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## Corporate Update

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### DIRECTORS' AND OFFICERS' LIABILITY

## Recent Decisions Provide Guidance On Debt Agreements

The combination of debt trading at a deep discount to par value and an increased role of hedge funds in the corporate bond market has spurred a wave of aggressive efforts by activist bondholders and their asset managers to declare a default under protective covenants and accelerate the entire debt, making principal and any accrued interest immediately due and payable, sometimes at a premium. The consequences of breaching a covenant that permits acceleration can be catastrophic if the company lacks the liquidity or financial resources to repurchase the debt. A "Change of Control" covenant is one such provision routinely included in a variety of debt agreements and other contracts, particularly indentures governing the issuance of corporate bonds and many credit agreements. A standard circumstance that triggers a Change of Control under indentures and other lending agreements is a breach of the "Continuing Director" provision, which generally occurs upon a change in the majority composition of the board, unless the incumbent board approves the change. That is, new board members usually can be Continuing Directors as long as a majority of the then-serving Continuing Directors approves the nomination or election of the new members.

Recent Delaware case law confirms that courts will interpret Continuing Director provisions in a commercially reasonable manner which will not recognize a breach unless a change in majority board composition contravenes the language and clear purpose of the provision. Last month, in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals Inc.*,<sup>1</sup> the Delaware Court of Chancery interpreted a Continuing Director provision in an indenture to permit the issuer's incumbent board of Directors to "approve" the nomination or election of dissident nominees as directors for purposes of making them Continuing Directors even though the incumbent directors did not support the dissident nominees' election to the board. Under this interpretation, a board may approve a slate of nominees for purposes of

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an indenture (thus sanctioning their nomination for election) without endorsing them, and may simultaneously recommend and endorse its own slate. *Amylin*, which is on appeal to the Delaware Supreme Court, also italicizes that director fiduciary duties extend to all aspects of corporate governance, including the negotiation and approval of material debt agreements. If challenged as an impediment to the stockholder franchise, the validity of such Change of Control provisions in indentures and other corporate debt agreements will turn on whether the decision to enter into the agreement reflected informed business judgment, including receiving advice from qualified outside counsel, and evaluation of the potential of a Continuing Director provision to entrench incumbent management or otherwise interfere with proxy contests. Insistence that a Continuing Director provision be read in a commercially reasonable manner was similarly underlain in *Law Debenture Trust Co. of New York v. Petrohawk Energy Corp.*,<sup>2</sup> in which the Court of Chancery held that a Continuing Director provision's requirement of a "nomination or election" to the board with the approval of a majority of the incumbent directors focuses not on the manner in which new directors were seated, but on whether a transaction causing a change in majority board composition was approved by the incumbent directors. This column also briefly summarizes the fast-growing case law holding that neither the Trust Indenture Act ("TIA") nor an indenture reporting covenant imposes an independent obligation on bond issuers to make timely filings of SEC reports, rejecting a New York Supreme Court decision to the contrary.

### Continuing Director Provisions

"Know your borrower" is a cardinal rule in commercial lending; lenders make lending decisions based in large part on the credibility

and business plans of a corporate borrower's management. Indentures sensibly recognize, however, that the composition of the board will not be frozen in time. "Continuing Directors" thus are typically defined as any director who was a member of the board when the notes were issued, and any board member who was nominated for election or elected to the board with the approval of a majority of the Continuing Directors who were board members at the time of such nomination or election. In this manner, noteholders have a limited contractual protection against hostile acquisitions (and other events causing a change in majority board composition) of an issuer to which they extended credit, but not against an acquisition or other management change where the new board has been approved by the then-serving Continuing Directors. The remedy provisions of most indentures provide that a breach of even a non-financial covenant such as the Continuing Director or Reporting Covenant (discussed below) constitutes a default, which if uncured during a specified period (usually 30-60 days) ripens into an Event of Default. In the event of a change in the board's majority composition not so approved, standard form indentures and many credit agreements grant a requisite majority of lenders the right to declare an Event of Default and accelerate the entire debt. Ordinarily only the trustee or holders of 25 percent in aggregate principal amount of the debt can accelerate the principal and any outstanding interest, and acceleration usually can be rescinded only by 50 percent of the holders. Confronted with a requisite majority of holders threatening to trigger domino accelerations across the issuer's other lending agreements, the issuer's management must brace for Enhanced Negotiating Techniques as holders make steep demands for a waiver of the default or rescission of the acceleration.

