

INSIGHTS

Delaware Court of Chancery Addresses Director's Duties In Connection With Change of Control Put Provisions

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In a recent decision issued by the Delaware Court of Chancery, Chancellor Strine enjoined an incumbent board from impeding a shareholder consent solicitation that sought to install a competing slate of directors. The Court held that the incumbent board likely breached its fiduciary duties by refusing to neutralize a change of control put provision in the company's credit agreements and by advising stockholders that the change of control put presented a substantial and unjustified risk to the company if the competing slate was elected. *Kallick v. SandRidgeEnergy, Inc., et al.*, C.A. No. 8182-CS (Del. Ch. Mar. 8, 2013). The decision underscores that Delaware courts will closely scrutinize any decision that potentially undermines stockholder's right to elect directors of their own choosing. The decision also provides meaningful guidance for Delaware corporate fiduciaries on change of control put provisions.

Case Summary

This litigation arose after a hedge fund, TPG-Axon (TPG), which held a 7% stake in SandRidge Energy (SandRidge), launched a consent solicitation to destagger SandRidge's board of directors (the Incumbent Board) by amending the company's bylaws so that it could remove the Incumbent Board and install its own slate of nominees (the TPG slate). Slip. Op. at 1. TPG claimed that SandRidge's performance had been subpar in comparison to other U.S. oil and gas companies, and, in spite of this subpar performance, the Incumbent Board had lavished \$150 million in compensation on the corporation's CEO. *Id.* By its consent solicitation, TPG sought to seat a new board that was committed to changing the company's management and exploring strategic alternatives, including a potential sale. *Id.* In response, the Incumbent Board campaigned to convince stockholders not to give consents to TPG and tried to obtain revocations from those who had given consents. *Id.* at 1-2. The Incumbent Board proffered several reasons why the stockholders should not elect the TPG slate, including that the TPG slate lacked "expertise in 'upstream' oil and gas exploration and ha[d] no specific experience with the company's principal asset, a 2.2 million acre oil and gas play in Kansas and Oklahoma" referred to as the "Mississippian Play." *Id.* at 2.

Most significantly, the Incumbent Board warned its stockholders twice in its SEC filings that the election of a new board not approved by the Incumbent Board would constitute a "Change of Control" for purposes of SandRidge's credit agreements, thus triggering the requirement in SandRidge's note indentures that it offer to repurchase \$4.3 billion of debt at 101% of par (the Proxy Put). *Id.* at 2-3, 11-12. The credit agreements provided that a change of control would trigger lenders' rights to redeem notes at 101% of par unless the Incumbent Board "approved" the new board majority. *Id.* The Incumbent Board warned that it may not have sufficient

liquidity to finance such notes and a mandatory refinancing would pose an "extreme, risky and unnecessary" financial burden on the company. *Id.* at 12. However, in an act that the Court deemed to be litigation gamesmanship, the Incumbent Board reversed course after the litigation had been filed, stating in an 8-K that there was no danger posed by the Proxy Put because SandRidge's debt was trading at prices above the repurchase price set by the indentures, and that SandRidge would be able to obtain the financing to repurchase any notes that were tendered. *Id.* at 4, 15.

Kallick (Plaintiff), a stockholder who supported the TPG consent solicitation, filed suit against SandRidge and the Incumbent Board (collectively, Defendants) to require the Incumbent Board to approve the TPG slate. *Id.* at 3, 16. Plaintiff later amended its request for relief to seek (1) to enjoin the Incumbent Board from soliciting consent revocations; (2) to have any consent revocations obtained declared invalid; and (3) to enjoin the Incumbent Board from taking any steps to hinder TPG's consent solicitation until they complied with their fiduciary duties and approved the TPG slate, or explained why they would not approve it. *Id.* at 16-17. The court held that the Incumbent Board likely breached its fiduciary duties by not approving the TPG slate and neutralizing the Proxy Put. *Id.* at 32, 36-37. The Court thus granted Plaintiff's request for a preliminary injunction, enjoining the Incumbent Board from: (1) soliciting any further consent revocations; (2) giving effect to any consent revocations received; and (iii) impeding TPG's consent solicitation process until the Incumbent Board approved the TPG slate for the limited purposes of the Proxy Put. *Id.* at 29, 36.

The Standard of Review

Defendants argued that the Incumbent Board's refusal to approve the TPG slate should be analyzed under the business judgment rule, a deferential standard that requires that a board decision be approved if it can be attributed to any rational business purpose. *Id.* at 25. Plaintiff, on the other hand, argued that the stringent standard established by the Delaware Supreme Court in *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661 (Del. Ch. 1988), should be applied. *Id.* at 26. Under *Blasius*, if a challenged action was "taken for the sole or primary purpose of thwarting a shareholder vote," the defendants have the burden of showing a "compelling justification" for their action. *Id.* (quoting *Blasius*, 564 A.2d at 661).

The Court rejected the application of both standards. *Id.* at 27. The Court instead held that *Unocal's* "flexible, intermediate standard of review" was the appropriate standard of review "to address situations where boards of directors make decisions that have clear implications for their continued control ..." *Id.* at 27-28 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954-55 (Del. 1985)). Under *Unocal's* "heightened reasonableness" standard, directors must identify "a circumstantially proper and non-pretextual basis for their actions, particularly when their actions have the effect of tilting the electoral playing field against an opposition slate." *Id.* at 28. The Court noted that "*Blasius's* importance rests more in its emphatic and enduring critical role in underscoring the serious scrutiny that Delaware law gives to director action that threatens to undermine the integrity of the electoral process, than in its articulation of a useful standard of review to decide actual cases." *Id.* at 26.

