Proskauer

The **“Board Flip”**:

How Effective is the Pre-Petition Exercise of Proxy Rights in the Face of Bankruptcy?

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1. Introduction

When debt restructuring discussions are at an impasse and the reservoir of goodwill between the parties has run dry, stakeholders face difficult choices. For a lender, one of the most powerful tools available is the exercise of rights under a voting proxy given by a parent holding company in connection with a pledge of a borrower’s stock or membership interests. Through the exercise of proxy rights, lenders may replace a borrower’s board of directors with a new board made up of independent directors. After a “board flip,” as it is commonly known, equityholders continue to own their interests in the borrower, but the economics associated with the interests are divorced from the voting rights associated with the interests, including the right to appoint directors or otherwise exercise control over the borrower.

Some have argued that a board flip should be unwound if the parent holding company promptly files for bankruptcy and makes a demand on the lender to relinquish voting control over the borrower, arguing that such voting control violates the automatic stay provisions of the Bankruptcy Code prohibiting creditors from controlling estate property or from attempting to collect a debt after the filing. This argument, and its various component positions discussed below, were squarely rejected in an April 2023 decision by Judge Laurie Selber Silberstein of the United States Bankruptcy Court for the District of Delaware (the “CII Decision”).[i] In her opinion for the court, Judge Silberstein held that the parent company could not recover control of its subsidiary whose lenders had properly exercised voting proxy rights prior to the parent’s bankruptcy filing.

We agree completely with Judge Silberstein's conclusion that, under Delaware law, a properly executed board flip in furtherance of well-drafted loan and security documents should withstand scrutiny in or outside of bankruptcy and will effectively divest a parent company of control over its borrower subsidiary. While exercising proxy rights is not the optimal recourse in every event of default, it is a valuable remedy that lenders rely upon when making investments and should rightfully be secure from post hoc attack on the grounds asserted by the debtor, and rejected by the court, in the CII Decision.

2. Background

CII Parent, Inc. (the "Parent") owns 100% of the equity of Community Investors, Inc. (the "Portfolio Company"), which in turn owns several indirect operating subsidiaries.[ii] Twin Brook Capital Partners LLC (the "Agent") is the agent for a group of senior secured lenders. In May 2019, the lenders made term and revolving loans secured by a pledge of the Parent's equity interests in the Portfolio Company (the "Equity Pledge"). In July 2022, following the occurrence of certain events of default, the parties entered into a written forbearance agreement, which expired in mid-November 2022.[iii]

In December 2022, the Agent notified the Parent and the Portfolio Company that it was exercising the voting proxy rights granted to it under the Equity Pledge. Contemporaneously, and as is common in these situations, the Agent used its proxy rights to (i) amend the organizational documents of the Portfolio Company, (ii) remove existing directors from the board, and (iii) appoint a new board consisting of independent directors. Six days later, the Parent filed for relief under Chapter 11 and made a written demand to the Agent to rescind its actions so that the Parent could reorganize the Portfolio Company and its subsidiaries.

3. Alleged Violations of the Automatic Stay

In its motion to enforce the automatic stay against the Agent, the Parent argued that (i) by refusing to return voting control over the Portfolio Company to the Parent, the Agent was exercising control over property belonging to the bankruptcy estate (i.e. the pledged equity), (ii) by preventing the Parent from controlling the board of the Portfolio Company, the Agent was interfering with property of the estate, and (iii) the Agent's refusal to rescind its proxy exercise and its execution of the board flip constituted a post-bankruptcy attempt to collect its debt – all in violation of the automatic stay imposed under section 362 of the Bankruptcy Code.

4. Was the Agent Exercising Post-Petition Control Over Estate Property?

There was no dispute that the Parent's stock in the Portfolio Company was property of its bankruptcy estate. To determine whether the Agent was violating the automatic stay, however, the court was required to examine a more specific question: whether the ***voting rights*** associated with the Parent's stock in the Portfolio Company were estate property.

Judge Silverstein's analysis started with the underlying loan and security documents. In addition to the Equity Pledge itself, the loan documents included a broad power of attorney containing an immediate and irrevocable appointment of the Agent as attorney-in-fact for the Parent. This appointment expressly authorized the Agent to act in the Parent's "place and stead" as a stockholder, including voting the pledged equity at any meeting of the stockholders or in any written consent as if the Agent were the owner. The court noted that a separate one-page proxy was included within the loan documents, and it too contained a broad appointment provision. The power of attorney provisions in the loan documents were supplemented by separate remedial provisions that gave the Agent equally broad authority to act with respect to the pledged shares.

a. Decoupling Economic Interests from Voting Rights

Recounting the history of Delaware law on the subject, Judge Silberstein observed that Delaware courts have historically expressed concern that voting proxies, which decouple the economic interests of equity ownership from stockholder voting rights, were at odds with stockholder welfare. More recently, however, courts have been increasingly willing to enforce proxies consistent with the treatment afforded voting trusts and other vote-buying arrangements. Despite this trend, Judge Silberstein observed that voting proxies will still be "narrowly" construed in favor of the stockholder.

b. Notice Requirement

The Parent first argued that the Agent's proxy exercise was ineffective because the Agent failed to provide advance notice.[iv] The Agent responded by pointing to numerous other loan terms where advance notice was expressly required.[v] That was not the case with respect to its proxy rights. Indeed, like many loan and security documents, the Agent was merely required to notify the Parent "substantially concurrently" with its exercise of proxy-related rights.[vi] Siding with the Agent, the court ruled that only concurrent notice was required to be provided and that such notice had in fact been given.[vii]

c. Duration

The Parent also argued that the Agent's proxy rights had expired at the time it purported to exercise them. Delaware law provides for a three-year limit on voting proxies "unless the proxy provides for a longer period."[viii] In this regard, the loan and security agreement provided that "the power-of-attorney and proxy granted hereby is coupled with an interest and shall be valid and irrevocable until the secured obligations have been paid in full . . . ."[ix] The court noted that the separate one-page proxy contained a similar provision that more clearly spoke to the duration of the proxy.[x] Despite a clever argument by the Parent that "until paid in full" referred to irrevocability and not duration, the court found the language of the loan documents to be clear on this point and "consistent with the entire thrust of this commercial transaction."[xi]

d. Action by Written Consent

Finally, the Parent claimed that even if the Agent's notice was proper and the proxy remained in effect longer than three years, the board flip was ineffective because the Agent lacked the authority to act by written stockholder consent.[xii] Although the court found that the language contained in the separate one-page proxy was insufficient on this point, the loan and security documents contained several other provisions that authorized the Agent to act by written consent.[xiii]

5. Conclusion

The court held that the Parent's claims of an automatic stay violation required it to establish that the Agent did not properly exercise its proxy. Because she concluded to the contrary, Judge Silberstein rejected these claims and found no stay violation. Noting that the purpose of Section 362 is to maintain the status quo at the time of the filing, the court concluded that the Agent's board flip validly occurred prior to bankruptcy and therefore that the status quo was preserved by denying the requested relief.[xiv] We agree fully with this decision.

[i] *In re CII Parent, Inc.*, Case No. 22-11345 (LSS) (Bankr. D. Del. April 12, 2023).

[ii] *Id*. at 4.

[iii] *Id.* at 6.

[iv] *Id*. at 16.

[v] *Id*.

[vi] *Id*. at 17.

[vii] *Id*.

[viii] *Id*. at 18 (citation omitted).

[ix] *Id*. at 18 (citation omitted).

[x] *Id*. at 19-20.

[xi] Id. at 21.

[xii] *Id*.

[xiii] *Id*.

[xiv] *Id*. at 25-31.

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