### 'Amylin'

*Amylin* and The Bank of New York Trust Company, N.A. as trustee, executed a New York-law governed indenture, pursuant to which *Amylin* issued approximately \$575 million in 3 percent convertible senior notes. The indenture contained a standard Change of Control provision, triggered "at any time the 'Continuing Directors' do not constitute a majority of the Company's board of Directors,"

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with Continuing Directors defined as those “whose nomination for election by the stockholders of the Company was approved by at least a majority of the directors then still in office (or a duly constituted committee thereof) either who were directors on the Issue Date or whose election or nomination for election was previously so approved.” Two Amylin shareholders announced that each would nominate separate slates of five individuals (the “dissident nominees”) for election to Amylin’s board of directors at Amylin’s 2009 annual meeting. Since Amylin’s board consisted of 12 directors, if six or more of the dissident nominees were elected at Amylin’s annual meeting, a Change of Control under the indenture could be triggered, giving noteholders the right to accelerate the company’s obligation to repurchase the notes at face value. One of the dissident stockholders therefore asked the board to “approve” the nomination of the dissident nominees in order to avoid a potential trigger of the Continuing Directors component of the Change of Control provision. Amylin solicited the indenture trustee’s agreement that under the terms of the indenture the board had the ability to “approve” the dissident nominees even though it did not support their election to the board, but the trustee refused.

A different stockholder sued Amylin (and in an amended complaint added the trustee), seeking a declaration that the board had (i) the power to “approve” the nomination of the dissident nominees even though it did not recommend their election, and (ii) a fiduciary obligation to exercise that approval power. Amylin filed a cross-claim against the trustee, seeking a declaration that the board had the right under the indenture to approve the election of any or all of the dissident nominees at any time up to their election. Amylin entered into a partial settlement with the stockholder under which Amylin agreed to approve the dissident nominees provided it obtained a final court order confirming that the board possessed the right under the indenture to do so.

Following a trial in which the principal issue was whether the Amylin board had both the power and the right under the indenture to approve the dissident nominees, Vice Chancellor Stephen Lamb answered the first question holding that the board had the power to approve the dissident nominees for election even though the board actively opposed their election. The court applied basic rules of contract interpretation requiring enforcement of unambiguous language according to its plain meaning. Rejecting the trustee’s argument that, for purposes of the Continuing Directors provision of the indenture, the word “approve” is synonymous with “endorse” or “recommend,” the court said that such an interpretation would mean that any election of stockholder nominees resulting from a contested election would preclude board approval of the dissident slate for purposes of the indenture and trigger a Change of Control. The trustee’s reading was unreasonable, the court stated, because its approval would render the Continuing Directors provision “a possible entrenchment mechanism.” An indenture provision “with such an eviscerating

effect on the stockholder franchise would raise grave concerns.” First, the court stated, binding the company to such a provision would implicate the board’s fiduciary duties, and “[t]he 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.” A provision so strongly in derogation of the stockholders’ franchise rights, the court added, might even be unenforceable as against public policy.

Having concluded that the board, “in the abstract,” can approve dissident nominees and still oppose those nominees in a proxy contest, the court determined it was premature to determine whether the Amylin board had properly exercised the right to do so, and dismissed that part of the case without prejudice. The court framed the question as whether under the circumstances the board’s approval of the dissident nominees comported with the board’s fiduciary duties. A board may approve dissident nominees, the court determined, if it determines in good faith that the election of one or more of those nominees would not constitute a breach of the directors’ duty of loyalty to the corporation and its stockholders. The court emphasized that in making this determination the directors have “absolutely no obligation to

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consider the interests of the noteholders.” The court declined to decide whether the right to approve had been properly exercised because the record concerning the board’s deliberation was not sufficiently developed, but did express some concern that negative public statements by the board about the dissident nominees conceivably suggested that the directors had concluded that electing the dissidents would harm the company. However, the court declined to reach that

conclusion and chalked those comments up to “[e]lection puffery.” It also noted that the timing of the decision to approve the dissident nominees raised at least a question of “whether the board’s decision to approve was made in a good faith exercise of its considered business judgment, or instead taken simply to avoid” litigation.

