

October 27, 2014

Pontiac General Employees Retirement System v. Healthways, Inc.

Delaware Chancery Court Declines to Dismiss Fiduciary Duty Claims Against Directors and Aiding and Abetting Claims Against Lender in Connection with Dead Hand Change of Control Provision in Credit Agreement

SUMMARY

In a bench ruling¹ issued on October 14, 2014, the Delaware Court of Chancery (VC Laster) declined to dismiss fiduciary duty claims against the directors of Healthways, Inc. (“Healthways”) and an aiding and abetting claim against SunTrust Bank (“SunTrust”), the lender administrative agent, for entering into a credit facility of Healthways that has a dead hand “proxy put” provision. The provision at issue allows the lenders to declare an event of default and accelerate the debt in the event that a majority of the Healthways board during a period of 24 months is comprised of “non-continuing” directors, including directors initially nominated as a result of an actual or threatened proxy contest. Rejecting the director defendant claims that the fiduciary duty claims were not ripe, the Court stated that Healthways’ stockholders may presently be “suffering a distinct injury” from the deterrent effect of the “proxy put” and the fact that the dissident directors are non-continuing directors under the “proxy put.” In addition, in a further significant development, the Court stated that its prior holdings on the “entrenching” nature of “proxy puts” placed SunTrust on notice that a borrower’s board runs the risk of breaching their fiduciary duties if they accept dead hand “proxy puts” in the borrower’s debt documentation without negotiating significant value in return. Because the dead hand “proxy put” was included in Healthways’ credit agreement shortly after the threat of a proxy contest had occurred, the Court found that there was sufficient “knowing participation” pled to survive a motion to dismiss the aiding and abetting claim against SunTrust.

SULLIVAN & CROMWELL LLP

The Court took pains to point out that the bench ruling was merely a finding at the pleading stage and that after discovery it could well be that the facts pled did not sustain a finding of a breach of fiduciary duty or aiding and abetting liability. However, the motion to dismiss ruling follows a line of Delaware opinions questioning the use of “proxy put” provisions in debt documents and suggests that directors and lenders may face liability for including such provisions in credit agreements, absent compelling reasons, given the inherent conflicts of interest that exist in negotiating these provisions between borrowers who may be seeking to continue in office and their lenders.

BACKGROUND

In 2010, Healthways entered into an amended and restated revolving credit and term loan agreement that contained a “proxy put” that would be triggered if, during any period of 24 consecutive months, a majority of the members of the board ceased to be composed of continuing directors, defined as directors then in office and those nominated or elected with the board’s approval. The “proxy put,” however, did not have a dead hand feature that would cause the change of control default to be triggered by the election of a dissident slate the current directors eventually approved.

Subsequently, Healthways came under pressure from stockholders, and, in 2012, the stockholders approved a precatory proposal to declassify Healthways’ board. In response, in 2013, Healthways amended its articles of incorporation to phase out the staggered board.

Less than two weeks after the 2012 stockholder vote on declassification, Healthways amended its credit agreement. The amendment added the dead hand feature to the change of control definition by defining continuing directors to exclude directors who are nominated or assume office as a result of an actual or threatened dissident proxy fight or consent removal process even if the continuing directors eventually approve their appointment. In December 2013, North Tide Capital, a company that owned 11% of Healthways’ stock, sent a series of public letters to the Healthways board expressing its concerns about the board’s leadership and the company’s performance. In January 2014, North Tide Capital indicated to the Healthways board that it intended to wage a proxy fight. After negotiation, North Tide gained representation on the Healthways board. The North Tide directors are not considered continuing directors for purposes of the dead hand “proxy put”.

The plaintiff stockholders of Healthways filed suit against Healthways’ directors and SunTrust, alleging that the director defendants had breached their fiduciary duties by entering into a credit agreement with a dead hand “proxy put” provision and that SunTrust aided and abetted the breaches. The plaintiffs also sought a declaratory judgment that the “proxy put” was invalid and unenforceable under Delaware law. The defendants filed motions to dismiss.