The Court's Reasoning

Applying the *Unocal* test, the court found that the Incumbent Board failed to demonstrate a reasonable justification for refusing to "approve" the TPG slate to neutralize the Proxy Put. *Id.* at 29. Emphasizing Delaware's "public policy of stringent policing of the fairness of corporate elections," the court cited *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals*, 938

A.2d 304 (Del. Ch. 2009), for the proposition that "a board deciding whether to approve directors for the purposes of a Proxy Put could not act consistently with its fiduciary duties by simply failing to approve any director candidates who ran against the incumbent slate." *Id.* at 5. Rather, the board

must respect its primary duty of loyalty to the corporation and its stockholders and may refuse to grant approval only if it determines that the director candidates running against them posed such a material threat of harm to the corporation that it would constitute a 'breach of the directors' duty of loyalty to the corporation and its stockholders' to 'pass[] control' to them.

Id. at 5 (citing *Amylin*, 983 A.2d at 316 n.37). Thus, "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 ..." *Id.* at 30 (emphasis in original).

The Court noted that the only circumstances where an incumbent board may interfere with stockholders' right to vote on an alternative slate of directors is where, for example, an incumbent board determines "that the rival candidates lacked ethical integrity, fell within the category of known looters, or made a specific determination that the rival candidates proposed a program that would have demonstrably material adverse effects for the corporation's ability to meet its legal obligations to its creditors ..." *Id.* at 5. Here, the Incumbent Board merely viewed the TPG slate as less qualified. *Id.* at 6. That was an insufficient basis for the Incumbent Board to refuse to "approve" the TPG slate for the purpose of neutralizing the Proxy Put. *Id.* If an incumbent board cannot identify "a specific and substantial risk" posed by the rival slate, and approval of that slate would not violate "the contractual duty of good faith owed to noteholders with the rights to the Proxy Put," the incumbent board must approve the slate "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." *Id.* at 30-31.

The Court emphasized that, as the Plaintiff argued, the Incumbent Board could have neutralized the effect of the Proxy Put simply by approving - but not endorsing - the TPG slate. *Id.* at 31. Indeed, the Court noted that the Incumbent Board could have approved the TPG slate for purposes of the Proxy Put while maintaining its own election campaign, which preserves the stockholders' right to choose directors. *Id.* In light of its inability to articulate a legitimate threat posed by the TPG slate, the Court concluded that the Incumbent Board's failure to approve the TPG slate for the purpose of neutralizing the Proxy Put likely constituted a breach of its fiduciary duty. *Id.* 29-32.

Takeaways

This decision underscores that Delaware courts will closely scrutinize any decision by a board of directors that potentially denies stockholders the right to vote on an alternative slate of directors. Directors thus would be wise to engage in a detailed and well-documented deliberative process whenever faced with such a decision. Absent a legitimate threat to the corporation, a decision that divests stockholders' voting rights likely will be deemed a breach of fiduciary duty. The decision that "we are better than the new guys and gals, so keep us in office ... does not come close to a reasoned conclusion that the electoral rivals lack the integrity, character, and basic competence to serve in office." *Id.* at 20.

This decision provides ample guidance to Delaware corporate fiduciaries regarding proxy put provisions. Faced with a proxy put provision with a change-of-control trigger, an incumbent

board generally is well-advised to take steps to try to neutralize the proxy put unless it can identify a specific and substantial risk presented by the competing slate. Under Delaware law, a director's interest in job security does not trump the stockholder's right to choose directors. In dicta, Chancellor Strine suggested that the inclusion of proxy put provisions in a company's indentures may not be appropriate in the first place. Chancellor Strine acknowledged the defensive value of mechanisms such as proxy puts but stressed that these provisions are "dangerous because ... doubt can arise whether the change of control provision was in fact sought by the third party creditors or willingly inserted by the incumbent management as a latent takeover and proxy contest defense." *Id.* at 28. "Given the obvious entrenching purposes of a Proxy Put provision, one would hope that any public company would bargain hard to exclude that toll on the stockholder franchise and only accede to the Proxy Put after hard negotiation and only for clear economic advantage." *Id.* at 8. In this case, the Court highlighted testimony by a director that suggested that he was not aware of the existence of the Proxy Put in the company's indentures until TPG commenced its consent solicitation. The Court also emphasized that the Incumbent Board and its financial advisors were unable to provide reliable market evidence that lenders place a tangible value on a proxy put trigger. *Id.* at 23. Directors should be sure to be fully informed of all material contract provisions. In particular, directors should pay very close attention to any provision that affects the stockholder franchise. With respect to proxy put provisions, the Court's analysis suggests that the decision to approve indentures containing such provisions may be ripe for challenge. Thus, directors should be careful to engage in a reasoned process to determine whether such provisions provide any value to the company. The approval of a proxy put provision solely to prevent a change of control may not withstand scrutiny.¹

¹ Since the decision, the parties reached a settlement whereby the SandRidge board of directors (the Board) was expanded to include four of TPG's nominees. In addition, the Board will complete a review by an independent firm of related-party transactions and decide by June 30, 2013, whether or not to terminate current CEO Tom Ward. If the Board does not terminate Mr. Ward, three current directors will resign, and one additional TPG nominee will be elected, resulting in a majority of the board being TPG nominees. In exchange, TPG agreed to terminate its consent solicitation and withdraw its notice of its intent to present certain proposals and nominate certain individuals for election as directors at SandRidge's 2013 annual meeting.