

Comments

STOCKHOLDER'S RIGHTS IN A CORPORATE
DEMOCRACY UNDER DELAWARE CORPORATION LAW
DURING BANKRUPTCY: *SAXON INDUSTRIES, INC.*
v. NKFV PARTNERS

The reorganization of a debtor corporation under the Federal Bankruptcy Act¹ imposes intense strain upon corporate affairs and governance. The struggle to control the assets of the corporation often pits creditors or tort victims against the stockholders. While the creditors are scrambling to have their outstanding debts settled, the stockholders are concerned with protecting their investments. This clash of interests inevitably leads to conflict. As the corporation's debts mount, the creditors impose increasing pressure to have their interests satisfied. During reorganization, issues concerning stockholders' rights often become obscured by the exigencies of the proceedings. Frequently, a stockholder believes that his interests are being less than fully represented.

When there has been an undue delay in the holding of the stockholders' meeting, stockholders usually desire to compel one. Until recently, two questions arose as to the propriety of compelling such a meeting. First, since the Bankruptcy Act mandates that a bankruptcy court administer the debtor's estate,² the distressed stockholder had to decide whether to bring the action to compel in that

1. Bankr. Act §§ 101, 301, 11 U.S.C. §§ 501, 701 (1978).

Historically, both Chapters 10 and 11 have dealt with corporate reorganization. The former provided a method for the arrangement of secured debts and stock dealings, whereas the latter pertained to unsecured debts of both corporate and individual debtors. Chapter 10 usually has been reserved for larger corporate debtors and was employed where there is a complex publicly held debt involving a large number of public investors. Since the similarities between both chapters were many, Congress merged these chapters in the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1979). For purposes of this comment and in comparison of the pre-case law, no further distinctions will be made. *See generally* 6 COLLIER ON BANKRUPTCY ¶ 0.12, at 120 (14th ed. 1978) [hereinafter cited as COLLIER]; *SEC v. American Trailer Rentals Co.*, 379 U.S. 594 (1965) (explanation of background and relationship of Chapters 10 and 11).

2. *See* Bankr. Act § 301, 11 U.S.C. § 701. Since the automatic stay provisions of the Bankruptcy Act apply, by implication, to creditor-debtor relations issues concerning corporate governance (stockholder/corporation) are not precluded. *See also* 11 U.S.C. § 362.

forum or in the state forum where corporate governance issues are traditionally resolved. Second, while state statutes often were specific as to what was required to compel a meeting, there was always some uncertainty as to the nature and adequacy of the debtor directors' defenses while in bankruptcy proceedings. Aside from the situation where the directors have failed to call an annual meeting and the stockholder simply desires one, the fact that the corporation is involved in bankruptcy proceedings often complicates the resolution of the stockholder's problem. The stockholders' interests must be weighed against the potential harm to the administration of the estate resulting from the free exercise of equitable rights. This competition of interests may preclude a stockholders' meeting when it would otherwise have been held.³

In a case of first impression, the Delaware Supreme Court in *Saxon Industries, Inc. v. NKFV Partners*⁴ addressed the issue of whether a stockholder could utilize Delaware Code section 211⁵ to compel a long overdue stockholders' meeting during the pendency of a Chapter 11 reorganization.⁶ In affirming the chancery court's order compelling the meeting, the supreme court balanced the interests of the parties. The court found that the scales tipped in favor of Delaware General Corporation Law⁷ which is concerned primarily with issues of corporate governance.⁸ Since Delaware has a policy of encouraging "the free exercise of a stockholder's right to elect directors," the court held that this forum should prevail when issues of corporate governance arise.⁹ Furthermore, the supreme court held that the affirmative defenses raised by *Saxon* in response to the section 211 motion were inadequate.¹⁰

The issues embraced by the *Saxon* court raise interesting questions as to the appropriate forum in which to compel a stockholders'

3. See *infra* notes 76-91 and accompanying text.

4. 488 A.2d 1298 (Del. 1984).

