CLEARY GOTTLIEB Alert Memo

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Court Decision Raises Questions as to Interpretation and Validity of "Continuing Director" Change in Control Provisions

A Delaware Chancery Court decision last week raises significant questions regarding the interpretation and validity of various types of "continuing director" change-in-control provisions that are common features in one formulation or another in loan agreements, indentures and other contracts. Following the opinion, some existing provisions may not be interpreted as expected by some lenders and other existing provisions may be invalid. The court's opinion also raises considerations for boards approving financing and other agreements (including employment agreements and benefit plans) with such provisions in the future and for lawyers negotiating such agreements, advising boards and drafting disclosure regarding such provisions.

San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc. arose out of a proxy contest in which two separate dissident stockholders[1] of Amylin, prevented from agreeing to form a unified minority slate by the Company's "poison pill," each proposed a slate of five nominees to the 12-member Amylin Board of Directors, thereby raising the possibility that a majority of the Board could be changed at the upcoming Annual Meeting despite each stockholder's seeking only minority representation. Amylin's public Indenture[2] contains a common change in control provision giving noteholders the right to put their notes to the company at par if "at any time Continuing Directors do not constitute a majority of the Company's Board of Directors". The term "Continuing Directors" is defined as directors in office on the Issue Date of the Notes and "any new directors whose election to the Board of Directors or whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office…either who were directors on the Issue Date or whose election or nomination for election was previously so approved."

One of the insurgents requested that the Board (consisting entirely of Continuing Directors) approve the nomination of both dissident slates of nominees for purposes of this Indenture provision, even though the Board continued to recommend its own slate and oppose the election of the dissidents' nominees. The Board refused the request and a stockholder commenced a suit seeking a declaration that the board had the power to approve the

[1] Cleary Gottlieb is counsel to one of the dissident stockholders, Eastbourne Capital Management.

[2] The Indenture is governed by New York law, and the Vice Chancellor applied principles of New York law.

dissidents' nominees and a fiduciary obligation to do so. In a partial settlement of the stockholder lawsuit, the Board agreed to approve both dissidents' slates of nominees subject to obtaining a court order confirming the Board's contractual right to do so. The Indenture Trustee, however, continued to litigate, arguing that the word "approve" in the Indenture is synonymous with "endorse" or "recommend", and that the Board could thus not both run its own slate and simultaneously "approve" the dissident slate for purposes of the Indenture.

Following a trial on limited issues, Vice Chancellor Lamb disagreed with the Indenture Trustee, concluding that the language of the Indenture was clear and that the Board had the right to approve the dissident nominees for purposes of the Indenture even though actively opposing their election. The court stated that to interpret the Indenture to prohibit such Board approval of dissidents would have:

> "an eviscerating effect on the stockholder franchise [that] 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 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."

Having decided that the board had the power to approve such stockholder nominees, the court turned to whether the board's agreement to approve the two slates in this case complied with the company's implied duty of good faith and fair dealing inherent in the indenture, as in all contracts. While the Vice Chancellor concluded that, under the record before him, a decision on this question was not ripe for resolution, the opinion discusses the relevant standard for a board's decision to exercise its power to approve nominees and concluded that "the board may approve a stockholder's 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.[3] And the court further noted that "the directors are under absolutely no obligation to consider the interests of the noteholders in making this determination".

[3] Although not ruling on the validity of the Board's decision to approve the dissident nominees, the court did not appear very concerned by the negative statements about such nominees that the company made in its proxy contest fight letters. Since the Board was not actually electing the dissident nominees, but merely permitting the stockholders to exercise their franchise to so elect those nominees without triggering the put provision, one might ask whether the standard should not be whether the election of the dissident nominees would be materially adverse, but should instead be merely whether allowing stockholders to make an unfettered voting decision would not be materially adverse to the interests of the corporation and its stockholders, arguably an easily satisfied standard.

Finally, the opinion addressed the plaintiff's claims that the indenture's Continuing Director put provision was invalid because Amylin's board had breached its duty of care by approving the indenture with such provision, given that the company's senior executives and directors (including the Finance Committee members who approved the indenture) had been unaware of the existence of the provision. The indenture had been negotiated entirely by outside counsel who did not call the provision to the board's attention, including in response to a question as to whether there was anything "unusual or not customary" in the indenture terms. The court concluded that retaining highly-qualified counsel, seeking advice from management and investment bankers as to the debt terms and asking counsel to point out anything unusual was sufficient to place the board's conduct outside of gross negligence and thus that the directors did not violate their duty of care. The court noted that "no one suggests that the directors' duty of care required them to review, discuss and comprehend every word of the 98-page Indenture."

In a concluding paragraph of dicta, the court suggested important considerations for boards, and counsel, considering the potential inclusion of continuing director put provisions (or similar provisions) in debt (and perhaps other) agreements.

> "This case does highlight 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. In the context of the negotiation of a debt instrument, this is particularly troubling, for two reasons. First, as a matter of course, there are few events which have the potential to be more catastrophic for a corporation than the triggering of an event of default under one of its debt agreements. Second, the board, when negotiating with rights that belong first and foremost to the stockholders (i.e., the stockholder franchise), must be especially solicitous to its duties both to the corporation and to its stockholders. This is never more true than when negotiating with debtholders, whose interests at times may be directly adverse to those of the stockholders. Outside counsel advising a board in such circumstances should be especially mindful of the board's continuing duties to the stockholders to protect their interests. Specifically, terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment."

The opinion raises significant issues for issuers and their directors, as well as for lenders and underwriters. If this very common indenture formulation is understood to operate as Vice Chancellor Lamb has ruled, a well-counseled board should be safe in accepting it if it continues to be demanded by potential lenders and the debt markets; however, as so interpreted, there may be few, if any, circumstances under which a board would not be empowered (and some might argue, obligated to its stockholders) to approve the nomination of an insurgent slate so as to avoid triggering the put or default. For that reason, lenders may want to reconsider the value of such a provision as so formulated. On the other hand, if lenders seek alternative formulations that address the issue more specifically and limit the

board's approval power (for example, using a formulation that does not recognize board approval after a proxy contest is commenced or threatened), directors will face difficult issues and, if they accept such a provision (for example, after they are advised that prospective lenders or underwriters have refused to proceed without such a provision or advised that the debt will be materially more expensive), there will be questions as to enforceability and potential litigation against directors.

For further information on this subject, please contact any of your regular contacts at the firm or any of our partners and counsel listed under "Capital Markets," "Corporate Governance," "Leveraged Finance" or "Mergers, Acquisitions and Joint Ventures" in the "Our Practice" section of our website (http://www.clearygottlieb.com).

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