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Putting poison in puts

By Neill May

What are "poison puts?" Discussions of poison puts seem to come in waves in the corporate M&A world, but I suspect the term is not widely understood. My guess is people would be more likely to understand the meaning of "poison putz," probably the guy with a toxic personality in Hebrew school.

A poison put is a provision in a debt agreement for a publicly traded issuer. In its simplest form, a poison put permits a debtholder to put its interest to the issuer (specifically, to require the issuer to buy back the debt) upon the occurrence of a change of control. The poison label is based on the fact these put rights can be unpalatable, or poisonous, to a potential acquiror of the issuer: the issuer (post-acquisition) may not have the resources or ability to fully repay or refinance the debt, and the put obligation may require repurchase of the debt at a premium which heightens the potential toxicity.

From the perspective of debtholders, the appeal of poison puts is completely understandable. Changes of control can have profound consequences on a borrower, and the lenders may want to head to the exits through the exercise of the put. The new owners/managers may themselves affect the business. Equally, if not more importantly, the terms of the control transaction (in particular, amount of debt incurred as part of the transaction) may have significant effects on the creditworthiness of the borrower and on the value of its debt; a highly-levered transaction may leave the issuer's creditors with much less valuable paper.

Motivated by these considerations, the Canadian Bond Investors Association published a paper in 2014 recommending strong protections for debtholders against the risks of a change of control, highlighting the benefits of change of control put options (their label for poison puts). The elements of the CBIA's recommendations reflect modern, broad conceptions of "control transactions": the put would trigger not just on a conventional change of control (acquisition of more than 50 per cent), but also on a merger or other form of transaction in which voting control is acquired, on a sale of all or substantially all of the issuer's assets, on a liquidation or dissolution, and (significantly, in an era of increasing shareholder activism) on a change of a majority of the issuer's board of directors (this element, in isolation, is sometimes referenced as a "proxy put").

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Predictably, issuers noticed that the poison puts were not only comforting lenders but having a deterrent effect on uninvited suitors. The balancing act between the protections for an issuer's creditors and the entrenchment effect for the issuer's board has been addressed in a number of recent Delaware decisions (the analysis and approach would be different in Canada, but the fundamental approaches taken are instructive). In both *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals* and *Kallick v. SandRidge Energy Inc.* the proxy put was structured so it was not triggered if the incumbent board consented to the new nominees. In *Amylin*, the court hinted, and in *SandRidge* it held, that incumbent boards have an obligation to approve the new nominees so as to avoid the trigger of a proxy put in circumstances where the nominations would not pose a material threat of harm to the issuer. For example, if the nominees lacked ethical integrity or advocated a program that would have demonstrably material adverse effects for the issuer's ability to meet its legal obligations to its creditors.

Some proxy puts do not have an exception for new directors approved by the old; that type of proxy put is called a "dead-hand proxy put" because it operates automatically after the "demise" of the incumbent board. In *Pontiac General Employees Retirement System v. Healthways Inc.*, the same Delaware court, in a bench ruling, refused to dismiss claims against the Healthways board or an aiding and abetting claim against its lenders for entering into a credit facility with a dead-hand proxy put. The threat of claims against lenders (for participating in the inclusion of these clauses in debt documents) may have a chilling effect on the unfettered scope expansion of poison puts.

The CBIA recommendations suggest a helpful element to the desired balance, recommending the put only be exercisable if there is both a change of control and an adverse effect on the issuer's credit ratings. This proposal contemplates poison puts that are more closely tied to the debtholder interests, which the puts were originally designed to serve, by capturing the concept of an adverse effect of a change of control on the issuer's credit quality.

That is the perspective from the debt community. It is not yet resolved, however, how the M&A world may settle the impediments to control transactions raised by poison puts. Sort of like the lack of clarity as to what legitimate democratic exercise in Ukraine that Vladimir Putin might regard as a "poison putsch," or how my golf game can continue to be sabotaged by "poison putts." **CL**

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