5. DEL. CODE ANN. tit. 8, § 211 (1974) (enunciates procedures used to govern the holding of stockholder meetings). See *infra* note 12 and accompanying text.

6. Since *Saxon* only dealt with issues concerning the Bankruptcy Act § 301, references made to bankruptcy proceedings in this comment, if not further specified are confined to this statutory section. See *supra* note 1.

7. *Saxon*, 488 A.2d at 1302-03.

8. See generally DEL. CODE ANN. tit. 8 (1974) (codification of Delaware General Corporation Law).

9. *Saxon*, 488 A.2d at 1302.

10. *Id.* at 1303. See *infra* notes 84-98 and accompanying text (affirmative defenses in § 211 actions).

meeting, as well as prerequisites for a section 211 action. To understand the full impact of *Saxon*, the interaction between Federal Bankruptcy Law and Delaware General Corporate Law will be explained and the mechanics of the section 211 motion analyzed.

I. BACKGROUND

Whether the bankruptcy proceeding is initiated due to creditor claims or the potential for extensive tort liability, the corporate organization is thrust into a state of turmoil. The provisions of Chapters 10 and 11 of the original Federal Bankruptcy Act (now found in Chapter 11) were designed to rehabilitate the corporate debtor while preserving the legal rights of the creditors and stockholders.¹¹ To effect this purpose, the bankruptcy court is vested with the broad powers of equity,¹² and thus is able to maintain a climate that is amenable to swift, fair, and efficient administration of the debtor's estate.¹³

Section 211 of the Delaware General Corporation law allows the court of chancery to summarily order an annual meeting of stockholders for the purpose of electing directors by application of any stockholder or director if thirteen months have elapsed since the last meeting.¹⁴ This section is designed to guarantee adequate stockholder representation.¹⁵

11. See *supra* note 2. See also *Valley Int'l Properties v. Los Campeones*, 568 S.W.2d 680 (Tex. Civ. App. 1978) (reviewing bankruptcy court jurisdiction).

12. See 28 U.S.C. § 1334 (1978) (as amended by Bankr. Act § 101—jurisdiction of bankruptcy courts). See also T. FINELETTER, *THE LAW OF BANKRUPTCY REORGANIZATION* 188-94 (1939); *Bailey v. Proctor*, 160 F.2d 78, 81 (1st Cir. 1947); *In re Bush Terminal*, 78 F.2d 662, 665 (2d Cir. 1935).

13. See Bankr. Act § 301, 11 U.S.C. § 701; accord *Valley Int'l*, 568 S.W.2d at 685.

14. See DEL. CODE ANN. tit. 8, § 211 (c) which provides in relevant part: If there be a failure to hold the annual meeting for a period 30 days after the date designated therefore, or if no date has been designated for a period of 13 months after the organization of the corporation or after its last annual meeting, the Court of Chancery may summarily order a meeting to be held upon the application of any stockholder or director The Court of Chancery may issue such orders as may be appropriate, including, without limitation, orders designating the time and place of such meeting, the record date for determination of stockholders entitled to vote, and the form of notice of such meeting.

15. See Walsh, *Delaware Statutory Provisions and Case Law Applicable to Directors and Shareholder Meetings*, 3 DEL. J. CORP. L. 182, 183-84 (1978) [hereinafter cited as Walsh]. Other jurisdictions have similar stockholder meeting provisions. See N.Y. BUS. CORP. LAW § 603 (McKinney 1983); TEX. BUS. CORP. ACT ANN. art. 2.24B (Supp. 1978). See generally 6 Z. CAVITCH, *BUSINESS ORGANIZATION WITH TAX PLANNING*

