Proxy Put (and pay a mootness fee) or face litigation.

118 Loan agreements constitute "material contracts" that must be filed as exhibits to the filings of SEC-registered companies. See 17 CFR § 229.601(b)(10). Trust indentures must be filed in connection with bond issuances as instruments defining the rights of security holders. See 17 CFR § 229.601(b)(4).

119 We found the provision in two forms. The first was:

> excluding . . . any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors.

The second was:

> excluding any such individual originally proposed for election in opposition to the Board of Directors in office at the Agreement Effective Date in an actual or

In this way, we assembled an original, hand-collected database of debt contracts containing the term. We assembled our control group using the 2015 version of Dealscan, a database that contains most sizable commercial loans in the United States.[120] We obtained company information from Compustat,[121] equity prices from the Center for Research in Security Prices (CRSP),[122] governance statistics from Institutional Shareholder Services (ISS),[123] and information on hedge fund activism from FactSet SharkRepellent.[124] After merging these data sources,[125] we emerged with a sample of 53,132 loans covering 7,788 companies from 1994 through 2014. As described in the sections that follow, we used this dataset to test the incidence and effect of the Dead Hand Proxy Put.

> threatened election contest relating to the election of the directors (or comparable managers) of Parent and whose initial assumption of office resulted from such contest or the settlement thereof.

Over the period from 1994 to 2014, we found approximately 2,000 incidents of the first form and 700 incidents of the second form.

120 Dealscan is commonly used in academic research on loans. See Michael Bradley and Michael R. Roberts, *The Structure and Pricing of Corporate Debt Covenants*, 5 Q J Fin 1550001-1, 1550001-9 (2015) ("From 1995 onward, Dealscan contains the 'large majority' of sizable commercial loans."). From Dealscan, we collected the spread of the loan over LIBOR and the amount and maturity of the loan.

121 Compustat is prepared and marketed by Standard & Poor's (S&P) Capital IQ division using information from firms' financial disclosures. Such information undergoes a standardization process before being coded into the Compustat database." Ryan J. Casey, et al, *Does Compustat Financial Statement Data Articulate?*, 1 J Fin Rptg 37, 37 n 1 (2016).

122 CRSP is a "comprehensive database for historical security prices and returns information" operated by the University of Chicago Booth School of Business that primarily targets the academic market. *Why CRSP?* (CRSP), archived at http://perma.cc/G9VV-TS47.

123 "The ISS governance standards include broad factors encompassing eight corporate governance categories: audit, board of directors, charter/by-laws, director education, executive and director compensation, ownership, progressive practices and state of incorporation." Pandej Chintrakarn, et al, *Does Corporate Governance Quality Affect Analyst Coverage? Evidence from the Institutional Shareholder Services (ISS)*, 22 Applied Econ Let 312, 313 (2015).

124 FactSet SharkRepellent is a database that tracks activist interventions, takeover defenses, and shareholder voting. See generally SharkRepellent.net, available at http://perma.cc/KHT4-CKJ5. It is used in empirical research in these areas. See, for example, Cain, et al, 164 U Pa L Rev at 679 (cited in note 12) (using the database in a study of responses to shareholder activism); Guhan Subramanian, *Delaware's Choice*, 39 Del J Corp L 1, 6 n 26, 10 (2014) (using the database in a study of takeover defenses).

125 We performed this merger using the linking table available through Wharton Research Data Services (WRDS). See Sudheer Chava and Michael R. Roberts, *How Does Financing Impact Investment? The Role of Debt Covenants*, 63 J Fin 2085, 2090–93 (2008) (creating the Dealscan-Compustat linking table).

A. Descriptive Statistics

Our searches yielded over 2,700 observations of Dead Hand Proxy Puts in loan agreements from 1994 through 2014. Over the same period, we found fewer than 60 observations of the provision in bond indentures. The prevalence of the provision in loan agreements as opposed to bond indentures may be explained by structural differences in the waivability of default.[126] Because waiver is a realistic possibility for loans, not bonds, and because the dead hand feature is, at its core, a reallocation of waiver authority, creditors may have invested in negotiating for it in loan agreements, but not bond indentures.[127]

Focusing therefore on loans rather than bonds, we find evidence of a strong link between Dead Hand Proxy Puts and hedge fund activism, starting with the incidence of the provision, which (as demonstrated in Figure 1 below) has increased dramatically.

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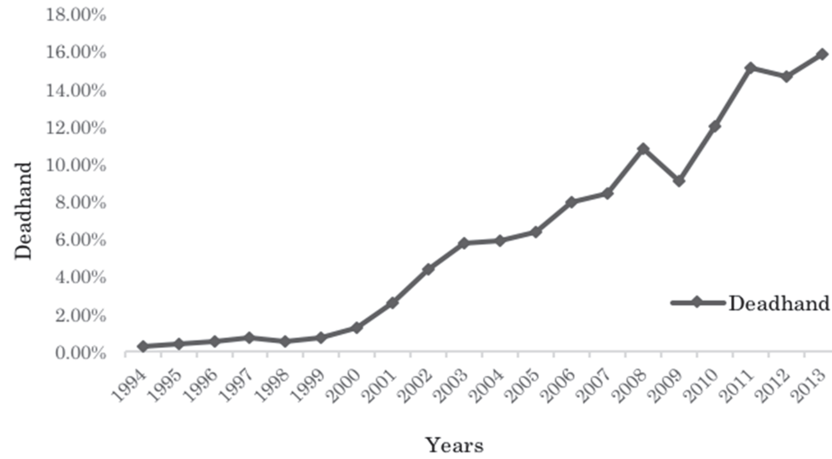
[126] Unlike loans, bonds are diffusely held and, due in part to the Trust Indenture Act's prohibition of majority-action modification of bond terms, lack a meaningful coordination mechanism. See The Trust Indenture Act of 1939 § 316(b), Pub L No 111-229, 53 Stat 1149, 1172, codified at 15 USC § 77ppp(b). Because a bond default gives each individual bondholder the right to immediate repayment—the right to "put" the debt back to the company—bondholders can be expected to react *en masse* one way or another, depending on market conditions.

By contrast, syndicated loans are made by a small number of banks accustomed to cooperation. Moreover, the syndicate has a coordination mechanism in the form of the administrative agent, appointed by the lenders to manage the loan. The lenders work through the administrative agent to waive or amend aspects of the original credit agreement. Furthermore, unlike most bondholders, banks may have ongoing business relationships—investment banking or other financial services relationships—with corporate borrowers. This makes them repeat players, amenable to negotiation.

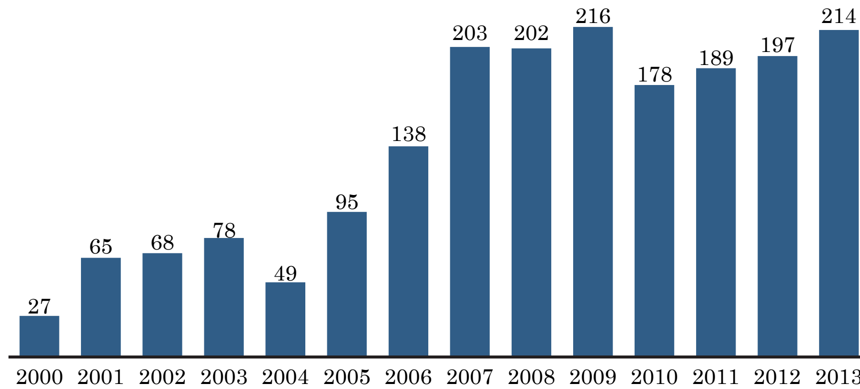
[127] It may seem odd that the board retains de facto waiver authority (via the power to "approve" dissident nominees) in the context of bonds. Bond creditors remain protected, however, as long as the dead hand feature appears in the company's loan agreements and the bond indenture contains a cross-default provision, as it almost certainly does. See Kruft, 113 Bank L J at 216 (cited in note 79) (describing cross-default provisions as standard). In this case, the loan creditors' decision to trigger default will also protect bondholders by triggering the cross-default provision. Consistent with this explanation, our companion paper finds a statistically significant increase in bond prices from the adoption of a Dead Hand Proxy Put in the company's loan agreements. See Griffith and Reisel, *Dead Hand Proxy Puts* at *19–20, 35 (cited in note 31).

FIGURE 1. DEAD HAND PROXY PUT ACROSS TIME, 1994–2014



Dead Hand Proxy Puts increased from 0.24 percent of loans at the outset of our sample period to more than 16 percent at the end of the sample period. The provision became more prevalent in the early 2000s and increased sharply after 2008. As shown in Figure 2 below, hedge fund activism increased sharply over the same period.[128]

FIGURE 2. ACTIVIST INTERVENTIONS ACROSS TIME, 2000–2013[129]



[128] Figure 2 shows activist interventions in publicly traded companies in the United States. In untabulated results, we checked the frequency of adoption by firms in our sample and confirmed the results reported in Figures 1 and 2.

[129] These data are from FactSet SharkRepellent.

The increasing incidence of Dead Hand Proxy Puts thus coincides with the rise of hedge fund activism.[130]

A further link between Dead Hand Proxy Puts and hedge fund activism can be seen by the types of companies adopting the provision. As shown in Table 1 in the Appendix, companies adopting the provision tend to be medium- to small-sized firms, with mean total assets of approximately $3.2 billion and median total assets of $946 million. When, in our companion paper, we compared the characteristics of these companies with companies in our control group, we found that companies adopting Dead Hand Proxy Puts are likely to be smaller, pay lower dividends, and have less total leverage than other firms.[131] These are common characteristics of the targets of hedge fund activists, especially those of activists planning to increase leverage in order to increase payouts to shareholders.[132] Our companion paper also tested whether companies that adopted Dead Hand Proxy Puts were more or less likely to be approached by hedge fund activists and found that firms adopting the provision are indeed more likely to be subject to future activist interventions, suggesting that the term is adopted in *anticipation* of hedge fund activism.[133] Dead Hand Proxy Puts thus appear to be closely associated with hedge fund activism.