The court gave short shrift to the contention that Amylin’s issuance of notes pursuant to an indenture with a Continuing Directors put provision constituted a breach of the board’s duty of care. The board had qualified counsel, solicited views from management and investment bankers as to the terms of the agreement, and even asked its counsel if there was anything “unusual or not customary” in the terms of the Notes, and was told there was not. Applying the gross negligence standard applicable to care-based fiduciary claims, the court ruled that Amylin’s board (or its delegate, the Pricing Committee) was not grossly negligent in failing to learn of the existence of the Continuing Directors provision.

In dicta that warrants close attention by advisers to boards that may consider agreeing to debt agreements containing Continuing Director put provisions, Vice Chancellor Lamb expressed concern “that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise.” First, “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,” the court emphasized, “than when negotiating with debtholders, whose interests at times may be directly adverse to those of the stockholders.” He admonished outside counsel advising a board in such circumstances to “be especially mindful of the board’s continuing duties to the stockholders to protect their interests.” In order to enable the board to exercise its fully informed business judgment, counsel should highlight for the board “terms which may affect the stockholders’ range of discretion in exercising the franchise,” even if the terms are customary.

Noteholder rights are created and limited by the indenture governing the debt, and unambiguous language in indentures must be enforced in a strict, commercially reasonable manner. So held the Court of Chancery in *Petrohawk*, in which the court further clarified that issuers of corporate debt permissibly may structure transactions to purposely avoid triggering mandatory debt redemption provisions. KCS Energy merged with Petrohawk, which assumed KCS’s obligations under a bond indenture. Before the merger, KCS had a seven-member board and Petrohawk had a nine-member board, with no overlap. The merger agreement provided that after the merger, Petrohawk would continue to have a nine-member board: five members of the post-merger board designated by Petrohawk, and

four designated by KCS. Pre-merger, the boards of both companies sought to ensure the merger did not trigger a Change of Control. To be considered a Continuing Director under the indenture, a director need only have been nominated for election or elected "with the approval" of the incumbent KCS directors. Thus in order to avoid triggering a Change of Control at least five of the post-merger directors needed to be Continuing Directors within the meaning of the indenture. Since only four of the former KCS board members would continue as directors of the post-merger entity, at a pre-merger KCS board meeting the KCS board unanimously adopted a resolution "confirm[ing] and approv[ing] the nomination and election of each of the [post-merger directors] as the members of the board of Directors of the surviving corporation." The pre-merger Petrohawk board adopted an identical resolution. After these resolutions were adopted and after the stockholders of both corporations approved the merger agreement, a certificate of merger was filed that simply identified the nine post-merger Directors as the Petrohawk board.

Shortly after the merger, a group of noteholders appointed a new indenture trustee, which sued Petrohawk in the Delaware Court of Chancery. The indenture trustee alleged that the merger triggered a Change of Control provision under the indenture for several reasons, including breach of the Continuing Director provision because the seating of post-merger directors did not involve a "nomination or election" in the strict corporate law sense, and demanded that Petrohawk immediately offer to redeem the notes at a premium, more than five years ahead of maturity.

Petrohawk moved to dismiss, arguing that as a matter of law, the board was seated in a manner that did not trigger a Change of Control under the Continuing Director provision of the indenture. In a lengthy opinion affirmed by the Delaware Supreme Court, Vice Chancellor Leo E. Strine, Jr. converted the motion to a summary judgment motion, and granted Petrohawk judgment on all claims, holding that bondholders' rights are limited to the protections bargained for in an indenture, and that asserted technicalities which do not violate the plain language of an indenture do not trigger a default. The court acknowledged that Petrohawk and KCS structured the merger to avoid triggering the change-of-control provision, but held that issuers of corporate debt are free to structure corporate transactions in a manner that purposely seeks to avoid triggering restrictive covenants.

