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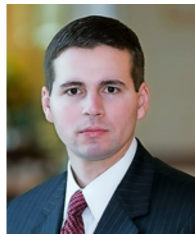
DELAWARE LAW

Dead Hand Proxy Puts Face Continued Scrutiny



BY T. BRAD DAVEY AND CHRISTOPHER N. KELLY

"Dead hand proxy puts" have emerged as the target *du jour* for entrepreneurial plaintiffs counsel litigating corporate governance claims. Since last fall, at least seven separate actions have been filed in the Delaware Court of Chancery challenging these change-of-control provisions commonly found in corporate debt instruments. During this same period, numerous companies have received stockholder demands seeking to investigate purported corporate mismanagement due to the presence of dead hand proxy puts in their debt instruments.

This explosion in litigation activity has been fueled, in part, by the Court of Chancery's characterization of dead hand proxy puts in October 2014 as "highly suspect" entrenchment devices.[1] More recently, however, the Court of Chancery has questioned whether the removal of these provisions confers a meaningful, quantifiable benefit on corporations, particularly in the absence of a pending or threatened proxy contest.[2] The Court of Chancery also has noted that as Delaware case law concerning proxy puts becomes more developed, "the situation begins to be less like chaining up a vicious bulldog and more like chaining up a toothless bulldog."[3] Because these more recent observations focus more on the value than the validity of claims challenging dead hand proxy puts, there is a "cost-of-defense" leverage point that is irresistible to certain entrepreneurial plaintiffs firms. As a result, this litigation activity is likely to be a fixture of the corporate governance landscape for as long as dead hand proxy puts remain in corporate debt instruments.

T. Brad Davey is a partner and Christopher N. Kelly is an associate with the Wilmington, Del. law firm of Potter Anderson & Corroon LLP. The views expressed by the authors are not necessarily the views of Potter Anderson & Corroon LLP or any of its clients.

Proxy Put Language

A "proxy put" is a change-of-control provision in a debt instrument that requires a corporation to pay off or redeem its debt in the event that more than half of an incumbent board of directors is replaced through an actual or threatened contested election. In the case of a credit agreement, a proxy put provision makes a change of control through a proxy contest an event of default that accelerates all debt to be immediately due and payable. In the case of an indenture, a proxy put grants noteholders the right to demand redemption of their notes at face value if such a change of control occurs. Proxy puts can take a "dead hand" form, such that a board is powerless to avoid application of the provision unless it is waived.

Debt instruments that contain proxy puts typically define a "Change of Control" as an event or series of events by which

> . . . a majority of the members of the board of directors or other equivalent governing body of the Company cease to be composed of individuals (i) who were members of that

[1] *Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014) ("*Healthways I*") (Tr. 80).

[2] *See The Fire & Police Pension Fund, San Antonio v. Stanzione*, C.A. No. 10078-VCG (Del. Ch. Feb. 25, 2015) (Tr. 7–9); *Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, C.A. No. 9789-VCL (Del. Ch. May 8, 2015) ("*Healthways II*") (Tr. 14–15).

[3] *Stanzione*, Tr. 8.

> board or equivalent governing body on the first day of such period, (ii) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (i) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body or (iii) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (i) and (ii) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body . . . .[4]

Were the provision to include a ''dead hand'' feature, it usually would end with following parenthetical:

> (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 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).[5]

On occasion, a debt instrument will define a ''Change of Control'' as occurring when ''Continuing Directors'' cease to constitute a majority of the members of the board of directors of the borrower,[6] and then will separately define ''Continuing Directors'' as either including with incumbent board approval (in the case of a traditional proxy put) or excluding (in the case of a dead hand proxy put) individuals who accede to the board by an actual or threatened proxy contest or consent solicitation.[7]

In the case of a credit agreement, a change of control invariably constitutes an ''Event of Default'' and authorizes the administrative agent to declare the unpaid principal and interest of the loan to be immediately due and payable.[8] For indentures, a change of control either by itself or combined with a decline in the ratings of the notes will typically constitute a ''Change of Control Triggering Event'' that entitles noteholders to demand redemption of any or all of their notes at face value (or more).[9] The additional requirement of a rating decline before triggering a note redemption may provide meaningful protection to companies against the prospect of having to pay off the debt, but companies facing a proxy contest may have their credit ratings downgraded or considered for downgrade for fear that the activist stockholder will (among other things) leverage the company to fund stock buybacks or dividends.[10]

