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# Delaware Court Interprets Continuing Director "Poison Put" Provision

Recently, the Delaware Court of Chancery issued a decision, *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.* ("*Amylin*"), interpreting a "Continuing Director" clause contained in a change of control provision commonly found in many indentures and loan agreements. A continuing director provision typically either requires the company to repurchase outstanding bonds or accelerates a loan if the majority of the company's board of directors ceases to be composed of continuing directors.

The *Amylin* decision interprets a typical formulation of a continuing director provision that is often included in debt agreements, but is not generally heavily negotiated by the parties. The case addresses the implications for a board of directors when considering these provisions in indentures and the impact of these provisions on the stockholder franchise. Set forth below are the factual circumstances underlying this case and key considerations for boards, underwriters and lenders to consider going forward.

**Factual Background**

*Amylin* arose out of a proxy contest in which two of Amylin's dissident stockholders each nominated a slate of five directors to the Company's twelve-person board. Shortly thereafter, one of those stockholders requested that the board approve a slate of directors that would include a significant number of the proposed stockholder nominees in order to prevent triggering the continuing director provision of an indenture governing a series of the Company's convertible notes. If triggered, the continuing director provision of the indenture allowed noteholders to put all or a portion of their notes to the Company at par. "Continuing Directors" were defined as follows:

> (i) individuals who on the Issue Date constituted the Board of Directors and (ii) any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the Issue Date or whose election or nomination for election was previously so approved.

As disclosed in the Company's annual report, the triggering of the provision would have had serious adverse implications for the Company because it did not have the liquidity or financial resources to satisfy

the potential payment obligations. The Company's credit facility contained a different and more restrictive change of control provision explicitly excluding directors nominated by dissident stockholders from the meaning of continuing director.

A stockholder of the Company filed a complaint alleging that the board's adoption of the continuing director provisions in the credit facility and the indenture and its failure to approve the stockholder nominees in order to avoid triggering the continuing director provisions violated the directors' duties of care and loyalty.[1] The plaintiff subsequently entered into a partial settlement with the Company, pursuant to which the plaintiff agreed to dismiss its claims relating to the breach of the duty of loyalty and its claim that the board breached its fiduciary duty by failing to act to approve the stockholder nominees. In exchange, the board issued a public statement that it would approve the stockholder nominees subject to a declaration by the court of its contractual right to do so. Thereafter, the dissident stockholders reduced the number of candidates they were nominating to five directors between the two stockholders such that the majority of the board would continue to be comprised of continuing directors regardless of the results of the election (or the court's decision).[2]

**Delaware Chancery Court Opinion**

Vice Chancellor Lamb noted several key issues for consideration. These included whether (1) the board had the power under the indenture to approve the slate of stockholder nominees while concurrently opposing them in the proxy contest, (2) the board's approval of the dissident nominees' slate comported with the Company's implied duty of good faith and fair dealing inherent in all contracts (including the indenture) and (3) the board and the pricing committee violated their duty of care by approving an indenture containing the continuing director provision.

This issue was one of contractual interpretation as to the meaning of "approve." In that regard, Vice Chancellor Lamb rejected the position of the trustee (also a defendant in the proceeding) that the word "approve," as contained in the continuing director provision of the indenture, was necessarily synonymous with "endorse or recommend," instead concluding that a board could approve a slate without also sanctioning the nomination of that slate and while simultaneously endorsing its own slate of nominees. Vice Chancellor Lamb concluded that any contrary position would effectively render the continuing director provision an entrenchment mechanism because the indenture "would prohibit *any* change in the majority of the board as a result of any number of contested elections, for the entire life of the notes."

Vice Chancellor Lamb noted that such a position would (1) render the continuing director provision in the indenture more restrictive than the one contained in the Company's credit facility, which explicitly

1 While similar claims relating to the credit facility were initially filed, the claims were rendered moot when the Company and the lenders agreed to a waiver of any event of default resulting from the election. Consequently, the court was not confronted with determining the validity of a change of control provision which might have exerted a significant influence on the stockholder voting decision and possibly determined the outcome of a proxy contest.

2 On June 10, 2009, Amylin announced the results of its annual stockholders meeting, at which only two of the five stockholder nominees were elected.

excluded directors nominated by dissident stockholders from the meaning of continuing director,[3] (2) raise "grave concerns" regarding the exercise of a board's fiduciary duties when agreeing to such a provision and (3) raise questions as to whether such a provision would be unenforceable as against public policy (though a provision that is "so strongly in derogation of the stockholders' franchise rights would likely put the trustee and noteholders on constructive notice of the possibility of its ultimate unenforceability"). According to Vice Chancellor Lamb, 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."

As to whether the board properly exercised its right to approve the dissident stockholder slate, Vice Chancellor Lamb noted that the key question was whether the approval of the slate, under the circumstances, comported with the Company's implied duty of good faith and fair dealing inherent in the indenture. Vice Chancellor Lamb noted that the board could approve the stockholder nominees if it made a good faith determination that their election would not be materially adverse to the interests of the Company or its stockholders.

Vice Chancellor Lamb ultimately determined that the issue was not ripe for consideration because it had not been presented with any evidence regarding the board's deliberations with respect to the approval and the reduction of the slate to five nominees made the issue academic as the provision was not being triggered.[4] Nonetheless, Vice Chancellor Lamb noted a concern as to whether the board's decision to approve the stockholder slate was made in a good faith in light of (1) negative public statements from directors regarding the nominees and (2) the board's approval of stockholder nominees following the settlement, which raised questions as to the directors' possible self-interest.

