HUNTON& WILLIAMS

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"Continuing Director" Change-in-Control Provisions

A recent Delaware Court of Chancery opinion has drawn attention to change-in-control provisions in commercial agreements due to their potential anti-takeover and entrenchment effects. Although such provisions are common, the decision warns that a board of directors must be "especially solicitous to its duties" to both the corporation and its stockholders when agreeing to contract provisions that discourage proxy contests.

In *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, the court interpreted a notes indenture which provided the noteholders with a redemption right triggered upon a "Fundamental Change." A "Fundamental Change" would occur if, among other things, "the Continuing Directors do not constitute a majority of the Company's Board of Directors." "Continuing Directors" was defined as "(i) individuals who on the Issue Date constituted the Board … and (ii) any new directors whose election … or whose nomination for election by the stockholders … was approved by at least a majority of the directors … either who were directors on the Issue Date or whose election or nomination … was previously so approved." This type of provision, sometimes referred to as a "poison put," is common in a wide variety of commercial contracts.

The issue presented was whether the change-in-control provision would be triggered if proxy contests being waged by two dissident stockholders were successful.[1] Although each dissident was seeking only minority board representation, together they raised the possibility of a majority change in the board's composition. The indenture trustee claimed that if a new board majority was elected, a "Fundamental Change" would occur. The company disagreed and approved the dissidents' nominees in order to classify them as "Continuing Directors" should they be elected at the stockholders meeting.

Interpreting the indenture, the court concluded that the board of directors could approve the dissidents' nominees, such that they would be "Continuing Directors," even though the board was simultaneously soliciting proxies and recommending that the company's stockholders vote in favor of management's slate. The court ruled that the term "approve," as used in the indenture, did not require the incumbent board to "endorse" or "recommend" the oppositions' nominees. The court then explained that the board's ability to approve those nominees was limited only by the implied covenant of good faith and fair dealing owed to the trustee. Accordingly, the court held that the board could approve the dissidents' nominees if it determined 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." Although the board would have to reconcile its approval of the dissidents' nominees with its criticism levied at them in its proxy fight letters, the court noted that the board would be "under absolutely *no* obligation to consider the interests of the noteholders" in making its determination.

The court concluded that the issue of whether the directors breached the implied covenant of good faith and fair dealing was not ripe. Nevertheless, the court expressed concern over the trustee's proffered interpretation of the indenture:

> A provision in an indenture with such an eviscerating effect on the stockholder franchise would raise grave concerns. In the first instance, those concerns would relate to the exercise of the board's fiduciary duties in agreeing to such a provision. *The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting such a provision, it*

[1] The dual proxy contests led to an important SEC no-action letter in March allowing each dissident to solicit proxies to vote for the other's nominees.

was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it. Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy (emphasis in original).

The court's dicta implies an inquiry that would not defer to basic freedom of contract principles and that would go beyond the business judgment rule, perhaps subjecting such provisions to intermediate scrutiny under *Unocal*. The court also noted that a change-in-control provision adopted with the primary purpose of interfering with stockholder voting rights would require a "compelling justification" under *Blasius*.

Finally, the court highlighted the "troubling reality that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise." "Few events," the court observed, could be "more catastrophic for a corporation than the triggering of an event of default under one if its debt agreements."

Conclusion

The *Amylin* decision suggests some change-in-control provisions may not be interpreted as expected, while others potentially may be invalid. Contracting parties, including creditors with legitimate interests in the control of corporate borrowers, should take note. The decision should also cause corporations to evaluate closely any commercial contracts, including finance documents, employment agreements, and benefit and compensation plans, that have the potential to entrench incumbent directors and officers or otherwise interfere with proxy contests. In each situation, the scope of the change-in-control provision should be balanced with the materiality of the consequences of a triggering event.

Moreover, directors should remember that fiduciary duties apply to all aspects of corporate governance, including negotiating and approving material agreements. A change-in-control provision approved for the purpose of protecting incumbent boards would surely implicate the duty of loyalty. Boards must also be mindful, however, of fulfilling their duty of care, which can be achieved by relying in good faith on outside advisors. In *Amylin*, the court concluded that the directors, who were not aware of the "Continuing Director" feature, had adequately informed themselves by consulting with outside counsel, who advised when the indenture was approved that the change-in-control provisions were not unusual.

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