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Lenders and Directors Beware of the Dead-Hand Proxy Put

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Shareholder activism is on the rise, and shareholder litigation against public company boards and management often increases when a public company is underperforming in relation to its industry competitors and/or is experiencing financial distress. Therefore, bankruptcy practitioners should take note of recent shareholder litigation against company boards and lenders challenging "proxy put" provisions in debt agreements (hereinafter, "loan agreements"). If a proxy-put provision under a loan agreement is triggered, a default occurs and the lender may accelerate the debt under the loan agreement. The default under the loan agreement may precipitate cross-defaults under other loan agreements, which could ultimately land a public company in bankruptcy.

This article discusses proxy-put provisions in loan agreements, as well as recent litigation in the *Healthways* case highlighting the dangers of the "dead hand" proxy put, and provides company directors and lenders with best practices for avoiding breach of fiduciary duty and aiding and abetting breach of fiduciary duty claims.

Proxy-Put Provisions in Loan Agreements

A proxy-put provision under a loan agreement generally provides that an event of default occurs if a majority of the borrowing company's board of directors is replaced by "noncontinuing directors" during a specified short period of time. A director is typically considered a "continuing director" as opposed to a "noncontinuing director" if the individual was on the company's board at the time that the loan agreement was entered into (the "incumbent board"), or if the individual was approved by a majority of the incumbent board members or their approved replacement directors.

As a direct address to shareholder activists, some proxy-put provisions specifically exclude from the definition of "continuing director" those directors whose initial nomination or assumption of office occurred as a result of an actual or threatened proxy contest.[2] If the proxy-put provision is triggered, a lender may opt to accelerate (or put back) the amounts that are due and owing under a loan agreement. The acceleration of debt under the loan agreement could result in serious financial harm to the company.

As the Delaware Court of Chancery has noted, "[g]enerally, shareholders have only two protections against a perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members."[3] Proxy puts stand in the way of shareholders' exercise of their right to vote to elect directors of a company in order to protect their positions in the event of a company's poor performance.

The Delaware Court of Chancery has cautioned directors and lenders that proxy puts that entrench incumbent boards and disenfranchise shareholders are dangerous.[4] The court's following discourse indicates that boards that allow proxy-put provisions in loan agreements must do so with caution because

> [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

1 This article represents the views of the author, and such views should not necessarily be imputed to Simmons Legal PLLC or its respective affiliates and clients.

2 *See, e.g., San Antonio Fire & Police Pension Fund v. Amylin Pharm. Inc.*, 983 A.2d 304, 309 (Del. Ch. 2009) (quoting credit agreement).

3 *See Kallick v. Sandridge Energy Inc.*, 68 A.3d 242, 261 n. 96 (Del. Ch. 2013) (citation omitted).

4 *Id.* at 259.

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 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.[5]

In addition, if a board's approval of a proposed dissident slate of directors would avoid the trigger of the proxy put under a loan agreement, the board is required to approve the slate unless the proposed slate poses a substantial risk to the company or its creditors.[6] One such substantial risk is the risk that if the rival slate of directors were elected to govern the company, the company would be placed in a position in which it might fail to honor its obligations to repay creditors.[7]

An incumbent board's ability to approve a dissident slate in order to avoid the trigger of the proxy put provides the board with a "fiduciary out." A "dead hand" proxy-put provision, however, does not provide a "fiduciary out" because it provides no exception for an incumbent board to approve an elected dissident slate of directors nominated by shareholders to avoid default.

Dead-Hand Proxy Put: Sword of Damocles

The court's ruling in *Pontiac General Employees Retirement System v. Healthways Inc.*[8] serves as a warning to directors and lenders regarding the dangers of including dead-hand proxy-put provisions in loan agreements.

