Shareholder Rights in Chapter 11

Hon. Leif M. Clark
US Bankruptcy Judge
(retired)
Shareholder Rights in the US

• In general, shareholder rights are governed by state law (e.g., Delaware law, NY law, etc)
• Shareholders have the right to select members of the Board of Directors
• Directors are expected to act in the best interests of their shareholders (duty of loyalty and in some states duty of care)
• Directors select officers, who also have similar duties of loyalty and care
Shareholder Rights in Bankruptcy

• Once the shareholders have authorized the filing of a Ch. 11, the debtor entity’s duties shift to include the creditors (in general)
• Directors and officers continue to operate the debtor, as debtor-in-possession, a quasi-fiduciary
• But creditors have priority of payment over shareholders, creating potential conflicts for officers and directors
• Can shareholders affect the decisions of officers and directors in bankruptcy?
• Can shareholders retain their interests?
SOME STATUTES
§ 1129(b)(2)(B)

(b) [if a class has voted to reject the plan, the plan may still be confirmed, but only if --]

(B) With respect to a class of unsecured claims—

(i) the plan provides that each holder of [an allowed] claim of such class [is fully satisfied]; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.....

clark@cbinsolvency.com
§ 1129(b)(2)(C)

(C) With respect to a class of interests—
(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to ... the value of such interest; or
(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.
§ 1123(a)(4)

A plan *shall* (4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest.
§ 1123(a)(6)

... a plan *shall* (6) provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in paragraph (5)(B) or (5)(C) of this subsection, of a provision prohibiting the issuance of nonvoting equity securities, and providing, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends.
§ 1145(a)(1)

[S]ection 5 of the Securities Act of 1933 and any State or local law requiring registration for offer or sale of a security or registration or licensing of an issuer of, underwriter of, or broker or dealer in, a security do not apply to—

(1) the offer or sale under a plan of a security of the debtor, of an affiliate participating in a joint plan with the debtor, or of a successor to the debtor under the plan—

(A) in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor or such affiliate; or

(B) principally in such exchange and partly for cash or property

[similar provision for warrants, options, etc.]
§ 510(b)

(b) For the purpose of distribution ... a claim arising from rescision of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.
In summary, then --

• Shareholders, as “claimants” by virtue of their interests, can receive a distribution on account of that interest, but only if no unsecured creditor class has voted to reject the plan.

• If shareholders retain their interest under the plan, however, their rights cannot be diluted by nonvoting stock.

• Claims arising from the purchase or sale of a security of the debtor are treated as equity.
SOME CASES ...
Corporate Governance Issues

Once a debtor enters chapter 11, it is a “debtor-in-possession” or “DIP” for short. The DIP acts in the stead of a trustee, responsible for gathering and preserving assets for the benefit of creditors. But what does this mean for corporate governance? To whom does the Board of Directors answer? And can they be removed? If so, by whom?
“shareholders' desire for leverage is not a basis for denying them an election, so long as leverage means only the improvement of their bargaining position or the assurance of their participation in negotiations. ... the Equity Committee is permitted to elect new directors in order to redirect or alter the course of a reorganization — ... the district court here explicitly recognized that the [Equity] committee is permitted to do that ...”

_In re Johns-Manville Corp._, 801 F.2d 60, 65-66 (1986)(emphasis added)
Johns-Manville (cont’d)

However: “In In re Potter Instrument Co., 593 F.2d 470 (2d Cir.1979), this court upheld the bankruptcy court's refusal, upon a finding of clear abuse, to order a shareholders' meeting to be called for the purpose of electing new directors. We reasoned that "such an election might result in unsatisfactory management and would probably jeopardize both [the debtor's] rehabilitation and the rights of creditors and stockholders — sounding the 'death knell' to the debtor as well as to appellant himself." Id. at 475.” Id., at 67 (emphasis added).
Johns-Manville (cont’d)

But the dissent points out: “To seek a shareholders' meeting at this late date, it seems to me, is ... a clear abuse. The Equity Committee, if it has its way, would set this reorganization back to square one. Apparently satisfied with the Board of Directors for three years following the filing of the bankruptcy petition, the committee waited until the directors finally proposed a plan to object, not only to the plan, but to the directors themselves. In addition to seeking to upset the plan, it is now trying to replace the directors, a result that would require negotiations to recommence from the beginning.”
Plan Treatment of Shareholders

If the plan gives stock to creditors, or allows existing shareholders to retain stock, the Code requires that voting rights be preserved. Thus, the Code contemplates returning corporate governance to shareholders after confirmation. But this requirement sometimes needs to be altered, for a variety of reasons.
Acequia

“Section 1123(a)(6) requires an ‘appropriate distribution of voting power’ as to ‘the several classes of securities possessing voting power....’ Section 1123(a)(7) (1982) provides that a plan must contain provisions ‘that are consistent with the interests of ... equity security holders and with public policy with respect to the manner of selection of any officer, director, or trustee ....’ See also 11 U.S.C. § 1129(a)(5)(A)(ii) (1982). Sections 1123(a)(6) and 1123(a)(7) must be read together. These provisions require that the court scrutinize any plan which alters voting rights or establishes management in connection with a plan of reorganization, whether or not the plan provides for the issuance of new securities.” 787 F2d 1352, 1362 (9th Cir. 1986)
Acequia (cont’d)

“We recognize that a shareholder's participation in a corporation ‘cannot be lightly cast aside....’ In re Lifeguard Industries, Inc., 37 B.R. 3, 17 (Bankr.S.D.Ohio 1983). Clinton, however, presented Judge Young with no reasonable alternative but to extend Haley's exclusive control beyond the two and one-half year period that the proxy was in effect.” Id., at 1362
The plan classified Clinton (H shareholder) and Haley (W shareholder) in the same class, but permitted only Haley to serve as an officer without the approval of the directors. § 1123(a)(4) says that “interests” have to be treated the same. Court said that this provision was not violated: “her position as director and officer of the Debtor is separate from her position as an equity security holder. Haley's shares are placed in the same class and subject to the same voting restrictions as Clinton's.”
Ahead Communications

Purpose of § 1126(a)(6) is to allocate voting power recognizes respective rights of claimants and shareholders, per their rank and rights they surrender. Creditors who receive shares should also receive voting rights. In addition, shareholders who retain their rights should also retain their right to select the future management of the company.

