CHANGE-OF-CONTROL PROTECTIONS IN SIGNIFICANT NON-DEBT COMMERCIAL AGREEMENTS: THE IMPORTANCE OF A "DEAD HAND" PROVISION

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Parties to significant commercial agreements may not currently be well protected against the risk of being forced to continue to partner with a counterparty after a change in control of the counterparty's board (for example, through a proxy contest).

Change-of-control protections can be especially important in certain commercial agreements—such as a major joint venture, critical supplier or key product licensing agreement—where the company's counterparty has been selected based on factors such as the ability to collaborate and to execute; trustworthiness in the marketplace; a compatible corporate culture; competitive position; and other similar factors. Through these provisions, companies seek to protect themselves against involuntarily having to partner with, for example, their competitors; shareholder activists who may have an agenda inconsistent with the objectives of the venture; or other parties that the company would not want to partner or collaborate with, rely on, or share its intellectual property with.

Accordingly, these types of agreements routinely include a right of the company (and/or its counterparty) to change the terms, obtain additional rights, or terminate the agreement upon a change of control of

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the other party, including through a merger, the acquisition by a third party of a significant percentage of the counterparty's outstanding stock, or a change in control of the counterparty's board of directors (a "board change-of-control provision"). However, because board change-of-control provisions in commercial agreements have generally not included a "dead hand" feature, these provisions may well not provide the protection that parties have sought (and that they generally assume they have). We recommend that parties to these types of agreements consider including a dead hand feature to ensure the effectiveness of the board change-of-control provision.

Key Points

- **Board change-of-control provisions without a dead hand feature are likely not effective.** A board change-of-control provision in a commercial agreement most likely will not be effective if it does not include a dead hand feature because (as discussed below) a counterparty's board can unilaterally avoid the triggering of the change of control protections by approving a dissident slate. Thus, companies should consider including a dead hand feature to obtain protection against being forced to "partner" with a party that takes control of a counterparty's board in a proxy contest.

- **Dead hand board change-of-control provisions are *not* like "dead hand poison pills."** Dead hand board change-of-control provisions are substantively different from, and should not be confused with, "dead hand poison pills" (which have been invalidated by the Delaware courts).

- **Dead hand board change-of-control provisions in debt agreements have been under attack but are legally permissible.** Similar provisions—board change-of-control provisions in debt (so-called "dead hand proxy puts," which contemplate the acceleration of debt upon a change of control of the borrower's board)—have been under attack, but, in our view, are legally permissible under most circumstances. Dead hand board change-of-control provisions in *non-debt* commercial agreements should be equally defensible.

- **Dead hand board change-of-control provisions are best adopted on a "clear day."** Dead hand change-of-control provisions are best adopted on a "clear day" (*i.e.*, when the company is not facing an actual or realistically potential proxy contest)—although, in our view, they are legally permissible under most circumstances even when not adopted on a clear day.

- **Reciprocity may be requested.** We note that, depending on the type of agreement and the leverage of the parties, a counterparty may require that a dead hand board change-of-control provision be reciprocal.

Board Change-of-Control Provisions Without a Dead Hand Feature Are Likely Not Effective

In significant commercial agreements where one or both parties are sensitive to who the counterparty is (for example, a major joint venture agreement), one or both of the parties typically will have the right to revise the terms, add restrictions on the counterparty, or terminate the agreement if a majority of the board of the other party is no longer comprised of "continuing directors." These provisions often do not include a "dead hand" feature.

Definitions

"Continuing directors" are those directors who were on the board when the agreement was entered into or replacement directors who were approved by a majority of those directors or their approved replacements. A "dead hand" feature in a board change-of-control provision provides that any director elected as a result of an actual or threatened proxy contest would not be considered a "continuing director" for purposes of the provision. Thus, a board would, in effect, be disabled from approving a dis-

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sident slate for the purpose of avoiding a triggering of the board change-of-control provision.

Without a Dead Hand, Approval of a Dissident Slate Can Avoid Triggering a Change-of-Control Provision

A continuing director requirement without a dead hand feature will often not be effective. The dead hand feature is needed because, without it, an existing board may be required by a court to—or otherwise may in any event—approve a dissident slate in order to avoid a triggering of the board change-of-control provision. Under recent case law relating to board change of control provisions in debt agreements, a board was required to approve a dissident slate to avoid the triggering of a change-of-control provision.[1] Generally, it may be expected that a board could be required by a court to approve a dissident slate if the triggering of the change of control provision would have a material adverse effect on the company, such that stockholders would be dissuaded from voting to replace directors. For example, approval likely would be required if a triggering of the change-of-control provision would give the counterparty the right to terminate the agreement and the agreement was both material to the company and irreplaceable or replaceable only at a material cost. (Approval would not be required if, under unusual circumstances relating to the characteristics of the nominees, doing so would constitute a breach of the directors' fiduciary duties.) In any event, as a practical matter, boards usually ultimately approve a dissident slate before losing a proxy contest.

A Dead Hand Makes a Change-of-Control Provision Effective

Thus, *without* a dead hand, the protection of a board change-of-control provision can be eliminated by actions of the board of the party experiencing the board change of control—meaning that the counterparty's protection was only illusory. *With* the dead hand, however, the board's approval of a dissident slate would be irrelevant for purposes of the board change of control provision because dissident nominees would be considered to be non-continuing directors irrespective of the approval. The dead hand feature thus is necessary to conform a board change-of-control provision to what may well be the parties' expectations. Notably, in none of the other types of change-of-control provisions included in agreements (*i.e.*, those triggered by a merger or acquisition of stock) is a party afforded a right or opportunity to avoid the triggering of the change-of-control protection for the other party upon the occurrence of the change-of-control event.