First Proxy Put Included in 2010 Credit Agreement

Healthways Inc. first included a proxy-put provision in a loan agreement that it entered into in 2010,[9] which provided that a default of the agreement would occur if, during any consecutive 24-month period, a majority of the Healthways board ceased to be comprised of continuing directors.[10] The proxy put in the 2010 loan agreement did not include a dead-hand feature.[11] A new rival director, whose nomination or election was "approved" by the majority of the board, was considered a "continuing director" for purposes of the proxy-put provision.[12]

Shareholders Vote to Declassify Healthways Board

In 2012, shareholder New York State Common Retirement Fund, noting its belief that "the ability to elect directors is the single most important use of the shareholder franchise," submitted a proposal to declassify the Healthways board.[13] The declassification would allow for the election of directors on an annual basis.[14] By an overwhelming majority, the shareholders voted on May 31, 2012, to approve the proposal for declassification of the board.[15]

Provision Included After Declassification Vote

On June 8, 2012, Healthways entered into a new loan agreement (as subsequently amended, the "2012 loan agreement"),[16] which provided for a $200 million revolving credit facility and a $200 million term loan facility.[17] The 2012 loan agreement provided that Healthways would be in default under the agreement if, within any consecutive 24-month period, the majority of the Healthways board ceased to be comprised of "continuing directors."[18] As the following definition of "continuing directors" under the 2012 loan agreement indicates, those directors that were nominated and/or elected as a result of an actual or threatened proxy fight were considered "non-continuing" directors:

> With respect to any period, any individuals (A) who were members of the board of directors or other equivalent governing body of the Borrower on the first day of such period, (B) whose election or nomination to that board or equivalent governing body was approved by individuals referred to in clause (A) above constituting at the time of such election or nomination at least a majority of that board equivalent governing body, or (C) whose election or nomination to that board or other equivalent governing body was approved by individuals referred to in clauses (A) and (B) above constituting at the time of such election or nomination at least a majority of that board or equivalent governing body *(excluding, in the case of both clauses (B) and (C), any individual whose initial nomination for, or assumption of office as, a member of that board or equivalent governing body occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors by any person or group other than a solicitation for the election of one or more directors by or on behalf of the board of directors)*.[19]

The new "dead-hand" proxy-put provision provided no exception for the incumbent board to approve a dissident slate of directors in order to avoid a default under the loan agreement. Therefore, an automatic trigger of the proxy-put default provision under the 2012 loan agreement would occur once a majority of the incumbent board was replaced by directors who were initially nominated or assumed office through an actual or threatened proxy contest.

Subsequent Company Debt with Cross-Default Provisions

In 2013, Healthways issued two sets of notes totaling $145 million.[20] The note agreements provided that Healthways would be in default under the notes if it defaulted on any other loans exceeding $10 million.[21] Therefore, a default under the 2012 loan agreement would cause a cross-default under the notes, which would push Healthways into further financial distress.

Continued Shareholder Activism Against Healthways Board

In late 2013, another large shareholder, North Tide Capital LLC, began firing letters to the Healthways board

5 *Amylin Pharm. Inc.*, 983 A.2d at 315 (citations omitted) (emphasis added).
6 *See Sandridge Energy*, 68 A.3d at 260-61.
7 *Id.* at 260-61.
8 C.A. No. 9789-VCL, Dkt. No. 37 (Del. Ch. Oct. 14, 2014) (transcript ruling).
9 *See* Verified Class Action and Derivative Complaint, C.A. No. 9789-VCL, Dkt. Nos. 1, 5 (Del. Ch. Jun. 24, 2014) (Complaint ¶¶ 32-33).
10 *Id.*
11 *Id.*
12 *Id.*
13 *Id.* at ¶ 34.
14 *Id.*
15 *Id.* at ¶ 36.

16 *Id.* at ¶ 38.
17 *Id.* at ¶ 39.
18 *Id.* at ¶ 42.
19 *Id.* at ¶ 43 (quoting 2012 loan agreement) (emphasis in original).
20 *Id.* at ¶¶ 46-47.
21 *Id.*

voicing its discontent with the company's performance and leadership.[22] Highlighting that "[f]rom its peak in early 2008, the company's market capitalization has declined more than 80% from $2.7 billion to less than $500 million today," North Tide called for the removal of Healthways's CEO.[23] North Tide, through much contentious communication with the Healthways board, was eventually able to obtain an agreement from the board to nominate for election three of the four individuals that North Tide desired to elect to the board.[24]

During the course of the contentious back-and-forth between the Healthways board and North Tide, one of Healthways's co-founders resigned.[25] In his resignation letter, he wrote that he was "no longer willing to continue as a director and watch [Healthways] fail to meet its potential and the reasonable expectations of shareholders."[26]

