IN THE UNITED STATES DISTRICT COURT
FOR THE WESTERN DISTRICT OF TENNESSEE
WESTERN DIVISION

HILTON HOTELS CORPORATION and PROMUS HOTEL CORPORATION,	)	
Plaintiffs,	)	**No. 00-2852 G/V**
v.	)	
LISA DUNNET, JAMES EVANS, JACK FERGUSON, JOHN LAVIN, STEPHEN PLETCHER, MARGARET ANN RHOADES, DICK TRUEBLOOD, and RAYMOND TERRY,	)	
Defendants.	)	

SUPPLEMENTAL ORDER ON MOTION FOR SUMMARY JUDGMENT

On December 28, 2002, the Court issued its Order Denying Plaintiffs' Motion for Summary Judgment. After receiving Plaintiffs' January 9, 2003 motion requesting an order allowing an interlocutory appeal, the Court has decided to more fully elaborate on the standard of review that the Court applied to the Board of Directors' decision to cancel the under water options at issue in this case. Accordingly, the Court is issuing this supplement to its order.

In their initial motion for summary judgment, Plaintiffs reasoned that under both Plans the Board was granted the power to interpret the terms of the Plans. Accordingly, Plaintiffs urged the Court to adopt a standard that only allows the Court to review the Board of Directors' decision where there is evidence that the decision was made arbitrarily, in bad faith, or in a fraudulent manner. By contrast, Counter-Plaintiffs essentially urged the Court to examine the Board of Directors' decision using a *de novo* standard of review because, Counter-Plaintiffs argue, one of the parties to a dispute should not be the arbiter of that dispute.

In their motion requesting an interlocutory appeal, Plaintiffs now raise the issue of the business judgment rule. Plaintiffs assert that the Board of Directors' decision should be reviewed under the heightened standard known as the business judgment rule, which requires a court to assume the directors acted in the best interests of the corporation.[1]

[1] The Court notes preliminarily that the business judgment rule would not apply to this case. The purpose of the business judgment rule is to prevent shareholders from second-guessing the decisions directors make on behalf of a corporation. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) ("It 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.") It arises mainly in shareholder derivative suits or lawsuits alleging that the directors breached their fiduciary duty to the corporation. Id. In that regard, the business judgment rule would be an appropriate benchmark had Promus' shareholders sued the Board in connection with the merger with Hilton. However, in this case the question is not whether the directors acted in the best interest of the corporation when they canceled the options (which, it appears, they did). The question is whether they properly administered the stock option plans with respect to the optionees' rights under the plans.

As the Court noted in its December 28, 2002 order, the Court has been unable to locate a Delaware decision discussing the standard of review that should be applied to a board of directors' decision regarding the interpretation of an employee stock option plan. Similarly, the parties have also been unable to direct the Court to an applicable Delaware decision. Case law from other courts is sparse. Absent a definitive case on this issue, the Court has examined the general principles of Delaware law and other similar types of contracts for guidance in determining what the Delaware Supreme Court would likely decide in this situation.

In particular, the Court has found contracts arising under the Employee Retirement Income Security Act ("ERISA"), 29 U.S.C. § 1001, *et seq.*, to be instructive. Similar questions regarding the standard of review often arise under ERISA where a benefits plan provides the administrator with the power to interpret the plan.

In this regard, the Court has found Goldstein v. Johnson & Johnson, 251 F.3d 433 (3d Cir. 2001), very helpful. In Goldstein, the Third Circuit analyzed the standard of review that should be used when a court is presented with an ERISA "top hat" plan that provides for the administrator to interpret the terms of the plan.[2] Id. at 442. A top hat plan differs from the typical ERISA plan because a top hat plan applies only to highly paid executives who are in a strong bargaining position relative to their employers and because the administrator is not considered the fiduciary of the plan. Id. According to the Third Circuit, top hat plans are "akin to unilateral contracts." Id. In these ways, an ERISA top hat plan resembles the stock option plan in this case, as modified by the 1998 Resolution.[3]

