Client update

Is the “Proxy Put” Dead? *Pontiac General Employees Retirement Fund v. Healthways*

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Directors may breach their fiduciary duties to stockholders, and their lenders may be liable for aiding and abetting their doing so, if they agree to a financing agreement that precludes a turnover in board membership resulting from an actual or threatened proxy solicitation. So ruled the Delaware chancery court recently, in denying a motion to dismiss in *Pontiac General Employees Retirement Fund v. Healthways, Inc.*[1] The lawsuit arose in response to Healthways amending its credit agreement to tighten the “continuing directors” trigger, also known as a “proxy put,” in the change of control restriction at a time of stockholder activism. In the court’s view, previous Delaware decisions provided notice that inclusion of such a provision is “highly suspect” and could involve a breach of fiduciary duties, sufficient to support an aiding and abetting claim against lenders.

CHANGE OF CONTROL PROVISIONS

Under many financing agreements, a change of control results in either a default allowing lenders to demand payment of their debt, or an obligation to offer to prepay the debt. A number of different events may constitute a change of control. The *Healthways* case, and its *Amylin*[2] and *SandRidge*[3] antecedents, all involved a change of control restriction on changes in the composition of the board of directors of a public company resulting from the “continuing” directors, including directors approved by the incumbent board for membership, ceasing to constitute a majority of the board of directors of the company.

Amylin: The Board Can Approve a Dissident Nominee

Amylin addressed the question of what it means for the board to “approve” nominees. The *Amylin* court found that, for purposes of avoiding a “continuing

[1] *Pontiac General Employees Retirement Fund v. Healthways, Inc.*, C.A. No. 9789-VCL, transcript (Del. Ch. Oct 14, 2014).

[2] San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc., C.A. No. 4446-VCL (Del. Ch. May 12, 2009).

[3] *Gerald Kallick v. SandRidge Energy, Inc.*, C.A. No. 8182-CS (Del. Ch. March 8, 2013).

director" change of control trigger, a board of directors has the right to approve a dissident slate of nominees while publicly opposing the slate, as long as in so approving the board of directors acts in good faith and in conformity with its fiduciary duties.

SandRidge: The Board Must Approve a Dissident Nominee

SandRidge addressed the question of whether the board has an obligation to approve nominees. In this case, the board of directors refused to approve a dissident slate of nominees, leaving it possible that their election could trigger a "continuing directors" change of control. Looking to *Amylin*, the court found that the board had a fiduciary duty to approve a dissident slate unless the nominees "posed such a material threat of harm to the corporation that it would constitute a "breach of the directors" duty of loyalty to the corporation and its stockholders" to "pass control" to them."[4]

Healthways: The Board Can't Agree to Remove Its Approval Right

Healthways amended its credit agreement only a few days after its stockholders voted to de-stagger its board of directors. The amendment in effect sidestepped *Amylin* and *SandRidge* by providing that anyone initially nominated to the board as the result of an actual or threatened proxy solicitation could not be a "continuing director," whether or not approved by the incumbent board.

The court equated the "continuing director" trigger to defensive measures such as a "poison pill" rights plan, and stated that it similarly has a limiting deterrent effect on actions the stockholders may want to pursue in the exercise of their rights. The court found that, even in the absence of an active proxy contest, the potential deterrent effect made it timely to determine if the directors' approval of the credit agreement amendment violated their fiduciary duties. The claim against the company accordingly survived the motion to dismiss.

The credit agreement agent bank moved to dismiss the aiding and abetting claim against it, focusing on the requirement that to aid and abet the claimed breach of fiduciary duty, it must have knowingly participated in the breach, and stating that it had simply negotiated for its own benefit. The court agreed that the bank could "negotiate for the best deal" it could get, but stated that it is not permitted to propose, insist on "or incorporate terms that take advantage of a conflict of interest that the fiduciary counterparts on the other side of the negotiating table

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[4] *Kallick*, at 5.

face."[5] In the court's view, by negotiating for a provision that created an entrenchment benefit for the directors, the bank lost the arm's-length negotiation defense to an aiding and abetting claim. Finally, the court found that *Amylin* and *SandRidge* gave lenders ample "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."[6] That in the court's view was sufficient to establish the element of knowledge for purposes of a motion to dismiss.

LESSONS

Delaware courts take a very skeptical view of "continuing director" change of control triggers, as a potential means of entrenching the incumbent board. The feature is clearly problematic for a company that is or may become public, particularly if it negates or limits the incumbent board's nominee approval right. If a lender insists on such a feature, the company and its counsel should seek to ensure that there is a record of informed consideration of the particular provision, and that the company obtained some valuable benefit in return. A simple win in the typical horse trading of negotiations may not be sufficient in a court's view. Restrictive modifications to an existing "continuing director" trigger should be very carefully evaluated.

Financing providers should consider whether the benefit provided by the "continuing directors" change of control trigger is worth the trouble. Given *Amylin* and *SandRidge*, a "continuing directors" provision with a board approval right provides little or no real world benefit, and there has been a trend towards excluding it entirely, particularly in capital markets transactions. Given *Healthways*, a "continuing directors" provision that does not provide a board approval right raises the risk of litigation against lenders by their borrowers' stockholders. The benefit may not be worth that risk, particularly for credits that include covenants governing fundamental credit matters, such as debt, investment and dividend restrictions, which will limit the actions any new board might take without the consent of their financing sources.

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Please do not hesitate to contact us with any questions.

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[5] *Healthways*, at 79.

[6] *Healthways*, at 80.