Lastly, Vice Chancellor Lamb considered whether the board or the pricing committee was grossly negligent and accordingly violated its fiduciary duties, for failing to learn of the continuing director provision. Vice Chancellor Lamb concluded that the board's duty of care was not breached. The board had retained "highly-qualified" legal counsel and received advice from the Company's management and financial advisors regarding the terms of the indenture and the pricing committee was told, in response to its inquiry, that the notes did not contain any "unusual or not customary terms." Although Vice Chancellor

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[3] The credit facility provided that a "change of control" included the following:

> an event or series of events by which . . . (b) during any period of 24 consecutive months, 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 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 (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).

[4] The plaintiff has filed an expedited appeal of the court's decision. Among other issues, the plaintiff is appealing the decision that the board's approval of the stockholder nominees was unripe and the dismissal of the plaintiff's claim regarding the duty of care.

Lamb noted that the duty of care did not require the board to review and understand every word of the indenture, he expressed concern that companies (and their counsel) often enter into contracts that may have the collateral effect of impinging on the exercise of the stockholder franchise. In that regard, he admonished that "terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board."

**Key Considerations Going Forward**

The Amylin case highlights several key considerations for boards, underwriters, lenders and other interested constituencies going forward.

1. The case is a reminder to boards and board committees that the duty of care requires consideration of all material information reasonably available to them when making business decisions. In particular, Vice Chancellor Lamb noted that a company's management and advisors should highlight to the board or responsible board committee contractual provisions that may impact the stockholder franchise, and in particular, with respect to debt instruments which may ultimately pit stockholders against debtholders. Because equity incentive plans, employment agreements, severance plans and certain other contracts often include change of control provisions which, if triggered, could result in executives becoming entitled to significant payments or accelerated or enhanced benefits, the *Amylin* decision may also have implications for agreements other than indentures and loan agreements.

2. *Amylin* also is a reminder of the importance of the stockholder franchise. Vice Chancellor Lamb commented on the "troubling reality" that corporations routinely negotiate contract terms that may, in some circumstances, adversely impact the exercise of the stockholder franchise. The decision emphasized that boards should be mindful of this consideration in negotiations with parties whose interests may be directly adverse to stockholders, such as debtholders. In addition, in this case Vice Chancellor Lamb indicated that the court might be troubled by a put provision triggered by a change in the majority of a board of directors over the life of the notes as a result of contested elections which did not contain a "savings clause" permitting incumbent directors to approve insurgent nominees.

   In the context of indentures and loan agreements, this type of provision is usually required by underwriters or lenders as a means to protect against potential or actual adverse credit developments, though change of control puts in debt instruments may have a defensive effect as well. When examining the terms of a proposed transaction, a company should consider the potential effects of the provision on the stockholder franchise. A future court examining this type of provision may look to several factors to determine whether the provision is enforceable, such as:

   - whether the inclusion of the provision was initiated by the underwriters or lenders or other counterparties to address legitimate lender concerns or by the company,

   - whether the company would have been able to negotiate the provision in good faith so as to seek to reduce its impact and whether alternatives were available, and

- whether the board was motivated by entrenchment or to facilitate a financing or other arrangement whose terms as a whole are beneficial to the company.

If the change of control provision is implicated in connection with a proxy contest, and in light of the potential for damaging consequences to the company (such as potential bankruptcy or costly refinancing), a board may be effectively compelled to "approve" the nomination of a competing slate of directors.

3. Restrictive provisions of agreements should be clearly and explicitly drafted so that the intention of the parties is evident. As the decision noted, indentures are read strictly and the issuer will have freedom to act, unless the indenture expressly restricts the issuer. Companies should keep in mind that courts will often look at other contracts of the company with similar provisions when interpreting a particular contractual provision. The decision focused on the difference between the continuing director definition in the indenture and the language in the change of control definition in the credit facility that specifically excluded individuals whose nomination or assumption of office was the result of an actual or threatened proxy contest. Therefore, companies should consider whether provisions across debt instruments and other agreements should be consistent if the intentions of the parties are the same so that differences are not given great and possibly unintended significance.

4. *Amylin* leaves open the question of those considerations that will result in a determination that a board properly exercised the "right" to "approve" a nominee slate that it was not also recommending to stockholders. Vice Chancellor Lamb noted that a board of directors may approve the stockholder nominees 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." Thus, companies and their counsel should consider structuring the board's decision-making process to demonstrate good faith decisions.

5. The decision raises questions regarding how a board "approves" a stockholder nominee in the context of a proxy contest. If the board has publicly opposed a nominee, it is unclear from the opinion what actions are necessary to evidence the board's subsequent approval. Presumably, if a failure to "approve" would result in bankruptcy or material financial difficulties for the company, a balancing will be involved. Thus, the board will have to consider, even though the dissident nominee may not be as qualified as the company nominee, would his or her election harm the company when compared with the possible damage resulting from a decision not to approve. In addition, a board should carefully document evidence of its deliberations regarding the approval of a dissident slate of directors. Even though Vice Chancellor Lamb did not determine whether the Amylin board made a good faith determination with respect to the stockholder nominees, the decision noted the lack of any board minutes, resolutions or other evidence in the record before it. The minutes of the meeting should set forth the considerations evaluated by the board in reaching its decision.

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Change of control provisions in loan and other debt agreements have a long history. They are intended to address valid concerns of lenders regarding the fundamental assumptions underlying the debt and to permit lenders to call that debt when various factors that may signal fundamental changes in the borrower's business occur (*e.g.*, a sale of the company, changes in board composition, or loss of key employees). The *Amylin* decision does not suggest that properly drafted change of control provisions are questionable. Rather, the decision reminds directors to be mindful of the consequences of these provisions and to exercise their fully informed business judgment in negotiating and approving them.

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