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Financial Restructuring & Reorganization ADVISORY ■

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Delaware Courts Leery of Shareholder Obstruction

"Blocking rights"—corporate governance provisions designed to prevent management from putting a company in a Chapter 11 case without certain stockholders' consent—have increasingly been the focus of bankruptcy courts across the country. On May 5, 2020, Judge Mary Walrath of the U.S. Bankruptcy Court for the District of Delaware refused to dismiss a corporate debtor's pending bankruptcy case on account of the debtor's failure to seek the consent of a stockholder with blocking rights.

Pace Industries, an Arkansas-based manufacturer of aluminum, zinc, and die cast and major supplier to the auto industry, sought Chapter 11 protection on April 12 in the District of Delaware, along with 10 affiliated entities (*In re Pace Industries*, No. 1:20-bk-10927). Leading up to the bankruptcy filing, Pace was experiencing severe liquidity issues to the extent that it had a mere $150,000 in cash at the time of filing. Still, Pace and its affiliates entered bankruptcy already proposing a prepackaged plan that would restructure approximately $324 million in debt, primarily through a debt-for-equity swap.

Five days after the bankruptcy petition was filed, the majority shareholder sought to dismiss the bankruptcy case because Pace did not obtain the shareholder's consent before seeking Chapter 11 protection. In its motion to dismiss, the shareholder alleged that its stock purchase agreement gave it the right to approve or veto any bankruptcy or liquidation filings in exchange for its equity infusion.

In its objection to the motion to dismiss, the company argued that circumstances such as Pace's allowed a company to seek bankruptcy protection without the shareholder's consent because enforcing the right would conflict with the important public policy of assuring companies can seek federal bankruptcy relief when needed or when it would be inequitable. Pace further alleged that the shareholder's attempt to block the bankruptcy filing was actually aimed at achieving leverage in its negotiations with the debtor's lenders.

At the hearing, the debtor's position was supported by the agent for its $232.1 million in secured notes. The agent emphasized at the hearing that, were the court to rule for the shareholder, the agent and other creditors were prepared to immediately launch an involuntary Chapter 11 proceeding, which would ultimately place the debtor back in the same position.

At the hearing, the shareholder pointed the court to the recent Fifth Circuit ruling on a similar issue where it concluded that an investor was not prevented from exercising its blocking rights to stop the corporation from seeking bankruptcy protection. Judge Walrath indicated that she "respectfully would decline to follow that case." She stated further, "I do believe, under Delaware state law, contrary to the Fifth Circuit, my interpretation of the law would and does find that blocking rights, such as exercised in the circumstances of this case, would create a fiduciary duty on the part of the shareholder."

Judge Walrath ultimately sided with the debtor and the agent to its secured lenders, holding that the shareholder's blocking rights provision "violates public policy and is void."

Due to COVID-19 and the state of the global economy, many companies are considering or are currently engaging in the process of a bankruptcy filing. Companies with blocking rights governance provisions (and the stockholders that enjoy those rights) should carefully examine the outcome of this ruling to determine whether their provision is enforceable. Similarly, any lender that has obtained or intends to require the issuance of an authority to file an opinion, analyzing the interplay of state-based corporate law and federal bankruptcy law with the authority needed to commence a bankruptcy case, should carefully consider whether bankruptcy courts will follow Judge Walrath's ruling.

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If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Gerard S. Catalanello
212.210.9509
gerard.catalanello@alston.com

Christopher K. Coleman
404.881.4941
chris.coleman@alston.com

Dennis J. Connolly
404.881.7269
212.905.9154
dennis.connolly@alston.com

Jonathan T. Edwards
404.881.4985
212.905.9126
jonathan.edwards@alston.com

William Hao
212.210.9417
william.hao@alston.com

Leib M. Lerner
213.576.1193
leib.lerner@alston.com

Diane C. Stanfield
213.576.1039
diane.stanfield@alston.com

William S. Sugden
404.881.4778
will.sugden@alston.com

James J. Vincequerra
212.210.9503
james.vincequerra@alston.com

John W. Weiss
212.210.9412
john.weiss@alston.com

David A. Wender
404.881.7354
david.wender@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ■ Suite 21B2 ■ No. 7 Guanghua Road ■ Chaoyang District ■ Beijing, 100004 CN ■ +86 10 8592 7500
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: Chase Tower ■ 2200 Ross Avenue ■ Suite 2300 ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LONDON: 5th Floor, Octagon Point, St. Paul's ■ 5 Cheapside ■ London, EC2V 6AA, UK ■ +44.0.20.3823.2225
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ■ 15th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RALEIGH: 555 Fayetteville Street ■ Suite 600 ■ Raleigh, North Carolina, USA, 27601-3034 ■ 919.862.2200 ■ Fax: 919.862.2260
SAN FRANCISCO: 560 Mission Street ■ Suite 2100 ■ San Francisco, California, USA, 94105-0912 ■ 415.243.1000 ■ Fax: 415.243.1001
SILICON VALLEY: 950 Page Mill Road ■ Palo Alto, California, USA, 94304 ■ 650-838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.239.3300 ■ Fax: 202.239.3333