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“Dead Hand Proxy Puts” — What You Need to Know

There has been much recent concern and confusion over the inclusion of “dead hand proxy puts” (and even proxy puts without a “dead hand” feature) in debt agreements. Dead hand proxy puts (sometimes called “poison puts” or “board change of control provisions”) provide a type of change of control protection that banks, as well as parties to many types of non-debt commercial agreements, have frequently utilized, without controversy. Nonetheless, dead hand proxy puts are now under attack. While proxy puts *without* a dead hand feature are generally not being challenged, based on recent case law, these provisions in most cases will not permit a bank to accelerate the debt on a change of control of the borrower’s board (as explained below).

Dead hand proxy puts. A proxy put permits the lender to accelerate debt if a majority of the borrower’s board becomes comprised of “non-continuing directors” over a short period of time (usually one or two years). “Continuing directors” are persons who were on the board when the debt contract was entered into or replacement directors who were approved by a majority of those directors or their approved replacements. The “dead hand” feature provides that any director elected as a result of an actual or threatened proxy contest will be considered a non-continuing director for purposes of the proxy put.

Without the dead hand, under recent case law (*SandRidge,* Del. Ch. 2012), in most circumstances, a board will be required to approve a dissident slate to avoid triggering the put. In any event, as a practical matter, boards usually have ultimately (i.e., before losing a proxy contest) approved a dissident slate that was supported by shareholders. Thus, *without* a dead hand, the restriction imposed by the put can be eliminated by actions of the board. *With* the dead hand, however, the borrower board’s approval of a dissident slate would be irrelevant for purposes of the proxy put because dissident nominees would be considered to be non-continuing directors irrespective of the approval.

Legal uncertainty and litigation campaign. Judicial concern about proxy puts in debt is based on their inherent potential entrenchment effect, because a triggering of the put could make a change in control of the board more costly—as the debt (and, through cross-acceleration provisions, possibly *all* of the company’s debt) could be required to be refinanced if the put were triggered. Proxy puts with a dead hand feature are more inherently entrenching than non-dead hand proxy puts as they disable a board from approving a dissident slate to avoid the put being triggered.

In *Healthways* (*Pontiac General v. Ballantine* (transcript, Oct. 14, 2014)), in an oral ruling denying a motion to dismiss, Vice Chancellor Laster emphasized that a borrower’s directors could face personal liability for a breach of the duty of loyalty, and that a bank could face liability for aiding and abetting the breach, in connection with including a dead hand proxy put in a company’s credit agreement. Much uncertainty ensued. At the settlement hearing for *Healthways* (May 8, 2015), the Vice Chancellor clarified that the decision had been based on the narrow facts of the case (known at the pleading stage of litigation), including in particular that the company was under pressure from stockholders and facing a

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potential proxy contest. Nonetheless, since *Healthways*, the plaintiffs' bar has been conducting a campaign challenging dead hand proxy puts in debt of public companies. As a result, pending further judicial clarification, companies with dead hand proxy puts in their debt, and their banks, now may face the cost, time, disruption and uncertainty of litigation or books-and-records requests.

Critical points.

- **Dead hand proxy puts.** In our view, *Healthways* has been widely misinterpreted. We believe that dead hand proxy puts in debt are legally permissible in most circumstances. However, the inclusion of a dead hand proxy put in debt will nonetheless subject a company and its bank to the possibility of the cost, time, distraction and uncertainty associated with being targeted in the plaintiffs' bar campaign against these provisions.

- **Non-dead hand proxy puts.** A non-dead hand proxy put in debt does not necessarily enable an acceleration of the debt on a change of control of the borrower's board. However, a non-dead hand proxy put should not subject a company or its bank to being targeted in the litigation campaign against dead hand proxy puts. In addition, a non-dead hand proxy put appears to continue to be a "market" term the absence of which may negatively affect the syndication or marketing of debt.

- **Consulting with counsel.** Given the uncertain legal backdrop and the ongoing litigation campaign, companies and banks should review with counsel their forms and new credit agreements in connection with the inclusion of dead hand proxy puts.

Reaction of banks and companies. The reaction of individual banks and companies has varied. Some banks are retaining a dead hand proxy put in their form credit agreement; some are eliminating the dead hand feature and retaining the proxy put; and some are eliminating the entire proxy put. Some banks that are eliminating the dead hand feature or the entire proxy put are considering adding upfront financial, incurrence, or other covenants. Companies have been uncertain whether they can or should agree to proxy puts (with or without a dead hand) and whether they should seek to amend any proxy put provisions in their existing debt.

