Law.com's In-House Counsel

Delaware Chancery Court Warns Corporations About Debt Agreements That Violate Stockholders' Rights

Sheri Qualters
The National Law Journal
May 28, 2009

A recent Delaware Court of Chancery decision instructing Delaware corporations and their lawyers not to ink debt agreements that violate stockholders' rights to nominate new directors is likely to generate attorney scrutiny of corporate debt agreements.

The May 12 decision by Vice Chancellor Stephen P. Lamb in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals Inc.*, No. 4446-VCL (New Castle Co., Del., Ch.), which is on appeal at the Delaware Supreme Court, dismissed a claim that the directors breached their duty of care partly because outside counsel created the 98-page indenture agreement, but warned that such provisions might be "unenforceable as against public policy."

The fight concerned so-called "continuing directors" provisions in Amylin Pharmaceuticals Inc.'s credit and debt agreements, which would allow the lender to declare the debt in default if the majority of directors change. The institutional shareholder plaintiff, San Antonio Fire & Police Pension Fund, and Amylin argued against indenture trustee Bank of New York Trust Co.'s claim that Amylin's board could approve dissident nominees for the purpose of allowing them to run against board-nominated directors without risk of default.

The indenture or debt agreement gave noteholders the right to "put" the deeply discounted notes to Amylin, or require the company to buy them at face value, if Amylin violated the debt terms.

Lamb also ruled as moot a claim seeking a declaration that the deal's continuing directors provision was invalid and unenforceable because the involved parties reached an agreement on the issue.

"This case does highlight the troubling reality that corporations and their counsel routinely negotiate contract terms that may, in some circumstances, impinge on the free exercise of the stockholder franchise," Lamb wrote. "Outside

counsel advising a board in such circumstances should be especially mindful of the board's continuing duties to the stockholders to protect their interests. Specifically, terms which may affect the stockholders' range of discretion in exercising the franchise should, even if considered customary, be highlighted to the board. In this way, the board will be able to exercise its fully informed business judgment."

Joel Friedlander, a plaintiff's lawyer on the case and a partner at Bouchard Margules & Friedlander of Wilmington, Del., declined to comment because the case is on appeal.

The plaintiffs' appeal argues that the Chancery decision didn't go far enough and "created doubt about whether the board could perform its obligations under the partial settlement without violating the implied covenant in the 2007 Indenture."

The pension fund's appeal takes issue with the Chancery Court ruling's language stating that the board could approve shareholder nominees under the terms of a credit or debt agreement if the incumbents "determine in good faith that the election of one or more of the dissident nominees would not be materially adverse to the interests of the corporation and/or its stockholders."

"This new rule affords incumbents wide latitude to prevent a proxy contest from going forward," states the appeal.

On the defense side, Young Conaway Stargatt & Taylor of Wilmington, which represented the company's creditor Bank of America, and Peter Ladig, a director at Wilmington's Bayard who represented the indenture trustee, also declined to comment. Attorneys at Richards, Layton & Finger in Wilmington and New York's Sullivan & Cromwell, who represented Amylin, did not respond to a request for comment.

In light of the Chancery decision, lawyers will need to spend more time educating boards about the risks of adopting debt provisions that potentially interfere with shareholder voting rights, said Victor Lewkow, a partner in the mergers, acquisitions and joint ventures practice at New York's Cleary Gottlieb Steen & Hamilton, who is not involved in the case

"It's more of a focus going forward in negotiating loan agreements to not just assume [these provisions are] automatically OK," Lewkow said.

The Chancery court is "going to look very carefully at provisions that purport to tie the hands of shareholders," said Ellisa Habbart, a founding partner of the Delaware Counsel Group and a Delaware law expert not involved in the case.

"To the extent that there are agreements out there, people need to interpret this language in line with what the court said," Habbart said. "It's more important than ever that lawyers do their job."