B. The Effect of Dead Hand Proxy Puts on the Price of Debt

Our account above identifies a benefit to creditors from the Dead Hand Proxy Put's creation of a repayment option in the event of a successful activist attack.[134] If creditors value this benefit, they should be willing to pay for it. In this context, paying for the benefit would involve discounting the cost of credit for borrowers willing to include the term. This is an empirical question. Are loans with Dead Hand Proxy Puts offered at lower interest rates than loans without the term? Our companion paper finds that they are.

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[130] See, for example, Frank Partnoy, *US Hedge Fund Activism*, in Jennifer G. Hill and Randall S. Thomas, eds, *Research Handbook on Shareholder Power* 99, 99 (Edward Elgar 2015) ("[S]ecurities filings suggest that hedge fund activism has been significant since the late 1990s, but not before.").

[131] See Griffith and Reisel, *Dead Hand Proxy Puts* at *27–28 (cited in note 31).

[132] See Brav, Jiang, and Kim, 4 Found & Trends Fin at 206–12 (cited in note 7).

[133] Griffith and Reisel, *Dead Hand Proxy Puts* at *29 (cited in note 31).

[134] See Part I.B.2.

We find that inclusion of a Dead Hand Proxy Put reduces firms' borrowing costs in a manner that is both statistically and economically significant.[135] Comparing the spreads of loans with and without the provision, we find that the mean loan spread is 222.86 basis points with the provision and 231.96 basis points without it, a difference that is statistically significant at the 1 percent level.[136] In regressions controlling for debtor and loan characteristics, we find that the presence of a dead hand provision is negative and statistically significant across all specifications.[137] In a further treatment effects model to address endogeneity concerns, we continue to find that Dead Hand Proxy Puts reduce the cost of borrowing.[138] These findings are statistically significant at the 1 percent level across specifications.[139]

The economic magnitude of the reduction in borrowing costs associated with Dead Hand Proxy Puts is also substantial. Our results suggest that the dead hand provision may reduce the cost of debt by up to 50 basis points.[140] This translates into substantial interest savings. Moreover, because most companies keep debt in their capital structure, we can assume annual savings over the life of the company.

Although we find the dead hand feature in loan agreements, not bond indentures, bondholders also appear to benefit from the presence of a Dead Hand Proxy Put in loan agreements. Bondholders react positively to the public announcement of loan contracts with Dead Hand Proxy Puts.[141] Mean bondholder returns upon the public announcement of loan contracts with the Dead Hand Proxy Put are positive and statistically significant at the 5 percent level. By contrast, mean bondholder returns upon the public announcement of loans without the provision are insignificant. While the difference in means between the two cases is insignificant, the difference in medians is significant at the 10 percent level. This finding can be explained by the protection that bondholders receive via the cross-default provision in the bond indenture, triggering a put right for bondholders if an issuer defaults on other

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[135] See Griffith and Reisel, *Dead Hand Proxy Puts* at *16–17, 31–32 (cited in note 31).

[136] Id at *17, 31.

[137] Id at *17, 32.

[138] Id at *18–20, 33–34.

[139] Griffith and Reisel, *Dead Hand Proxy Puts* at *34 (cited in note 31).

[140] Id at *19, 34 (unpacking the logarithm in order to be able to interpret the basis point amount).

[141] Id at *20–22, 35.

indebtedness.[142] The Dead Hand Proxy Put in loan agreements thus seems to generate a positive externality for bondholders.[143]

In finding that creditors discount the price of debt for companies agreeing to Dead Hand Proxy Puts, our companion paper demonstrates an important firm-level benefit from the provision. Firm-level benefits do not necessarily translate into shareholder benefits, however, because the potential for entrenchment costs may more than offset the shareholder benefit from a reduction in the price of debt. Although our companion paper finds strong evidence of creditor- and firm-level benefits from the Dead Hand Proxy Put, it did not settle the question whether shareholders benefit from the provision. We seek to answer that in this Article, by focusing close attention, in the next Part, on the entrenchment hypothesis.

IV. THE ENTRENCHMENT COSTS OF DEAD HAND PROXY PUTS

In spite of the benefit to creditors and the concomitant reduction in the price of debt demonstrated above, the Dead Hand Proxy Put may nevertheless harm shareholders by insulating managers from the market for corporate control and thereby increasing managerial agency costs.[144] An implication of this view is that Dead Hand Proxy Puts, as a result of their entrenchment costs, should decrease share price for firms adopting them. This is the "entrenchment hypothesis," and we set out in this Part to test it. First, we examine the association of Dead Hand Proxy Puts with known entrenchment provisions. Second, we perform an event study, analyzing shareholder reaction to each of the Delaware Court of Chancery's three Dead Hand Proxy Put rulings. As discussed in greater detail below, neither set of tests finds evidence of significant entrenchment costs associated with the provision.

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[142] See generally Kruft, 113 Bank L J 216 (cited in note 79) (describing cross-default provisions).

[143] The protection offered to bond creditors is less comprehensive than the protection offered to loan creditors. For example, if the lender agrees to amend or waive the Dead Hand Proxy Put in the credit agreement, the bondholders lose their protection, as occurred in the *Amylin* case. See Part II.A. Similarly, if the activist refinances or buys out the loan agreement containing the provision, the bondholders again lose their protection. Nevertheless, in situations in which this does not occur, bond creditors may free ride on the protection the provision provides to loan creditors.

[144] See note 29 and accompanying text (discussing the intellectual lineage of this view).

A. Relationship to Other Entrenchment Devices

What is the relationship between the Dead Hand Proxy Put and other corporate governance provisions? If the Dead Hand Proxy Put functions as a kind of "embedded defense," what is its relationship with the firm's "structural defenses," such as staggered boards and poison pills?[145] The entrenchment hypothesis suggests that the Dead Hand Proxy Put might function as either a complement to or a substitute for other forms of takeover defense. For example, given the provision's ability to obstruct proxy fights and the pressure on firms to destagger their boards, it may be that Dead Hand Proxy Puts function as a substitute for the staggered board.[146] Indeed, there is evidence that this is precisely what occurred with the adoption of the provision in *Healthways*.[147] Alternatively, firms might view the Dead Hand Proxy Put as a complement to other defenses and adopt the provision to ensure maximal effectiveness of their panoply of defensive provisions. In this way, the entrenchment hypothesis might support a negative (suggesting substitution) or positive (suggesting complementarity) association with other defensive provisions but, either way, would seem to suggest an association with other defensive provisions.

Our first empirical test of this relationship was to examine the correlation between the Dead Hand Proxy Put and the staggered board provision. However, we found, in unreported regressions, no statistically significant relationship between the two provisions. We therefore broadened our approach beyond the simple staggered board provision to test the relationship between Dead Hand Proxy Puts and company scores on two widely used corporate governance indices: the G-index and the E-index.[148]

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[145] See Arlen and Talley, 152 U Pa L Rev at 597–605 (cited in note 13). See also text accompanying note 13 (distinguishing between structural and embedded defenses).

[146] See Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 Del J Corp L 149, 155–58 (2008) (discussing the pressure on firms to destagger boards).

[147] See note 100 and accompanying text (discussing pressure on the company to destagger, culminating in the removal of the staggered board provision and adoption of the Dead Hand Proxy Put).

[148] Jay B. Kesten, *Managerial Entrenchment and Shareholder Wealth Revisited: Theory and Evidence from a Recessionary Financial Market*, 2010 BYU L Rev 1609, 1627–29 (discussing the importance of the two indices and updating their findings).

The G-index, developed by Professors Paul Gompers, Joy Ishii, and Andrew Metrick, scores twenty-four corporate governance variables.[149] The E-index, developed by Professors Lucian Bebchuk, Alma Cohen, and Allen Ferrell, focuses specifically on a small number of entrenchment-related variables, including poison pills, staggered boards, golden parachutes, and supermajority voting requirements.[150] On both indices, a higher score is associated with weaker protection of shareholder rights or, in the case of the E-index, greater managerial entrenchment. As shown in Table 1 in the Appendix, the mean G-index score of companies adopting Dead Hand Proxy Puts is 9.4, and the median is 9. The mean E-index score is 2.5, and the median is 3.

In order to test the impact of the factors contained in these indices on the adoption of Dead Hand Proxy Puts, we ran a set of probit regressions[151] reported in Table 2 in the Appendix. Although we found a positive and statistically significant (at the 10 percent level) association between the G-index score and the adoption of Dead Hand Proxy Puts, suggesting that companies with *weaker* shareholder rights are *more likely* to include the provision in their loan contracts, financial variables are far more significantly related to the adoption of the provision.[152] However, we could find no statistically significant association between the E-index and adoption of the Dead Hand Proxy Put.[153] This is consistent with our finding of no statistically significant relationship between the Dead Hand Proxy Put and the staggered board, but it is inconsistent with the prediction, from the entrenchment hypothesis, that Dead Hand Proxy Puts should be associated with other defensive provisions. Dead Hand Proxy Puts appear to be neither a complement to nor a substitute for standard antitakeover provisions.

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[149] Paul Gompers, Joy Ishii, and Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q J Econ 107, 110–19 (2003) (devising the governance-index, or "G-index," and evaluating its effect on firm value).

