DELAWARE CORPORATE LAW BULLETIN

Delaware Court Addresses Entrenchment Claims Brought Against Directors Under Activist Hedge Fund Attack

*Robert S. Reder**
*Stanley Onyeador***

Chancery Court finds terms of settlement with hedge fund not subject to Unocal *enhanced scrutiny review.*

But refuses to dismiss fiduciary claims arising from defensive bylaw amendments adopted post-settlement.

* Robert S. Reder, Professor of the Practice of Law at Vanderbilt University Law School, has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

** Stanley Onyeador, Vanderbilt University, J.D./M.B.A. Candidate, May 2017. Thanks to Professor Reder and the *Vanderbilt Law Review* for the ability to participate in this *En Banc* series.

INTRODUCTION

Emboldened by the well-chronicled decline in the prevalence of classified board structures and other corporate defense measures over the last decade-and-a-half,[1] activist stockholders, including cash-rich hedge funds, have significantly expanded their role in American corporate governance.[2] Given the power of these activists, as well as the costs—both in terms of time and money—of conducting a full-throated defense, target boards of directors increasingly prefer to settle rather than fight, particularly boards of large market-cap companies confronted by top-tier activists.[3] By contrast, some commentators urge resistance to activist threats and demands, suggesting that target boards have become too quick to settle.[4]

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1. *See, e.g.*, Steven Davidoff Solomon, *With Fewer Barbarians at the Gate, Companies Face a New Pressure*, THE NEW YORK TIMES (July 20, 2013, 1:49 PM), http://dealbook.nytimes.com/2013/07/30/with-fewer-barbarians-at-the-gate-companies-face-new-pressure/?_r=0 [https://perma.cc/3U6L-LKK9] (comparing 2003 where "60 percent of companies in the S.&P. . . . had a staggered board" with 2013 where "only 11 percent do"); John Laide, *Shareholder Activism Continues to Increase While Takeover Defenses Decline*, SHARKREPELLANT.NET (Jan. 7 2008), https://www.sharkrepellent.net/pub/rs_20080107.html [https://perma.cc/R4YG-C8TM] (describing the continued trend of "dismantling takeover defenses"); Robin Sidel, *Where Are All the Poison Pills?*, THE WALL STREET JOURNAL (Mar. 2, 2004, 12:01 AM), http://www.wsj.com/articles/SB107818176447743400 [https://perma.cc/HMG8-7YC2] (showing "companies have taken steps to dismantle their pills" while "fewer companies are putting the measure in place").

2. *See, e.g.*, Chelsea Naso, *Activism Primed For Busy 2016 As Playing Field Evolves*, LAW360 (Dec. 24, 2015, 8:37 PM), http://www.law360.com/articles/736011/activism-primed-for-busy-2016-as-playing-field-evolves [https://perma.cc/5QAX-928F] (foreshadowing "another strong year" of "[s]hareholder activism" in 2016); John Laide, *Record-Setting Year for Activism*, SHARKREPELLANT.NET (Dec. 15, 2015), https://www.sharkrepellent.net/request?an=dt.getPage&st=undefined&pg=/pub/rs_20151215.html&rnd=516435 [https://perma.cc/7TTE-LYQE] (detailing the "record-setting" number of "activist campaigns" in 2015).

3. *See, e.g.*, Nato, *supra* note 2 (mentioning that "boardrooms are more likely to quietly settle than drag out a proxy battle"); Kurt Orzeck, *Wachtell Lipton Founder Suggests Settling with Activists*, LAW360 (Apr. 20, 2015, 8:51 PM), http://www.law360.com/articles/650253/wachtell-lipton-founder-suggests-settling-with-activists?article_related_content=1 [https://perma.cc/93SC-DWBC] (reporting Martin Lipton "told his clients [] to consider settling with activist investors instead of engaging in drawn-out battles").

4. *See* Matt Turner, *Here is the letter the world's largest investor, BlackRock CEO Larry Fink, just sent to CEOs everywhere*, BUSINESS INSIDER (Feb. 2, 2016, 8:03 AM), http://www.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2 [https://perma.cc/BM39-HFWE] (regarding Larry Fink's letter cautioning CEOs against subscribing activists' short-term value strategies of financial engineering); Michael Flaherty & Anjali Athavaley, *US companies quicker to give board seats to activists*, REUTERS (Sep. 25, 2015, 1:00 AM), http://www.reuters.com/article/hedgefunds-activists-idUSL4N11N4OM20150925 [https://perma.cc/FL2Y-9CTG] (reporting that "[s]ome investors worry that companies are bowing to activists' demands too easily").