In *Saxon*, the Federal Bankruptcy Act and Delaware General Corporation Law collided when a stockholder of a debtor corporation protected under Chapter 11, sought to compel a stockholders' meeting for the purpose of electing directors.¹⁶ *Saxon Industries, Inc.*, a publicly held Delaware corporation in the paper converting/distribution business, was operating as a voluntary debtor-in-possession¹⁷ when a motion to compel a stockholders' meeting was filed by NKFw Partners¹⁸ in the Delaware Chancery Court.¹⁹ The last meeting had been held thirty-one months earlier.²⁰ In the several months prior to the suit, *Saxon* was showing a profit. Due to an overwhelming debt surplus²¹ and the on going bankruptcy proceedings, *Saxon* entered negotiations concerning a merger with Alco Standard Corporation.²² NKFw was dissatisfied with the status of the reorganization and did not believe the board was acting in the stockholders' best interests.²³ After the motion to compel was filed, *Saxon* transferred it to the U.S. Bankruptcy Court for the District of Delaware.²⁴ That court realized that the "Delaware Court of Chancery has a nationally recognized expertise in the resolution of corporate matters" and remanded to the Delaware Chancery Court.²⁵

§ 117.04[1] n.9 (1985); 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2025 (rev. perm. ed. 1980).

16. *Saxon*, 488 A.2d at 1300 (Delaware proceeding was filed with the approval of the equity committee and the New York Bankruptcy Court).

17. See 11 U.S.C. §§ 1107, 1108.

18. NKFw owned 100 shares of *Saxon* stock and brought the motion to compel on its own behalf and as a representative for the Committee of Equity Security Holders of *Saxon Industries, Inc.* Brief for Appellee at 5, *Saxon Industries, Inc. v. NKFw Partners*, 488 A.2d 1298 (Del. 1984). Pursuant to 11 U.S.C. § 1103 (1978), an Equity Committee was appointed to represent the *Saxon* stockholders in the Chapter 11 reorganization. This Committee consisted of the seven largest stockholders who were willing to serve. *Saxon*, 488 A.2d at 1299 n.2.

19. *NKFw Partners v. Saxon Indus., Inc.*, No. 7468 (Del. Ch. Aug. 17, 1984).

20. *Saxon*, 488 A.2d at 1299. Under Delaware law, the *Saxon* board was able to elect five new directors. Vacancies occurring between the holding of annual meetings may be filled by the majority of remaining directors. DEL. CODE ANN. tit. 8, § 223(a)(1). *Saxon*, 488 A.2d at 1299 n.3.

21. *Saxon*, 488 A.2d at 1298. *Saxon's* auditors assigned a debt valuation at \$200 million despite the company's recent profits. *Id.* The appellees alleged that *Saxon's* value may have differed from the 200 million assessed by company auditors. Specifically, the presence of a large net operating loss tax carryforward may have not been considered, and thus would have raised the value of *Saxon*. Brief for Appellee at 6 n.4, *Saxon Industries, Inc. v. NKFw Partners*, 488 A.2d 1298 (Del. 1984).

22. *Saxon*, 488 A.2d at 1299.

23. *Id.* at 1300.

24. See 28 U.S.C. § 1471(d) (1978).

25. See *In re Saxon Indus.*, 39 Bankr. 49 (Banker. S.D.N.Y. 1984). On May

Saxon alleged that the only reason that NKFW brought the suit was to receive a more substantial payment in the reorganization. It also contended that the federal bankruptcy court was the forum to determine the overall fairness²⁶ of the reorganization. Saxon also believed that there was no need to call such a meeting since federal bankruptcy law requires that all stockholders have an opportunity to vote on the plan.²⁷ The chancery court found first that Delaware courts were the appropriate forum for the section 211 action. Second, the alleged adverse effects of a stockholders' meeting upon a reorganization did not outweigh a stockholder's right to compel an election of directors.²⁸

II. ANALYSIS

A. Delaware Chancery Court as the Appropriate Forum for Matters Concerning Corporate Governance

Even where the corporate debtor has not remained in possession of its property and a trustee is appointed, the debtor still retains its viability as a corporation and capacity to retain its officers and directors.²⁹ Corporate democracy during reorganization, as with all corporations in normal circumstances, guarantees that the stockholders are represented by directors of their choice.³⁰ Thus, the

1, 1984 the Bankruptcy Court for the Southern District of New York granted *nunc pro tunc*, an application submitted by the equity stockholders to retain Delaware counsel for the § 211 action. *Saxon*, 488 A.2d at 1300.