Filing of Breach of Fiduciary Action Against Board, Lender

To investigate the legality of the dead-hand proxy put, on March 20, 2014, Healthways shareholder Pontiac Employees Retirement System served a demand on Healthways to inspect its books and records.[27] Subsequently, on June 19, 2014, Pontiac filed a complaint on its behalf and on behalf of similarly situated shareholders against the directors of Healthways that authorized the 2012 loan agreement in whole or part (collectively, the "directors"), SunTrust Bank as administrative agent under the loan agreement (the "lender"), and Healthways as nominal defendant.[28] Pontiac alleged that the directors breached their fiduciary duties by approving the dead-hand proxy-put provision in the 2012 loan agreement, given that the put served no purpose other than the entrenchment of the incumbent board and impairment of the rights of shareholders to choose directors.[29] Pontiac further asserted that the dead-hand proxy put "removes from the board of directors the power to disable the Proxy Put by approving any new director whose nomination or assumption of office occurs as a result of an actual or threatened solicitation of proxies or consents for the election or removal of one or more directors."[30]

The lender was sued for aiding and abetting the directors' breach of fiduciary duty by knowingly allowing inclusion of the dead-hand proxy-put provision in the 2012 loan agreement.[31] Pontiac also sought a declaratory judgment from the court that the dead-hand proxy-put provision was unenforceable.[32]

Court's Ruling on Dismissal Motion

The directors and lender both moved to dismiss the complaint filed against them.[33] In considering the facts and legal arguments in the case, the court referred to the dead-hand proxy put as the "Sword of Damocles" hanging over shareholders' heads.[34] The put had a chilling effect and deterred shareholders from waging proxy contests.[35] In deciding against dismissal of the complaint against the directors, the court pointed to the following alleged facts, which indicated that the directors may have breached their fiduciary duties by adopting the proxy put: (1) activist shareholders' rising opposition; (2) "the identified insurgency"; (3) the change in historical practice regarding inclusion of the dead-hand proxy put in the company's debt agreements; (4) a lack of documents revealing thoughtful consideration of adding the dead-hand proxy-put provision; and (5) the negotiation of inclusion of the provision in the loan agreement.[36]

> **[L]enders cannot take advantage of a borrower's conflict of interest that is created by a questionable provision in a loan agreement.**

The court likewise did not dismiss the complaint against the lender.[37] The court emphasized that given the court's prior precedent, lenders were on notice that proxy puts could lead to a breach of fiduciary duty.[38] Further, lenders cannot take advantage of a borrower's conflict of interest that is created by a questionable provision in a loan agreement.[39] After the court's motion-to-dismiss ruling, the parties settled the dispute. Pursuant to the settlement, the proxy-put provision in the 2012 loan agreement was removed.[40]

Conclusion and Best Practices

Although the *Healthways* litigation settled after the motion-to-dismiss rulings, lenders and directors should heed the warnings regarding the dangers of proxy puts that were underscored by the litigation. In order to safeguard against proxy-put litigation, lenders and directors should, at a minimum, keep a record (1) revealing the justification for inclusion of the proxy put in a loan agreement; (2) regarding the negotiations that took place with respect to the proxy put; and (3) showing what consideration the company received for including a proxy-put provision in a loan agreement. The proxy-put provision should also provide the directors a "fiduciary out" whereby they can approve a rival slate of directors to avoid triggering a loan default. abi

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22 *Id.* at ¶¶ 59-68.
23 *Id.* at ¶ 60.
24 *Id.* at ¶ 68.
25 *Id.* at ¶ 63.
26 *Id.*
27 *Id.* at ¶ 13.
28 *See Pontiac Gen. Emps. Ret. Sys. v. Healthways Inc.*, C.A. No. 9789-VCL, Dkt. Nos. 1, 5 (Del. Ch. June 19, 2014).
29 *Id.* at ¶¶ 14, 72.
30 *Id.* at ¶ 109 (internal quotation marks omitted).
31 *Id.* at ¶ 103.
32 *Id.* at ¶ 115.
33 *See Healthways Inc.*, C.A. No. 9789-VCL, Dkt. No. 37 (Del. Ch. Oct. 14, 2014) (transcript ruling).
34 *Id.* at 74.
35 *Id.*
36 *Id.* at 75-76.
37 *Id.* at 78-80.
38 *Id.*
39 *Id.*
40 *See Healthways Inc.*, C.A. No. 9789-VCL, Dkt. No. 38 (Del. Ch. Feb. 11, 2015).