Earlier this year, in *In re Ebix, Inc. Stockholder Litigation* ("*Ebix*"),[5] the Delaware Court of Chancery was faced with litigation arising from a stockholder challenge to a board of directors' response to a threatened proxy fight from an activist hedge fund. The key question before the court was the proper standard of judicial review to apply to the board's two-tiered response: a settlement with the hedge fund coupled with enhanced takeover defenses to address potential future activism. Specifically, should either of these measures attract enhanced scrutiny as a defensive measure under the Delaware Supreme Court's iconic decision in *Unocal Corp. v. Mesa Petroleum Co.*[6] and its progeny ("*Unocal*"), or were the board's actions entitled to the protection of the more deferential business judgment rule? As is typical of Delaware litigation in the corporate arena, the choice of the standard of review directly impacted the court's ultimate ruling.

I. FACTUAL BACKGROUND

On November 11, 2014, Barington Capital Group, L.P. ("Barington"), an activist hedge fund, announced a proxy contest to replace two-thirds of the board of directors of Ebix, Inc. ("Ebix"). In making this announcement, Barington complained that, among other things, "pending litigation and investigations, poor financial reporting, substandard corporate governance and a lack of independent directors" had depressed Ebix's stock price.[7]

Two weeks later, on November 26th, Ebix avoided the proxy contest by negotiating a Director Nomination Agreement with Barington (the "Nomination Agreement"). Pursuant to the Nomination Agreement, Ebix expanded its board from six to eight and filled the resulting vacancies with Barington designees.[8] In exchange, Barington agreed to an "extendable 'standstill period' " during which Barington "must vote all of its stock for the Board's nominees and in harmony with Board recommendations on matters that include advisory executive compensation votes, as well as refrain from soliciting proxies, presenting proposals, or initiating litigation."[9] The standstill period would last until the *earlier of* ninety days before Ebix's 2015 annual meeting *and* ten days before any advance notice deadline for director nominations for that meeting. Further, Ebix was entitled to extend the

5. C.A. No. 8526-VCN (Del. Ch. Jan. 15, 2016).
6. 494 A.2d 946 (Del. 1985).
7. C.A. No. 8526-VCN at 12–13.
8. *Id.* Barington was also paid $140,000, presumably to defray its related legal expenses.
9. *Id.* at 14.

period "to an equivalent time frame surrounding the 2016 annual meeting" by recommending reelection of Barington's designees at that meeting.[10]

Although Barington's threat seemingly had been neutralized, on December 19th, the Ebix board adopted a "bundle of bylaws" (the "Bylaw Amendments") containing fairly typical takeover defense mechanisms, including:

- A "*Special Meeting Bylaw*" limiting "stockholders' ability to call and conduct business at special meetings"[11] and permitting the board to deny a special meeting request for seven enumerated reasons.[12]
- A "*Control of Meeting Bylaw*" giving the chair of a stockholders' meeting discretionary authority in running the meeting, including who may attend and opening and closing election polls.[13]
- An "*Advance Notice Bylaw*" imposing certain timing and informational "conditions on a stockholder's ability to make a proposal or nominate a director" at a stockholders' meeting.[14]
- A "*Consent Bylaw*" requiring a stockholder proposing action by written consent in lieu of a stockholders' meeting to request that the board specify a record date, which in turn would allow the board to delay such action by up to twenty days.[15]

Crucially, though the Bylaw Amendments were adopted roughly three weeks *after* signing of the Nomination Agreement, they were *prepared* on November 17th, in the wake of Barington's threatened proxy contest and *before* the settlement with Barington.[16]

A number of Ebix stockholders brought a derivative action in the Delaware Court of Chancery, challenging both the Nomination Agreement and the Bylaw Amendments.[17] Plaintiffs alleged these

10. *Id.*

11. *See, e.g.*, *id.* at 15.

12. Including (1) if the request is made 120 days before or 30 days after the anniversary of the last annual meeting; (2) if, in the Board's judgment, a "Similar Item" was raised at a meeting twelve months before the request or, if including an election of directors, 120 days before the request; and (3) if a "Similar Item" appears in the notice of an annual or special meeting called but not yet held or called within 120 days of the request. *Id.*

13. *Id.* at 16.