THE COURT'S RULING

A. FIDUCIARY DUTY CLAIMS

In denying the motion to dismiss the breach of fiduciary duty claims, the Court rejected the defendant directors' claim that the dispute was not ripe because the "proxy put" had not yet been triggered. Likening the dead hand "proxy put" to rights plans (including those with dead hand provisions)² and defensive provisions in merger agreements that the Court has ruled on, the Court stated the existence of the put "necessarily has an effect on people's decision-making" about running a proxy contest or negotiating for board representation. This "Sword of Damocles," the Court said, makes ripe for decision the adoption of the dead hand "proxy put" in the face of stockholder insurgency. Moreover, the Court stated, the fact that the North Tide directors are treated as non-continuing and therefore as different for the dead hand "proxy put" necessarily presents a current injury, and thus a ripe issue. Noting that the denial of the motion to dismiss does not mean that adoption of a "proxy put" is a per se breach of fiduciary duty, the Court stated that the facts will need to be developed, "namely, what the board did or didn't do or knew or didn't know and what the back and forth was, if there was any, with SunTrust."³

B. AIDING AND ABETTING CLAIMS

The Court also denied SunTrust's motion to dismiss on the aiding and abetting claim, noting that there was "ample precedent" from the Court putting lenders on notice that dead hand "proxy puts" were "highly suspect" because of their "recognized entrenching effect" and could lead to a fiduciary duty breach by borrowers.⁴ That fact, when combined with the fact that the credit agreement only included a dead hand "proxy put" after there were threats of a proxy contest by certain stockholders, the Court stated, was sufficient at the pleading stage to show "knowing participation" by SunTrust and therefore sufficient to survive a motion to dismiss.

In particular, the Court pointed to *Kallick v. SandRidge Energy, Inc.*⁵ and *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*,⁶ as evidence that everyone was on notice that "these provisions were something you ought to really think twice about."⁷ In *SandRidge*, the Court made clear in a preliminary injunction context that absent a specific and substantial risk posed by an insurgent slate, a board that fails to approve the insurgent slate to avoid triggering the change of control put would likely breach its duties of loyalty. Likewise, in *Amylin*, the Court noted that change of control put provisions (that did not include a dead hand feature) in an indenture could raise grave concerns about whether they eviscerated the stockholder franchise and that in adopting such a provision a board would have to believe in good faith that in return it was receiving extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it.⁸ Recognizing that evidence of arm's-length negotiation generally negates claims for aiding and abetting liability, the Court stated that negotiating for the best deal one can get, however, does not accord a party the privilege afforded to arm's-length negotiators if they "propose terms, insist on terms, demand terms, contemplate terms, incorporate terms that take

SULLIVAN & CROMWELL LLP

advantage of a conflict of interest that the fiduciary counterparts on the other side of the negotiating table face.”⁹ Comparing the case to a third-party deal acquisition, the Court noted that an acquirer cannot offer side benefits, entrenchment benefits, or other concepts that create a conflict of interest for the fiduciaries with whom it is negotiating without putting itself at risk.¹⁰

Finally, the Court noted that the rulings of the Court should be viewed through the pleading stage lens and that it may well be that SunTrust did not aid or abet anything and that discovery was needed to understand whether the dead hand “proxy put” was responsive to stockholder pressure or some other “driver.”¹¹

IMPLICATIONS

The *Healthways* decision suggests that Delaware will closely scrutinize change of control put provisions in loans, bonds, and other debt instruments and that issuers and lenders should note the Court’s ruling in *Healthways* when negotiating their credit facilities even though the ruling was in the context of a motion to dismiss.

* * *

ENDNOTES

- 1 *Pontiac General Employees Retirement System v. Healthways, Inc.*, C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014) (transcript ruling) (hereinafter, “Tr.”).
- 2 The Court stated that it was “unable to distinguish” the facts in the present case from *Carmody v. Toll Brothers*, 723 A.2d 1180 (Del. Ch. 1998), in which the Chancery Court rejected the defendants’ ripeness arguments against a plaintiff’s challenge to the validity of a dead hand poison pill.
- 3 Tr. at 76-77.
- 4 *Id.* at 80.
- 5 68 A.3d 242 (Del. Ch. 2013). For a full discussion of the *SandRidge* decision, see our publication, dated March 14, 2013, entitled “[Kallick v. SandRidge Energy, Inc.](#)”
- 6 983 A.2d 304 (Del. Ch. 2009). For a full discussion of the *Amylin* decision, see our publication, dated June 12, 2009, entitled “[San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.](#)”
- 7 Tr. at 80.
- 8 Prior to trial, the plaintiffs in *Amylin* dropped their duty of loyalty and disclosure claims under a settlement, and therefore the only issues before the Court were the questions of whether the board had the power under the indenture to approve the dissident slate where it had recommended that stockholders vote against their election, whether the board breached its duty of care by entering into the indenture, and whether the continuing directors provision in the indenture was invalid under Delaware statutory law.
- 9 Tr. at 79.
- 10 *Id.*
- 11 *Id.* at 81.

