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Trends in Finance Law: Decline of the "Dead Hand" Proxy Put

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Should parties extending credit be allowed to accelerate their debt solely as a result of a change in the majority of the borrower's Board of Directors? As shareholder activism continues to rise, lender-friendly covenants known as "dead hand" proxy puts in credit agreements and indentures have recently faced increased judicial scrutiny. The flood of litigation has been driven, in part, by the conclusion of the Delaware Court of Chancery in October 2014 that "dead hand" proxy puts are "highly suspect" entrenchment tools employed by lenders and corporate borrowers to discourage shareholder activism. In an effort to avoid costly litigation, lenders and noteholders are rethinking the value, and evaluating the risk, of including "dead hand" proxy put provisions in their debt agreements.

Proxy Puts, Generally, in Debt Agreements

Typically, a "proxy put" (or "change of control") covenant in a credit agreement or indenture will provide that lenders or noteholders, as applicable, may accelerate their indebtedness ahead of scheduled maturity upon the occurrence of a change in a majority of the borrower's directors, within a 12- or 24-month period, *without the consent of the borrower's "continuing directors."* The term "continuing directors" is generally defined to mean persons who were on the board when the debt agreement was entered into, or replacement directors who were nominated by a majority of the directors who were either in office when the debt agreement was entered into or whose nomination was previously so approved. Lenders frequently add the proxy put concept in their loan documents to protect themselves from unanticipated changes in a borrower's executive management team out of concern that such changes may adversely impact a borrower's creditworthiness. A change of control based on a proxy put is typically included in addition to a triggering event based on a material change in the equity ownership of the borrower (e.g., in the event that more than 25 to 35 percent of the voting control of the borrower changes hands).

Dead Hand Proxy Puts

In the case of a "dead hand" proxy put – which is less common in debt instruments than the standard proxy put provision – the definition of "continuing directors" expressly excludes any person whose nomination for election to the board of directors occurs as a result of an actual or threatened proxy fight. As a result, *even if the board approves* a dissident slate of nominees, a change of control would still be triggered under the debt agreement, thereby giving rise to an acceleration event. Such "dead hand" proxy put provisions are designed to safeguard lenders against the risk that a majority of a borrower's board of directors is unexpectedly replaced by activist shareholders that may want to institute lender-unfriendly corporate strategies, such as instituting share buybacks or paying dividends.

In the recent cases discussed below , complainants have argued, and courts have agreed, that proxy puts – primarily "dead hand" proxy puts – could be problematic because such provisions tend to entrench incumbent directors and discourage dissidents whose appointment to management could benefit all investors.

Litigation in the Delaware Court of Chancery

1. Unenforceable Against Public Policy?

In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals*, C.A. No. 4446-VCL (Del. Ch. May 12, 2009), the Delaware Court of Chancery examined the impact of a standard proxy put provision in the context of a proxy fight. The provision in question did not contain the “dead hand” prong of the definition of “continuing directors.” Nonetheless, the court was among the first to suggest that proxy put provisions “might be unenforceable as against public policy,” and noted that a proxy put provision “can operate as improper entrenchment devices that coerce stockholders into voting only for persons approved by the incumbent board.”

In *Amylin*, the board purported to “approve” a slate of directors nominated by dissident stockholders, solely for the purpose of avoiding a change of control under its indenture. The triggering of a change of control under Amylin’s indenture provided the noteholders with a right to redeem Amylin’s convertible notes at face value. In reality, the board publicly opposed the proposed slate of directors in a proxy contest. The plaintiffs argued that the board’s ability to so “approve” the dissident nominees for the narrow purposes of the indenture was disingenuous and inconsistent with the terms of the indenture. The court ultimately held that the board could approve the slate as a contractual matter – even though the board did not affirmatively endorse the new slate – if it determined 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.” In dicta, the court indicated that proxy put provisions are likely to face ongoing skepticism.

