Chancery Court Holds that a Board's Refusal to "Approve" the Nomination of a Dissident Slate of Director Nominees for Purposes of Deactivating a Change of Control Put Provision is a Breach of Fiduciary Duty

On March 8, 2013, the Delaware Chancery Court, in an unpublished opinion by Chancellor Strine, ruled that an issuer's board of directors cannot withhold its "approval" of the nomination of a dissident slate for purposes of using covenants in New York law indentures to pressure stockholders to vote for the incumbent board in a proxy contest. The approval would enable the issuer to avoid triggering a put right at 101% of par with respect to the notes issued under the indentures.

Kallick v. SandRidge Energy, Inc.[1] arose out of a proxy contest in which stockholder TPG-Axon Partners, LP ("TPG") nominated its own slate of directors (collectively, the "Dissident Nominees") for election to replace the entire seven-member board of directors of SandRidge Energy, Inc. ("SandRidge") via a consent solicitation for majority shareholder approval. The indentures governing SandRidge's $4.3 billion of outstanding senior notes (the "Indentures") contain "Change of Control" provisions that require SandRidge to offer to repurchase the debt issued under the Indentures at 101% of par if during any 24-month period a majority of the members of SandRidge's board cease to be comprised of continuing directors.[2] The Indentures provide, in relevant part, that a Change of Control occurs if:

> during any period of two consecutive years, individuals who at the beginning of such period constituted the Board of Directors of the Company or any Successor Parent (*together with any new directors whose selection to such board or whose nomination for election by the stockholders of the Company or any Successor Parent, as the case may be, was approved by a vote of 66 2/3% of the directors then still in office who were either directors at the beginning of such period or whose election or nomination for election was previously so approved*), cease for any reason to constitute a majority of such Board of Directors then in office . . . . .[3] [emphasis added]

Stockholder Gerald Kallick sought, among other relief, to enjoin SandRidge from interfering with TPG's consent solicitation until the incumbent board had approved the Dissident Nominees, thereby disabling the Change of Control trigger. SandRidge maintained that it could rightfully withhold its approval of the Dissident Nominees, citing the concern that such approval would be confusing to the company's stockholders and detrimental to its position in the credit markets.

SandRidge contended that noteholders could sue the company if it approved the Dissident Nominees in bad faith and that approving the nominees for purposes of deactivating the Proxy Put would compromise the company's ability to obtain financing at favorable prices. At the same time, SandRidge also admitted that approving TPG's slate for the limited purpose of neutralizing the Proxy Put would not violate any duties the company owes to its noteholders and that even if the Proxy Put was triggered, it would be able to refinance the debt issued under the Indentures if necessary. Kallick asserted that, in taking its stance against approving the Dissident Nominees, the incumbent board was in breach of its fiduciary duty because the board had failed to identify any reasonable basis for failing to approve the Dissident Nominees. Chancellor Strine held in favor of

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1 C.A. 8182-CS (Mar. 8, 2013), available at http://courts.delaware.gov/opinions/download.aspx?ID=186150 (the "SandRidge Opinion").

2 SandRidge's credit agreement contains a similar "Change of Control" trigger that would require the repayment of any amount outstanding under the credit facilities.

3 SandRidge Opinion at 13. This provision was referred to in the opinion as the "Proxy Put."

Kallick's position, ruling that the incumbent board had no reasonable basis for withholding its approval of the Dissident Nominees and enjoining it from interfering with TPG's consent solicitation until it approved the nominees.

In so holding, Chancellor Strine cited *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*,[4] in which the Delaware Chancery Court interpreted a New York law-governed indenture to permit an issuer's board of directors to "approve" the nomination for election as directors members of a slate proposed by dissident stockholders. The purpose of the approval in *Amylin* was to enable the issuer to avail itself of a "continuing directors" exception to a change in "majority of directors" prong of a "Change in Control" covenant and thus avert triggering a put right at par with respect to the notes issued under the Amylin indenture. Board approval was given for this purpose even though the board, in the context of a proxy fight, did not recommend that stockholders elect any of the dissidents' proposed nominees, actively and publicly opposed their election, and recommended a board-proposed slate of directors.

