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IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

IN AND FOR NEW CASTLE COUNTY

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM,	:	
Plaintiff,	:	
v.	:	**C.A. No. 19191**
JAMIE B. COULTER, JOHN D. WHITE, FRED B. CHANEY, WILLIAM B. GREENE, JR., MICHAEL J. ARCHER, CLARK R. MANDIGO, WILLIAM H. TILLEY, and DENNIS L. THOMPSON,	:	
Defendants,	:	
and	:	
LONE STAR STEAKHOUSE & SALOON, INC.,	:	
Nominal Defendant.	:	

MEMORANDUM OPINION

Date Submitted: June 15, 2004
Date Decided: April 21, 2005

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NOBLE, Vice Chancellor

Nominal Defendant Lone Star Steakhouse & Saloon, Inc. ("Lone Star" or the "Company") agreed to make change of control payments to certain employees if a majority of its board of directors ceased to be "Existing Directors." "Existing Directors" were those directors in office at the time of the change of control agreements and those new directors who were "approved" by Existing Directors. The views of new directors who were not approved as "Existing Directors" would not be considered in determining whether subsequent new directors would be considered "Existing Directors." The question is whether such a provision contravenes the teachings of *Carmody v. Toll Brothers, Inc.*,[1] which concluded that directors may not be granted distinctive voting powers unless they are authorized by the certificate of incorporation, something Lone Star's certificate of incorporation does not do. An answer to that question is required by this skirmish between Plaintiff California Public Employees' Retirement System ("CalPERS") and various individual defendants, current and former directors of Lone Star. CalPERS, through its motion for partial summary judgment, asserts that the change of control agreements approved by the defendant directors are invalid because of the Existing Directors provision.

[1] 723 A.2d 1180 (Del. Ch. 1998).

I. BACKGROUND

Lone Star maintains that, in order to encourage its senior management to remain with the Company during challenging times with the possibility of a material change in the composition of its Board of Directors, it agreed to pay additional compensation to those employees in the event a change of control were to occur.[2] A "change of control" that would require additional compensation could occur in several ways:[3] a shift in shareholder voting power, a change in the composition of the board, a merger or similar transaction, or liquidation. CalPERS' motion is premised upon the definition of change of control relating to board composition; by definition, a change of control is said to have occurred if:

> (ii) The individuals who, as of January 3, 2001, are members of the Company's Board of Directors (the "Existing Directors"), cease, at or prior to January 3, 2003, for any reason, to constitute at least a majority of the number of authorized directors of the Company as determined in the manner prescribed in the Company's Certificate of Incorporation and Bylaws; *provided, however, that if the election, or nomination for election, by the Company's stockholders of any new director was approved by a vote of at least a majority of the Existing*

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[2] CalPERS suggests that the change of control agreements were implemented as part of a scheme to entrench existing management.

The parties dispute the potential cost of the change of control provisions at issue. Lone Star asserts that its exposure was less than $10 million. In contrast, CalPERS argues that payments to Defendants White and Aaron alone could have exceeded $30 million. The pending motion does not require resolution of this debate.

[3] Only Defendant Coulter, the founder and largest shareholder of Lone Star, would have been entitled to his "golden parachute" solely upon the happening of a change of control. The other employees would have become entitled to their change of control payments only upon the occurrence of a "second trigger," such as a change in their duties.

> *Directors, such new director shall be considered an Existing Director*; provided further, however, that no individual shall be considered an Existing Director if such individual initially assumed office as a result of either an actual or threatened election contest or other actual or threatened solicitation of proxies by or on behalf of anyone other than the Board of Directors (a "Proxy Contest"), including by reason of any agreement intended to avoid or settle any election contest or Proxy Contest[.][4]

This provision may act to deprive an employee of the change of control benefits to which he would otherwise be entitled if the Existing Directors (*i.e.*, the "old" directors) approve a sufficient number of new directors so that the remaining "old" directors and the "approved" new directors constitute a majority of the Board. The Board need not act (or vote) to preclude the employee from receiving change of control benefits. It is simply a matter of whether, in the event of a change in board composition, enough of the "old" directors "approved" a sufficient number of the "new" directors.