[150] See generally Lucian Bebchuk, Alma Cohen, and Allen Ferrell, *What Matters in Corporate Governance?*, 22 Rev Fin Stud 783 (2009) (devising the entrenchment-index, or "E-index," and evaluating its effect on firm value).

[151] See James H. Stock and Mark W. Watson, *Introduction to Econometrics* 389–94 (Pearson 2007) (explaining that probit regression models are nonlinear regression models that estimate the probability a binary dependent variable occurs).

[152] See Appendix Table 2, Specification 1.

[153] See Appendix Table 2, Specification 2.

If, following the entrenchment hypothesis, Dead Hand Proxy Puts destroy shareholder wealth, shareholders with greater leverage—that is, those holding large blocks of stock—should be able to prevent managers from implementing them. We therefore sought to test whether firms with large blockholders, defined here as holders of 5 percent or more of a company's outstanding shares, are more or less likely to adopt the provision.[154] As shown in Appendix Table 2, we tested the impact of blockholding in two ways. First, we find no relationship between *outside* blockholders and the adoption of Dead Hand Proxy Puts.[155] That is, companies with unaffiliated blockholders—those without intracorporate ties or roles in management—are no more or less likely to adopt Dead Hand Proxy Puts than other firms. However, we do find a strongly statistically significant *negative* association between *inside* blockholders and adoption of the provision.[156] That is, companies with affiliated blockholders are significantly less likely to adopt Dead Hand Proxy Puts than peer firms. We interpret these results to reflect firms' susceptibility to activism more than they reflect the potential entrenchment costs of the provision. Because activists are unlikely to view firms with large inside blockholders as attractive targets, creditors may choose not to invest in negotiating for the additional protection against activism in such cases. At the same time, if the Dead Hand Proxy Put seriously harmed shareholder value, we would have expected outside blockholders to use their leverage to block it.

In sum, our findings on the relationship of other entrenchment devices and the impact of blockholding do not support the entrenchment hypothesis. Instead, we find no evidence of a statistically significant relationship between the Dead Hand Proxy Put and other entrenchment devices. And outside blockholders appear uninterested in using their leverage to block adoption of the provision.

B. Shareholder Reaction to Dead Hand Proxy Puts

Shareholder reaction offers a more direct test of the entrenchment hypothesis. If Dead Hand Proxy Puts destroy shareholder

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[154] See Jennifer Dlugosz, et al, *Large Blocks of Stock: Prevalence, Size, and Measurement* *5–11, 22 (NBER Working Paper No 10671, Aug 2004), archived at http://perma.cc/9FTP-P5FV (discussing methodologies for measuring blockholdings).

[155] See Appendix Table 2, Specification 3.

[156] See Appendix Table 2, Specification 4.

value, shareholders should react negatively to them. Contrary to this hypothesis, in our companion paper, we found evidence that shareholders react favorably to the announcement of loans with Dead Hand Proxy Puts.[157] However, we found no statistically significant difference in shareholder reaction to the announcement of loans with and without the provision, suggesting that the result may have been driven more by shareholder response to the extension of credit than to the terms of the loan.[158]

In this Section, we further test shareholder reaction to Dead Hand Proxy Puts by performing a set of event studies based on the three Delaware cases restricting Dead Hand Proxy Puts. We treat each ruling as an exogenous shock, forcing shareholders of companies with Dead Hand Proxy Puts to reevaluate the value of their shares. Because each case restricts the provision, *Healthways* most of all,[159] the entrenchment hypothesis predicts a *positive* shareholder response to each ruling, especially *Healthways*. This, however, is not what we find. We describe the results of our tests of each case below.

1. Shareholder reaction to *Amylin*.

Table 3 in the Appendix presents the results of our test of shareholder reactions to the *Amylin* decision. Contrary to the prediction of the entrenchment hypothesis, we find a highly statistically significant *negative* shareholder response to the case. However, we find no statistically significant difference between the reaction of companies with or without the Dead Hand Proxy Put,[160] suggesting that the shareholder reaction is not driven by the provision but by other factors. *Amylin*, recall, was a May 2009 decision. While early 2009 was not the height of the credit crunch,

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[157] See Griffith and Reisel, *Dead Hand Proxy Puts* at *35 (cited in note 31).

[158] See id. In unreported results, we further examined the intuition that shareholders may be reacting more to the extension of credit than to presence or absence of a Dead Hand Proxy Put by separately testing the shareholder response of companies with investment-grade debt. We hypothesized that because the extension of credit is a less significant event for such companies, shareholders would be more likely to react to the specific terms of the debt rather than the mere extension of credit. Nevertheless, the results for this subsample mirrored the larger result. Shareholders reacted positively to the filing of loan contracts both with and without Dead Hand Proxy Puts, and there was no statistically significant difference in shareholder reaction to loans with or without the provision. There may be important signaling effects associated with loan announcements—such as funding for new growth projects—that drive shareholder reactions without regard to the credit quality of the borrower.

[159] See Part II.C.

[160] See Appendix Table 3, Panel A.

it was the midst of the financial crisis. It is thus possible, especially for the generally small- to medium-sized companies in our sample, that market-wide events may explain this result. Moreover, the result disappears when we further test the sensitivity to activism[161] or to Delaware incorporation.[162] We find no statistically significant result in either of these tests.

In light of these inconsistent results and the presence of confounding factors, we hesitate to draw any inference from our tests of the *Amylin* case. The remaining cases—*Sandridge* and *Healthways*—may provide better tests of the entrenchment hypothesis.

2. Shareholder reaction to *Sandridge*.

Table 4 in the Appendix presents the share price reaction to the *Sandridge* decision. Here we do find a statistically significant difference between median equity returns of adopters and nonadopters in their reaction to the case.[163] Again, however, the underlying reaction points in the wrong direction. Though we had hypothesized a *positive* shareholder reaction to the decision, we find instead a strongly statistically significant *negative* median shareholder reaction to the decision. In other words, shareholders of firms with Dead Hand Proxy Puts reacted *more negatively* to *Sandridge* than the shareholders of firms without the provision. These results are consistent with our other tests but, because they suggest that shareholders often view Dead Hand Proxy Puts favorably, contrary to the entrenchment hypothesis.

Interestingly, when we interact the shareholder response to *Sandridge* with the firm's susceptibility to activism, the results change.[164] Here we find that shareholders of firms that experience shareholder activism reacted *positively* to the decision, as the entrenchment hypothesis predicts. This result, however, is only weakly statistically significant. Moreover, the result disappears when Delaware incorporation is added as an additional control.[165] Hence, the results of our *Sandridge* event studies,

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161 See Appendix Table 3, Panel B.

162 See Appendix Table 3, Panel C. See also Appendix Table 3, Panel D (testing the combined effect of hedge fund activism and Delaware incorporation and finding no statistically significant result).

163 See Appendix Table 4, Panel A.

164 See Appendix Table 4, Panel B.

165 See Appendix Table 4, Panel D. Delaware incorporation is not otherwise significant in these tests. See Appendix Table 4, Panel C.

while not entirely consistent, generally contradict the entrenchment hypothesis.

3. Shareholder reaction to *Healthways*.

Healthways promised the strongest test of the entrenchment hypothesis. Unlike the other two decisions, which were technically dicta as applied to Dead Hand Proxy Puts, *Healthways* directly addressed the provision, erecting substantial barriers to its adoption. Thus, if any of the three rulings was especially salient to shareholders, we reasoned, *Healthways* would be the one. As Table 5 in the Appendix shows, however, this was not the case.

Consistent with the entrenchment hypothesis, we do find that shareholders of firms with Dead Hand Proxy Puts reacted positively to the case, at least with regard to mean excess equity returns.[166] But this finding is only weakly statistically significant, and, more importantly, there is no statistically significant difference between the reaction of shareholders of companies that have and have not adopted the provision. Without this difference, the finding that some shareholders reacted as predicted does not provide meaningful support for the hypothesis.[167]

The rest of the *Healthways* tests fare no better. Susceptibility to activism is not an important predictor of shareholder response,[168] nor is Delaware incorporation[169] or the combination of the two variables.[170] Our tests of the *Healthways* decision, it turns out, have yielded the least conclusive results.

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In sum, our empirical tests have produced evidence generally contrary to the entrenchment hypothesis. Not only do Dead Hand Proxy Puts appear not to destroy firm value, we have found evidence that shareholders in at least some instances react positively

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166 See Appendix Table 5, Panel A.

167 Although we do find a moderately strong, statistically significant difference between the median market-adjusted excess equity returns of adopters and nonadopters, we do not find a statistically significant positive median excess equity return for adopters. The finding, therefore, cannot support the hypothesis.

168 See Appendix Table 5, Panel B. We do find a weakly statistically significant response to activism for the market-adjusted excess return model, but for the full sample only and not the dead hand subsample.

169 See Appendix Table 5, Panel C.

170 See Appendix Table 5, Panel D. Again, we find a weakly statistically significant response to activism for the full sample, but not the dead hand subsample. See note 168.

to the provision. Our tests of the *Sandridge* decision provide the strongest evidence contrary to the entrenchment hypothesis, because shareholders of companies with Dead Hand Proxy Puts responded more negatively to the decision than shareholders without the provision. Our tests of the other two cases produced no statistically significant difference between these groups of shareholders. The *Healthways* tests, in particular, are inconclusive. Nevertheless, taken as a whole, our empirical tests do provide evidence that shareholders are generally not harmed by the provision and that, in at least some instances, they may benefit from it.

V. ANALYSIS AND IMPLICATIONS

How can we explain our findings? The results of our empirical tests seem to fly in the face of the large body of evidence that shareholders respond positively to shareholder activism[171] and negatively to provisions with the potential to entrench managers.[172] This Part reviews a set of possible explanations, finding some more plausible than others. Ultimately, the most likely explanations in our view focus on the discounted value of voting rights and on the benefit shareholders receive from appointing creditors as gatekeepers over value-creating versus value-destroying forms of hedge fund activism.

