

CORPORATE AND SECURITIES LAW

Alert

NEWS FOR THE CLIENTS AND FRIENDS OF BASS, BERRY & SIMS PLC

Delaware Court Provides Important Guidance to Directors and Companies in Approving and Applying Continuing Directors “Poison Put” Provision

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On May 12, 2009, the Delaware Chancery Court issued an opinion in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc. et al.* (“Amylin”) interpreting a so-called “poison put” provision in a bond indenture in the context of a proxy fight. This decision has significant ramifications regarding the interpretation of these provisions and offers important guidance to boards and companies in approving and applying these provisions.

A poison put is a “change of control” provision that allows lenders or bondholders to declare a default under a debt agreement and accelerate repayment of (or “put”) the outstanding debt at its principal value. The poison put emerged in bond indentures following the famed RJR Nabisco and other large leveraged buyouts of the late 1980’s that left risk averse bondholders stunned, holding “junk bonds” overnight without any recourse. These provisions were renewed in force most recently following the surprising wave of mega-LBOs in 2006 and 2007, which again left many unsuspecting bondholders unprotected. Indeed, following this mega-LBO resurgence, the Credit Roundtable, an association of fixed income investors, issued a white paper in December 2007 (updated in July 2008) recommending that bond indentures include change of control covenants (i.e., poison puts).

The purpose of a change of control covenant is to provide the bondholders an opportunity to reconsider their original investment decision if the issuer is acquired by new owners. Though initially intended to capture equity control changing hands (particularly to buyout funds who will significantly increase the company’s leverage and alter or eliminate the independent governance structure), the definition of change of control was soon expanded to include the event of the issuer’s board of directors no longer consisting of a majority of directors who were either directors at the time the debt was issued or whose nomination or election was approved by those incumbent directors – commonly referred to as a “Continuing Directors” provision. Lenders and bondholders are risk assessors and, as a result, corporate governance, control and capital structure are each material to the pricing and valuation of bond issues. These debtholders would also suggest this protection is necessary as boards do not owe any fiduciary duty to debtholders (at least prior to insolvency), and, therefore, debtholders’ only protections are the covenants they are able to negotiate.¹ It is not surprising, therefore, that debtholders need to be comfortable with a company’s existing board and management.

¹ The court reaffirmed this concept in the Amylin case discussed below, noting that a board has no obligation to consider “the interests of the bondholders” in making any good faith decision under the indenture.

Though typically not intended or approved by issuers as explicit takeover defenses like the better known “poison pill,” the poison put has gained recent attention (or notoriety) from shareholder activists and hostile suitors in connection with proxy fights and takeover attempts – being cast as a tool for board and management “entrenchment.” This is in response to the subject issuers publicly appealing to shareholders and the dissidents to withdraw or reduce their nominees to avoid triggering such a provision. A change of control put could potentially have disastrous consequences for an issuer, especially given the limited access to refinancing in the current economic environment or when the debt is impaired. Not surprisingly, these dissidents or hostile suitors have demanded that issuers “approve” their nominees or seek a waiver from the lenders to avoid triggering this default – which would likely be viewed as irresponsible if triggered by the dissidents or hostile suitors.

Recently, the Delaware Chancery Court (Chancellor Lamb) interpreted a Continuing Directors provision in this context in the Amylin case. In the Amylin case, two separate dissident shareholder groups had proposed competing slates of nominees in a contested annual director election for Amylin Pharmaceuticals, in response to which Amylin publicly warned of the consequences of triggering its poison put. As a result, the shareholders sued Amylin² and, among other things, requested that Amylin approve the nomination of the dissidents’ slates for purposes of the Continuing Directors provisions in the Amylin debt agreements³ to enable the shareholders to fully exercise their franchise without triggering the poison put. Ultimately, in partial settlement of the litigation by the dissidents, Amylin agreed to approve each of the dissident slates solely for purposes of negating a default under the Continuing Directors provision but continued to oppose their election publicly and in its proxy materials. However, this agreement was subject to the bondholders agreeing that the Amylin board had this authority under the bond indenture. Not surprisingly, the bondholders were not receptive to such nominal “approvals”⁴ and disagreed that the Amylin board had the authority to grant such approvals.⁵ The bondholders likely desired an opportunity to assess the long-term platform of the dissidents and the independence and qualifications of their nominees to confirm their willingness to grant a waiver and maintain their investment. Accordingly, Amylin and the indenture trustee litigated the proper definitional interpretation of the Continuing Directors provision, including whether the Amylin board had the power under the bond indenture to approve the dissident nominees while contesting their actual election.