14. *Id.*

15. *Id.*

16. *Id.* at 13.

17. The lawsuit also initially challenged Ebix's entry into a credit agreement containing a "proxy put" enabling "lenders to accelerate repayment if a majority of incumbent directors were

board actions were "improper entrenchment devices, . . . that is, a mechanism the directors endorsed *because of* its functional capacity to help them maintain control of the company or otherwise keep their jobs."[18] As such, plaintiffs asserted that the directors' approval of these actions "amounted to a breach of fiduciary duties."[19] Plaintiffs also argued that both measures "are defensive measures whose adoption warrants strict scrutiny under *Unocal*."[20] The defendant directors asked the Court to dismiss both aspects of this action under Court of Chancery Rule 12(b)(6) for failure to state a claim under Delaware law for which relief may be granted.

II. VICE CHANCELLOR NOBLE'S *UNOCAL* ANALYSIS

A. Threshold Considerations

In considering the defendant directors' motion to dismiss plaintiffs' challenge to each of the corporate actions taken by Ebix's board, Vice Chancellor John W. Noble had to determine, *first*, the appropriate standard of judicial review and, *second*, whether the particular corporate action withstood that level of review. The Vice Chancellor essentially had two choices in tackling the first question. The directors urged applicability of the business judgment rule, the Delaware "default" standard which "presumes 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.' "[21] This is a deferential standard that reflects the Delaware judiciary's guiding philosophy that a rational business decision taken in good faith by a disinterested board of directors should not be second-guessed by a court.

Plaintiffs countered that "a more searching inquiry" under *Unocal* was appropriate. The Vice Chancellor explained that enhanced scrutiny under *Unocal* applies "whenever the record reflects that a board of directors took defensive measures in response to a perceived threat to corporate policy and effectiveness which touches on issues of corporate control."[22] Further, an actual hostile takeover attempt is not

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replaced with persons either the incumbents did not approve or who received a nomination due to an actual or threatened proxy contest." However, this claim was mooted when Ebix and its lenders amended the credit agreement to omit the "proxy put." *Id.* at 12.

18. *Id.* at 42.
19. *Id.*
20. *Id.*
21. *E.g.*, *id.* at 44 (quoting Aronson v. Lewis, 473 A.3d 805, 812 (Del. 1984)).
22. *Id.* at 42, 45.

a prerequisite to application of enhanced scrutiny. Rather, "*Unocal* has [also] been 'applied to a preemptive measure where the corporation was not under immediate "attack" ' but nonetheless enacted a measure 'in contemplation of an ephemeral threat that somehow could materialize in the future.' "[23]

Once a court determines that a board action triggers *Unocal* scrutiny, "the Board has the burden of showing (1) that it 'had reasonable grounds for believing that a danger to corporate policy and effectiveness existed,' and (2) 'that [its] defensive response was reasonable in relation to the threat posed.' "[24] If the board successfully carries this burden, the business judgment presumption applies to its action.[25]

The Vice Chancellor also explained that *Unocal*'s threshold question is particularly significant in the context of a motion to dismiss—triggering *Unocal* "poses systematic difficulty for defendants seeking dismissal under Court of Chancery Rule 12(b)(6), given the limited record from which they might . . . demonstrate reasonableness."[26] Under Court of Chancery Rule 12(b)(6), the court had to accept all well-plead facts as true, draw all reasonable inferences in favor of plaintiffs, and deny the motion unless plaintiffs could not recover under any reasonably conceivable set of circumstances.[27] Accordingly, the procedural posture of the case seemingly favored the Ebix plaintiffs.

B. Nomination Agreement Not Subject to Unocal *Scrutiny*

Despite the Nomination Agreement's clear defensive effect—the Agreement's "standstill and voting provision prevent Barington . . . from soliciting proxies, presenting proposals, or voting against Board-recommended matters and nominees"[28]—Vice Chancellor Noble declared that "[e]ntry into the Director Nomination Agreement cannot be viewed as defensive for purposes of triggering *Unocal*."[29] The Vice Chancellor deemed the Nomination Agreement a permissible

23. *Id.* at 45 (citing Kahn v. Roberts, 679 A.2d 460, 466 (Del. 1996) (quoting Moran v. Household Int'l, Inc., 500 A.2d 1346, 1350–53 (Del. 1985))).