A. An Excessively Conditional Entrenchment Effect?

Dead Hand Proxy Puts do not preclude hedge fund activism in the way that, for example, the combination of a poison pill and a staggered board precludes a hostile takeover.[173] A Dead Hand Proxy Put operates as, at most, a tax on hedge fund activism. This can impose a significant marginal cost—hedge fund activists, unlike corporate raiders, typically do not have sufficient financing to replace the target company's entire capital structure.[174] However, a Dead Hand Proxy Put will be truly outcome determinative

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[171] See notes 38–40 and accompanying text.
[172] See note 29 and accompanying text.
[173] See Bebchuk, Coates, and Subramanian, 54 Stan L Rev at 899 (cited in note 63).
[174] See text accompanying note 18.

only when: (1) the activist can credibly threaten a control contest;[175] (2) prevailing interest rates create an incentive for creditors to put the debt;[176] (3) the company has inadequate cash reserves and access to financing to repay or replace the debt;[177] and (4) the creditors are unwilling or unable to negotiate a waiver of the default.[178] It is possible, therefore, that shareholders are not sensitive to this level of conditionality.

While we accept that Dead Hand Proxy Puts are by no means preclusive, we doubt that excessive conditionality explains our findings. First, two of the basic conditions—lack of access to credit and the presence of creditors unwilling to waive default—will be true of many financially troubled companies. Insofar as some activists target financially troubled companies, these conditions will be present in every such intervention.[179] Moreover, as noted, the credible threat of a proxy fight is the basis of every activist intervention, regardless of whether a proxy fight is ultimately launched.[180] As a result, the only truly variable condition is whether prevailing interest rates are above or below the level at which the loan was underwritten, and we doubt shareholders are unable to take interest-rate risk into account.

More generally, even if they are less preclusive than standard takeover defenses, Dead Hand Proxy Puts could have an important deterrent effect on shareholder activism. In the words of the *Healthways* court:

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[175] For companies over which a control contest could not succeed for structural reasons, such as a large controlling shareholder aligned with management, the provision will not be relevant because the threat of a successful control contest is not credible. Of note on this point is our finding that affiliated blockholding is *negatively* associated with the adoption of Dead Hand Proxy Puts. Staggered board provisions may also block control contests, but we find no association between the presence of staggered boards and Dead Hand Proxy Puts. See Part IV.A (reporting these findings).

[176] See, for example, *Sandridge*, 68 A3d at 256. The board argued that the proxy put presented no threat because the bonds were trading at a price that created no incentive for holders to put them back on the company, even if the provision was triggered. See id at 245.

[177] See, for example, *Amylin*, 983 A2d at 310 n 7.

[178] As noted, this will always be true in the case of bonds, but bank lenders may be willing to waive events of default for a fee or on the basis of business relationships. Recall that the Dead Hand Proxy Put in the credit agreement in *Amylin* was waived for a 50 basis point fee. See id at 312.

[179] This point was made at oral argument in *Healthways*. See *Healthways* Transcript at *47 (cited in note 25) (plaintiffs' counsel asserting that a company facing activist attack is also more likely to face "[a] bank that doesn't want to give you a waiver or doesn't want to let you refinance").

[180] See note 17 and accompanying text.

> [B]ecause the proxy put exists, it necessarily has an effect on people's decision-making about whether to run a proxy contest and how to negotiate with respect to potential board representation. As with other defensive devices, such as rights plans, one necessarily bargains in the shadow of a defensive measure that has deterrent effect. A truly effective deterrent is never triggered.[181]

Considering the consistently demonstrated positive effect on share price of an announced activist intervention, any device that would substantially deter activism also seems likely to impact share price. The fact that the Dead Hand Proxy Put does not, we argue below, may teach something both about how shareholder votes are valued and about shareholder attitudes toward particular activist strategies.

B. The Discounted Present Value of Future Votes?

Dead Hand Proxy Puts impinge on shareholder voting rights.[182] Shareholder voting rights, in theory at least, have value.[183] It would therefore seem to be a reasonable inference that a device that impinges on voting rights would have a negative effect on share value. We nevertheless find that Dead Hand Proxy Puts have no negative impact on share price. This may reflect shareholders' tendency, demonstrated in the empirical literature on shareholder voting, to discount the value of voting rights except in circumstances in which the right to vote is especially salient.

The empirical literature on shareholder voting generally confirms the view that voting rights have value, but results vary depending on the methodology used. Studies that estimate the value of voting rights by comparing the prices of various classes of stock typically find that shares with stronger voting rights trade at a small premium.[184] However, most of these studies suffer from

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[181] *Healthways* Transcript at *72–73 (cited in note 25).

[182] *Amylin*, 983 A2d at 319 (warning that the dead hand provision may "impinge on the free exercise of the stockholder franchise"); *Sandridge*, 68 A3d at 259 (scrutinizing terms that "have the effect of tilting the electoral playing field").

[183] See Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 70–72 (Harvard 1991).

[184] See, for example, Ronald W. Masulis, Cong Wang, and Fei Xie, *Agency Problems at Dual-Class Companies*, 64 J Fin 1697, 1720 (2009) (finding a 2.4 percent premium for voting rights in a study of 457 companies with dual-class shares from 1995 to 2003); Tatiana Nenova, *The Value of Corporate Voting Rights and Control: A Cross-Country Analysis*, 68 J Fin Econ 325, 334 (2003) (finding a 2 percent premium for voting rights in a study of thirty-nine US companies with dual-class shares in 1997); Luigi Zingales, *What*

small sample sizes, significant differences in liquidity between the treatment and control groups, and selection biases.[185] Similar difficulties affect studies estimating the value of voting rights by comparing the price of privately negotiated block sales to the price of publicly traded minority shares.[186] An alternative methodology that estimates the value of voting rights by focusing on the equity lending fee around shareholder record dates (when voting rights are set) returns mixed results.[187] A more recent methodology measures the value of voting rights by comparing the price between a common (voting) stock and a synthetic (nonvoting) security designed to replicate the cash flows of the underlying common share.[188] This method suggests that voting rights are not highly valued by shareholders unless the voting rights are made salient by the calling of a special meeting, the announcement of hostile hedge fund activism, or the announcement of a merger.[189]

Determines the Value of Corporate Votes?, 110 Q J Econ 1047, 1058–60 (1995) (finding a 10.5 percent premium for voting rights in a study of ninety-four companies with dual-class shares from 1984 to 1990); Ronald C. Lease, John J. McConnell, and Wayne H. Mikkelson, *The Market Value of Control in Publicly-Traded Corporations*, 11 J Fin Econ 439, 469 (1983) (finding a 5.4 percent premium for stronger voting rights in a study of twenty-six companies with dual-class shares between 1940 and 1978).

[185] Most of these studies focus on companies with dual-class shares, but dual-class capital structures present situations with especially strong private benefits of control. Although private benefits of control are typically viewed negatively in the literature, some dual-class capital structures may enhance long-term value by inducing commitment and investment by the controller. See Albert H. Choi, *Costs and Benefits of Concentrated Ownership and Control* *11–18 (Virginia Law Economics Research Paper No 19, Aug 10, 2016), archived at http://perma.cc/FJ6W-63TZ.

[186] These studies also find a positive value for voting rights. See Michael J. Barclay and Clifford G. Holderness, *Private Benefits from Control of Public Corporations*, 25 J Fin Econ 371, 378 (1989) (finding a 20 percent premium on sixty-three control block transfers between 1978 and 1982); Alexander Dyck and Luigi Zingales, *Private Benefits of Control: An International Comparison*, 59 J Fin 537, 551 (2004) (finding a 1 percent premium on forty-six control block transfers in the United States between 1990 and 2000).

[187] Compare Susan E.K. Christoffersen, et al, *Vote Trading and Information Aggregation*, 62 J Fin 2897, 2912–14 (2007) (using a bank database of equity lending fees and finding no value attributable to voting rights), with Reena Aggarwal, Pedro A.C. Saffi, and Jason Sturgess, *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 70 J Fin 2309, 2315–17 (2015) (finding that equity lending fees increase on record dates when supply is restricted).

[188] Avner Kalay, Oğuzhan Karakaş, and Shagun Pant, *The Market Value of Corporate Votes: Theory and Evidence from Option Prices*, 69 J Fin 1235, 1245–51 (2014) (devising the methodology and emphasizing its advantages in applying to a larger number of stocks and suffering less from selection effects).

[189] Id at 1247, 1254–55, 1261–62, 1264–65 (finding an average voting premium of 0.16 percent across the sample but significant increases in the context of special meetings,

The notion that the value of voting rights is deeply discounted by shareholders unless the voting rights are made salient by an exogenous event may help to explain the lack of shareholder response to Dead Hand Proxy Puts. The Dead Hand Proxy Puts in our study are generally introduced on a "clear day," when there is no specific threat of hedge fund activism on the horizon.[190] In such cases we generally find no evidence of a shareholder reaction to the impingement of voting rights that the Dead Hand Proxy Put represents.[191] This finding supports the notion that shareholders discount the value of their voting rights and, by implication, the cost of any impingement to their voting rights, unless the voting rights are made salient.

Finally, it makes sense that our study would return weak results at best on the value of voting rights. Most studies of the value of voting rights are binary, comparing the value of voting and nonvoting shares. But Dead Hand Proxy Puts do not deprive shareholders of voting rights. They merely tax the exercise of those rights in a specific set of circumstances.[192] Because this impingement of voting rights falls significantly short of outright deprivation, we would expect a proportionally smaller shareholder reaction to the provision.