395 BR 512 (D.Conn. 2008)
Limits on Filing Rights

The decision to file for ch 11 relief can often be made at the Board of Directors level, but the by-laws might require that shareholders authorize the filing. When that happens, the court may be called upon to examine the *bona fides* or legitimacy of the filing decision, and to perhaps dismiss the case.
Solvent company filed for chapter 11. Creditors sought to dismiss the case as filed in bad faith. The court granted the motion to dismiss, but only because there was intent to gain a litigation advantage. Court acknowledged that solvent enterprises may file, and that preserving value for shareholders is a legitimate basis for filing, provided rehabilitation of the enterprise is the goal. 200 F.2d 154 (3rd Cir. 1999)
Integrate Telecom Express, Inc.

Solvent enterprise may file, including to preserve shareholder value, but may not file to obtain a litigation advantage. 384 F.3d 108
Bankruptcy Remoteness

Sometimes, lenders desire to make a borrower “bankruptcy remote” as a condition to lending. This is accomplished by requiring the creation of a bankruptcy remote entity whose by-laws include a requirement of unanimity by the Board, one of whose directors is designated as “independent.” Does this strategy work?
Subsidiary corporations were created to hold title to properties on which loans were made. At the insistence of the lender, provisions were placed in the by-laws to make the subsidiaries “bankruptcy remote” – that is, unanimous consent of all board members was required to authorize the filing of a petition, one board member was “independent” but in fact “… serve[d] as an independent director for three other entities at the request of DLJ [the noteholder], receiving $10,000 per year per transaction. Therefore, Richardson receive[d] the aggregate amount of $55,000 annually for serving on the various boards of directors created pursuant to DLJ-structured deals.” 214 B.R. 713 (Bankr. SDNY 1997)
“[C]orporate action taken by an insider without board or shareholder authority may later be found to have been appropriate in circumstances where the existence of the corporation is very much at risk. Here, with foreclosures being instituted by the Movants against each Debtors' property and the Debtors' board stymied in filing for bankruptcy in light of the blocking vote held by Richardson, Ginsberg's acts to garner support from willing creditors to file involuntary cases in order to thwart financial ruin would appear to be right in line with [case law].”
“[the board members’] intention was to circumvent the inability of the Debtors to act in the face of the pending foreclosure proceedings by taking some action to preserve value for the Debtors' estates and creditors. ... The Movants may feel bruised because the Respondents outmaneuvered what the Movants thought was an iron-clad provision in the corporate by-laws preventing a bankruptcy filing, but this does not mean that, without more, the petitions must be dismissed.” Id., at 737.
Tax implications of debt for equity

One reorganization tool available under ch 11 is debt for equity swaps. But the US Tax Code requires that “stock for debt” plans not result in a “change of control.” Otherwise, valuable tax benefits, such as net operating loss carrybacks and carryforwards, can be lost. See 26 USC § 382. The presence of such valuable benefits can be good for existing shareholders.
Charter Communications

Plan provided that a significant shareholder would retain his 35% voting power, despite the fact that, as a result of the restructuring, his shares would be diluted to the point of being worthless. The provision was necessary to avoid triggering “change of control” – which would have had significant adverse tax consequences under the Internal Revenue Code. 419 B.R 221 (Bankr. SDNY 2009)
Getting around Absolute Priority

Equity interests cannot, under a plan, retain their interests or receive anything on account of those interests if a class of unsecured claims senior to them votes “no” on any such plan. Are there ways around this rule in the face of such opposition? There are two that have been tried—“new value” and “gift plans.”
Case v Los Angeles Lumber Products

While junior interests should normally receive nothing if senior interests are not paid in full, the courts recognize an exception for “new value,” provided –

• the contribution is “new”
• the contribution is “necessary”
• the contribution is “substantial”
• the resulting interest granted is reasonably equivalent to the amount contributed

308 U.S. 106 (1939)
Lightsquared

A contribution of “new value” by existing shareholders does not need to meet the “new value” test if the existing shareholders are already out of the money. “The Plan is not a "new" value plan—in such a plan, junior creditors "leap over" more senior creditors whose claims are not paid in full. Here, the standalone valuation found by the Court is that there is no equity cushion. That finding is no "leap" ahead of Ahuja.” 534 BR 522 (SDNY 2015)
Armstrong World Industries

While it is possible for a secured creditor to “gift” its own interests to lower classes without passing “new value” standards, the key question is whether the gift consists of the creditor’s property, as opposed to gifting what would otherwise be the debtor’s property.

432 F.3d 507 (3rd Cir. 2005)
Conclusion

• Despite being last in order of distribution, shareholders still have power to affect reorganization

• Their rights can be wiped out or diluted in a plan

• But they may be able to preserve their rights

• Courts can, in some circumstances, enjoin shareholders from controlling the board
Thanks so much for your attention