There are legitimate business reasons for lenders to seek to include proxy puts in corporate debt instruments.[11] Lenders ''like to know who their borrowers are'' and want to understand and be comfortable with the direction of the company's business.[12] A change of control at the board level potentially could alter a company's credit risk profile for the worse; in such event, proxy puts provide lenders the opportunity to consider whether to accelerate repayment of the debt to protect their interests.[13] These provisions are routinely included in credit agreements and indentures, and may have become even more prevalent in the wake of the current wave of stockholder activism.

II. Proxy Put Case Law

A. San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals Inc., 983 A.2d 304 (Del. Ch. 2009).

In *Amylin*, the Court of Chancery held that a ''continuing director'' provision in an indenture permitted the board of directors of Amylin Pharmaceuticals Inc. to ''approve'' as continuing directors persons nominated by dissident stockholders and thereby avoid triggering a default, notwithstanding that the board was opposing the election of the stockholder nominees.[14]

The indenture gave noteholders the right to demand redemption of any or all of their notes at face value upon the occurrence of certain events, including a ''Fundamental Change,'' defined as ''any time the Continuing Directors do not constitute a majority of the Company's Board of Directors.''[15] The indenture defined ''Continuing Directors'' as (i) individuals who on the issue date constituted the board of directors or (ii) any new directors whose nomination or election to the board of directors was approved by at least a majority of the directors then still in office who were directors on the issue date or whose nomination or election was previously so approved.[16] The Court interpreted ''approve'' to mean ''give formal sanction to; to confirm authoritatively.''[17] Under this interpretation, ''the board may approve a slate of nominees for purposes of the [i]ndenture . . . without endorsing them, and may simultaneously recommend and endorse its own slate instead.''[18]

In language that would portend the court's analysis of dead hand proxy puts, the Court rejected an interpretation of the continuing director provision that would have denied the board the flexibility to approve the insurgent slate without endorsing them:

> A provision in an indenture with such an eviscerating effect on the stockholder franchise would raise grave concerns. In the first instance, those concerns would relate to the exercise of the board's fiduciary duties in agreeing to such a

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[4] *See, e.g.*, *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304, 309 (Del. Ch. 2009).
[5] *See, e.g.*, *id.*
[6] *See, e.g.*, *Healthways I*, Tr. 6.
[7] *See, e.g.*, *id.* at 6–7.
[8] *See, e.g.*, *Amylin*, 983 A.2d at 309.
[9] *See, e.g.*, (''Defined Term''), A dictionary of legal, industry-specific, and uncommon terms, *available at* https://definedterm.com/change_of_control_triggering_event.
[10] *See* L. Hoffman, *Banks Feel the Heat From Lawsuits*, WALL ST. J. (Apr. 28, 2015).
[11] *See Healthways I*, Tr. 26–29.
[12] *See id.* at 27–29.
[13] *See id.* at 26.
[14] *Amylin*, 983 A.2d at 307.
[15] *Id.* at 307–08.
[16] *Id.* at 308. A separate credit agreement also provided that an event of default would occur thereunder if ''Continuing Directors'' failed to constitute a majority of the members of Amylin's board, but contained a ''dead hand'' feature by defining ''Continuing Directors'' as excluding individuals 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. *Id.* at 309. The banks that were parties to the credit agreement agreed to waive any default under the dead hand proxy put provision in exchange for a 50-basis point fee on any outstanding balance, mooting that issue. *Id.* at 312.
[17] *Id.* at 314.
[18] *Id.* at 314–15.