Rationale for including a dead hand proxy put. *First*, a dead hand proxy put serves to protect a bank's legitimate commercial interest in "knowing its borrower" and in ensuring that it has confidence in the basic business approach that will pertain over the life of the credit. This type of protection has become even more important to banks with the advent of shareholder activism and the election of slates of dissident nominees who sometimes have agendas for short-term shareholder value maximization that may be inconsistent with a borrower's business strategy as communicated to the lender at the time the credit was extended. In *Healthways*, Vice Chancellor Laster reasoned that banks could better protect their interests through additional financial covenants restricting the borrower's actions; however, we note that covenants cannot cover every eventuality or ensure an overall business approach that will facilitate debt repayment (and that, for companies, additional covenants could be more burdensome than the dead hand proxy put). *Second*, proxy puts are expected by the debt market—and the dead hand feature is necessary for the proxy put to be more effective. *Third,* we note that the other change of control provisions routinely included in debt agreements are automatic in their application upon the occurrence of the change of control event, without any right or opportunity of the company to take action that would avoid the triggering of the provision. Thus, a proxy put, with a dead hand included, could be thought of as no less entrenching of a board than other change of control provisions that are non-controversial.

Rationale for including a *non-dead hand* proxy put instead of a dead hand. Proxy puts without a dead hand feature have not been targeted in the plaintiffs' bar campaign. Thus, critically, their inclusion in debt would not be expected to subject the company or the bank to liability or the cost of litigation. Most proxy puts in debt do *not* include a dead hand. While proxy puts appear in almost all public company debt agreements, the dead hand feature appears in less than 10% of public company credit agreements (according to a recent Thomson Reuters report). Rationales for including a proxy put without a dead hand (even though the provision is not as protective to lenders) are: (i) the market still expects to see these provisions and their absence would negatively affect the syndication or marketing of the debt; (ii) there may be future judicial developments that modify the holding in *SandRidge* (that boards will be required to approve dissident slates to block the triggering of a proxy put); (iii) in certain situations – *i.e.*, where approval of a dissident slate would constitute a breach of the board's fiduciary duties, thus the situations in which the bank's concern would be greatest – *SandRidge* does not require board approval of a dissident slate (in which case a proxy put without a dead hand would be effective); and (iv) inclusion of the provision underscores the bank's interest in the composition of the company's board.

Relevant considerations. The relevant considerations for banks and companies in determining whether or not to include a dead hand proxy put in debt include:

- **Bank's rationale—**the bank's reasons for requesting the provision.
- **Bank's insistence—**the level of the bank's insistence that the provision be included.
- **Bank's litigation risk—**the bank's assessment of the likelihood of its being sued; the cost, time, and distraction associated with litigation; and the degree of the substantive risk of aiding and abetting liability.
- **Company's rationale—**the advantages and disadvantages to the company of agreeing, or refusing to agree, to include the provision.
- **Company's alternatives—**the company's view of the alternatives likely to be available to the company if it refuses to include the provision (and the bank then will provide, syndicate, or market the debt on less favorable terms).
- **Possible entrenchment effect—**the potential entrenchment effect of the provision, including an assessment of the materiality of a triggering of the put, based on: the magnitude of the debt; the likely extent of cross-acceleration of other company debt; the likelihood that refinancing could be arranged; and the likely additional cost of refinancing.
- **Company's litigation risk—**the company's assessment of the likelihood of its being sued; the cost, time, and distraction associated with litigation; and the degree of the substantive risk of liability.

Supporting factors. The following factors would, as a legal matter, tend to support a company's decision to agree to a dead hand proxy put (and the converse would tend to create a higher bar for establishing the validity of the provision):

- **"Clear day".** A dead hand proxy put will be more easily defended if it is adopted on a "clear day" – *i.e.*, when a company does not face an actual or realistically potential proxy contest. If not a "clear day," there is a risk that a court will presume that entrenchment is the primary motive for adoption of the put—although, even under these circumstances, we believe that a company can,

as a legal matter, agree to the provision if there is a sufficient foundation for the court to conclude that the primary motivation was protection of the bank's interests.

- **Prior practice.** A dead hand proxy put should be more defensible if it has historically been included in the bank's and the company's debt agreements.
- **Other change of control provisions.** The inclusion of other change of control provisions should indicate the bank's overall concern with respect to change of control protection.
- **Market expectation.** If there is a market expectation that a proxy put will be included, then the absence of the put could be expected to negatively affect the provision, syndication or marketing of the debt.