The Change of Control Contracts all had an effective date of January 3, 2001, and, by their terms, they all expired on January 3, 2003. Lone Star never

[4] Change of Control Contract, Art. I, Sec. 1(d)(ii) (emphasis added). There are ten Change of Control Contracts at issue. Although other terms may vary, the definition of change of control is a constant. The Company's use of an Existing Directors provision is not unique. *See, e.g.*, II BLOCK ET AL., THE BUSINESS JUDGMENT RULE: FIDUCIARY DUTIES OF CORPORATE DIRECTORS 1296 (5th ed. 1998) (observing that a change in control is "typically triggered," *inter alia*, by "a change in the majority of the members of the board of directors during a specific period of time unless the new directors are nominated or approved by the persons serving as the corporation's directors at the beginning of the specified period.").

made any payments under them. The Change of Control Contracts have not been renewed.[5]

II. CONTENTIONS

CalPERS has moved for partial summary judgment on Count XIV of its Amended Complaint.[6] CalPERS alleges that the Existing Directors provision in the Change of Control Contracts violated 8 *Del. C.* § 141 and, thus, was adopted in violation of defendant directors' fiduciary duties because it illegally conferred upon directors differential voting powers based on a classification not present in Lone Star's Certificate of Incorporation.[7] CalPERS specifically limits its summary judgment application to this issue of liability and currently seeks no determination of damages.

The Defendants oppose CalPERS' motion for partial summary judgment, contending that the Existing Directors provision of the Change of Control Contracts is consistent with 8 *Del. C.* § 141. Additionally, the Defendants argue that CalPERS' claim is moot because the contracts at issue have expired, no

[5] CalPERS contends that the Change of Control Contracts have had adverse consequences for Lone Star nonetheless. For example, in April 2002, Lone Star announced a letter of intent for an acquisition of all of its shares by Bruckmann Rosser Sherrill & Co. ("Bruckmann Rosser"). The letter of intent expired by its terms, and the contemplated transaction was not consummated. According to CalPERS, Bruckmann Rosser abandoned the transaction because of the burden of the payments associated with the Change of Control Contracts.

[6] This claim now appears as Count VIII of its Second Amended Complaint and will be addressed as such.

[7] The Defendants acknowledge that Lone Star's charter does not authorize any relevant differential voting powers among Lone Star's directors.

payments were made pursuant to them, they have not been renewed, and there is no intention to renew them. Finally, the Defendants, who have not formally moved for summary judgment, also seek summary judgment on the issue of the validity of the Existing Directors provision as a matter of law.

III. ANALYSIS

A. *Standard for Summary Judgment*

When there is no dispute of material fact and a party is entitled to judgment as a matter of law, the Court may grant summary judgment.[8] On a motion for summary judgment, the burden is on the moving party and the Court is required to view the facts in the light most favorable to the nonmoving party.[9] In addition, the Court may grant summary judgment to the nonmoving party if the "state of the record is such that the non-moving party is clearly entitled to such relief."[10] Here, the material facts are not in dispute. CalPERS' motion presents a question of law: the validity of the Existing Directors' provision under the Delaware General Corporation Law.

B. *Defendants' Mootness Argument*

The Defendants contend that CalPERS' claim must be dismissed as moot because no concrete harm occurred: the contracts expired on their own terms

[8] *See, e.g.*, *Continental Ins. Co. v. Rutledge & Co.*, 750 A.2d 1219, 1227-28 (Del. Ch. 2000).
[9] *Motorola, Inc. v. Amkor Tech., Inc.*, 849 A.2d 931, 935 (Del. 2004).
[10] *Stroud v. Grace*, 606 A.2d 75, 81 (Del. 1992) (quoting *Bank of Del. v. Claymont Fire Co. No. 1*, 528 A.2d 1196, 1199 (Del. 1987)); *see also Telstra Corp. Ltd. v. Dynegy, Inc.*, 2003 WL 1016984, at *5 & n.14 (Del. Ch. Mar. 4, 2003).

without payment and have not been renewed. For the reasons set forth below, I conclude that CalPERS' claim is not moot.

