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June 16, 2009

Delaware Chancery Court Considers Director Change of Control Provisions in Indentures

The recent decision of the Delaware Chancery court in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc*. C.A. No. 4446-VCL (Del.Ch., May 12, 2009) arose from a proxy contest in which two separate dissident stockholders, Icahn Partners LP and Eastbourne Capital Management, L.L.C., each sought the election of its slate of five director nominees to Amylin's 12-member board. Amylin's indenture, governed by New York law, contained a continuing director change of control provision. The indenture gave noteholders the right to require Amylin to redeem the notes at face value if at any time "continuing directors" did not constitute a majority of Amylin's board. "Continuing directors" are defined as directors in office on the date of the issuance of the notes and any subsequent directors whose election to the board was "approved" by at least a majority of such initial directors or subsequent directors whose election to the board was previously so approved. The three main issues before the court were:

- Whether Amylin's board had the power to "approve" as "continuing directors" for purposes of the indenture change in control provision the dissident nominees after it had opposed their election and continued to offer an opposing slate of company nominees;
- If Amylin's board had the power to approve the dissident nominees, whether that approval violates the company's duty of good faith and fair dealing under the indenture; and
- Whether Amylin's board met its duty of care at the time of approving the indenture if it failed to learn of the continuing director change of control provision.

The indenture trustee argued that the Amylin board could not approve the dissident slates after having contested their election because the word "approve" should be synonymous with "endorse or recommend" and the actions of the Amylin board in supporting an opposing slate of company nominees did not indicate such an endorsement or recommendation of the dissident slates. The court disagreed with the trustee. The court stated that such an interpretation would prohibit any change in the majority of the board as a result of any contested election for the entire life of the notes, resulting in "an eviscerating effect on the stockholder franchise [that] would give rise to grave concerns." The court noted two concerns regarding the trustee's argument, first whether the board, consistent with its fiduciary duties, could agree to a provision that had the impact suggested by the trustee, and second, whether such a provision might be unenforceable as against public policy. The court pointed out that a provision "so strongly in

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derogation of stockholders' franchise rights" would give noteholders constructive notice of its unenforceability.

The court next considered whether the board had the right to approve the dissident nominees or whether such approval violated the company's implied duty of good faith and fair dealing inherent in all contracts. The court held that a board "may approve the stockholder nominees if the board determines 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 or it stockholders." The court, however, did not rule on whether the standard was met in this case because a settlement was reached with the dissident stockholders, making the issue unripe for determination.

Finally, the court concluded that the Amylin board had not violated its duty of care notwithstanding its failure to learn of the continuing director change of control provisions at the time the indenture was approved. The court based its decision on the board having retained highly qualified outside legal counsel and obtaining advice from management and investment bankers as to the terms of the indenture. Also, before approving the indenture the board had asked and been told by its outside counsel that there was nothing "unusual or not customary" in the terms of the indenture. In dismissing this claim, the court noted that this case "highlights the troubling reality that corporations and their counsel routinely negotiate terms that impinge on the free exercise of stockholder franchise."

This decision raises a number of important issues:

- First, it highlights the troublesome nature of continuing director change of control provisions. The common formulation, adopted by Amylin, appears to have lost some of its potency from the noteholder perspective because the incumbent directors can at any point "approve" a dissident slate of directors (even when the incumbent board previously opposed the dissident slates' election). However, if such provisions are drafted more stringently, the board increases its exposure to claims of breach of fiduciary duty and the provision may nonetheless be set aside as unenforceable on grounds of public policy. Interestingly, Amylin had a credit agreement that had a stricter change of control provision, specifying that "continuing directors" could not be any individual whose initial nomination occurred as a result of an actual or threatened solicitation of proxies for election of directors by any dissident shareholders. This provision was never before the court for consideration as it was waived by the lenders, but the court suggested that it might not have found this more restrictive definition to violate public policy "because of the relative ease with which consents or waivers are obtained in bank lending [as compared to] public debt instruments."
- Second, a board may find itself in the precarious position of exposing itself to a claim of breach of fiduciary duty, on the one hand, if it approves a dissident slate while believing that such election would be materially adverse to the interests of the corporation or its stockholders and, on the other hand, for disenfranchising stockholders and exposing the company to the adverse consequences of debt repayment if it does not approve a dissident slate.
- Finally, this decision reminds boards and counsel that they should proactively review agreements to identify and consider the appropriateness of provisions that restrict the voting rights of stockholders, even if they are "usual and customary".

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues discussed in this memorandum may be addressed to Kenneth M. Schneider (212-373-3303) and Frances F. Mi (212-373-3185).