Client Alert

March 15, 2013

Board Enjoined from Impeding Hostile Consent Solicitation Without First Approving Rival Director Slate under Credit Agreement Proxy Put Provision

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The Delaware Chancery Court recently enjoined a board of directors from impeding a stockholder's solicitation of written consents to replace the board, unless the board first approved the stockholder's nominees for purposes of a change in control provision in the company's credit agreements (*Kallick v. SandRidge Energy, Inc.,* March 8, 2013). The court found that the board's failure to provide that approval, without a "rational, good faith justification," even while otherwise campaigning against the stockholder's nominees, would violate the board's fiduciary duties.

BACKGROUND

TPG-Axon owned approximately 7% of SandRidge. Dissatisfied with the company's performance, TPG demanded that the company declassify the board, add stockholder representatives to the board, replace the CEO and explore strategic alternatives.

The board resisted by, among other things, adopting a poison pill. TPG responded by soliciting written consents from other stockholders to declassify the board and replace the current directors with TPG nominees.

The board told stockholders that electing TPG's director slate would trigger the company's obligation under its credit facilities to offer to repurchase the outstanding debt (a so-called "proxy put" or "poison put"). The board initially said that repurchasing the debt would be harmful to the company, but later indicated that the repurchase would not be harmful. The proxy put could be avoided entirely if the board approved TPG's director slate, but the board refused to do so, saying, among other things, that the rival slate was not as qualified or experienced as the board.

The plaintiff, a company stockholder who supported TPG's consent solicitation, argued that the board was breaching its fiduciary duties by failing to approve the TPG slate.

THE COURT'S DECISION

The court invoked the *Unocal* standard of review, which requires a board, when acting in a manner that implicates its continued control, to justify its actions as reasonable in light of the threat faced by the company. The court also relied on its 2009 *Amylin* decision, which applied *Unocal* in another proxy put situation and held that the board, in deciding how to exercise its approval discretion under a proxy put provision during an election contest, must focus on the best interests of the corporation and its stockholders. The *Amylin* court also held that the board's only duty to creditors in exercising such approval discretion was to honor the implied covenant of good faith and fair dealing.

According to the court, while a board can oppose a rival director slate through legitimate means, the board may refuse to approve the rival slate for purposes of defusing the proxy put only if the board determines that the rival slate poses "such a material threat of harm" to the company that it would be a breach of the board's duty of loyalty to allow control to pass to them. The court stated that this could apply where, for example, the rival slate proposed changes that would materially adversely affect the company's "ability to meet its legal obligations to its creditors."

In this case, the court found that the directors did not provide an appropriate reason not to approve the TPG nominees for purposes of the proxy put. Rather, the court determined, the board had simply decided that it was "better" than TPG's slate. Such a decision, however, "does not come close to a reasoned conclusion that the electoral rivals lack the integrity, character, and basic competence to serve in office." Thus, in failing to so approve the TPG slate, the directors breached their duty of loyalty.

Prior Decision to Agree to the Proxy Put. The court also discussed the board's initial decision to include the proxy put in the credit agreement. The court noted that "one would hope" that a board would "bargain hard" to avoid proxy puts and other change in control provisions that have entrenching purposes and accede to them only for "clear economic advantage." Not all change in control arrangements raised the same concerns, however. As an example, the court distinguished such provisions in some severance agreements, noting that "an employee has an obvious interest in knowing who her boss is."

Injunction. The court enjoined the board from soliciting further consent revocations, relying on revocations already received or otherwise impeding TPG's consent solicitation efforts unless and until the board approved the rival slate for the purposes of the proxy put. The day after the court's ruling, the board approved TPG's director slate for purposes of the proxy put.

IMPLICATIONS

Relying on Proxy Puts and Other Change in Control Arrangements. A board's refusal or failure to defuse a proxy put or similar change in control arrangement that has an entrenching effect will be reviewed under a heightened reasonableness standard. The burden will be on the board to identify a "specific and substantial" risk to the company or other proper basis for the board's actions; differences in view as to the most effective policies for the company are not likely to suffice.

Agreeing to Proxy Puts and Other Change in Control Arrangements. Boards should understand the impact, as well as the benefits, of proxy puts and other change in control provisions before agreeing to them in the first place. The court noted that companies should accept proxy puts only after "hard negotiation" with lenders. "Most important[ly]," independent directors should "police" such provisions "to ensure that the company … is not offering up these terms lightly precisely because of their entrenching utility, or accepting their proposal when there is no real need to do so."

Implementation of Staggered Board Provisions. Because the company's staggered board provision was in its bylaws and not in its certificate of incorporation, TPG was able to solicit stockholder consents to undo the classification without any board vote. While not an issue in the litigation, the court characterized this placement in the bylaws as a "defensive planning flaw." Including the classification provisions in a company's certificate of

incorporation, which requires a board vote to amend, provides greater protection in this regard. We note, though, that, regardless of where implemented, stockholder groups increasingly are calling on companies to declassify their boards, and the proportion of companies with staggered boards is falling.

***Use of Written Consents by Dissidents*.** TPG was able to move quickly, without waiting for a stockholder meeting, because the company allowed stockholders to act by written consent. Many public companies prohibit stockholder action by written consent, but, like the staggered board noted above, stockholder groups increasingly are seeking to eliminate such protections.

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