The Inability to Satisfy Common Stockholder Voting Requirements: Is Bankruptcy a Potential Solution?

March/April 2007

Timothy Hoffmann

Metromedia International Group, Inc.'s board of directors faced a perplexing dilemma. Approached with an attractive offer from a potential purchaser, the board wanted to sell the corporation's primary asset and cease operations. In order to consummate the transaction, however, Delaware law and the company's certificate of incorporation required approval from the majority of Metromedia's common stockholders. Metromedia's advisors informed Metromedia's directors they could not hold a shareholder meeting or solicit proxies due to the company's failure to comply with federal reporting requirements. As a result, the directors believed they could not obtain the required shareholder approval.

The board decided to pursue an alternate route to complete the transaction — bankruptcy. Their strategy contemplated finalizing an agreement to sell Metromedia's controlling equity interest in Magitcom, a profitable mobile telephone provider in the Republic of Georgia, after which Metromedia would file a chapter 11 petition and a motion seeking court approval of the Magitcom sale under section 363 of the Bankruptcy Code. Metromedia would then seek to confirm a liquidating chapter 11 plan.

To ensure that Metromedia's "impaired" creditors would vote in favor of the chapter 11 plan, the board entered into a voting lock-up agreement with the company's preferred stockholders. During the course of negotiations, the board provided the preferred stockholders with certain non-public information regarding the company's financial status. Based upon this information, the preferred shareholders negotiated a favorable financial position for themselves with respect to the proposed transaction and bankruptcy.

Before Metromedia filed for bankruptcy, however, two large Metromedia common stockholders sued in Delaware Chancery Court to enjoin the Magitcom sale as well as the effectiveness of the lock-up agreement. The court ultimately ruled in favor of the plaintiff-stockholders, finding that the board’s proposed strategy constituted “inequitable conduct.”

The Legal Standard

Under Delaware law, stockholders maintain a fundamental right to vote on certain corporate matters. For example, Delaware courts consistently reverse board actions that interfere with the stockholders’ franchise in connection with director elections. In this context, any board action “designed principally to interfere with the effectiveness of a [stockholder] vote” is subject to intense judicial scrutiny, and the board “bears the heavy burden of demonstrating a compelling justification for such action.” Under the “compelling justification” standard, Delaware courts look beyond directors’ honesty and subjective good faith beliefs, the typical anchors of the less stringent business judgment rule.

Outside of the director election context, however, Delaware courts seldom employ the “compelling justification” standard. They generally do so only when “self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter and to thwart what appears to be the will of a majority of the stockholders.”

In this case, the Delaware Chancery Court determined that Metromedia's directors did not act in either self interest or contrary to the wishes of the stockholder majority in resolving to file for bankruptcy as a means to consummate the proposed sale. According to the court, the common stockholders seeking to enjoin the sale represented the view of only a minority of Metromedia's stockholders. As such, the court declined to apply the "compelling justification" standard.

Even so, the court determined that Metromedia's directors could not utilize bankruptcy as a vehicle for consummating the Magitcom sale. Mindful of the broad discretion that directors hold under the business judgment rule and related doctrines, the court ruled that the board's strategy exceeded certain equitable bounds.

First, the court found the directors' proposed use of the bankruptcy process to be inequitable because, among other things, Metromedia was a solvent company with little debt and substantial cash flow. Explaining that no economic reason existed for Metromedia to seek bankruptcy relief and that the anticipated filing was driven principally by the board's desire to avoid a common stockholder vote on the Magitcom sale, the court concluded that a chapter 11 filing under the circumstances would constitute "bad faith," despite the absence of any insolvency requirement for a bankruptcy filing. Second, the court determined that the lock-up agreement provided Metromedia's preferred shareholders with voting rights to which they were not entitled under the corporation's charter, which gave common stockholders the right to vote on fundamental corporate changes. The proposed bankruptcy strategy, the court emphasized, inequitably reallocated control of the company from common stockholders to preferred stockholders and creditors, a course of action that was untenable in the absence of insolvency.

The court decreed that the Magitcom sale could be consummated only if the transaction was approved pursuant to a vote of Metromedia's common shareholders. The court advised the board to seek an exemption from SEC reporting requirements in order to hold a shareholder meeting for that purpose and emphasized that it held the authority to appoint a receiver for Metromedia if the board failed to abide by its ruling.

Outlook

Principles of corporate governance that determine how a company functions outside of bankruptcy are transformed, and in some cases abrogated, once the company files for chapter 11 protection, when the debtor's board succeeds to management of a "debtor-in-possession" that bears fiduciary obligations to the chapter 11 estate and all stakeholders involved in the bankruptcy case. Although shareholders may still have the right to convene meetings post-bankruptcy for, among other things, the election of directors, major corporate decisions, such as significant asset sales, are no longer subject to shareholder approval, except to the extent that any proposed sale must be approved by "impaired" creditors and shareholders pursuant to the chapter 11 plan confirmation process. Instead, decisions involving non-ordinary course business transactions must be approved by the bankruptcy court as an exercise of the debtor-in-possession's sound business judgment.

This is precisely why Metromedia's board opted for a bankruptcy filing as a means of skirting SEC reporting requirements that precluded convening a meeting of the company's common stockholders for the purpose of voting on the Magitcom sale. The Chancery Court understandably concluded that their plan to abrogate shareholder voting rights was objectionable as a matter of Delaware law, given the company's financial health, but the court's observations in dicta concerning the "bad faith" of a bankruptcy filing under the circumstances bear closer scrutiny. Many public companies, solvent or insolvent, file for chapter 11 with the intention of effectuating a sale of substantially all or significant portions of their assets. The ability in bankruptcy to, among other things, sell assets free and clear of competing claims and interests, to avoid certain transfer taxes, and to consummate sales expeditiously without the need for shareholder approval makes chapter 11 the preferred mechanism for many asset sale transactions. Few bankruptcy courts find that such filings amount to "bad faith" warranting dismissal.

Esopus Creek Value LP v. Hauf, 913 A.2d 593 (Del. Ch. 2006).