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Delaware Court Raises Bar for Use of "Poison Put" Provisions

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In a recent case that arose in the context of a consent solicitation seeking a change of control of a public company, the Delaware Court of Chancery found the target board in breach of its fiduciary duties for not approving a dissident slate for the purposes of preventing a change-of-control-triggered put right in the company's debt agreements. *Kallick v. SandRidge Energy, Inc.*, C.A. No. 8182-CS (Del. Ch. Mar. 8, 2013). Chancellor Strine's ruling extends prior Delaware law on the topic and provides cautionary guidance about the future effectiveness of such clauses, which are common features of debt documents and other commercial arrangements.

The case arose out of a hedge fund's efforts to destagger and replace a majority of the board of directors of SandRidge Energy via a consent solicitation. In opposing the consent solicitation, the company initially warned shareholders that a change in the majority of the board that was not approved by the company's directors would obligate the company to offer to repurchase $4.3 billion of debt at 101% of par pursuant to certain provisions in its debt instruments—provisions sometimes called "poison puts" or "proxy puts." The company subsequently changed its public posture and noted that the put was "unlikely" to be harmful, because the debt was then trading above par, making it doubtful that the put would be exercised. However, the board failed to decide whether to "approve" the dissident nominees for purposes of the debt documents, thus leaving a cloud of uncertainty regarding the put and drawing a legal challenge from a shareholder.

Noting Delaware's sensitivity towards the stockholder franchise, Chancellor Strine applied *Unocal*'s intermediate standard of review both to the board's decision to agree to the "poison put" provisions in the first place and to its subsequent conduct with respect to such clauses. Citing

former Vice Chancellor Lamb's 2009 decision in *Amylin*, the Court explained that a board has the power and, so long as it is complying with the contractual implied covenant of good faith and fair dealing, also the right to approve dissident nominees for purposes of avoiding the triggering of a poison put—even while the board is conducting a public campaign against those nominees. Although the Court briefly acknowledged that poison put provisions are often requested by the lenders, and may benefit companies through better debt terms, it nonetheless narrowly cabined the board's discretion in this context, requiring the board to approve the dissident nominees unless passing control to them would constitute a breach of the duty of loyalty. According to Chancellor Strine, it is not enough for a board to believe that it is better qualified, or has better plans, than the dissident slate. Instead, a board may only decline to approve dissident nominees where the board can "identify that there is a specific and substantial risk to the corporation or its creditors posed by the rival slate" (such as by showing the nominees "lack the integrity, character, and basic competence to serve in office") or where the dissident slate has announced plans that might affect the company's ability to "repay its creditors." The Court found that the directors here failed to identify such a threat, and enjoined them from opposing the consent solicitation until they approved the dissident nominees (shortly after the Court's ruling, the board approved the nominees and the two sides subsequently settled the contest). The Court also observed that boards may have greater flexibility in applying change-of-control clauses in other contexts like employment agreements, where the employee beneficiaries of those agreements may have a more extensive concern for the identity of their bosses.

Chancellor Strine's decision emphasizes the heightened level of scrutiny Delaware courts will apply in the context of shareholder voting rights, even when, as here, there was not a significant showing of actual coercive harm. It also raises serious questions about how future change-of-control provisions will be drafted and negotiated, since contractual considerations will continue to play a role in Delaware's analysis of these provisions and companies must also consider how to properly disclose the limitations on such provisions. The decision is a further reminder that boards should engage in a careful, well-documented process whenever they enter into or apply contractual provisions that could affect shareholder voting.