In applying the *Amylin* holding to SandRidge's case, Chancellor Strine noted that 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, in particular, because the proposed slate posed a danger that the company would not honor its legal duty to repay its creditors. The Chancellor stated:

> In other words, unless the incumbent board determined, by way of example, 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, the incumbent board should approve the rival slate and allow the stockholders to choose the corporation's directors without fear of adverse financial consequences, and also eliminate the threat to the corporation of a forced refinancing.[5]

Chancellor Strine further noted that under *Amylin*, it was held that an incumbent board acting in good faith can approve insurgent nominees (thereby defusing a Proxy Put) without actually endorsing the Dissent Nominees. Chancellor Strine concluded, therefore, that it was in SandRidge's best interest to allow its stockholders to choose its board "without fear of a compelled refinancing."

While the court generally relied on the holding in *Amylin*, the *SandRidge* decision was also driven by the specific facts of the case. For example, although SandRidge first told its shareholders that triggering the Proxy Put would "present an extreme, risky and unnecessary financial burden"[6] to the company, a month later the company reversed course, admitting that the notes that would be subject to the Proxy Put were trading above the repurchase price and thus noteholders were not likely to tender their notes at a below-market price.[7] Further, SandRidge acknowledged that its own financial advisor had offered to pay off the existing noteholders and refinance the debt in exchange for a 1.0% commitment fee. These factual findings by the court allowed the court

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[4] 983 A.2d 304 (Del. Ch. 2009) ("*Amylin*"). Additional information about the Amylin decision is available at *Chancery Court Holds that a Board has the Power to "Approve" the Nomination of a Dissident Slate of Director Nominees in Order to Qualify the Dissident Nominees as "Continuing Directors" for Purposes of a Change of Control Put Provision in a New York Law Indenture*, CAHILL GORDON & REINDEL LLP (May. 21, 2009).

[5] SandRidge Opinion at 5.

[6] The incumbent board also warned that the company "may not have sufficient liquidity to fund the purchase price for such senior notes as required under the Indentures."

[7] In fact, the notes had been trading above the repurchase prices set in the Indentures prior to TPG's launch of its consent solicitation.

to arrive at a clear holding that the duty of loyalty owed by a board requires it "to exercise [its] contractual discretion with the best interests of [the company] and its stockholders firmly in mind, to the extent that it can do so without breaching the very limited obligations it owes to its noteholders."[8]

The Court also took the opportunity to underscore the guidance to corporate boards set forth in *Amylin*, noting with respect to "change of control" provisions that it was "[m]ost important . . . because of management's special interest in retaining office, the independent directors of the board should police aspects of agreements like ["change of control" provisions], to ensure that the company itself is not offering up these terms lightly precisely because of their entrenching utility, or accepting their proposal when there is no real need to do so."[9] This decision is also a reminder that boards of directors should document their review process carefully when approving any agreement that contains features that might present barriers to a takeover of the company.[10]

Post-Decision Developments

Following this decision, on March 14, 2013, SandRidge announced a settlement with TPG, in which it agreed, among other things, to expand the board by four seats to be filled with directors nominated by TPG. As part of the settlement, the company also agreed to either remove its chairman and chief executive or to give up three existing board seats, whereby TPG would name an additional board member and gain majority representation on the SandRidge board.

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Charles A. Gilman at 212.701.3403 or cgilman@cahill.com; Jon Mark at 212.701.3100 or jmark@cahill.com; or John Schuster at 212.701.3323 or jschuster@cahill.com; Diana Ni Hunter at 212.701.3140 or dhunter@cahill.com.

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8 *SandRidge* Opinion at 31.

9 The court's comment was prompted in part by the following deposition testimony of the sole independent director whose testimony was in the record: "Q: [W]ere you aware of [the Proxy Put] at the time the company entered into its first note indenture? A: I don't remember. That was, gosh, five years ago. Q: Do you have any— A: *I don't know if it was in there. I mean, to answer your question, I do not know if it was in there or not"*) [emphasis added by the court]. *SandRidge* Opinion at 9, n.24.

10 The *SandRidge* court noted "[a]s Vice Chancellor Lamb put it in Amylin: — 'The court would want, at a minimum, to see evidence that the board believed in good faith that, in accepting [a Proxy Put], it was obtaining in return extraordinarily valuable economic benefits for the corporation that would not otherwise be available to it.' [*Amylin*] 983 A.2d304, 315 (Del. Ch. 2009)." SandRidge Opinion at 8, n.22. Of possible interest, the *SandRidge* court did not quote or refer to the next sentence from the *Amylin* decision, which read, "Additionally, the court would have to closely consider the degree to which such a provision might be unenforceable as against public policy." 983 A.2d at 315.