The Court should not resolve moot issues because (a) deciding moot issues wastes judicial resources on academic questions with little or no practical benefit, and (b) the common law "develops incrementally and in a fact-driven manner. This orderly progression of the law would be disturbed by issuing advisory opinions."[11] The mootness doctrine, thus, provides for dismissal of litigation that may have once have presented a justiciable controversy if that controversy no longer exists.[12]

In the matter at hand, CalPERS' claim is not moot for three reasons. First, it is not clear that the Change of Control Contracts were harmless. CalPERS alleges general harm, arguing that Lone Star's potential golden parachute payments "were so large as to be prohibitive in completing a transaction."[13] CalPERS also alleges specific harm, contending that the size of the potential payments effectively ended a transaction in February 2002 with Bruckmann Rosser.[14] However minimal the harm may have been, the possibility that the payments would have come due upon

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[11] *Kingsbridge Capital Group v. Dunkin' Donuts Inc.*, 1989 WL 89449, at *8 (Del. Ch. Aug. 7, 1989).
[12] *Glazer v. Pasternak*, 693 A.2d 319, 320 (Del. 1997).
[13] Mem. of Law in Supp. of Plf.'s Mot. for Partial Summ. J., at 4.
[14] *Id*. at 4 n.2.

a change of control and may have caused *some* harm cannot be excluded on this record.

Second, CalPERS' claim should not be dismissed as moot because it challenges a practice capable of repetition. One of the well-recognized exceptions to the mootness doctrine involves situations that are "capable of repetition but evade review."[15] Although Lone Star has not renewed the expired contracts and there is no evidence before the Court that it intends to renew them, Lone Star may engage in similar conduct in the future.

Third, in pursuing breach of fiduciary duty claims, proof of specific harm is unnecessary, as "[e]very wrong demands a remedy."[16] Thus, mere uncertainty associated with the harm from an alleged breach of fiduciary duty does not allow for dismissal on grounds of mootness.

Accordingly, the Defendants' application to dismiss CalPERS' claim on mootness grounds is denied.[17]

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[15] *See, e.g.*, *General Motors Corp. v. New Castle County*, 701 A.2d 819, 823 n.5 (Del. 1997) (noting that "recognized exceptions to the mootness doctrine [include] situations that are capable of repetition but evade review" and citing sources supporting this principle).

[16] *Cantor Fitzgerald L.P. v. Cantor*, 2000 WL 307370, at *32 (Del. Ch. Mar. 13, 2000).

[17] In a sense, the issue may be one of "ripeness" and not "mootness." Both concepts address similar concerns that arise from resolution of questions not based on a current and real dispute between the parties with a meaningful stake in the outcome. Ripeness, in general, is applied to those questions which "[have] not yet matured to a point where judicial action is appropriate." *Saito v. McCall*, 2004 WL 3029876, at *5 (Del. Ch. Dec. 20, 2004) (quoting *Stroud v. Milliken Enters., Inc.*, 552 A.2d 476, 480 (Del. 1989)). Mootness is applied to those questions which, although once ripe, no longer frame an issue deserving judicial attention. Here, for example, the Change of Control Contracts

C. *The "Existing Directors" Provision*

The critical role of the board of directors in the governance of a Delaware corporation is established by 8 *Del. C.* § 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. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

The voting powers of various directors may be differentiated in accordance with 8 *Del. C.* § 141(d), which provides in part:

> (d) The directors of any corporation organized under this chapter may, by the certificate of incorporation or by an initial bylaw, or by a bylaw adopted by a vote of the stockholders, be divided into 1, 2 or 3 classes; . . . The certificate of incorporation may confer upon holders of any class or series of stock the right to elect 1 or more directors who shall serve for such term, and have such voting powers as shall be stated in the certificate of incorporation. The terms of office and voting powers of the directors elected in the manner so provided in the certificate of incorporation may be greater than or less than those of any other director or class of directors. If the certificate of incorporation provides that directors elected by the holders of a class or series of stock shall have more or less than 1 vote per director on any matter, every reference in this chapter to a majority or other proportion of directors shall refer to a majority or other proportion of the votes of such directors.

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may have had an impact on Bruckmann Rosser's decision to abandon an acquisition of the Company. There was, however, no specific instance when a vote by a director other than an Existing Director would have mattered or was even likely to have mattered. Nonetheless, the Existing Directors provision is integral to the Change of Control Contracts and, as such, is properly considered by the Court.