C. An Efficient Shareholder-Creditor Bargain?

A third possibility is that the Dead Hand Proxy Put represents an efficient bargain between creditors and shareholders with respect to hedge fund activism. Hedge fund activism may be value-creating, or it may be redistributive—typically from creditors or other constituencies to shareholders.[193] The Dead Hand Proxy Put can be modeled as a means of mitigating the shareholder-creditor conflict in the context of activism.[194] In order to ensure that shareholders will not appropriate creditor wealth by means of hedge fund activism, the provision allocates exclusive waiver authority to creditors.

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hedge fund activism, friendly merger announcements, and contentious merger announcements, which result in 0.15 percent, 0.09 percent, 0.22 percent, and 0.35 percent increases, respectively).

[190] See Appendix Table 1 (reporting that only 20.4 percent of loan contracts adopting the Dead Hand Proxy Put experienced activism at any time during the sample period).

[191] See Part IV.B.

[192] See notes 175–79 and accompanying text.

[193] See Part I.A.

[194] See Part I.B.

Because the beneficiaries of the provision under this account are creditors, we would expect shareholders to react negatively to it. Yet we find that shareholders do not react negatively to the provision when it is adopted nor do they react positively to the cases restricting the provision.[195] In fact, several of our tests suggest that shareholders view the provision positively. This raises the question whether the provision creates some benefit for shareholders beyond the cost of capital reduction. How do shareholders benefit by allocating waiver authority exclusively to creditors? The key to this puzzle may be a more nuanced account of shareholder and creditor interests with respect to hedge fund activism.

Shareholders are often seen as the beneficiaries of activism due to the consistent bump in share price associated with activist interventions.[196] Nevertheless, considerable debate remains over whether activism aimed at financial restructuring is consistent with shareholders' long-term interests.[197] Creditors' interests, likewise, have been shown to depend on the motives of the activist.[198] Creditors are harmed by activists who engage in financial restructuring and by activists that attempt to force an acquisition on the company.[199] By contrast, creditors have not been shown to be harmed by activist interventions aimed at reducing entrenchment—for example, by replacing an underperforming CEO or reducing compensation packages.[200] Indeed, such efforts may even benefit creditors by growing the pie and thereby increasing the likelihood of repayment.

If creditors analyze the waiver decision along these lines, their choices in enforcing the Dead Hand Proxy Put may benefit shareholders. Creditors have no interest in blocking all forms of activism; they have an interest in blocking only those that legitimately harm creditor interests, such as interventions aimed at financial restructuring or forced merger. Appointing creditors,

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[195] Even if a negative shareholder reaction to adoption of the provision may have been muted by the positive reaction to the extension of credit, shareholders should have reacted strongly to the cases, which had the effect of relieving shareholders of the provision's burden after they had already locked in the benefit of a reduced cost of capital for their loans. See Part IV.B.

[196] See text accompanying notes 38–40.

[197] See text accompanying notes 41–45.

[198] See generally Sunder, Sunder, and Wongsunwai, 27 Rev Fin Stud 3318 (cited in note 52).

[199] See id at 3329–30. These are paradigmatic forms of "asset dilution" and "asset substitution." See text accompanying note 50.

[200] See Sunder, Sunder, and Wongsunwai, 27 Rev Fin Stud at 3329–30 (cited in note 52).

through the waiver decision, to this gatekeeping role may be largely consistent with long-term shareholder welfare. Creditors would allow activist contests aimed at reducing entrenchment to proceed, thereby benefiting shareholders.[201] And they would obstruct activism aimed at short-term financial engineering, potentially also benefiting shareholders. The harder category is forced mergers.

Activism ending in merger-and-acquisition activity is strongly associated with shareholder gains.[202] Yet, because merger activity is a source of risk for creditors—indeed it is the risk for which the change-of-control provision was invented—they are unlikely to waive protection and allow the intervention to proceed. Nevertheless, Dead Hand Proxy Puts are unlikely to have a substantial impact on activist bids seeking to force merger activity. When the hedge fund's endgame is acquisition, it is more likely to have access to capital to replace the target's debt because that capital would be needed in the acquisition in any event. Moreover, because a merger would accelerate indebtedness under the control share trigger when consummated, the threat of acceleration from the dead hand feature is largely superfluous and therefore unlikely to deter the activist.[203]

Understood in light of these interests, the shareholder-creditor bargain underlying the Dead Hand Proxy Put takes on a different character. While it remains an ex ante shareholder commitment not to appropriate creditor wealth through hedge fund activism, it is not a commitment to foreswear all forms of activism. Rather, the provision establishes creditors as gatekeepers over hedge fund activism, obstructing financial restructuring and other redistributive forms of activism while allowing to proceed activist interventions targeting entrenched managers or seeking other changes not generally harmful to creditor interests. Insofar as this arrangement is consistent with long-term shareholder interests, we would *not* anticipate a negative shareholder reaction to the provision but rather a positive one. Our results are consistent with this account.

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201 See Bebchuk, 113 Colum L Rev at 1684–86 (cited in note 48) (emphasizing the potential of activism to create shareholder value by disciplining underperforming managers); Brav, Jiang, and Kim, *The Real Effects of Hedge Fund Activism* at *14, 40 (cited in note 41) (finding evidence of reduced entrenchment from activist interventions).

202 See Greenwood and Schor, 92 J Fin Econ at 366 (cited in note 7).

203 See note 73 and accompanying text.

D. Trade-off in Equipoise?

Another possible explanation for our results is that the benefit from the reduction in the price of debt we demonstrated in our companion paper offsets any harm to shareholders. According to this account, the Dead Hand Proxy Put may well be harmful to shareholders, but the harm is sufficiently offset by the benefit they receive in the form of reduced borrowing costs. The lack of shareholder reaction to the adoption of the provision thus reflects perfectly offsetting costs and benefits—a trade-off in equipoise.

While we suspect that there may be some trade-off dynamics at play here, the simple version articulated above is inconsistent with our findings. A trade-off in equipoise would explain the absence of a shareholder reaction to the provision when adopted.[204] But under this account, the exogenous shock of the Delaware rulings should have produced a sharp shareholder reaction. Because the rulings relieved shareholders of the cost of the provision but allowed them to retain the benefits of a lower cost of debt capital, shareholders should have reacted positively to the cases. They did not.[205] Our results are therefore inconsistent with a trade-off in equipoise.

E. Lingering Entrenchment Effects of the Basic Change-of-Control Provision?

Finally, the absence of a negative shareholder response to the Dead Hand Proxy Put may reflect the fact that although the cases restricted the dead hand feature, they left intact the structure of the underlying change-of-control provision. It is, after all, the acceleration of indebtedness under the standard proxy fight trigger that makes a control contest so costly for hedge fund activists. The dead hand feature merely shifts the power to waive that provision. The cases that focused on the dead hand feature—especially *Amylin* and *Healthways*—thereby left the entrenchment effect of the basic provision untouched. Shareholders may thus have failed to respond to the restriction of the dead hand feature because the entrenchment effect inherent in the basic provision persists.

Although there may indeed be a lingering entrenchment effect from the basic change-of-control provision, we do not think

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[204] See Griffith and Reisel, *Dead Hand Proxy Puts* at *8, 35 (cited in note 31).
[205] See Part IV.B.

this effect explains our results. In the absence of the dead hand feature, the basic provision empowers incumbent management to waive the change-of-control provision by approving the dissident slate, and *Sandridge* unambiguously holds that it would be a breach of fiduciary duty for the incumbent board to refuse to approve a dissident slate when there is no good reason not to do so.[206] The incumbent board, in other words, must approve a dissident slate that is reasonably qualified for board service. Thus, at least since *Sandridge*, as long as the activist nominates a reasonably qualified slate, the standard change-of-control provision provides no protection at all. There should thus be a minimal entrenchment effect, if any, associated with the standard change-of-control provision. The dead hand feature, by contrast, makes it impossible for the incumbent board to approve dissident nominees. The entrenchment potential of the Dead Hand Proxy Put is thus substantially greater than the standard change-of-control provision, and we would have expected this difference to appear in the data. Therefore, in our view, the most likely explanations for our findings lie in the discounted value of voting rights and in the benefit shareholders receive from appointing creditors as gatekeepers over hedge fund activism.

VI. LESSONS FOR LEGAL POLICY

Several of the above explanations, operating separately or together, may account for our findings. Ordinarily, the existence of multiple possible explanations would pose a challenge for the formation of legal policy, but in this case, all of the potential explanations point in the same direction. Dead Hand Proxy Puts are a source of corporate value with no measurable harm to shareholders. This could be because the cost of the impingement on voting rights is negligible until the provision is used to defend against an activist intervention. Or it could be because as long as creditors exercise their waiver rights in good faith, they actually benefit shareholders by screening out the most damaging forms of hedge fund activism. Or it could be that once these benefits are taken into account along with the reduced cost of capital, shareholders benefit more from the provision than they suffer. The

[206] *Sandridge*, 68 A3d at 260–61.

policy recommendation that follows each of these potential explanations is the same—a rule of deference when the provision is adopted.

The provision may nevertheless be misused. For example, entrenched managers, eager to protect themselves from an activist agenda aimed at reducing entrenchment, may ask creditors not to waive the provision even though the creditor's interests are not legitimately threatened. Creditors, because they get important repeat business from corporate managers, not shareholders, have a strong incentive to do as managers ask. The result may be that Dead Hand Proxy Puts are enforced when they should be waived and, as a result, that they ultimately harm shareholders by excessively inhibiting hedge fund activism. For this reason, courts retain an important role in policing the use of the provision. We specify the appropriate standards in the first Section below, then situate our recommendations in light of existing jurisprudence in the final Section.

