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Proxy Contests and "Continuing Director" Provisions

On March 8, 2013, the Delaware Court of Chancery addressed "continuing director" provisions in debt instruments and how such provisions affect proxy contests and the exercise of a board's fiduciary duties. "Continuing director" provisions, or "proxy puts," typically trigger a default or accelerate amounts due upon a change in a majority of the board of directors. In *Kallick v. SandRidge Energy, Inc.*, Chancellor Leo E. Strine, Jr., found that incumbent directors likely breached their fiduciary duties by refusing to approve a dissident slate of director nominees under a "continuing director" provision. The court found that the board had not made a good faith determination that approval of the dissident slate would be harmful to the corporation and its stockholders.[i]

Background

In *SandRidge*, a large stockholder filed a consent solicitation statement with the Securities and Exchange Commission seeking to elect a new board of directors at SandRidge Energy, Inc. ("SandRidge"). In response, the board of SandRidge filed a consent revocation statement that, among other things, warned stockholders that a majority change in the composition of the board would trigger a "Change of Control" provision in SandRidge's debt instruments. That trigger, in turn, would subject SandRidge to an obligation to repurchase $4.3 billion in notes. The board advised SandRidge's stockholders that the company "may not have sufficient liquidity" to repurchase the notes and that "[a] mandatory refinancing of this magnitude would present an extreme, risky and unnecessary financial burden."

The indentures provided, in pertinent part, that the obligation to repay would be triggered if:

> during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors of the Company or any Successor Parent (*together with any new directors whose election to such board or whose nomination for election by the stockholders of the Company or any Successor Parent, as the case may be, was approved by a vote of 66 2/3% of the directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved*), cease for any reason to constitute a majority of such Board of Directors then in office . . . .

The court first determined that the SandRidge board was using the "continuing director" provision in a defensive manner. As a result, Chancellor Strine applied the intermediate standard of review provided by the Delaware Supreme Court in *Unocal Corp. v. Mesa Petroleum Co.*[ii] In this context, Chancellor Strine found that there was no "rational, good faith justification for [the board's] non-decision as to approval" of the dissident slate.

Chancellor Strine acknowledged that the purpose of "continuing director" provisions was to provide creditors with some protection against a new board that "would threaten [creditors'] legitimate interests in getting paid."[iii] Chancellor Strine then cited to the Court of Chancery's 2009 decision in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, which held that, in the context of "continuing director" provisions, a board's obligation to a creditor is to comply with the implied covenant of good faith and fair dealing. The *Amylin* court stated that to fulfill this obligation, the board "may approve the

stockholder nominees if the board 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."

Accordingly, Chancellor Strine stated that "a board may only *fail* to approve a dissident slate if the board determines that passing control to the slate would constitute a breach of the duty of loyalty, in particular, because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors." He suggested that this might arise where the rival candidates were "known looters" or "persons of suspect integrity" or if the incumbents were aware that the candidates had a plan for the corporation that would be considered "a genuine and specific threat to the corporation and its ability to honor its obligations to its creditors."

The court also addressed the SandRidge board's argument that the inexperience of the dissident slate justified the board's decision. Chancellor Strine found that this "we are better than the new guys and gals" argument was insufficient:

> where an incumbent board cannot identify that there is a specific and substantial risk to the corporation or its creditors posed by the rival slate, and approval of that slate would therefore not be a breach of the contractual duty of good faith owed to noteholders with the rights to the Proxy Put, the incumbent board *must approve* the new directors as a matter of its obligations to the company and its stockholders, even if it believes itself to be better qualified and have better plans for the corporation than the rival slate.

Finding on the preliminary record that the board likely violated its fiduciary duties, Chancellor Strine partially granted the plaintiff's request for injunctive relief. Rather than requiring the incumbent board to approve the dissident slate as requested by the plaintiffs, however, Chancellor Strine tailored the injunction to prohibit the board from (i) soliciting further consent revocations, (ii) relying on any previously acquired consent revocations, and (iii) inhibiting the active stockholder's consent solicitation until the board approves the slate or explains in full why they will not approve it.

Conclusion

SandRidge shows that Delaware courts will scrutinize contractual provisions that potentially disenfranchise stockholders. As Chancellor Strine explained, Delaware has a "public policy of stringent policing of the fairness of corporate elections," stockholders have a "right to make a free, uncoerced choice," and "it is vital that the stockholders have a genuinely fair opportunity to elect new directors." Thus, directors should be aware that "continuing director" provisions may have limited efficacy in defending proxy contests or hostile takeovers.

It is important to note that Chancellor Strine's decision is limited to the board's decision on whether to approve dissident nominees under a particular "continuing director" provision. The holding did not speak to the various permutations of "proxy puts" or the board's fiduciary duties in approving such provisions generally. Boards should continue to be briefed, however, on the implications of important change-in-control provisions in material contracts. As *SandRidge* noted, "boards have a duty to their stockholders to pay very close attention to provisions that affect the stockholder franchise, such as Proxy Puts."

Lenders should also take note of the court's holding. "Continuing director" provisions can help lenders protect against a significant change in board composition that may adversely affect the borrower's risk profile. As *Amylin* advised, however, a "continuing director" provision that inhibits stockholders from exercising their fundamental rights may be unenforceable as a matter of public policy in Delaware. Moreover, *SandRidge* stated that companies have "very limited obligations" to creditors and shows that boards may have little discretion in determining whether to approve a dissident slate of directors under "continuing director" provisions.

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[i] *Kallick v. SandRidge Energy, Inc.*, C.A. No. 8182-CS, mem. op. (Del. Ch. Mar. 8, 2013).
[ii] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985).
[iii] *San Antonio Fire & Police Pension Fund v. Amylin Pharms., Inc.*, 983 A.2d 304 (Del. Ch. 2009).