CalPERS' contention that the Existing Directors provision impermissibly discriminates against new directors is premised upon *Carmody v. Toll Brothers* in which this Court concluded that "[t]he plain, unambiguous meaning of the quoted language [of 8 *Del. C.* § 141(d)] is that if one category or group of directors is given distinctive voting rights not shared by the other directors, those distinctive voting rights must be set forth in the certificate of incorporation."[18] CalPERS argues that the Existing Directors provision runs afoul of the holding of *Carmody* because it confers different voting powers on Lone Star's directors without any authorization provided by Lone Star's charter. More specifically, only the actions of Existing Directors are considered in ascertaining the status of the new director for purposes of the Existing Directors provision; the views of directors who are not considered Existing Directors are not considered.[19]

Carmody involved a challenge to a "dead hand" poison pill. The rights plan at issue in *Carmody* could only be redeemed by those directors who adopted the plan or their designated successors. Thus, the rights plan empowered some, but not necessarily all, of the directors to redeem the pill. The Court held that

[18] *Carmody*, 723 A.2d at 1191.

[19] It should be reiterated that CalPERS' pending motion is limited to an attack on the Existing Directors provision as a matter of law, and it does not challenge the Change of Control Contracts generally (*i.e.*, but for the Existing Directors provision).

"[a]bsent express language in the charter, nothing in Delaware law suggests that some directors of a public corporation may be created less equal than other directors, and certainly not by unilateral board action."[20]

Crucial to an understanding of *Carmody* is an understanding of the unique nature of the dead hand poison pill because of its impact on potential business combinations or acquisition opportunities. Delaware requires that the board retain the power to redeem the poison pill[21] in order to fulfill its fiduciary duties as circumstances change. The Court in *Carmody* concluded that, by purporting to limit the right of new directors to vote on whether to redeem the pill, the dead hand provision materially interfered with the ability of the directors to manage the business and affairs of the corporation. Indeed, because the rights plan was to exist for more than a decade, it "would embed structural power-related distinctions between groups of directors that no successor board could abolish" for an extended period of time.[22]

Lone Star entered into Change of Control Contracts with several employees. Those agreements required the Company to compensate covered employees upon a "change of control." One of the ways by which a "change of control" would occur

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[20] *Carmody*, 723 A.2d at 1191.
[21] *See, e.g.*, *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281, 1291-92 (Del. 1998). No issue regarding the powers and duties of committees of directors under 8 *Del. C.* § 141(c) has been presented.
[22] *Carmody*, 723 A.2d at 1192.

was if a majority of the Board consisted of directors who were not on the Board as of the effective date of the agreements. Lone Star and the employees, however, agreed that not all changes in control of the Board should entitle the employees to change of control benefits. Some "changes of control" could occur without any of the adverse consequences which prompted implementation of the Change of Control Contracts. For example, the directors could change, but the new members might be committed to the same personnel and policies. The Board and the covered employees chose, as a matter of contract, to allow the incumbent directors, in effect, to determine if there had not been a change of control that should trigger payment of the change of control benefits. If the Existing Directors had voted to approve the new directors, then the new directors could be fairly deemed "Existing Directors" for these purposes, and the change of control payments would not be triggered.

Carmody, of course, addressed efforts to confer greater or distinctive voting power on some directors at the expense of other directors. Accordingly, it is necessary to consider whether the Existing Directors provision affects the "voting powers" of the Company's directors. If the directors in office at the time of the Change of Control Contracts approve a new director and, thus, the new director is classified as an Existing Director, all directors had the same input, and the concerns motivating the *Carmody* Court are not implicated. Similarly, if those

directors fail to support another new director, that director will not be deemed an Existing Director, but there still has been no exercise of differential voting power. The question presented by CalPERS' motion arises, however, when the next director comes to the Board and the director who is not classified as an Existing Director will not be considered in the subsequent determination of whether the next director is to be considered an Existing Director. Thus, the issue becomes: is this case really about voting power as that concept is used in *Carmody* and 8 *Del. C.* § 141(d)?