Dead Hand Board Change-of-Control Provisions Are *Not* Like "Dead Hand Poison Pills"

Dead hand board change-of-control provisions are substantively different from, and should not be confused with, "dead hand poison pills." A "dead hand poison pill" is a shareholder rights plan ("poison pill") in which a company's board, after a change in control of the board, is disabled from redeeming the plan for a specified period after election of the new board. Dead hand poison pills have been invalidated by the Delaware courts because their impact is to restrict directors in carrying out their fiduciary duty in determining whether to redeem a poison pill. Importantly, however, while both dead hand board change-of-control provisions and dead hand poison pills include a dead hand feature, there are critical differences between them.

- **A poison pill is adopted unilaterally by a company for its own interests.** First, a poison pill is adopted by a company's board, acting unilaterally, for the company itself, and the interests being served are the company's, not a counterparty's. By contrast, a board change-of-control provision in a commercial agreement is the product of negotiation with a counterparty and is intended to meet the objectives and protect the interests of the counterparty and/or both parties.

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- **Triggering a poison pill is economically catastrophic.** Second, the triggering of a poison pill is economically catastrophic. By contrast, the triggering of a board change-of-control provision in a commercial agreement can result in the affected company's losing, or having to replace, the benefits of the agreement—the significance of which will vary depending on the circumstances.

- **A dead hand poison pill cannot be redeemed.** Third, a dead hand poison pill cannot be redeemed either by the board or through negotiation with a counterparty to avoid its being triggered. By contrast, the triggering of a commercial agreement can potentially be avoided through renegotiation with, or waiver by, the company's counterparty.

Dead Hand Board Change-of-Control Provisions In Debt Agreements Have Been Under Attack But Are Legally Permissible

There has been recent judicial criticism of dead hand change-of-control provisions in debt agreements (*see Pontiac v. Ballantine* ("*Healthways*").[2] These provisions—so-called "dead hand proxy puts"—contemplate the acceleration of debt upon a change of control of the board of the borrower and include the dead hand feature that disables the borrower's board from approving a dissident slate to avoid a triggering of the put. In *Healthways*, in denying a motion to dismiss, in an oral ruling from the bench, Vice Chancellor Laster ruled that the Healthways Inc. directors could have liability for a breach of the duty of loyalty, and the bank lender could have aiding and abetting liability for the breach, for including a dead hand proxy put in the company's credit agreement.

Widespread Misinterpretation of Healthways

The Vice Chancellor emphasized that the dead hand feature was added to the longstanding board change-of-control provision at a time that the borrower was "in the shadow" of a realistically potential proxy contest. The court was skeptical that the "primary driver" for inclusion of the provision was protection of the bank's legitimate commercial interests as opposed to the potential entrenchment effect for the directors. (The inherent entrenchment effect arises because shareholders may be dissuaded from changing the composition of the board, as the change could trigger the put, which, unless waived by the bank, would result in a need to refinance the company's debt.) The Vice Chancellor emphasized that, without a record developed as to the negotiations between the parties and the board's deliberations with respect to the provision, the court could not determine the motivation for its inclusion. Further, the Vice Chancellor stated his view that a bank could protect itself more effectively by adding covenants to the credit agreement.

The Vice Chancellor's comments have been widely interpreted (*mis*interpreted, in our view[3]) as invalidating dead hand proxy puts in debt. 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]." 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 will be evaluated by the courts based on the facts and circumstances of each case.

Plaintiffs' Bar Campaign Against Proxy Puts

Nonetheless, since *Healthways*, the plaintiffs' bar has been conducting a campaign against dead hand proxy puts in debt of public companies. We expect that further judicial clarification of the validity of dead

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hand proxy puts will be forthcoming and will put an end to the campaign. In any event, though, under *Healthways*, it is clear that dead hand proxy puts are legally permissible under most circumstances. In our judgment, board change-of-control provisions in nondebt commercial agreements should be at least as readily understood as having commercial rather than entrenchment motivations given (i) the importance, for legitimate commercial reasons, of protection against a board change of control in light of the more "personal" nature of the arrangements, as noted above, which can impact *both* parties to an agreement and (ii) the difficulty in providing the same protection by other means, such as additional covenants.

Dead Hand Board Change-of-Control Provisions Are Best Adopted on a "Clear Day"

If a dead hand feature were adopted, or added to an existing board change-of-control provision, at a time when the company was facing an actual or realistically potential proxy contest, a court might be skeptical that the primary motivation for inclusion of the provision was the legitimate commercial interests of one or both of the parties as opposed to the potential entrenchment of the directors. Thus, adopting the provision on a "clear day"—*i.e.*, when a company does not face an actual or realistically potential proxy contest—should, as a legal matter, tend to support the validity of the provision (while the converse would tend to create a higher bar for establishing the validity of the provision). If a dead hand is adopted when the company faces an actual or realistically potential proxy threat, the board should be advised as to (and should consider specifically) the effects of the provision, including the possible entrenchment effect. These factors should be less important in the case of immateriality of the provision—*i.e.*, the relative unimportance of the agreement or its being readily replaceable without significant additional cost.

Conclusion

Companies should consider the desirability of including a dead hand feature in the board change-of-control provisions of their significant non-debt commercial 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). While none of the other change-of-control provisions routinely included in these types of agreements affords the counterparty a right or opportunity to avoid the triggering of the change-of-control protection for the other party 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, without the dead hand, except in extreme circumstances, a board will most likely be required to (or otherwise will) approve a dissident slate to avoid triggering the change-of-control protection. It should, of course, be kept in mind 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.

ENDNOTES:

[1] *See SandRidge*, Del. Ch. 2012.

[2] Transcript, Del. Ch. Oct. 8, 2015.

[3] *See* our memorandum, "Dead Hand Proxy Puts—What You Need to Know," June 5, 2015.

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