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'Poison Puts' Under Fire After Strine's SandRidge Ruling

By **Liz Hoffman**

Law360, New York (March 18, 2013, 6:50 PM ET) -- A recent Delaware Chancery Court ruling that boards can't use the threat of change-of-control provisions in their debt documents to thwart a proxy contest may raise another question, lawyers say: Should those provisions be there in the first place?

Chancellor Leo Strine ruled March 8 that SandRidge Energy Inc. couldn't refuse to approve a hedge fund's board nominees simply because its directors thought they were better suited to keep running the company. In doing so, he ripped SandRidge's claims that replacing its board — as TPG-Axon Capital Management LP was seeking to do — would force the company to repurchase $4.3 billion in outstanding bonds.

Lawyers say the ruling, which echoes a 2009 decision in the same court, should encourage companies to think carefully about what provisions go into their debt documents, long before they run into a proxy fight that could trigger them.

“Here you have a company five years after it signed these credit agreements, and the court is not only calling a provision in those agreements into question, but putting the onus on the board to drop it,” said Keith Gottfried of Alston & Bird LLP. “I think you'll see people considering that risk up front.”

At issue are so-called continuing-director provisions, which can force a company to refinance debt if dissidents seize majority control of its board. These clauses are ostensibly meant to protect banks and bondholders but are often called “proxy puts” or “poison puts” for their ability to shield boards in proxy fights, and they have come under fire from judges suspicious of defensive boardroom maneuvering.

In a 2009 case involving Carl Icahn and Amylin Pharmaceuticals Inc., Vice Chancellor Stephen Lamb hinted that these provisions may “impinge on the free exercise of stockholder franchise.” Chancellor Strine echoed that point in his SandRidge decision, ordering the board to approve the directors solely for the limited purpose of the proxy put. In other words, if TPG-Axon's nominees were elected, the company would not have to repurchase the notes.

“SandRidge is an exclamation point on Amylin,” said Steven Levine of Brown Rudnick LLP. “These two decisions put the board in a position where it is going to face a lot of pressure to allow for more free and open voting … [regardless of] what provisions are in its debt agreements.”

Another reading of Chancellor Strine’s ruling is that proxy puts themselves aren't the issue — especially since they can easily be diffused by granting limited approval — but rather whether boards are informed

about them. A deposition in the SandRidge case suggests its directors didn't know about the change-of-control clause until TPG-Axon launched its proxy contest, a fact Chancellor Strine said was “not comforting.”

While directors are involved in broad borrowing strategy, they aren't often consulted on the minutia of credit agreements. That could change in the wake of the SandRidge decision, said Covington & Burling LLP partner Peter Schwartz.

“I think companies will be dressing up board resolutions and highlighting any provisions that could impact a shareholder vote down the road,” he said. “I would be surprised if this doesn't affect practice in the boardroom.”

Read more broadly, the SandRidge decision may apply to more than debt agreements, lawyers said. Gottfried said the ruling opens the door for the Delaware court to scrutinize provisions in any contract that could be taken as a defensive measure. Those include employment contracts with top executives, sales contracts with big customers and licensing agreements for key technologies — anything that, if it were unavailable to a new, dissident board, would ding the company's value.

“There is an avenue now for the court to challenge change-of-control provisions in all kinds of contracts,” Gottfried said. “I think companies will be trying to minimize provisions that are triggered by a change of control” not approved by the incumbent board.

They can try, but they will likely face stiff resistance from creditors, attorneys said.

Banks and bondholders like the certainty of knowing they can cash out if a company is sold. And if they plan to sell the debt on to other investors, standard protections make for a smoother syndication process, said Chris Leon of Womble Carlyle Sandridge & Rice PLLC.

“Banks aren't going to stop asking for change-of-control protections,” Leon said. “They want to know who they're lending to.”

Bondholders may be wary, too. In general, change comes more slowly to bond indentures, which tend to be driven by market standards, Levine said. And debt investors have been stung by weak protections before, like when Icahn staged a coup for Dynegy Inc. in 2011 that sought to wipe out the bondholders and wrest control of the company.

Levine said that since Amylin, he has pushed his corporate clients to push for a deletion of the proxy-put provision. And except for the odd convertible notes issuance, lenders have pushed back hard.

The point may be moot in today’s bull credit market, when many corporate bonds are trading at premium to their face value and investment-grade borrowers have access to cheap, available money. SandRidge itself admitted that most noteholders would probably pass on a tender offer and that, as a fallback, it had a bank willing to step in and refinance the debt.

But open credit markets can close quickly, and companies should be prepared to defend their use of certain covenants going forward, Schwartz said.

“For finance lawyers, [SandRidge] is a decision where, if they weren't paying attention after Amylin, they certainly will be now,” he said.

The case is Gerald Kallick v. SandRidge Energy Inc. et al., case No. 8182, in the Court of Chancery of the State of Delaware.

--Editing by Elizabeth Bowen and Chris Yates.