In Goldstein, the Third Circuit determined that although "discretion" may be explicitly written into a top hat plan document, the plan should be treated as a unilateral contract and "neither party's interpretation should be given precedence over the other's, except in accordance with ordinary contract principles." Id. at 443. The court went on to state that, in accordance with ordinary contract principles, "where one party is granted discretion under the terms of the contract, that discretion must be exercised in good faith -- a requirement that includes the duty to exercise the discretion reasonably." Id. at

[2] Where an ordinary ERISA plan provides for the administrator to interpret the terms of the plan, the Supreme Court has instructed that a denial of benefits should be given deference upon review. Firestone Tire & Rubber Co. v. Bruch, 489 U.S. 101 (1989).

[3] The Court notes that with this decision the Court is not attempting to establish a fiduciary duty on behalf of the Board of Directors as administrators of the stock option plans to optionees under the plans.

444.[4]

The Court's review of ERISA case law also shows the importance of examining any potential conflict of interest that may arise when a plan administrator interprets the terms of a benefit plan. In Pinto v. Reliance Standard Life Ins. Co., 214 F.3d 377 (3d Cir. 2000), the Third Circuit considered whether an insurance company that both funds and administers a benefits plan is generally acting under a conflict that warrants a heightened form of the arbitrary and capricious standard of review. The court determined that a heightened degree of scrutiny was appropriate because of the insurer's financial conflict. Id. at 379.

Further, the Delaware Supreme Court has long recognized that where a board of directors faces a conflict of interest in connection with a transaction, a court should more carefully examine the board's decision. See, e.g., Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985) (recognizing that directors may act primarily in their own interests when addressing a potential takeover bid and applying "an enhanced duty which calls for *judicial examination at the threshold* before

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[4] The court also rejected the idea that such contracts should be voided as unconscionable because the clause granting interpretive discretion essentially designates an interested party as an arbitrator. Goldstein, 251 F.3d at 444. The court simply held that the discretion must be exercised reasonably and in good faith. Id.

the protections of the business judgment rule may be conferred") (emphasis added). Additionally, the Delaware Supreme Court has protected parties with weak bargaining positions relative to a corporate transaction when those parties rights will be affected by the transaction. See, e.g., Harman v. Masoneilan Int'l, Inc., 442 A.2d 487, 492 (Del. 1982) (stating that a majority shareholder and its director designees occupy a fiduciary relationship to the minority shareholders and must establish the transaction's "entire fairness" to the minority shareholders).

Given the above case law and the discretion granted to the Board of Directors in this case, the Court finds it appropriate to adopt the standard of good faith and reasonableness set forth in Goldstein, subject to the idea that the Court must review the Board's decision more closely where there is evidence of a conflict of interest or bias.

In this case it appears that Hilton held a controlling position relative to Promus. Promus had no choice but to cancel the options or lose the merger. In this situation, it would be difficult for the Promus Board of Directors to give unbiased consideration to the proper interpretation of the Plans and the special situation of Counter-Plaintiffs, who held a three-year extension pursuant to the 1998 Resolution. The Promus Board of Directors owed an overriding duty of loyalty to the corporation and its shareholders; it had far less obligation to Counter-

Plaintiffs, who no longer worked for Promus.[5] Given this inherent conflict of interest, the Court evaluated more carefully (i.e. less deferentially) the decision to cancel these options.[6]

The Court believes that the Delaware Supreme Court would recognize the conflict and adopt a Goldstein-type standard of review under the peculiar facts of this case. It is by utilizing such an analysis that the Court reached the conclusions set forth in the order of December 28, 2002.

ENTERED this ____ day of January 2003.

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JON P. McCALLA
UNITED STATES DISTRICT JUDGE

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5 The fact that Promus made its decision to cancel the options of former employees holding a special three-year exercise right distinguishes it from the fairly typical situation in which a corporation cancels under water options belonging to current employees in order to complete a merger.

6 It should be noted that Plaintiffs' interpretation nullified all rights Counter-Plaintiffs had earned under the Plans and rendered the promise that Promus provided under the 1998 Resolution completely illusory.