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> provision. The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting such a provision, it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it. Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy.[19]

The court rejected the plaintiff's contention that the board breached its duty of care by adopting an indenture that contained a continuing director provision, reasoning that the board received advice from ''highly-qualified counsel,'' management and investment bankers—''not the sort of conduct generally imagined when considering the concept of gross negligence.''[20]

B. Kallick v. Sandridge Energy Inc., 68 A.3d 242 (Del. Ch. 2013).

In *SandRidge*, the Court of Chancery granted a stockholder's request for injunctive relief after concluding that the company's directors likely violated their fiduciary duties by failing to exercise the flexibility afforded by *Amylin* to approve a dissident slate to avoid triggering a proxy put in the company's indentures.[21]

Under the terms of SandRidge's indentures, the election of a dissident slate without the approval of at least two-thirds of the incumbent directors would constitute a change of control entitling the company's lenders to put $4.3 billion worth of notes back to the company.[22] When the incumbent board's approval of the dissident slate for purposes of neutralizing the proxy put did not appear to be forthcoming,[23] the plaintiff filed suit for breach of fiduciary duty.[24]

Applying intermediate scrutiny under *Unocal Corp. v. Mesa Petroleum Co.*,[25] the court found that the defendant-directors failed to demonstrate a reasonable justification for their refusal to determine whether to approve the dissident slate.[26] The court explained that ''a board may only *fail* to approve a dissident slate if the board determines that passing control to the slate would constitute a breach of the duty of loyalty, in particular, because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors.''[27] ''[T]he thin and shifting arguments of the incumbent board d[id] not persuade [the Court] that any legitimate interest of Sandridge was served by the board's failure to make an approval decision.''[28] Rather, in the court's view, ''the incumbent board's behavior is redolent more of the pursuit of an incremental advantage in a close contest[.]''[29] Accordingly, the court held that the defendants likely breached their fiduciary duties to SandRidge and its stockholders,[30] and enjoined ''the incumbent board from: (i) soliciting any further consent revocations; (ii) relying upon or otherwise giving effect to any consent revocations they have received [prior to the Court's decision]; and (iii) impeding [the] consent solicitation process in any way, unless and until the board approves the [dissident] slate for the limited purposes of the [p]roxy [p]ut.''[31]

C. Pontiac General Employees Retirement System v. Ballantine (''Healthways I''), C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014) (Transcript).

In this transcript ruling, the Court of Chancery declined to dismiss a stockholder challenge to a dead hand proxy put contained in Healthways Inc.'s revolv-

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[19] *Id.* at 315. Because the size of the dissident slate had been reduced so that a majority of the board would remain continuing directors, the court found unripe the question whether the board properly exercised its right to approve the stockholder nominees, but noted that the board may give its approval if it determines in good faith that ''the election of one or more of the dissident nominees would not be materially adverse to the interests of the corporation or its stockholders.'' *Id.* at 316.

[20] *Id.* at 318–19. The court noted that outside counsel advising a board ''should be especially mindful of the board's continuing duties to the stockholders to protect their interests,'' and ''highlight'' any terms that ''may affect the stockholders' range of discretion in exercising the franchise.'' *Id.* at 319. On appeal, the Delaware Supreme Court affirmed the Court of Chancery's determination that the board did not breach its duty of care in authorizing the corporation to enter into an indenture with a proxy put, for the reasons the chancery court noted as well as because the plaintiff made no showing that approving the proxy put ''would involve any reasonably foreseeable material risk to the corporation or its stockholders.'' *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 981 A.2d 1173, n.2 (Del. 2009) (table). ''That risk materialized only months later, and was aggravated by the unexpected cataclysmic decline in the nation's financial system and capital markets beginning in the Spring of 2008.'' *Id.*

[21] *Kallick v. Sandridge Energy Inc.*, 68 A.3d 242, 244-47 (Del. Ch. 2013).

[22] *Id.* at 250.

[23] The incumbent directors even warned stockholders that the company ''may not have sufficient liquidity to fund the purchase for such senior notes as required under the [i]ndentures,'' and that a ''mandatory refinancing of this magnitude would present an extreme, risky and unnecessary financial burden'' on the company. *Id.*

[24] *Id.*

[25] 493 A.2d 946 (Del. 1985). Defendants urged the application of the business judgment rule and plaintiff argued that the refusal to approve the dissident slate should be reviewed under *BlasiusIndus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). The court rejected both of these arguments. *Sandridge*, 68 A.3d at 258–59. The court stated that *Blasius* did not address a situation where the proxy put did not have the ''sole or primary purpose'' of impeding the stockholders' vote because it may have a legitimate purpose of protecting creditors who insisted on its inclusion, but does not have the ''obvious potential to tilt the electoral playing field toward the incumbent board.'' *Id.* at 258–59.