The court commenced its analysis by noting that "standardized agreements" such as indentures must be interpreted by examining the language of the agreement itself because common provisions are "not the consequences of the relationship of particular borrowers and lenders and do not depend upon particularized intentions of the parties to an indenture." The noteholders focused on the "entirely technical" claim that the directors of the post-merger board were not elected in the formal sense under Delaware

corporate law. Whether the board was seated in strict compliance with Delaware corporate law was irrelevant, the court held, because "it is obvious that the provision does not use the term 'election' in any formal sense tied to" Delaware corporate law. "Otherwise," the court observed, "the term would exclude from the status of Continuing Directors persons appointed by the KCS board incumbents to fill vacancies, an unreasonable result serving no legitimate purpose for the Noteholders." The critical requirement of the Continuing Director Provision was that the incumbent board approve any new directors before they take office, by whatever means of selection. Because merger-related documents demonstrated that the pre-merger KCS board unanimously approved the composition of the post-merger board, the court held that there was "no substantive or equitable basis" for the noteholders' claim.

### Reporting Covenants

Two years ago, boards of companies with corporate debt were surprised and unsettled by a New York State Supreme Court decision, *Bank of New York v. BearingPoint Inc.*,<sup>3</sup> holding that an issuer's failure to file Exchange Act reports timely with the Securities and Exchange Commission (SEC) breached §314(a) of the TIA and a standard indenture provision known as the "reporting covenant," requiring the issuer to deliver copies of such reports to the indenture trustee within a specified time after they are filed with the SEC. A variety of circumstances can result in a delayed filing—such as a restatement, a significant ongoing internal investigation, and compliance with Sarbanes-Oxley-required management reports on internal control over financial reporting. *BearingPoint* held that the reporting covenant "unambiguously obligates BearingPoint to make the required SEC filings and to provide copies of them to the trustee," and BearingPoint's "tortured parsing" of the provision vitiated the clear purpose of the indenture to provide information to investors so they could protect their investments.

In several instances of delayed filings, aggressive institutional investors organized, retained counsel and citing *BearingPoint*, threatened or actually purported to declare the company in default of the reporting covenant under the indenture, and threatened acceleration of the principal and interest owed. Concern among issuers of corporate debt that BearingPoint would become a pathbreaking decision have subsided recently, as a growing body of thoroughly reasoned federal case law has rejected the decision. In April, the Fifth Circuit joined the Eighth Circuit and several district courts to hold that a failure to file reports timely with the SEC violates neither §314(a) of the TIA nor indenture covenants patterned after that provision. In *Affiliated Computer Services Inc. v. Wilmington Trust Co.*,<sup>4</sup> the Fifth Circuit held that the plain language of a standard indenture Reporting Covenant and §314 of the TIA required only that the companies deliver to

the indenture trustee reports that were actually filed with the SEC, and imposed no obligation that such filings be timely made with the SEC pursuant to SEC rules.

### Conclusion

Bondholder rights generally are contractual-only: they derive exclusively from and are limited by the indenture. Directors must nevertheless be mindful that corporate debt agreements can implicate their fiduciary duties to stockholders and the company, and must act on an informed basis and review material information reasonably available to them (including advice of experienced counsel) before agreeing to a provision in an indenture or credit agreement that could be construed as affecting the shareholder franchise. After receiving advice of counsel, a board considering a debt agreement should weigh the economic benefit to the corporation of entering into the proposed agreement against the potential consequences if a Change of Control provision with a put right is triggered. Amylin's approach to the Continuing Director provision should insulate an informed board acting in good faith and in an informed manner from liability for (1) adopting indentures and credit agreements containing such a provision that could trigger a put right, and (2) exercising the board's right to approve dissident nominees within the meaning of a debt agreement even though the board opposes their election.

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1. 2009 WL 1337150 (Del. Ch. 2009).

2. 2007 WL 2248150 (Del. Ch. 2007), aff'd, 947 A.2d 1121 (2008).

3. 13 Misc.3d 1209(A), 824 N.Y.S.2d 752 (Sup. Ct. N.Y. Co. 2006).

4. 2009 WL 1011695 (5th Cir. 2009).

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