Importance of process. If there is a challenge, the process will be important in a court's evaluation of whether a proxy put was adopted for a legally proper purpose—i.e., to protect the bank's legitimate commercial interests, rather than to potentially entrench the company's directors. Relevant considerations will include: which party requested the provision; what the reasons for the request were; what the level of insistence was that the provisions be included; and whether the board considered the provision and understood its effects (including the potential entrenchment effect). Although board involvement may not otherwise be required, if a dead hand proxy put is included in debt, the board should be involved.

These process points should be less important in the case of (i) a non-dead hand proxy put, (ii) a bank form agreement in which a dead hand proxy put has historically been included, (iii) a "clear day", and/or (iv) immateriality of the provision (based on the amount of the debt and the likelihood of a limited cost for refinancing if the put is triggered).

Banks may consider the possibility of developing new approaches. Banks may wish to consider whether the following types of approaches might be acceptable to them from a business point of view and might facilitate a borrower's consideration of the bank's request for a dead hand proxy put.

- *Pending judicial clarification, a bank and a company could consider various "placeholder"-type provisions*, such as: (i) including a dead hand proxy put but providing for its automatic elimination if (contrary to expectations) judicial clarification indicates that dead hand proxy puts are generally invalid; (ii) including a dead hand proxy put, but with different terms (for example, additional covenants) that would apply initially and then would not apply after judicial confirmation of the validity of dead hand proxy puts; or (iii) not including a dead hand proxy put initially, but having different terms (for example, additional covenants) that would apply unless and until the company exercised an option to include a dead hand proxy put (which it might decide to do after judicial clarification is provided).
- *To assist a company in determining whether to agree to a proxy put provision*, a bank could clarify for the borrower specific alternatives to agreeing to the provision. For example, a bank could consider whether "springing covenants" and/or an increased interest rate would apply on a board change of control if a dead hand proxy put is not included. The company's understanding of the alternatives might assist in providing a foundation for a court's evaluation of whether the borrower received a significant economic benefit from agreeing to include the dead hand put.

- *To allay the concerns of borrowers over agreeing to a proxy put*, banks could consider offering to provide a "buy-out right" for the company that would permit elimination of the dead hand proxy put in the future.

Potential for aiding and abetting liability for banks. Arm's length negotiation between a bank and a borrower generally would not subject a bank to aiding and abetting liability for a breach of fiduciary duty by a company's board in approving a provision for its entrenchment effect. However, based on *Healthways*, a bank may be exposed to aiding and abetting liability if a court is skeptical that the bank was in fact negotiating for its own interest (and believes that the bank was merely acquiescing to the board's conflict of interest in seeking to entrench directors). Relevant factors in establishing the bank's motive would include the bank's general practice with respect to utilizing dead hand proxy puts; what other change of control triggers the bank usually insists on; and, in a situation where the borrower may be realistically subject to a proxy contest, why the bank desires the proxy put in that particular case.

Response to a dissident slate. In presenting arguments to shareholders with respect to a board's recommendation against a dissident slate, a company should not use the threat of a need to refinance the company's debt as a primary reason to reject the slate—although the fact that the company's debt would have to be refinanced would, of course, be disclosed to the shareholders.

Private companies should have extra leeway. This memorandum is addressed primarily to debt of public companies. Dead hand proxy puts in the credit agreements of private companies should not be problematic—as there will have been actual or de facto shareholder approval of the arrangements.

Board change of control protections in *non*-debt commercial agreements. Companies should consider the desirability of including a dead hand feature in the board change of control provisions of their significant *non-debt* agreements where composition of the counterparty's board is important to the company (such as, for example, a major joint venture, critical supplier, or key product licensing agreement). An effective change of control protection is especially important in significant non-debt commercial agreements, as selection of the counterparty often depends on factors such as the ability to collaborate and to execute; trustworthiness in the marketplace; a compatible corporate culture; competitive position; and so on. These types of agreements routinely include protection for one or both parties with respect to the other party's change of control through a merger, an acquisition of a significant percentage of the company's stock, or a change of control of the board. While none of these other change of control provisions affords the counterparty a right or opportunity to avoid the triggering of the change of control protection upon the occurrence of the change of control event, a *board* change of control provision does provide that opportunity *unless* a dead hand feature is included—because, as in the case of a proxy put (discussed above), without the dead hand, except in extreme circumstances, a board will be required to (or otherwise will) approve a dissident slate to avoid triggering the put. It should be kept in mind, however, that, depending on the importance of the protection to the counterparty and the counterparty's negotiating leverage in the transaction, the counterparty may require that the provision be reciprocal.