[26] The defendant-directors argued that the stockholder nominees lacked sufficient energy industry experience and approving them would compromise the company's ability to obtain financing because lenders may charge a higher price for credit, perceiving SandRidge as a company that circumvents change of control provisions. *Id.* at 253–55. The court was not persuaded by these arguments, finding that there was no ''reasonable basis to dispute the basic qualifications of the [dissident] slate,'' that ''credit is easy to obtain, providers are competing to lend, and there will be insubstantial costs to refinance,'' and that there was no evidence ''that lenders place a tangible value on a Proxy Put trigger.'' *Id.* at 255–57.

[27] *Id.* at 260 (emphasis in original). As examples, the court stated that approval properly could be withheld where the proposed new board consisted of ''known looters'' or persons of suspect integrity, or where ''the insurgent slate could have plans for the company posing a genuine and specific threat to the corporation and its ability to honor its obligations to its creditors[.]'' *Id.*

[28] *Id.* at 261.

[29] *Id.*

[30] *Id.*

[31] *Id.* at 264.

ing credit and term loan agreement.[32] An earlier iteration of the credit agreement contained a proxy put, ''continuing director'' provision that lacked a dead hand, and the dead hand feature allegedly had been added following a stockholder proposal to declassify the company's board ''that signaled[ ] . . . some degree of stockholder dissatisfaction with the company.''[33]

The court refused to dismiss the lawsuit on ripeness grounds, holding that the case was ripe because of two present injuries the stockholders allegedly were suffering: (1) the deterrent effect of the proxy put, which ''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'';[34] and (2) ''the noncontinuing directors currently serving on the board are currently designated as such[,] . . . [a]nd hence, they are currently suffering an injury in the form of being treated differently than the other directors on the board.''[35] The court explained:

> What I think is ripe now is a claim that, based on the facts of this case, the board of directors breached its duties in a factually-specific manner by adopting this . . . dead hand proxy put arrangement in the context of the facts and circumstances here, including the rise of stockholder opposition, the identified insurgency, the change from the historical practice in the company's debt instruments, the lack of any document produced to date suggesting informed consideration of this feature, the lack of any document produced to date suggesting negotiation with respect to this feature, etc.[36]

The court not only found that the complaint stated a claim against the defendant directors, but also that it stated a claim for aiding and abetting against SunTrust Bank, the administrative agent for the bank group that extended credit in the form of a syndicated credit facility.[37] The court reasoned, in pertinent part, that ''[t]here was ample precedent from this Court putting lenders on notice that these provisions were highly suspect and could potentially lead to a breach of duty on the part of the fiduciaries who were the counter-parties to a negotiation over the credit agreement.''[38] The court noted that as alleged, the company's previous credit agreement lacked a dead hand aspect to its proxy put provision, and that the dead hand feature was added after the incumbent board came ''under pressure from stockholders, including the threat of a potential proxy contest.''[39] The court concluded: ''for pleading-stage purposes, . . . [SunTrust Bank is] a party to an agreement containing an entrenching provision that creates a conflict of interest on the part of the fiduciaries on the other side of the negotiation.''[40]

[32] *Healthways I*, Tr. 77, 80.
[33] *Id.* at 68–69.
[34] *Id.* at 72.
[35] *Id.* at 75.
[36] *Id.* at 75–76. The court did caution that ''This is not a per se analysis. No one is suggesting that. 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.'' *Id.* at 76.
[37] *Id.* at 24, 81.
[38] *Id.* at 80.
[39] *Id.*
[40] *Id.* at 80–81.