24. *See, e.g.*, Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1371 (Del. 1995).

25. *See, e.g.*, *In re* Santa Fe, 669 A.2d 59, 70 (Del. 1995) (citing Unitrin, 651 A.2d at 1374). ("Once the Board has established the reasonableness of its perception of a threat and the proportionality of the response, it receives the protection of the business judgment rule.").

26. *See, e.g.*, *id.* at 72; *In re* Ebix, C.A. No. 8256-VCN at 46.

27. *See, e.g.*, *id.* at 41–42.

28. *Id.* at 47 ("[T]he Director Nomination Agreement . . . contain[s] mechanisms that might help Ebix's incumbent management maintain control of the company in some manner.").

29. *Id.* at 51–53.

consequence of "mutual concessions" and "bargaining" between Ebix and Barington, concluding the entrenchment characteristics were "collateral effects" and therefore "not *per se* subject to *Unocal* scrutiny."[30]

Vice Chancellor Noble reasoned that it would be "counterintuitive" and "enigmatic" to apply *Unocal* to a board's agreement to "dilute its own control by surrendering board seats to insurgents."[31] Essentially, he held that a board is not subject to *Unocal* scrutiny for responding to a threatened proxy contest by surrendering some corporate control in a settlement agreement with the activist investor. Rather, the appropriate standard of review is the business judgment rule.

Next, the Vice Chancellor concluded that plaintiffs had not offered "well-pled facts" to rebut the favorable presumption of the business judgment rule. Their complaint, focused on entrenchment, did not allege that the board was "uninformed" or "failed to adequately contemplate the merits" of the Nomination Agreement, nor did it call into question the "disinterestedness" of the directors.[32] Therefore, because "entry into the Director Nomination Agreement is clearly attributable to a rational business purpose, this Court will not substitute its own business judgment for that of Ebix's Board."[33] On this basis, the Vice Chancellor dismissed plaintiffs' claims insofar as they related to the Nomination Agreement.

C. Bylaw Amendments Do Not Withstand Unocal *Scrutiny*

Vice Chancellor Noble's analysis of plaintiffs' allegations regarding the Bylaw Amendments yielded a much different result—that is, application of *Unocal's* enhanced scrutiny standard of review rather than the business judgment rule.

For purposes of the first prong of the *Unocal* test, the Vice Chancellor characterized the Bylaw Amendments as "entrenchment measures" implemented "to stave off Barington" following announcement of its intention to wage a proxy contest to potentially gain control of the board.[34] In so ruling, the Vice Chancellor found three facts particularly material:

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30. *Id.* at 48 (citing Stroud v. Grace, 606 A.2d 75, 83 (Del. 1992)) (holding that a private contract between shareholders and a private company whose "defensive effects" were "collateral at best" would not receive *Unocal* scrutiny).

31. *Id.* at 49.

32. *Id.* at 53.

33. *Id.*

34. *Id.* at 49.

- Though the settlement embodied in the Nomination Agreement theoretically "eliminated the Barington threat," Vice Chancellor Noble noted the Bylaw Amendments were prepared at the behest of the board just six days after Barington's threat was issued, well before the Nomination Agreement was signed.[35] The Vice Chancellor found that, unlike the fact patterns of precedent cited by the director defendants for the proposition that no *Unocal* threat existed at the time the Ebix board formally adopted the Bylaw Amendments, there was "a reasonable inference that improper motives were at work."[36]
- Because the standstill embodied in the Nomination Agreement potentially could last for no more than two years, the Vice Chancellor viewed the Bylaw Amendments as a "forward-looking prophylactic" against the future threat when "Barington's guaranteed complacency expired."[37] In this connection, the Vice Chancellor explained that Delaware precedent requires *Unocal* scrutiny in "this sort of scenario" where the board responds to a "threat to corporate control that is not immediate, but rather perceived as a future possibility."[38]
- The authority granted to the Ebix board by the Bylaw Amendments to delay or prevent director elections at special meetings had "clear defensive value."[39] Specifically, the Vice Chancellor reasoned that Delaware precedent requires *Unocal* scrutiny for a charter provision that, at the least, allows a board to delay special stockholder meetings for 120 days and, at the most, prevents elections at special meetings.[40]

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35. *Id.* at 51.