SULLIVAN & CROMWELL LLP

ABOUT SULLIVAN & CROMWELL LLP

Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

CONTACTING SULLIVAN & CROMWELL LLP

This publication is provided by Sullivan & Cromwell LLP as a service to clients and colleagues. The information contained in this publication should not be construed as legal advice. Questions regarding the matters discussed in this publication may be directed to any of our lawyers listed below, or to any other Sullivan & Cromwell LLP lawyer with whom you have consulted in the past on similar matters. If you have not received this publication directly from us, you may obtain a copy of any past or future related publications from Nathalie-Claire Chiavaroli (+1-212-558-3976; chiavarolin@sullcrom.com) in our New York office.

CONTACTS

New York

Francis J. Aquila	+1-212-558-4048	aquilaf@sullcrom.com
Audra D. Cohen	+1-212-558-3275	cohenad@sullcrom.com
H. Rodgin Cohen	+1-212-558-3534	cohenhr@sullcrom.com
Mitchell S. Eitel	+1-212-558-4960	eitelms@sullcrom.com
John E. Estes	+1-212-558-4349	estesj@sullcrom.com
Brian T. Frawley	+1-212-558-4983	frawleyb@sullcrom.com
Joseph B. Frumkin	+1-212-558-4101	frumkinj@sullcrom.com
C. Andrew Gerlach	+1-212-558-4789	gerlacha@sullcrom.com
Brian E. Hamilton	+1-212-558-4801	hamiltonb@sullcrom.com
John L. Hardiman	+1-212-558-4070	hardimani@sullcrom.com
Matthew G. Hurd	+1-212-558-3122	hurdm@sullcrom.com
Alexandra D. Korry	+1-212-558-4370	korrya@sullcrom.com
Stephen M. Kotran	+1-212-558-4963	kotrans@sullcrom.com
S. Neal McKnight	+1-212-558-3316	mcknightn@sullcrom.com
Mark J. Menting	+1-212-558-4859	mentingm@sullcrom.com
Scott D. Miller	+1-212-558-3109	millersc@sullcrom.com
James C. Morphy	+1-212-558-3988	morphyj@sullcrom.com
Keith A. Pagnani	+1-212-558-4397	pagnanik@sullcrom.com
George J. Sampas	+1-212-558-4945	sampasg@sullcrom.com
Melissa Sawyer	+1-212-558-4243	sawyerem@sullcrom.com
Alan J. Sinsheimer	+1-212-558-3738	sinsheimera@sullcrom.com

SULLIVAN & CROMWELL LLP

Krishna Veeraraghavan	+1-212-558-7931	veeraraghavank@sullcrom.com
<hr/> Washington, D.C.		
Janet T. Geldzahler	+1-202-956-7515	geldzahlerj@sullcrom.com
<hr/> Los Angeles		
Eric M. Krautheimer	+1-310-712-6678	krautheimere@sullcrom.com
Alison S. Ressler	+1-310-712-6630	resslera@sullcrom.com
<hr/> Palo Alto		
Sarah P. Payne	+1-650-461-5669	paynesa@sullcrom.com
<hr/> London		
Richard C. Morrissey	+44-20-7959-8520	morriseyr@sullcrom.com
David Rockwell	+44-20-7959-8575	rockwelld@sullcrom.com
<hr/> Paris		
William D. Torchiana	+33-1-7304-5890	torchianaw@sullcrom.com
<hr/> Frankfurt		
Krystian Czerniecki	+49-69-4272-5525	czernieckik@sullcrom.com
David Rockwell	+49-69-4272-5533	rockwelld@sullcrom.com
<hr/> Melbourne		
Robert Chu	+61-3-9635-1506	chur@sullcrom.com
<hr/> Tokyo		
Izumi Akai	+81-3-3213-6145	akaii@sullcrom.com
Keiji Hatano	+81-3-3213-6171	hatanok@sullcrom.com
<hr/> Hong Kong		
William Y. Chua	+852-2826-8632	chuaw@sullcrom.com
Michael G. DeSombre	+852-2826-8696	desombrem@sullcrom.com
Chun Wei	+852-2826-8666	weic@sullcrom.com
<hr/> Beijing		
Garth W. Bray	+86-10-5923-5958	brayg@sullcrom.com