

Chapman Client Alert

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Current Issues Relevant to Our Clients

Preferred Shareholder Denied Right to Block Bankruptcy Filing by Delaware Bankruptcy Court

On May 5, 2020, in a case of first impression in Delaware, the Hon. Mary F. Walrath, a Delaware bankruptcy judge, rejected a preferred shareholder's motion to dismiss Pace Industries' chapter 11 cases for failure to obtain its consent to file, a right provided in the debtor's certificate of incorporation, finding that a minority shareholder's blocking rights were unenforceable as violative of federal policy.

Pace Industries, LLC and its affiliated debtors ("*Pace*"), suppliers of aluminum, zinc and magnesium die-cast and finished products and a major supplier to the auto industry, filed for chapter 11 protection on April 12, 2020, and entered bankruptcy with a prepackaged plan of reorganization to exchange its outstanding debt for equity in the reorganized company.

Five days after the petition date, counsel for Macquarie Septa I LLC ("*Macquarie*"), a preferred shareholder of a Pace subsidiary, filed a motion requesting that the bankruptcy court dismiss the cases of certain subsidiaries (the "*KPI Intermediate Debtors*") as a matter of state law, for failure to obtain proper corporate authority to file voluntary bankruptcy petitions. In connection with Macquarie's purchase of the preferred shares, KPI amended its certificate of incorporation to include a provision that any action to initiate bankruptcy proceedings required consent from the holders of the majority in interest of Series A Preferred Stock.

In its motion to dismiss the cases, Macquarie argued that the directors of the KPI Intermediate Debtors lacked authority to file bankruptcy petitions because Macquarie had never consented to the filings. Macquarie also argued that (i) providing consent rights under Delaware law to shareholders (i.e., Macquarie) did not violate federal public policy, (ii) because Macquarie's only financial interest is as a preferred shareholder, this case was distinguishable from those decisions denying creditors the right to use a nominal equity position or "golden share" to block a bankruptcy filing. Finally, Macquarie cautioned that the only issue at

stake is the enforceability of the lawful grant of authority to shareholders, rather than the debtors' best interests or the high likelihood of involuntary proceedings following a dismissal.

The debtors responded that Macquarie's blocking right should be invalidated as contrary to federal public policy. Moreover, absent a voluntary filing, certain of their creditors would bring involuntary proceedings against them and that enforcing Macquarie's blocking rights would threaten the debtors' best chance at a successful restructuring while conferring no appreciable benefit on Macquarie, an out-of-the-money shareholder. Finally, the debtors argued that, even if Macquarie has the power to exercise control over the KPI Intermediate Debtors, it owes a fiduciary duty to the debtors to consider the best interests of the debtors with respect to the bankruptcy filing.

In her decision, Judge Walrath recognized that there was no Delaware precedent for this dispute, but nevertheless refused to dismiss the KPI Debtors' cases, finding that (i) blocking rights, as exercised by Macquarie, would create a fiduciary duty on the part of the shareholder to the debtors and (ii) the attempt to prevent access to bankruptcy courts and the Bankruptcy Code would violate the federal public policy of allowing debtors to obtain bankruptcy relief. In so ruling, Judge Walrath declined to follow the decision of the Fifth Circuit in *In re Franchise Services of North America, Inc.*, 891 F.3d 198 (5th Cir. 2018), *as revised* (June 14, 2018) that an equity investor was not prevented from using a voting right to stop a corporation from filing for bankruptcy.

The Delaware Bankruptcy Court's decision is important as we are likely to see an increase in bankruptcy filings in which courts will face issues regarding the enforceability of provisions negotiated by creditors and shareholders restricting an entity's ability to file for bankruptcy.

For More Information

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