36. *Id.* at 52. For instance, in *Goggin v. Vermillion Inc.*, 2011 Del. Ch. LEXIS 80, C.A. No. 6465-VCN (Del. Ch. 2011), the board did not know of the threat at the time it made the challenged decision, whereas the Ebix board was well aware of Barington's threatened proxy contest when it authorized preparation of the Bylaw Amendments and realized Barington's "future capacity to re-initiate dissenting behavior"; in *Kahn v. Roberts*, 689 A.2d 460 (Del. 1996), no hostile bidder had surfaced and there was no probability that one would emerge, whereas Barington had publicly announced its intent to seek control of the Ebix board; and in *Doskocil Cos. Inc. v. Griggy*, 1988 Del. Ch. LEXIS 113 (Del. Ch. 1988) , the board had been considering the challenged action for over a year before the threat emerged, whereas the Bylaws Amendments were "conce[ived] closely after Barington's emergence."

37. *Id.* at 50.

38. *Id.* at 50–51.

39. *Id.* at 50.

40. *Id.* The Vice Chancellor noted that "bylaw amendments enacting shorter special meeting delay periods have received *Unocal* scrutiny in past cases." *Id.* (citing Mentor Graphics Corp. v.

Considering these three facts "in concert," Vice Chancellor Noble found the Bylaw Amendments to be "defensive measures in response to a threat to corporate control," thereby subjecting their adoption to enhanced *Unocal* scrutiny.[41]

Turning to the *Unocal* test's second prong, Vice Chancellor Noble ruled that the defendant directors failed to satisfy their burden of establishing that the Bylaw Amendments were "within the range of reasonableness."[42] The Vice Chancellor rejected their "attempt to vindicate each bylaw individually," reminding that the "salvo of new provisions accomplishing the number and nature of reforms at work here" must be considered collectively.[43] While "many of the complained-of features . . . only give rise to inconvenience, the reasonableness of a defensive response whose munitions include the ability to foreclose the use of special meetings to hold elections requires an explanation not evident on the face of these pleadings."[44] Accordingly, the Vice Chancellor refused to dismiss plaintiffs' breach of fiduciary duty claims relating to the Bylaw Amendments.

CONCLUSION

Vice Chancellor Noble's analysis in *Ebix* provides pertinent—and timely—guidance for target boards defending against threats from activist investors. Though enhanced scrutiny under *Unocal* is not automatically applicable to all board responses, the directors and their legal advisors cannot assume that Delaware courts will defer to their business judgments in this area.

First, *Ebix* establishes that *Unocal* generally is not invoked when a target board surrenders board seats to an activist in exchange for a standstill, even if such an action has a clear defensive effect in eliminating the immediate threat. Of course, this is a highly factual analysis, so alternative factual circumstances could lead to a different result. Accordingly, a board should carefully evaluate the defensive effects of a settlement agreement with an activist stockholder to maximize the chances that any entrenchment characteristics therein will be deemed "collateral" rather than primary.

Quickturn Design Sys., Inc., 728 A.2d 25, 38–43 (Del. Ch. 1998); Kidsco v. Dinsmore, 674 A.2d 483, 487–89, 494–97 (Del. Ch. 1995)).

41. *Id.* at 51.

42. *Id.* at 54.

43. *Id.* (citing Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1387 (Del. 1995) (scrutinizing "inextricably related" defensive actions "collectively as a unitary response to a perceived threat")).

44. *Id.* at 55.

Second, *Ebix* confirms that a "perceived threat" prompting defensive action need not be immediate to trigger *Unocal* scrutiny, particularly when the insurgent stockholder has the ability to wage a future proxy contest. Though Barington's threatened proxy contest was no longer immediate at the time the Ebix board adopted the Bylaw Amendments, the standstill provision's limited lifespan rendered Barington a dormant future threat. Thus, once perceived as imminent, a threat will likely be subject to *Unocal* scrutiny until *permanently* eliminated.

Finally, *Ebix* corroborates Delaware courts' skepticism of defensive measures that interfere with stockholders' ability to wage a successful proxy contest for corporate control. Though Vice Chancellor Noble viewed several of the Bylaw Amendments individually as mere inconveniences, their collective impact on stockholders' ability to elect directors *via* a special meeting tipped the scales, at least for purposes of the defendant directors' motion to dismiss. Thus, in responding to a threatened proxy contest, a target board must continue balancing innocuously dilatory tactics against defensive measures that may actually preclude a proxy contest for corporate control, and focus on the collective impact of all measures to be taken.