D. The Fire & Police Pension Fund, San Antonio v. Stanzione, C.A. No. 10078-VCG (Del. Ch. Feb. 25, 2015) (Transcript).

In this transcript ruling, the court awarded $128,000 in attorneys' fees to plaintiff's counsel for the ''modest benefit'' resulting from Arris Group Inc.'s elimination of a dead hand proxy put from its credit agreement soon after the filing of a lawsuit.[41] The court explained, in pertinent part:

> Although, as I have found, the provision did infringe on the stockholders' franchise by potentially discouraging the stockholders from bringing a dissident slate of directors, the narrowed focus of the proxy put at issue here, both in terms of the provision resetting every year and requiring a majority of dissident directors be elected to take effect, dilute the provision's harmful effect, leaving much of the stockholders' franchise intact. Moreover, as our case law describing the use of similar proxy puts as problematic becomes more developed, the value of removing such a device decreases. The situation begins to be less like chaining up a vicious bulldog and more like chaining up a toothless bulldog.[42]

E. Pontiac General Employees Retirement System v. Ballantine (''Healthways II''), C.A. No. 9789-VCL (Del. Ch. May 8, 2015) (Transcript).

In this second transcript ruling in *Healthways*, the Court of Chancery approved the settlement of the stockholder litigation challenging the dead hand proxy put, including a $1.2 million payment to plaintiffs' counsel.[43] Under the terms of the settlement, the dead hand proxy put would be eliminated from the company's credit agreement without any fees being paid to the lenders, and any future material contracts (*i.e.*, contracts of $20 million or more) containing change-of-control provisions would be brought to the board's attention, and all currently existing material contracts would be reviewed for change-of-control provisions and any such provisions would be brought to the board's attention.[44]

In approving the settlement and fee award, the court stressed that its ruling on the motion to dismiss had not been a finding of liability that the Healthways' board breached its fiduciary duties or that SunTrust aided and abetted such breach.[45] The court emphasized that its ruling on the motion to dismiss ''was a contextual ruling based on the facts of this case applying the reasonably conceivable standard,''[46] and was not a ruling that a dead hand proxy put constituted a *per se* breach of fiduciary duty by a company's board of directors and aiding and abetting by a company's lender.[47] The court explained that key to its prior decision was the fact that the dead hand proxy put allegedly had been adopted ''in the shadow of a proxy contest.''[48]

Conclusion & Takeaways

While directors and lenders can take some comfort in the Court of Chancery's latest observations regarding

[41] *Stanzione*, Tr. 7–9.
[42] *Id.* at 7–8.
[43] *Healthways II*, Tr. 42.
[44] *Id.* at 5, 29.
[45] *Id.* at 34–36.
[46] *Id.* at 36.
[47] *Id.*
[48] *Id.* at 35–36.

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dead hand proxy puts, it is clear that the court will continue to scrutinize these provisions. The strong language in *Amylin* regarding the circumstances pursuant to which a board's approval of a dead hand proxy put would be appropriate combined with the rejection of a ripeness defense in *Healthways I* make clear that it will be difficult to obtain a dismissal of claims challenging these provisions prior to discovery.

Entrepreneurial plaintiffs firms know that and understand that, as a result, the cost of defending such a provision is not insubstantial. Thus, even though recent comments from the court have rightly questioned the value of removing dead hand proxy puts (particularly in the absence of a pending proxy contest), certain entrepreneurial plaintiffs firms will continue to pursue this litigation to exploit the ''cost of defense'' leverage point and extract attorney's fees. The court should—and likely will—continue to reduce fees awarded to these firms for pursuing this litigation. Unfortunately, until those fees approach zero, challenging dead hand proxy puts will likely remain an attractive business proposition for some entrepreneurial plaintiffs firms.

In this litigation environment, any board considering a debt instrument that contains a dead hand proxy put provision should discuss the ramifications of the provision and seek to obtain economic value in exchange for including the provision in the agreement. To the extent a company's already existing debt agreements contains a dead hand proxy put, it may be worthwhile for the company to consider proactively seeking an amendment to delete the dead hand aspect of the provision. This could reduce the company's risk of stockholder litigation and save the company from potentially having to pay a plaintiffs' attorney fee award. Depending on the circumstances, lenders may be amenable to such an amendment to eliminate their risk of potential aiding and abetting liability.