DELAWARE COURT OF CHANCERY PROHIBITS A FINANCIALLY HEALTHY COMPANY FROM AGREEING TO SELL SUBSTANTIALLY ALL OF ITS ASSETS THROUGH A BANKRUPTCY FILING WITHOUT APPROVAL OF THE COMPANY'S COMMON STOCKHOLDERS UNDER 8 *DEL. C.* § 271(a)

In *Esopus Creek Value LP v. Hauf*, No. 2487-N (Del. Ch. Nov. 29, 2006), the Delaware Court of Chancery prohibited a financially healthy corporation, which had not yet filed for bankruptcy protection, from proceeding with an agreement to sell substantially all of its assets under Section 363 of Chapter 11 of Title 11 of the United States Code (the "Bankruptcy Code") without first obtaining approval of the corporation's common stockholders pursuant to Section 271(a) of the Delaware General Corporation Law ("DGCL").

In early to mid-2006, Metromedia International Group, Inc. ("Metromedia") was approached by a group of investors proposing a sale of Metromedia's principal asset, a 50.1% equity interest in Magticom, the Republic of Georgia's leading mobile telephone provider. At that time, Metromedia was in no financial difficulty, had no substantial long-term or secured debt, possessed sizeable free cash flow and EBITDA and was substantially appreciating in value as a result of Magticom's resurgent performance. Metromedia, however, had not been able to comply with its financial reporting obligations under the federal securities laws for several years.

Because the proposed transaction would constitute a "sale of all or substantially all" of Metromedia's assets, Metromedia was obligated under § 271(a) of the DGCL to obtain the approval of the company's common stockholders. However, Metromedia's board of directors (the "Board"), relying on advice from legal counsel, believed that a § 271 vote was not possible to obtain because Section 14(c) of the Securities and Exchange Act of 1934 (the "'34 Act") barred the company from calling a meeting or soliciting proxies from the common stockholders.

Faced with this perceived conundrum, the Board adopted a plan consisting of the following four steps to use the Bankruptcy Code as a vehicle to effectuate the transaction: (1) execute an agreement providing for the sale of Magticom; (2) file a voluntary bankruptcy petition under the Bankruptcy Code; (3) move the bankruptcy court to approve the Magticom sale under Section 363 of the Bankruptcy Code; and (4) solicit votes on and seek court approval of a plan of reorganization (the "Plan") under Section 1129 of the Bankruptcy Code. Metromedia took the position that under the Bankruptcy Code it would not be required to solicit the votes of the common stockholders, either with respect to the asset sale or the approval of the Plan. In contrast, approval of the Plan would require the approval of two-thirds in amount and fifty percent in number of the company's preferred stockholders. As a result, the company negotiated and entered into a voting lock-up agreement with the holders of roughly 80% of the preferred shares.

After the announcement of the proposed transaction, two common stockholders of Metromedia filed a complaint seeking, *inter alia*, to have Metromedia enjoined from executing an agreement with the buying group absent an affirmative vote of a majority of the company's common stockholders pursuant to § 271(a) of the DGCL. After briefing and expedited discovery on plaintiffs' motion for a preliminary injunction, the defendants backpedaled from their position that the Magticom sale could be accomplished in Bankruptcy Court without a common stockholder vote and instead suggested that the

parties stipulate that: (1) the transaction would be subject to a vote of the common stockholders under § 271(a); (2) the Board would seek exemptive relief from the SEC to permit the company to solicit proxies and to provide its stockholders with financial information concerning the Magticom assets; (3) regardless of whether the SEC granted exemptive relief, the company would distribute all information required under Delaware law to ensure that the § 271 vote was informed; and (4) the company would take all necessary steps to encourage common stockholders to attend the § 271 meeting and vote on the proposed transaction. This suggestion was amenable to the plaintiffs and the Court and, contemporaneously with entering an Order embodying the parties' agreement, Vice Chancellor Lamb issued his Opinion to explain the foundations of the Order.

The Court first determined the appropriate level of review, concluding that the Board's decision to pursue the transaction did not trigger the "compelling justification" standard required under *Blasius Industrial, Inc. v. Atlas Corp.,* 564 A.2d 651, 669 (Del. Ch. 1988). The Court stated that "when the matter to be voted on does not touch on issues of directorial control, courts will apply the exacting *Blasius* standard sparingly, and only in circumstances in which 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 the instant case, the Court reasoned that since (1) there was no entrenchment motivation evident in the director's decision, (2) the Board had previously agreed to hold a stockholder meeting for election of directors on December 15, 2006, and (3) it was not clear that a majority of the stockholders had voiced disapproval of the transaction, the compelling justification standard of *Blasius* could not be properly invoked.

Notwithstanding its finding that the Board's actions did not invoke the stringent *Blasius* standard of review, the Court determined that the decision to structure the transaction as a bankruptcy sale offended fundamental notions of equitable conduct under *Schnell v. Chris Craft Indus., Inc.*, 285 A.2d 437 (Del. Ch. 1971) and its progeny. *First*, the Court noted that Metromedia was clearly solvent, stating that it "seems an abuse of the bankruptcy process for a robust and healthy company, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing." Although the Court noted that it was not explicitly deciding that "good faith" was lacking to justify the filing of a bankruptcy petition under the Bankruptcy Code, the Court stated that "the inquiries relevant to a 'good faith' standard provide ample support for the notion that the board's conduct here inequitably abridged the justified expectations of the common stockholders."

Second, the Court found that the "single self-admitted purpose" of Metromedia's plan to file bankruptcy in order to avoid compliance with § 271 of the DGCL and the fact that Magticom's value was appreciating were both indicative of inequitable conduct.

Third, the Court found that the enfranchisement of the preferred stockholders, who otherwise would not have had the right to vote on the transaction under Metromedia's basic organizational documents, also suggested that the company acted inequitably. The Court stated that, "[by] entering into the lock-up agreement, . . . the directors effectively granted the preferred stockholders substantial additional bargaining power to influence the company's disposition of its remaining assets." While theoretically legal, the Court determined that the structure of the proposed transaction inequitably reallocated control over the corporate enterprise.

Fourth, although there was some evidence that the company's counsel had been informally told by SEC staff that exemptions from the reporting requirements under the '34 Act were highly unlikely to be granted, the Court appeared troubled by Metromedia's failure to further pursue the availability of such exemptions with the SEC. Looking to its analysis of a related issue in *Newcastle Partners, L.P. v. Vesta Insurance Group, Inc.,* 887 A.2d 975 (Del. Ch. 2005), *aff'd,* 906 A.2d 807 (Del. 2005), the Court noted that "the SEC often uses it[s] exemptive authority in a manner that supports important state law standards of corporate governance," like the stockholder voting requirement in § 271 of the DGCL.

Finally, the Court somewhat ominously concluded its Opinion by suggesting that, under § 322 of the DGCL and general principles of equity, the Court had the power to appoint a receiver to address noncompliance with its order or management's failure to properly hold a stockholders' meeting and election.

The *Esopus Creek* decision principally reinforces the fundamental point that a Delaware Court will, in appropriate circumstances, enjoin conduct it finds to be inequitable, even though such conduct is otherwise lawful. The Opinion, however, also highlights a tension between the suffrage rights of stockholders and the bankruptcy goal of maximizing value. The Court's ruling seems to indicate that, at least when the contemplated sale through bankruptcy of substantially all of the assets of a financially healthy company is concerned, the goal of maximizing value for all stakeholders may have to yield to state law corporate governance protocols in certain situations.

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