A new director will "be *considered* an Existing Director," if that director was "approved by a *vote* of at least a majority of the Existing Directors." By reference to a vote of the Board, one determines whether the new member will be considered an "Existing Director." The Board, however, does not vote on the specific question of whether the new director will be an "Existing Director." Indeed, there is nothing in the Existing Directors provision of the Change of Control Contracts that requires any board vote following the initial approval of the contracts. The contractual rights of the employees were fixed when they executed their Change of Control Contracts. A new board member who is not considered an Existing Director is not denied the right to vote in any instance. Instead, the Existing Directors provision simply provides an after-the-vote measure for ascertaining whether there is continuity within the Board even though its

membership has changed. In short, the Change of Control Contracts require reference to the results of a vote by the Board (or some members of the Board) in order to determine the status of ongoing rights of certain employees to change of control payments.[23] Thus, the Existing Directors provision neither limits nor expands the voting powers of any director. As such, the Existing Directors provision contravenes neither *Carmody* nor 8 *Del. C.* § 141(d).[24]

In sum, the corporate governance considerations underlying *Carmody* are not implicated in the Existing Directors provision at issue here. It is reasonable that a change of control agreement have some mechanism by which the corporation's obligation to make such payments can be avoided if the composition of the Board has changed in name only. The definitional approach adopted by Lone Star is an acceptable methodology; it may not be the only one. More

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[23] That the specific reference required by the Existing Directors provision may be to less than all of the directors who voted does not differentiate among the directors with respect to voting powers because the question which is answered by such reference is not one submitted (or which otherwise needs to be submitted) for board action. Moreover, nothing in the Existing Directors provision restricts the ability of any director to participate fully in the process of selecting directors.

[24] I note that CalPERS focuses its challenge on an aspect of the Change of Control Contracts that can only benefit the Company. The Company and the employees were not obligated (except as the result of negotiation) to allow the Company to avoid golden parachute payments in the event that the changes in board composition were immaterial. Moreover, CalPERS does not assert that Change of Control Contracts must have some revocable feature akin to the board's power to redeem a poison pill. Also, although the question of severability is beyond the scope of this memorandum opinion, if CalPERS were to prevail, the result might simply be the removal of the challenged provision from the Change of Control Contracts, with a net result that the Company would have lost the right to refuse to make Change of Control payments under certain circumstances.

importantly, CalPERS has not demonstrated that the Delaware General Corporation Law precludes, or, in this instance, should preclude, a flexible approach that acts to protect a corporation's interests, to the detriment of the favored employees who would otherwise benefit, perhaps unfairly, from a simple change in personnel on the Board.[25]

IV. CONCLUSION

Accordingly, CalPERS' motion for partial summary judgment is denied. Because the question of whether the Existing Directors provision is invalid as a matter of law has been resolved adversely to CalPERS and because the Defendants, although nonmoving parties, are clearly entitled to summary judgment, partial summary judgment will be entered in favor of Defendants and against CalPERS with respect to Count VIII of CalPERS' Second Amended

[25] The judicial decision-making process is necessarily dependent upon the factual context in which the dispute arises. As the Defendants have noted, the factual background to the pending motion is sparse. There are two matters relating to context that bear mention. First, the Change of Control Contracts were only for two years. In contrast, the "dead-hand" provision challenged in *Carmody* was of ten years' duration. *Carmody* acknowledges that a similar "dead-hand" provision of "limited duration" might have been viewed differently. 723 A.2d at 1195 n.52. By concluding that the voting power, as such, of the directors is not compromised here, the Court need not consider this aspect. Second, while the Existing Directors provision adopted by the Company does not, as the result of its mere existence, run afoul of *Carmody* or 8 *Del. C.* § 141(d), incumbent directors may not employ a similar device, in a different context, to deprive various directors of their voting power or to deprive them of the capacity to exercise that power when necessary. *See, e.g.*, *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971). In short, it is well within the range of the possible that a board's adoption of a provision comparable to the Existing Directors provision could, under certain circumstances, constitute a breach of the fiduciary duties owed by the board to the shareholders.

Complaint to the extent that it purports to challenge the validity of the Existing Directors provision as a matter of Delaware statutory law.

An order will be entered in accordance with this memorandum opinion.