² The complaint was filed against Amylin and each of its directors, alleging various fiduciary duty breaches in connection with the approval and application of the Continuing Directors provision, and disclosure of the related risks.

³ The Amylin indenture defined “Continuing Directors” as:

“(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 shareholders 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.”

Amylin’s credit facility also contained a Continuing Directors provision, but the administrative agent agreed to a consent and waiver.

⁴ The Trustee argued that “approve” was synonymous with “endorse” in this context. The court disagreed, noting that endorse likely means approve but that the reverse is not true.

⁵ An important purpose of such provisions – from the bondholders’ perspective – is to allow them the unilateral ability to waive such provision in connection with a potential change in control (including, or maybe especially, in the form of a proxy contest).

Relying on a strict textual interpretation of the Continuing Directors provision, the court ruled that the provision as drafted did not prevent the Amylin board from “approving” the nomination of the dissident slate while nevertheless opposing their actual election. In particular, the court found that the provision did not expressly prohibit board “approval” after commencement of a proxy fight and that any interpretation that it did could severely limit the shareholder franchise (by coercing shareholders into only voting for directors actually supported by the existing directors).

Though not formally ruled on, the court went on to suggest that the right or “power” to approve dissident directors in this context (i.e., while opposing them in the actual election) was subject to the implied covenant of good faith and fair dealing under the indenture – which required that the board must make this approval in the good faith belief 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.”

Finally, the court also ruled that the Amylin board did not breach their duty of due care (i.e., citing a “gross negligence” standard) in failing to learn of and specifically consider and approve the poison put provision – in particular noting the highly-qualified outside legal and financial advisors and that the directors did not have an obligation to know every term of the indenture. However, given the magnitude of a default under a debt agreement, the court elaborated that boards should request that, even if “customary,” their advisors inform them of the default provisions and those which could impair the shareholder franchise so that the board will be able to exercise its fully informed business judgment.

The court also informally suggested that boards that actually and intentionally limit the shareholder franchise in this context (i.e., by agreeing that the board cannot approve dissident nominees after commencement of a proxy fight) could face a tough burden in demonstrating the “extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it” in order to satisfy the board’s fiduciary duties.

The Amylin case is of particular relevance for boards and companies in the current environment where many companies are struggling with (or will soon be facing) financing or refinancing needs, and where many of these companies may be presently vulnerable to takeover attempts or overtures by activist shareholders. Under these circumstances, and because lenders will likely continue to insist on Continuing Director provisions, directors may feel they are between a rock and a hard place. Nevertheless, directors can take comfort from the court’s application and discussion of the applicable gross negligence and duty of care standards in Amylin, but need to be aware of the issues this case presents and the helpful warnings offered by the court to future boards.

Accordingly, we offer the following suggestions for our friends and clients:

- Review Existing Material Agreements for Poison Puts; Advanced Preparation Required. Companies should review their existing debt (*and other material*) agreements now to identify the change in control provisions and their potential impact in a proxy contest or hostile takeover – particularly companies who may be currently vulnerable to shareholder activism or takeover attempts. Such provisions can also restrict the ability of a board or shareholders to pursue a friendly takeover offer. The contractual, fiduciary and strategic issues that companies and boards may face are potentially daunting, so advanced and careful planning and preparation will help facilitate a successful result.