A. Deference When Adopted, Scrutiny When Used

Given the presence of benefits and the absence of demonstrable harms flowing from the Dead Hand Proxy Put, courts should defer to the parties in adopting the provision. In other words, courts should not allow the prospect of unproven potential fiduciary duty concerns to trump the corporate benefit of a reduction in the cost of capital and other potential benefits. In the corporate-law context, freedom-of-contract principles imply application of the business judgment rule.[207] Alternatively, courts could apply the deferential version of scrutiny used in *Moran*, in which the adoption of a poison pill was approved on the basis of little more than the company's concern that it might one day receive a hostile takeover bid.[208] Following *Moran*, courts should defer to boards that agree

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[207] See *Smith v Van Gorkum*, 488 A2d 858, 872 (Del 1985), quoting *Aronson v Lewis*, 473 A2d 805, 812 (Del 1984):

> The business judgment rule exists to protect and promote the full and free exercise of the managerial power granted to Delaware directors. . . . The rule itself "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."

See also 8 Del Code Ann § 141(a) ("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.").

[208] *Moran*, 490 A2d at 1074–75 (applying a lighter version of *Unocal* scrutiny to the adoption of the poison pill in light of the rationale for adoption articulated in the company's

to Dead Hand Proxy Puts unless plaintiffs can provide evidence that the adoption itself is a pretext meant to entrench management. For example, if evidence indicated that the provision was incorporated into a credit agreement at the insistence of management rather than the creditors, then further inquiry may be justified. But this really is the business judgment rule by another name.[209] Courts should dismiss in the absence of evidence that the defendants' proffered justifications for the provision are mere pretext.

However, due to the risk that creditors may enforce the provision to defend management's interests rather than their own, courts should police its *use* under a standard of intermediate scrutiny. When the provision is invoked in a proxy fight, courts should inquire into the motives of the parties and examine whether waiver was sought, whether it was granted, and if not, whether enforcement of the provision is proportional to the threat to creditor interests realistically posed by the activist.

The Dead Hand Proxy Put becomes a fiduciary duty concern for a board when its trigger would damage the firm and therefore influence shareholder voting in the proxy contest. In this situation, fiduciary duty requires the board to seek a waiver of the provision. Failure to attempt to negotiate a waiver should be treated as a breach of fiduciary duty regardless of the board's opinion of the activist and its agenda.[210]

Creditors, not managers, control the waiver decision, and waiver is not required. When creditor interests are clearly threatened—as, for example, when the activist's agenda includes financial restructuring or plans to force a merger onto the target company—the creditor's decision to enforce the provision should be respected by courts. However, failure to secure a waiver in situations in which the creditor's interests are not plainly threatened—as when the activist's agenda is focused on reducing management entrenchment—suggests a need for further inquiry and

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board minutes, but promising a more intense version of the scrutiny when the pill is later used).

[209] See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand L Rev 83, 94–95 (2004).

[210] Management remains entitled to vigorously dispute the activist's claims. However, our analysis has revealed that the Dead Hand Proxy Put is meant to protect creditors, not management. See text accompanying notes 75–76. The provision should be invoked only to protect the legitimate interests of creditors.

therefore access to some amount of discovery. Enforcing the provision in the absence of any legitimate threat to the creditor's interests may expose the creditor to invalidation of the provision under the implied covenant of good faith and fair dealing.[211] Moreover, further inquiry may unearth evidence suggesting that the target board did not negotiate for the waiver in good faith, supporting a breach of the duty of loyalty by the target board. Evidence that the target board and the creditor colluded in enforcing the provision to protect management (rather than the creditor) from the threat of shareholder activism may further expose the creditor to liability for aiding and abetting the target board's underlying breach of fiduciary duty.[212]

A second step in the analysis, assuming the presence of a valid threat to creditor interests, is an inquiry into whether enforcement of the Dead Hand Proxy Put is proportional to the threat. An activist may take steps to mitigate a legitimate threat to creditors such that the flat refusal to waive the provision is no longer reasonable. For example, if an activist seeking financial restructuring also offers to guaranty the loan, perhaps by providing a commitment letter from a highly rated financial institution to back the guaranty, then a creditor's continued refusal to waive the provision seems disproportionate to the actual threat. A disproportionate response is a further basis for inquiry into the relationship between the target board and the creditor, potentially leading to invalidation of the provision in violation of the implied covenant of good faith and fair dealing, liability of the target board for breach of fiduciary duty, and when the creditor is complicit in the breach, aiding and abetting liability. If, by contrast, the activist makes no such attempt to cure the threat to creditors' interests, enforcement of the provision should be accepted as proportionate to the threat.

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211 See *Nemec v Shrader*, 991 A2d 1120, 1125–26 (Del 2010) (en banc) (describing the requirements of the implied covenant of good faith and fair dealing); Mohsen Manesh, *Express Contract Terms and the Implied Contractual Covenant of Delaware Law*, 38 Del J Corp L 1, 13 (2013) ("[U]nder the doctrine's broader conception, even the express terms of an agreement are subject to and limited by an unwaivable, overriding obligation.").

212 See *Healthways* Transcript at *78–79 (cited in note 25) (finding potential liability for aiding and abetting the bank counterparty to the credit agreement). See also *Lee v Pincus*, 2014 WL 6066108, *2, 14 (Del Ch) (dismissing claims of aiding and abetting against underwriters on the basis of lack of well-pleaded allegations that they "extracted unreasonable compensation or any form of improper 'side deal'" in exchange for lockup waivers); *In re Comverge, Inc Shareholders Litigation*, 2014 WL 6686570, *19–20 (Del Ch) (refusing to apply liability for aiding and abetting in the absence of complicity or fraud).

The resemblance between the test we have sketched and the *Unocal* standard is no coincidence. Like the threat-proportionality standard in *Unocal*,[213] our test is designed to provide room for contracting parties to negotiate and enforce agreements in good faith. Moreover, our proposal extends the approach taken in *Sandridge*, which applied *Unocal* to an approval decision,[214] to the context of Dead Hand Proxy Puts, in which approval is unavailable. The question therefore becomes waiver. In this context, *Unocal* ought to apply to the conduct of the board in seeking and obtaining waiver. While our approach is largely consistent with *Sandridge*, it is inconsistent with aspects of *Amylin* and *Healthways*, which we discuss immediately below.

B. Toward a Less "Ideological" Corporate Law

Blasius, like many of former Chancellor William T. Allen's decisions, was extremely influential in the subsequent development of corporate law.[215] The decision announced a "sacred space" for shareholder voting and emphasized the shareholder franchise as the "ideological underpinning" of corporate law.[216] In spite of more recent rulings confining the actual standard applied in *Blasius* to a vanishingly narrow category of cases,[217] the ideology underpinning the decision often reappears in cases on shareholder voting.[218] In order for the jurisprudential standards we sketch above to work, courts must reject the elevation of the shareholder franchise to the status of a sacred and inviolate principle. Instead, under appropriate circumstances, courts

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[213] *Unocal*, 493 A2d at 954–55.

[214] *Sandridge*, 68 A3d at 258–63.

[215] See id at 258 (discussing *Blasius*'s "emphatic and enduring critical role"); Leo E. Strine Jr, *The Story of* Blasius Industries v. Atlas Corp.*: Keeping the Electoral Path to Takeovers Clear*, in J. Mark Ramseyer, ed, *Corporate Law Stories* 243, 290–91 (Foundation 2009).

[216] See *Blasius*, 564 A2d at 659. See also Thompson and Smith, 80 Tex L Rev at 263 (cited in note 99) (describing "the part of corporate-governance structure that permits shareholder self-help by voting or selling when director defensive actions reach too far").

[217] See, for example, *Third Point LLC v Ruprecht*, 2014 WL 1922029, *15 (Del Ch) ("[B]ecause of its strict criteria, the 'compelling justification' standard announced in *Blasius* 'is rarely applied either independently or within the *Unocal* standard of review.'"), quoting *MM Cos v Liquid Audio, Inc*, 813 A2d 1118, 1130 (Del 2003).

[218] See, for example, *Chesapeake Corp v Shore*, 771 A2d 293, 323 (Del Ch 2000) (recommending that Delaware courts "infuse our *Unocal* analyses with the spirit animating *Blasius* and not hesitate to use our remedial powers where an inequitable distortion of corporate democracy has occurred"). See also *Pell v Kill*, 135 A3d 764, 785–87 (Del Ch 2016) (applying enhanced scrutiny infused with the spirit animating *Blasius*).

should allow the right to vote to be traded for value, like any other term of an investment contract.

Of the three Dead Hand Proxy Put cases, the ideological view of shareholder voting is most apparent in *Amylin*, which squarely raises the question whether a board ought to have the power to burden shareholders' voting rights in exchange for a lower cost of capital.[219] In *Amylin*, the court demonstrated sympathy for the view that the corporation could not trade voting rights because the corporation does not own or control the right to vote shares—shareholders do.[220] Reasoning from this view, because it amounts to the corporation obtaining a benefit by offering something to the lender that it does not control, the Dead Hand Proxy Put amounts to taking from shareholders to give to the corporation (and its creditors). It is like a home buyer receiving a lower mortgage rate in exchange for providing a security interest on someone else's house.

This line of reasoning, however, is problematic for several reasons. First, taken to its logical conclusion, it suggests that the corporation can never encumber the shareholder franchise. But this is plainly contradicted by existing corporate-law jurisprudence, which permits staggered boards to encumber the franchise by transforming elections for board control into elections for one-third of the board at a time[221] and which allows termination fees and other defensive provisions to encumber shareholder voting on mergers.[222] Second, such ideological reasoning contradicts the

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[219] According to the court:

> [T]he board, when negotiating with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise), must be especially solicitous to its duties both to the corporation and to its stockholders. . . . Specifically, terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board.