Legal permissibility of dead hand proxy puts. Notwithstanding recent developments and confusion, in our view, proxy puts in debt—including dead hand proxy puts—appear to be legally permissible so long as (i) the motivation for including the provision related primarily to protecting the bank's legitimate interests rather than an entrenchment effect for the company's directors and (ii) the process supports that conclusion. (*Nonetheless, importantly, inclusion of the provision creates a potential litigation risk, as noted above.*)

- ***Healthways.*** In *Healthways,* Vice Chancellor Laster presumed that the primary motivation for the widespread inclusion of proxy puts in credit agreements is not the protection of the bank's legitimate interests but the entrenchment effect on the company's directors—a presumption that would be rebutted, the Vice Chancellor stated, only if the company received an "extraordinary economic benefit" not otherwise available to it for agreeing to include the put.

- ***Healthways* was grounded in the narrow facts of the case.** Our view of the *Healthways* decision has been that it was grounded in the narrow facts of the case, particularly the fact that Healthways had amended a longstanding proxy put to add a dead hand feature when it was facing shareholder pressure and a potential proxy contest. Indeed, the dead hand was adopted just days after the company's shareholders had approved a resolution calling for the company to, and the company had agreed to, declassify the board (and, within months thereafter, the company was engaged in a proxy contest). Further, the court noted that, at the pleading stage, there was no record as to: whether it had been the bank or the company that had requested the provision; whether there had been any negotiation over including the provision; or whether the Healthways board had been advised with respect to, or had understood or considered, the possible entrenchment effect of the provision.

- **Clarification of *Healthways*.** In recent remarks made during the settlement hearing for the *Healthways* case, Vice Chancellor Laster characterized *Healthways* as "probably one of the more frequently misrepresented or misunderstood rulings of mine." The Vice Chancellor confirmed that: "[*Healthways*] was a contextual ruling based on the facts of th[at] case applying the reasonably conceivable standard [applicable at the motion to dismiss stage of litigation]." The Vice Chancellor emphasized that "the facts in the complaint suggested that this provision [(the dead hand)] was inserted in the shadow of a control contest. And that can't be stressed enough." Because the Vice Chancellor's remarks were made orally from the bench during a settlement hearing, they have not been widely received and, in any event, do not carry the imprimatur of a definitive resolution of the issues addressed. However, the remarks confirm that dead hand proxy puts are not per se improper (even, we note, if adopted "in the shadow" of a proxy contest)—but, rather, will be evaluated by the courts based on the facts and circumstances of each case.

- **Court should provide further clarity.** We expect that the court will provide further clarity in this area that will confirm the validity of dead hand proxy puts—and put an end to the plaintiffs' bar campaign against them. Companies and banks that want to include dead hand proxy puts in debt could then do so, based on the advantages and disadvantages of including these provisions, without the cost and uncertainty associated with the litigation campaign.

- **Dead hand proxy puts protect the same interests as change of control provisions in non-debt commercial agreements are intended to protect.** We note that, in non-debt agreements, through change of control provisions, companies seek to protect themselves against being forced to partner with, for example, their competitors; shareholder activists who may have an agenda inconsistent with the objectives of the venture; a company with an incompatible corporate culture, an inability to execute, or a negative reputation; or other parties that the company would not want to partner or collaborate with, rely on, or share its intellectual property with. While the change of control provisions in non-debt commercial agreements are often reciprocal, protecting both parties against a change of control of the other's board (unlike proxy puts in credit agreements, which unilaterally protect the bank against the borrower's board change of control), *the substance*

of the protection being sought by the parties is similar to the protection the bank seeks in a proxy put in a debt agreement.

- **Dead hand proxy puts have suffered from a misguided association with "dead hand poison pills".** We also note that dead hand proxy puts are *substantively different* from dead hand poison pills (which have been invalidated by the Delaware courts)—and their treatment by the court should accordingly be different. While they both include a dead hand feature, the critical differences are that: (i) a poison pill is adopted by a company's board, acting unilaterally, for the company itself—thus, the only interests possibly being served are the company's, not a counterparty's (while a proxy put in debt is a product of negotiation with the lender counterparty, included to meet the objectives and protect the interests of the counterparty); (ii) the triggering of a poison pill is economically catastrophic (while the triggering of a proxy put in a credit agreement will potentially result in the acquiror having to refinance the company's debt—which typically will involve a definable cost, the significance of which will vary depending on the company's and market circumstances); and (iii) a dead hand poison pill cannot be redeemed either by the board or through negotiation with a counterparty to avoid its being triggered (while the triggering of a credit agreement proxy put can potentially be avoided through re-negotiation with, or waiver by, the company's creditors).

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