- Adequately Disclose Risk Factors. Although dismissed as part of the settlement with the dissidents, the dissidents initially claimed breaches of the duty of disclosure in the allegedly misleading and inadequate risk factor disclosure regarding the Continuing Directors provision in Amylin's annual report on Form 10-K. Accordingly, companies should ensure their risk factors accurately describe the risks attendant to any Continuing Directors provisions.
- Be Fully Informed and Receive Commensurate Benefit in Accepting Poison Puts. Poison puts are no longer a dirty little secret, and the Amylin court made clear that boards have a continuing duty to protect their shareholders' interests notwithstanding a need to incur indebtedness and the fact that such provisions are customary and typically required by the debtholders. To ensure compliance with their fiduciary duties, directors should be informed of and attentive to all change of control provisions in new debt and other material agreements going forward – particularly those which may impair the shareholder franchise. Boards should not be passive in these approvals and should ask questions of their advisors to their satisfaction. Future courts may not be as forgiving after the warnings set forth in Amylin. Bondholders are unlikely to drop these provisions for new issues and may seek ways to modify the Continuing Directors provisions to avoid the result in the Amylin case. Boards need to fully understand the impact (financial, business and otherwise) of the company's refusal to accept the poison put. Each situation will be different and a company's financing options may be particularly limited in the current economic environment or if otherwise in distress, but care should be taken to negotiate these provisions carefully (particularly Continuing Director provisions) and to seek to ensure that the company is receiving commensurate economic and other benefit by accepting these provisions – even if advised that they are “customary.”
- A Poison Put is not a Poison Pill; Be Wary of Heightened Scrutiny. Boards should be well-advised prior to using the poison put as an affirmative takeover defense (i.e., by a decision *not* to “approve” a dissident slate) or giving the appearance of doing so (i.e., by publicly using this provision as leverage against the dissident), as this may draw undesired public criticism and litigation – which could undermine the company's other efforts to purport to represent the best interests of the shareholders in connection with the proxy fight or takeover response. While not addressed by the Amylin court, boards should also be mindful that using a poison put as a takeover defense may trigger heightened scrutiny of the board's actions beyond the “gross negligence” and business judgment rule standard – similar to a court's analysis of the adoption and use of a “poison pill.”⁶ Similarly, heightened scrutiny may apply to a board that agrees to such a provision for a new issue when “in play” or otherwise engaged in a proxy or takeover battle.
- There is not Carte Blanche to “Approve” Directors; Breaches of Duty of Loyalty may not be Indemnifiable. Boards do not have the unfettered right to grant an “approval” to circumvent a Continuing Directors provision as a result of the implied covenant of good faith and fair dealing applicable to commercial agreements. In particular, boards are required to make a “good faith” decision that the election of one or more of the dissident nominees would not be materially adverse, or pose danger, to the interests of the corporation or its shareholders. Companies should take care that their public opposition to the dissident nominees does not go beyond “election

⁶ Although the implied duty of good faith and fair dealing to the lenders may provide a board some flexibility to *not* approve a dissident slate, the intent, circumstances and manner in which the approval is denied would nonetheless be scrutinized.

puffery” to avoid potentially undermining the credibility of a board’s “good faith” decision to approve the nomination by the dissidents. Perhaps more importantly, the failure to meet this standard could also indicate a duty of loyalty breach – for which directors may be personally monetarily liable (and without D&O coverage).⁷

- Expect Hindsight Scrutiny; Process and Record are Critical. Courts will likely apply greater hindsight scrutiny in future cases and may expect to see “evidence” of fully informed and good faith decision making. Boards should take care to get expert legal and, as appropriate, financial advice and should exercise their business judgment in good faith and on a fully informed basis. Boards and their advisors should create a good “record” of the decision making process.
- Be Well Advised. Directors and officers are entitled to reasonably rely on expert advisors selected with due care. The need to observe proper process and decision making will likely necessitate the early involvement of experienced outside legal and, in some cases, financial advisors.

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⁷ The Amylin court hinted that approving a dissident slate solely to avoid litigation and potential damages would not likely satisfy its good faith analysis.

Bass, Berry & Sims Corporate and Securities Group

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