Amylin, 983 A2d at 319.

[220] See id. According to this reasoning, voting rights belong to shareholders, not the corporation or the board, while the benefit of a reduction in the cost of capital, meanwhile, redounds to the corporation. Shareholders may enjoy the benefit of a reduced cost of capital derivatively, but they do not possess it directly in the same way that they possess the right to vote their shares. See *Tooley v Donaldson, Lufkin, & Jenrette, Inc*, 845 A2d 1031, 1035–39 (Del 2004) (distinguishing between rights and injuries leading to derivative versus direct claims).

[221] See, for example, *MM Cos*, 813 A2d at 1122 (discussing a staggered board arrangement). See also Bebchuk, Coates, and Subramanian, 54 Stan L Rev at 893–95 (cited in note 63) (reviewing the state statutory basis for the staggered board arrangement).

[222] Courts customarily accept termination fees set at 3 percent of deal value but warn that termination fees in excess of 5 percent of deal value may be excessive. See *Louisiana Municipal Police Employees' Retirement System v Crawford*, 918 A2d 1172, 1181 n 10 (Del

nexus-of-contracts theory of the firm, which is frequently cited as the basis of modern corporate law.[223] From this perspective, the corporation is a combination of the interests of various constituencies, not a thing unto itself.[224] Corporate interests therefore do not *conflict* with shareholder interests. They are, rather, one and the same.[225] Third and finally, elevating the shareholder franchise above all else means eliminating an entire class of potential value-enhancing trades. But the corporation is an investment vehicle, not a democratic republic, and the encumbrance of voting rights in exchange for a lower cost of capital—that is, greater cash-flow rights—is an option investors might reasonably select. Treating shareholder voting as sacred thus interferes with the larger corporate purpose of increasing shareholder wealth.

Likewise, although the *Healthways* court does not place as much emphasis on *Blasius*, by relying on *Toll Brothers* and declaring the dead hand provisions in the two cases indistinguishable, it invokes another ideological line of reasoning.[226] The dead hand poison pill in *Toll Brothers* was invalidated, ultimately, on the basis of an antidisablement principle: the incumbent board could not agree to the dead hand provision because it had the effect of disabling a future board of noncontinuing directors from redeeming the poison pill even if fiduciary duty would have required it.[227]

Ch 2007) (noting that while "a '3% rule' for termination fees might be convenient for transaction planners," the court would not adopt it as a "blanket rule"); *Comverge*, 2014 WL 6686570 at *14 (stating that a breakup fee of 5.55 percent would "test[ ] the limits" of what the court has considered a reasonable range for breakup fees). Ultimately, "the reasonableness of such a fee depends on the particular facts surrounding the transaction." *In re Cogent, Inc Shareholder Litigation*, 7 A3d 487, 503 (Del Ch 2010) (quotation marks omitted).

[223] In the words of Allen:

> The dominant legal academic view does not describe the corporation as a social institution. Rather, the corporation is seen as the market writ small, a web of ongoing contracts (explicit or implicit) between various real persons. The notion that corporations are "persons" is seen as a weak and unimportant fiction.

William T. Allen, *Contracts and Communities in Corporation Law*, 50 Wash & Lee L Rev 1395, 1400 (1993).

[224] See Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 Colum L Rev 1416, 1426 (1989); Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 Iowa L Rev 1, 16–17 (2002).

[225] Shareholder interests may, of course, conflict with the interests of other corporate constituencies, such as creditors. But these differences should be analyzed, as we have done, as differences between corporate constituencies, not differences in interest between the corporation and its shareholders.

[226] *Healthways* Transcript at *74 (cited in note 25), citing generally *Toll Brothers*, 723 A3d 1180.

[227] See *Toll Brothers*, 723 A2d at 1191–92. The same rationale was subsequently articulated by the Delaware Supreme Court:

Although the principle is now ingrained in Delaware law,[228] it remains problematic because it suggests, in its strong reading, that corporations can never make binding contracts.[229]

Putting aside the wisdom of this principle in the abstract, it was not necessary to invoke it in *Healthways* because there are several important distinctions between the dead hand poison pill and the Dead Hand Proxy Put. The dead hand poison pill is a unilateral defensive action of the board, whereas the Dead Hand Proxy Put is a term agreed between the counterparties to a contract. Unlike the dead hand provision in a poison pill, which expressly inhibits board action, the Dead Hand Proxy Put merely allocates waiver authority under a contract to the counterparty to that contract. Moreover, unlike dead hand poison pills which preclude takeover, the change-of-control provision in a debt contract merely triggers a repayment obligation. This may be costly, but it does not, as we have seen, preclude activist intervention. By eliding these distinctions and instead emphasizing the antidisablement principle, the *Healthways* court issued an unnecessarily ideological critique of Dead Hand Proxy Puts. Unsurprisingly, the decision led to a wave of shareholder suits targeting the provision.[230]

What has happened since *Healthways*? When we separated our 2014 results for the adoption of Dead Hand Proxy Puts by month, we found a sharp decline at the end of the year—*Healthways* was decided in mid-October of that year. However, although the rate of adoption seems to have slowed, the provision continues to be

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> While the Delayed Redemption Provision limits the board of directors' authority in only one respect, the suspension of the Rights Plan, it nonetheless restricts the board's power in an area of fundamental importance. . . . Therefore, we hold that the Delayed Redemption Provision is invalid under Section 141(a), which confers upon any newly elected board of directors *full* power to manage and direct the business and affairs of a Delaware corporation.

Quickturn Design Systems, Inc v Shapiro, 721 A2d 1281, 1291–92 (Del 1998).

[228] See *Paramount Communications Inc v QVC Network Inc*, 637 A2d 34, 51 (Del 1994) ("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."); *Omnicare, Inc v NCS Healthcare, Inc*, 818 A2d 914, 936–37 (Del 2003) (stressing the need for a fiduciary out in a merger agreement).

[229] *Omnicare*, the ultimate decision under this principle, has been roundly criticized by academics, practitioners, and jurists alike. See Sean J. Griffith, *The Omnipresent Specter of* Omnicare, 38 J Corp L 753, 754 nn 2, 5 (2013) (noting the legacy of the opinion, including Allen's remark that it was the "worst Delaware opinion" ever and similarly critical academic commentary).

[230] See note 27.

adopted by companies incorporated both in Delaware and elsewhere. In 2015, Delaware-incorporated companies adopted 48 Dead Hand Proxy Puts, and companies incorporated elsewhere adopted the provision 103 times. Why did *Healthways* and the shareholder suits filed in its wake not eliminate the provision entirely?

In our view, the continued adoption of Dead Hand Proxy Puts is explained by the weaker reading of *Healthways*, which suggested, citing *Moran*, that the fiduciary duty breach lay not in the provision itself but in adopting it without careful deliberation.[231] The message received by corporate counsel may thus have been not that Dead Hand Proxy Puts are dead but that boards must be able to provide evidence of careful deliberation in adopting them. Our hunch, therefore, is that after the initial wave of cases attacking the provision clears the system, future boards will be able to produce board minutes reciting talismanic phrases of careful deliberation entitling them to victory on a motion to dismiss.

We do not support the recitation of talismanic phrases. Our view, stated above, is that courts should apply business-judgment-rule deference to the decision of boards to adopt the provision while reserving the right to scrutinize the use of the provision. Nevertheless, a principle of law that allows boards to move forward with wealth-enhancing transactions provided they say the right things seems superior to one that precludes such transactions on the basis of ideology. It may thus be that the weak reading of *Healthways* provides the necessary opening for the jurisprudential standards we propose above.

CONCLUSION

We have studied the effect of Dead Hand Proxy Puts on shareholder value. Firms save on their cost of debt capital by agreeing to the provision. At the same time, however, the provision threatens shareholder interests by discouraging activism and entrenching underperforming managers. We test the effect of the provision on a large sample of firms and a broad database of loans over a twenty-year period from 1994 to 2014. Our empirical

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[231] *Healthways* Transcript at *73–74 (cited in note 25) (discussing *Moran*). See also *Moran*, 500 A2d at 1349 (deferring to Martin Lipton's statement in the company's board minutes that the board adopted the poison pill out of concerns over "the increasing frequency of 'bust-up' takeovers . . . and the possible adverse effect this type of activity could have on employees and others").

results suggest that shareholders are not harmed by the provision and that, in at least some instances, they may benefit from it. We offer several possible explanations for these findings, all of which point in the same direction for legal policy. This ultimately leads us to propose a jurisprudential framework of deference when the provision is adopted but scrutiny when it is used—focusing on questions such as whether waiver is sought, whether it is granted, and, if not, whether it is validly denied.

APPENDIX

TABLE 1. DESCRIPTIVE STATISTICS

The table presents summary statistics for company characteristics for loan contracts with a Dead Hand Proxy Put. The sample covers the time period from 1994 to 2014. *ROA*, Return on Assets, is earnings before interest, taxes, depreciation, and amortization, divided by total assets. *MB*, Market Book, is total assets, minus book equity, plus market equity, divided by total assets. *Book leverage* is long-term debt plus short-term debt, divided by total assets. *Cash* is cash plus short-term investments, divided by total assets. *PPE* is property, plant, and equipment, divided by total assets. The firm-level variables are calculated one year prior to the loan start date. *G-index* is the Gompers, Ishii, and Metrick governance index, in which high index values represent lower shareholder rights.[232] *E-index* is the Bebchuk, Cohen, and Ferrell entrenchment index, in which high index values represent lower shareholder rights.[233] *Activism* takes the value of one for firms subject to hedge fund activism at any time during our sample period and zero otherwise.