2. Breach of Fiduciary Duties

Similar to *Amylin*, in *Kallick v. SandRidge Energy*, C.A. No. 8182-CS (Del. Ch. March 8, 2013), the Delaware Court of Chancery evaluated a board’s actions during a proxy contest. Under the terms of SandRidge’s indenture, the election of a dissident slate without the approval of at least two-thirds of the incumbent directors would constitute a change of control, thereby entitling SandRidge’s noteholders to redeem approximately $4.3 billion of notes. As was the case in *Amylin*, the indenture contained a standard proxy put provision, and did not contain the “dead hand” prong in the definition of “continuing directors.” In this case, SandRidge’s board of directors refused to approve the dissident slate of director nominees. Further, SandRidge warned its stockholders that that the stockholder election of the proposed slate of nominees, without the approval of the continuing directors, would trigger a redemption right and cause severe financial distress for SandRidge. The court was highly critical of the actions of SandRidge’s board. Using *Amylin* for support, the court stated “a board may only fail to approve a dissident slate if the board determines that 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.”

By refusing to approve the new slate of directors and relying on proxy put implications in its indenture to dissuade the stockholders, the court found that the board was likely breaching its fiduciary duties to its stockholders. The court’s decision highlighted the concern that proxy put provisions have the potential to disenfranchise stockholders by attaching dire economic consequences to their decision to elect new directors.

3. Aiding and Abetting Claim Plausible

In *Pontiac General Employees Retirement System v. Healthways,* C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014) (transcript ruling), the Delaware Court of Chancery refused to dismiss a stockholder's claims alleging that (a) the board of Healthways breached its fiduciary duties to its stockholders by agreeing to a credit agreement containing a "dead hand" proxy put and (b) SunTrust Bank, the administrative agent under Healthways' syndicated credit agreement, aided and abetted the board's breach of fiduciary duty to its stockholders. In this case, the Court examined a "dead hand" proxy put, which – unlike the proxy put provisions reviewed in *Amylin* or *SandRidge* – permitted the lenders to accelerate the indebtedness under the credit agreement in the event of the election of a dissident stockholder's nominees as a majority of the board of the borrower, regardless of whether the current board ultimately approves the dissident stockholder's nominees.

The dispute in the *Healthways* case arose after Healthways became the target of a proxy contest, which resulted in a vote by the stockholders to de-stagger the board against the board's wishes. Within days of such vote, the board entered into an amendment to its credit agreement, providing for a "dead hand" proxy put that allowed lenders to declare a default under the credit agreement in the event that a majority of the board, during a two-year period, was comprised of non-continuing directors (including directors initially nominated as a result of an actual or threatened proxy contest, whether or not the incumbent board approved such slate). Earlier versions of the credit agreement contained the standard proxy put provisions. As a result, it appeared to the court that the "dead hand" feature was incorporated into the credit agreement immediately after the board became aware that it was dealing with "some degree of stockholder dissatisfaction."

The court ruled that the aiding and abetting claim had been adequately pleaded, and permitted subsequent proceedings to determine whether there had been a breach of fiduciary duty and, if so, whether SunTrust Bank knowingly participated in such breach. The court noted that, even if the negotiations between a borrower and its lenders are on arms-length terms, the lenders are not entitled to "insist on terms, demand terms, contemplate terms, incorporate terms that take advantage of a conflict of interest that the fiduciary counterparts of the other side of the negotiating table face." The court also noted that, in the wake of the decisions in *Amylin* and *SandRidge*, "[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."

At the settlement hearing for Healthways on May 8, 2015, the Vice Chancellor observed that the decision had been based upon, and should be limited to, the specific facts of the case. Nonetheless, increased judiciary scrutiny has caused some lenders to drop these types of provisions from their financing agreements.

Is this the End of the Dead Hand Proxy Put?

The Delaware Court of Chancery has raised the concern that "dead hand" proxy put provisions improperly coerce and bully stockholders to vote for incumbent directors and against any dissident nominees or risk having the debt of the corporation accelerated. The threat of litigation has caused many borrowers to actively seek amendments to their debt agreements to remove such provisions. While lenders may argue that including a "dead hand" proxy put provision is both a customary and appropriate device to protect the lenders' prospects for repayment, the possibility of judiciary scrutiny has caused some lenders to reevaluate whether the risk of shareholder activist litigation is worth the benefit of these restrictive provisions. In recent months, a number of large institutional lenders have dropped the "dead hand" feature of the proxy put provision from their debt agreements. Instead, lenders should consider whether relying on a borrower's financial covenant tests and other protections in the credit agreement are sufficient to measure a borrower's ongoing strength and creditworthiness after an unexpected shift in management.

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