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KIRKLAND **M&A UPDATE**

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# Finding the Antidote – Addressing Poison Put Provisions in Debt Instruments

*Directors and executives should carefully consider the justifications for including proxy put provisions in new or renewed debt instruments. Similarly, existing debt instruments, especially those with a dead hand provision, should be reviewed to determine if any proactive changes are warranted.*

A number of recent contested proxy situations have highlighted so-called "proxy put" provisions in companies' debt instruments. These provisions (also referred to as "poison puts") provide that a change in the majority of a company's directors without the approval of the sitting board will constitute a change of control and, typically, an event of default. As a result, the company's debt may be accelerated (most common in credit agreements) or the company may be required to offer to repurchase its debt at a premium (most often in bond indentures). If these provisions are triggered, the company may face the unwelcome choice between refinancing its accelerated debt on possibly unfavorable terms or suffering a liquidity crisis.

## *Neutralizing Proxy Puts by "Approving" Insurgent Slates*

Proxy put provisions can play a significant role in proxy contests in which a shareholder (such as an activist fund) is seeking to replace a majority of a company's board. In the 2009 *Amylin* case, the Delaware Chancery Court clarified that a board of directors generally *may* "approve" an insurgent slate of directors in a proxy contest for the limited purpose of avoiding the triggering of a proxy put provision while continuing to publicly oppose the election of the insurgent directors in a proxy contest. The 2013 Delaware Chancery decision in *Sandridge* took this a step further by finding that a company's directors *must* approve a dissident slate of directors in a proxy contest in order to avoid the triggering of a proxy put provision, unless the board determines that allowing the dissident slate to take control of the board would pose a specific and substantial risk to the corporation or its creditors. A recent presentation by Goldman Sachs counted as many as 4,500 existing proxy put provisions across the borrower universe, making the treatment of these provisions a live issue in many contests for corporate control.

## *Eliminating the Board's Discretion Through "Dead Hand" Provisions*

While the *Sandridge* case illustrates the Delaware courts' expectation that directors will carefully evaluate neutralizing proxy puts in proxy contest situations, many companies' debt instruments include an enhanced "dead hand" proxy put provision which eliminates the ability of the board to approve for proxy put purposes a slate of directors that was nominated in connection with an actual or threatened proxy contest (thereby negating the *Sandridge* discretionary fix). According to a recent Thomson Reuters survey, nearly 10 percent of S&P 100 companies have dead hand provisions in their credit agreements (in our experience, dead hand provisions in notes indentures are less common). These provisions have received renewed attention from both the courts and the plaintiffs' bar in recent months.

In the 2014 *Healthways* case, the Delaware Chancery Court refused to dismiss a breach of fiduciary duty claim against the board of a company that restated its credit agreement to add a dead hand provision in the shadow of a proxy contest. Importantly, the court also refused to dismiss an aiding and abetting claim against the company's lenders, finding that prior decisions like *Sandridge* about the entrenching effect of these provisions put all lenders on notice that a company's directors may breach their fiduciary duties if they accept dead hand provisions in their company's debt instruments. In May 2015, the Delaware Chancery Court approved a settlement of the *Healthways* case, with the company and its lenders agreeing to amend the company's credit agreement to remove the dead hand provision and the company agreeing to pay attorneys' fees of up to $1.2 million. Importantly, the settlement explicitly provided that the lenders could not be paid any fees for eliminating the dead hand provision.

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## *The Current Litigation Landscape*

Following the *Healthways* case, we have noticed an uptick in plaintiffs' firms seeking to force companies to remove dead hand provisions from their credit instruments, even in the absence of an actual or threatened proxy contest. As a first step in these actions, a shareholder may make a demand for books and records of the company under the applicable state corporate statute (in Delaware, Section 220 of the DGCL) seeking information about the circumstances in which the dead hand provision was adopted and the level of board engagement in the decision-making process. Some companies have quietly settled these actions following the receipt of a books and records demand by negotiating with their lenders to remove the dead hand provision. As recently highlighted in *The Wall Street Journal*, other companies and their lenders have faced lawsuits alleging breaches of fiduciary duties (and aiding and abetting claims) for agreeing to these provisions.

## *Assessing the Risks*

Companies should consider assessing their vulnerability to these types of claims and decide whether a proactive response is advisable. As a first step, companies should review their existing debt instruments to determine whether dead hand provisions are present. If present, an appropriate course of action can be determined, including potentially removing the dead hand provision through an amendment. Such a removal would require the cooperation of a company's lenders and could involve the payment of amendment or consent fees, to be weighed against the potential costs and distraction of litigation.

The willingness of a company's lenders to remove a dead hand provision and the amount of any related fees will vary based on a number of factors, including the particular banks involved, the circumstances under which the amendment is being sought and the balance of the covenant package. However, the threat of shareholder litigation against the lenders could be a powerful motivating factor in facilitating discussions with creditors about removing a dead hand provision or to exclude dead hand provisions from debt instruments in the first place.

In approving the *Healthways* settlement and the corresponding $1.2 million fee, Vice Chancellor Laster cautioned that his earlier decision to allow the case to proceed should not be misrepresented as justifying "an alarmist view" of potential liability with respect to dead hand proxy puts. Particularly troubling to the court in *Healthways* was the addition of a dead hand component in the shadow of a proxy contest, as opposed to having been implemented on a clear day. A useful comparison is Vice Chancellor Glasscock's approval of just $128,000 in attorneys' fees in a settlement by Arris Group providing for the removal of the company's dead hand proxy put which had been adopted on a clear day (although the plaintiffs have appealed the fee award to the Delaware Supreme Court).

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In an era of heightened shareholder activism, proliferating proxy contests, an active plaintiffs' bar and enhanced director scrutiny, proxy put provisions are likely to receive greater attention from shareholders and ultimately the courts. To date, this trend has not received as much public attention as some other governance and litigation topics because much of the action is occurring in private discussions between companies, lenders and plaintiffs. Taking a proactive approach in consultation with experienced counsel may be the best path to achieving an optimal outcome. Directors and executives are well advised to give thoughtful consideration to the reasons and justifications for including proxy put provisions in new or renewed debt instruments. Similarly, existing provisions, especially those with a dead hand provision, should be reviewed to determine if any proactive changes are warranted.

If you have any questions about the matters addressed in this *M&A Update*, please contact the following Kirkland authors or your regular Kirkland contact.

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