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Change of Control Defaults: Healthways Case May Put Lenders' Protections in Doubt

In Delaware, arms-length negotiations may no longer be sufficient to protect an unwitting lender from a derivative claim brought by a borrower's shareholder with respect to certain change of control defaults contained in credit agreements. Following a recent spate of lawsuits against lenders in Delaware involving change of control provisions in credit agreements, in negotiating these provisions, lenders should consider how the Delaware courts would perceive such provisions if challenged. If the facts surrounding the inclusion of these provisions are not closely examined, a lender could open itself up to a claim for aiding and abetting a breach of the board of directors' fiduciary duty, especially if the underlying credit agreement involves a publicly traded company, and the provision was inserted when a proxy contest has been threatened or has occurred.

The recent lawsuits center around the use of a so-called "dead hand proxy put" in which an event of default is triggered under a credit agreement if a certain number of the directors in place at the time the credit agreement is executed are replaced in a proxy contest, regardless of whether the existing board approved of the new slate of directors. These lawsuits have arisen in response to an October 14, 2014 bench ruling in the Delaware Court of Chancery, in which the Delaware court refused to dismiss a claim for aiding and abetting a breach of fiduciary duty by the borrower's board of directors against a state chartered bank (the *"Bank"*).[1] The Bank had served as the administrative agent under a credit facility with Healthways, Inc. (*"Healthways"*).

In *Healthways*, the plaintiff, the Pontiac General Employees Retirement System, brought an action against Healthways' directors and the Bank alleging that the directors had violated their fiduciary duties to Healthways by entering into the underlying credit agreement, and that the Bank had aided and abetted the alleged breach of fiduciary duty. Additionally, the plaintiff sought a judgment from the Delaware court that the "dead hand proxy put" was invalid and unenforceable under Delaware law. The defendants filed motions to dismiss, which were heard by the court in October 14, 2014, and ruled upon by the court that same day.

Healthways was party to an amended and restated revolving credit and term loan agreement with the Bank, as administrative agent (the *"Credit Agreement"*). The issues involved in the Delaware litigation arose from the fifth amendment to that Credit Agreement (the *"Fifth Amendment"*). Prior to the Fifth Amendment, the Credit Agreement included as part of the change of control provision that an event of default would occur if during any consecutive 24 month period, a majority of the members of Healthways' board ceased to be composed of so-called "continuing directors" – defined as directors who were in office at the time in which the amended credit agreement was entered, and subsequent directors who were nominated or elected with the board's approval. Thus, if the current board at the time approved a successor slate of directors, then the change in control provision would not be triggered. This type of "poison proxy put" provision falls within the market standard for such provisions contained in credit agreements.

In 2012, over the board's objection, Healthways' shareholders approved a non-binding proposal to declassify the board, which had been staggered. Eventually, the board agreed to declassify. Less than two weeks after its decision to declassify, the board entered into the Fifth Amendment with the Bank. As a part of the Fifth Amendment, the parties agreed to the so-called "dead hand proxy put," in which the change in control definition was amended to define "continuing directors" to exclude directors nominated and assuming office by way of an actual or threatened dissident proxy fight or consent removal process, even if those directors were eventually approved by the current directors.

In January 2014, following stockholder pressure and a proxy contest threat, the board agreed to appoint new directors who had been nominated by certain dissident shareholders. Pursuant to the Fifth Amendment, these new directors were "non-continuing directors" with respect to the "dead hand proxy put", however their appointment did not trigger an event of default because the new directors constituted less than a majority of the board. Had a sufficient number of new directors been nominated by dissident shareholders, and appointed within 24 months of

the appointment of these non-continuing directors, the "dead hand proxy put" would have been triggered, resulting in an event of default under the credit agreement.

Following the threat of a proxy fight with respect to Healthways, the plaintiff filed its action in Delaware state court. The individual director defendants argued, among other things, that the action should be dismissed because the dead hand proxy put had not yet been triggered and, thus, the action was not ripe for review by the court. The Delaware court, however, compared the dead hand proxy put to the "Sword of Damocles," and found that the serious threat of triggering the event of default caused by the change of control rendered plaintiff's complaint ripe for adjudication. In addition, the court found that an injury had been alleged in the plaintiff's complaint because the credit agreement required disparate treatment of Healthways' directors, in that some directors were treated as continuing directors and other directors were treated as non-continuing directors.

Additionally, and more troubling to lenders, the court refused to dismiss an aiding and abetting the breach of fiduciary duty claim against the Bank. In not dismissing the aiding and abetting claim, the court found that due to prior precedent from the court with respect to dead hand proxy puts, such provisions were "highly suspect" due to their "recognized entrenching effect," and the lender should have been on notice of these cases.[2] Additionally, the court found it suspect that the credit agreement was amended to include the dead hand proxy put shortly after the threatened proxy fight. This, in itself, according to the court was sufficient to show a "knowing participation" by the Bank, allowing the claim to survive a motion to dismiss.

While the Delaware court recognized that arms-length negotiations usually negate a claim for aiding and abetting a breach of fiduciary duty, it noted that such negotiations related only to economic terms. While a lender, under the Delaware court's analysis, could manipulate the interest rate or coverage ratio contained in a credit agreement for its benefit, the Delaware court found that offering entrenchment benefits, such as the "dead hand proxy put," negated such arms-length bargaining. The court reasoned that the directors of a public company have the same incentives as the stockholders of the company to respond to economic terms but that certain entrenchment provisions, such as the dead hand proxy put involved in the *Healthways* case, may place the incentives of the board in conflict with the incentives of the shareholders.

Although the *Healthways'* court's findings creates legal uncertainty around dead hand proxy puts, it is important to note the facts surrounding the inclusion of such proxy puts within the change of control definition in a credit agreement. As noted, in *Healthways*, the dead hand proxy put provision was added to the credit agreement in the Fifth Amendment within weeks of a proxy contest, which, on its face, creates suspicion that the provision was not included as a part of an arms-length negotiation, but rather was added by the lenders, and agreed to by the board, to protect the board in the face of shareholder pressure. Such facts, in our view, are distinguishable from those situations in which a credit agreement is negotiated at arms-length while no proxy contest has been threatened or occurred. In this situation, a "dead hand proxy put" may be a legitimate negotiating point for a lender, because it allows that lender to protect its legitimate interest in knowing how the borrower's board manages its business.

Although the Delaware court has not ultimately ruled on the legality of "dead hand proxy puts" in a credit agreement negotiated in good faith and as a part of an arms-length negotiation between the borrower and its lenders, the *Healthways* decision should alert lenders to closely examine the change of control provisions contained in their credit agreements. As can be seen by at least three actions filed in the Delaware courts within the first half of 2015 alleging similar aiding and abetting claims, some shareholders are paying close attention to the credit facilities of the companies in which they own shares, in order to determine whether suit can be brought against the borrower's board of directors and lenders. Despite these actions filed by the plaintiffs' bar, however, parties should consider the particular facts of their situation to determine the risk of pursuing a "dead hand proxy put" in a credit agreement.

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1 *Pontiac Gen. Employees Ret. Sys. V. Balantine*, C.A. No. 9789-VCL, 2014 WL 6388645 (Del. Ch. Oct. 14, 2014) (Court transcript).

2 *See, e.g., San Antonio Fire & Police Pension Fund v. Amylin Pharm. Inc.*, 983 A.2d 304 (Del. Ch. 2009); *aff'd* 981 A.2d 1173 (Del. 2009).

For More Information

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