Firm Characteristics	Obs	Mean	Median	Std Dev
Total assets (million $)	2,488	3,179.332	945.815	7,274.310
Log (Total assets)	2,488	6.875	6.852	1.557
ROA	2,171	0.116	0.115	0.097
MB	1,994	1.734	1.437	0.984
Dividend per share	2,131	0.541	0.000	3.911
Book leverage	2,448	0.309	0.277	0.245
Cash	2,194	0.108	0.057	0.130
PPE	2,463	0.474	0.362	0.395
G-index	235	9.409	9.000	2.365
E-index	631	2.497	3.000	1.425
Activism	2,511	0.204	0	0.403

[232] See Gompers, Ishii, and Metrick, 118 Q J Econ at 110–19 (cited in note 149).
[233] See Bebchuk, Cohen, and Ferrell, 22 Rev Fin Stud at 788–801 (cited in note 150).

TABLE 2. DEAD HAND PROXY PUT, CORPORATE GOVERNANCE INDICES, AND BLOCKHOLDINGS

	(1)	(2)	(3)	(4)
G-index	0.0031*			
	(0.002)			
E-index		0.0047		
		(0.004)		
Outside Blockholders (%)			0.0002	
			(0.000)	
Affiliated Blockholders (%)				–0.0016***
				(0.001)
Log (Total assets)	–0.0112***	–0.0161***	–0.0134***	–0.0137***
	(0.003)	(0.004)	(0.003)	(0.003)
ROA	–0.0469	–0.1355**	–0.0513	–0.0500
	(0.041)	(0.058)	(0.056)	(0.056)
MB	0.0075*	0.0089	0.0047	0.0047
	(0.004)	(0.006)	(0.005)	(0.005)
Dividend per share	–0.0007	–0.0184**	–0.0176**	–0.0191**
	(0.005)	(0.009)	(0.007)	(0.008)
Book leverage	–0.0182	–0.0525	–0.0098	–0.0070
	(0.018)	(0.033)	(0.028)	(0.028)
PPE	–0.0276**	–0.0462***	–0.0277*	–0.0279*
	(0.013)	(0.017)	(0.014)	(0.014)
Cash	–0.0152	0.0131	–0.0254	–0.0308
	(0.036)	(0.044)	(0.037)	(0.036)
Constant	–1.6433***	–0.8406**	–0.4569	–0.3222
	(0.454)	(0.362)	(0.711)	(0.727)
Observations	5,301	9,522	11,232	11,232
Log pseudolikelihood	–791.8	–2,374	–1,892	–1,881

The table presents results of the probit regression. The probability of inclusion of a Dead Hand Proxy Put in a loan contract is estimated. The sample covers the time period from 1994 to 2014. The variables are described in Table 1. Average marginal effects are reported. Data for blockholders were created following the procedure in *Large Blocks of Stock: Prevalence, Size, and*

Measurement.[234] *Outside Blockholders* is the percentage held by all outside blockholders. *Affiliated Blockholders* is the percentage held by all affiliated blockholders. Standard errors are adjusted for clustering at the firm level. Asterisks ***, **, and * indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively. All specifications include year and industry dummies.

TABLE 3. SHAREHOLDER RESPONSES TO THE *AMYLIN* DECISION

The table presents shareholder returns around the *Amylin* decision. Equity returns over three days, starting on the announcement day, are reported. *Activism* takes the value of one for firms subject to hedge fund activism and zero otherwise. Standard errors are adjusted for clustering at the firm level. Asterisks ***, **, and * indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

PANEL A. MEAN AND MEDIAN COMPARISON

	Deadhand = 0		*Deadhand = 1*		
	Obs	Mean	Obs	Mean	Diff
Excess equity return (Market Model)	7,919	–0.009***	592	–0.01**	0.001
Excess equity return (Market adjusted)	7,919	–0.02***	592	–0.02***	0.000
	Obs	Median	Obs	Median	Diff
Excess equity return (Market Model)	7,919	–0.004***	592	–0.008***	0.004
Excess equity return (Market adjusted)	7,919	–0.009***	592	–0.01***	0.001

[234] Dlugosz, et al, *Large Blocks of Stock* at *5–11 (cited in note 154).

PANEL B. EFFECT OF HEDGE FUND ACTIVISM

Subsample with Deadhand

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.01**	0.01	592	0.0036
Excess equity return (Market adjusted)	–0.02***	0.0035	592	0.0004

Full Sample

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.009***	0.004	8,511	0.0002
Excess equity return (Market adjusted)	–0.018***	0.006	8,511	0.0003

PANEL C. EFFECT OF DELAWARE

Subsample with Deadhand

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	–0.005	–0.007	592	0.003
Excess equity return (Market adjusted)	–0.016*	–0.004	592	0.001

Full Sample

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	–0.004	–0.007	8,511	0.002
Excess equity return (Market adjusted)	–0.012***	–0.009*	8,511	0.003

PANEL D. EFFECT OF HEDGE FUND ACTIVISM IN DELAWARE

Subsample with Deadhand

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.014**	0.012	401	0.008
Excess equity return (Market adjusted)	–0.022***	0.011	401	0.005

Full Sample

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.012***	0.003	5,372	0.0001
Excess equity return (Market adjusted)	–0.022***	0.006	5,372	0.0002

TABLE 4. SHAREHOLDER RESPONSES TO THE *SANDRIDGE* DECISION

The table presents shareholder returns around the *Sandridge* decision. Equity returns over three days, starting on the announcement day, are reported. *Activism* takes the value of one for firms subject to hedge fund activism and zero otherwise. Standard errors are adjusted for clustering at the firm level. Asterisks ***, **, and * indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

PANEL A. MEAN AND MEDIAN COMPARISON

	Deadhand = 0		*Deadhand = 1*		
	Obs	Mean	Obs	Mean	Diff
Excess equity return (Market Model)	5,971	0.0004	787	0.0007	–0.0003
Excess equity return (Market adjusted)	5,971	0.002**	787	0.002	0.000
	Obs	Median	Obs	Median	Diff
Excess equity return (Market Model)	5,971	–0.001***	787	–0.004***	0.003***
Excess equity return (Market adjusted)	5,971	–0.001***	787	–0.004***	0.003***

PANEL B. EFFECT OF HEDGE FUND ACTIVISM

Subsample with Deadhand

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.003	0.016*	787	0.0292
Excess equity return (Market adjusted)	–0.001	0.016*	787	0.0296

Full Sample

	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.000	0.003	6,758	0.001
Excess equity return (Market adjusted)	0.002*	0.003	6,758	0.0001

PANEL C. EFFECT OF DELAWARE

Subsample with Deadhand

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	–0.000	0.001	787	0.0003
Excess equity return (Market adjusted)	0.001	0.003	787	0.001

Full Sample

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	–0.001	0.002	6,758	0.001
Excess equity return (Market adjusted)	–0.000	0.003*	6,758	0.002

PANEL D. EFFECT OF HEDGE FUND ACTIVISM IN DELAWARE

Subsample with Deadhand

	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.001	0.002	495	0.0006
Excess equity return (Market adjusted)	0.003	0.001	495	0.0002

Full Sample

	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.001	–0.001	4,218	0.0001
Excess equity return (Market adjusted)	0.003***	–0.001	4,218	0.0002

TABLE 5. SHAREHOLDER RESPONSES TO THE *HEALTHWAYS* DECISION

The table presents shareholder returns around the *Healthways* decision. Equity returns over three days, starting on the announcement day, are reported. *Activism* takes the value of one for firms subject to hedge fund activism and zero otherwise. Standard errors are adjusted for clustering at the firm level. Asterisks ***, **, and * indicate significance at the 1 percent, 5 percent, and 10 percent levels, respectively.

PANEL A. MEAN AND MEDIAN COMPARISON

	Deadhand = 0		*Deadhand = 1*		
	Obs	Mean	Obs	Mean	Diff
Excess equity return (Market Model)	4,077	0.005***	764	0.003	0.002
Excess equity return (Market adjusted)	4,077	0.006***	764	0.007*	–0.001
	Obs	Median	Obs	Median	Diff
Excess equity return (Market Model)	4,077	–0.002***	764	0.001	–0.003
Excess equity return (Market adjusted)	4,077	–0.002***	764	0.001	–0.003**

PANEL B. EFFECT OF HEDGE FUND ACTIVISM

Subsample with Deadhand				
	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.002	0.003	764	0.0004
Excess equity return (Market adjusted)	0.005	0.007	764	0.0024
Full Sample				
	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.004**	0.006	4,841	0.002
Excess equity return (Market adjusted)	0.005***	0.008*	4,841	0.003

PANEL C. EFFECT OF DELAWARE

Subsample with Deadhand

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	0.005	–0.003	764	0.001
Excess equity return (Market adjusted)	0.006	0.001	764	0.001

Full Sample

	Constant	Delaware	N	R^2
Excess equity return (Market Model)	0.004**	0.0004	4,841	0.001
Excess equity return (Market adjusted)	0.004**	0.003	4,841	0.001

PANEL D. EFFECT OF HEDGE FUND ACTIVISM IN DELAWARE

Subsample with Deadhand

	Constant	Activism	N	R^2
Excess equity return (Market Model)	–0.001	0.009	484	0.004
Excess equity return (Market adjusted)	0.004	0.01	484	0.001

Full Sample

	Constant	Activism	N	R^2
Excess equity return (Market Model)	0.003	0.008*	3,076	0.004
Excess equity return (Market adjusted)	0.006**	0.009*	3,076	0.005