26. *Saxon*, 488 A.2d at 1300 (court relied on 11 U.S.C. § 1128 which allowed for the bankruptcy court to hold a hearing to determine the fairness and confirm the reorganization plan).

27. See 11 U.S.C. § 1126 (preferred stockholders sought replacement of board of directors pursuant to debtor's articles of incorporation, which allowed such action when dividends had not been paid or earned in two years). See also *Saxon*, 488 A.2d at 1300.

28. *NKFW Partners v. Saxon Indus., Inc.*, No. 7468 (Del. Ch. Aug. 17, 1984).

29. See JACKSON REPORT ON RECEIVERSHIP AND BANKRUPTCY PROCEEDINGS IN U.S. COURTS, S. DOC. NO. 268, 74th Cong., 2d Sess. 64 (1936) (corporation should be actually functioning, not a shell or automaton) [hereinafter cited as JACKSON REPORT].

30. See *In re Bush Terminal*, 78 F.2d 662 (1935).

The stockholders should have the right to be adequately represented in the conduct of the debtor's affairs, especially in such an important matter as reorganization of the debtor. Such representation can only be obtained by having as directors persons of their choice. [S]tockholders, if they feel that the present board of directors is not acting in their interest, [may] cause a new board to be elected which will act in conformance with the stockholders wishes

bankruptcy proceeding ordinarily does not interfere with the stockholders' fundamental right to adequate representation or their ability to enforce that right.³¹

Bankruptcy court jurisdiction attaches when the bankruptcy proceeding is initiated. Thereafter, that court has exclusive power to ensure that the proper administration of the estate is unhampered. The primary focus of this forum is to ensure the equitable administration of the debtor's estate.³² In fact, the bankruptcy court has no original jurisdiction over activities concerning corporate governance unless those activities interfere with the administration of the estate.³³ This jurisdictional barrier in a bankruptcy proceeding reinforces the fact that the corporate entity of the debtor is to be preserved.³⁴ Thus, for the bankruptcy court to become involved in the internal matters of the corporation, some adverse impact upon the estate is required.³⁵ Most state courts, as well as federal bankruptcy courts, have held that despite the pendency of the bankruptcy proceeding, stockholders' meetings should be permitted.³⁶ In *In re J.P. Linahan*,³⁷ the Second Circuit held:

[T]he right of the majority of stockholders to be represented by directors of their own choice and thus to control corporate

Id. at 664. See also JACKSON REPORT, *supra* note 29, at 64. But see *In re Johns-Manville Corp.*, 52 Bankr. 879 (Bankr. S.D.N.Y. 1985) (directors have broader fiduciary obligation during reorganization not only to represent the stockholders but to protect creditor interests).

31. See *In re J.P. Linahan, Inc.*, 111 F.2d 590, 592 (2d Cir. 1940) (reorganization). See also *In re FSC Corp.*, 11 B.C.D. 886, 888, 38 Fed. Reg. 346, 349 (W.D. Pa. 1983) (receivership).

32. See *In re Plankinton Bldg. Co.*, 138 F.2d 221, 222 (7th Cir. 1943).

33. See *Bailey v. Proctor*, 160 F.2d 78, 82 (1st Cir. 1947); *In re Public Serv. Holding Corp.*, 141 F.2d 425, 426 (2d Cir. 1944); *In re Plankinton*, 138 F.2d at 222; *J.P. Linahan*, 111 F.2d at 591; *In re Wisconsin Cent. Ry.*, 94 F. Supp. 165 (D. Minn. 1950); *In re Lionel*, 30 Bankr. 327, 329 (Bankr. S.D.N.Y. 1983); *Valley Int'l*, 568 S.W.2d at 686; T. FINELETTER, *THE LAW OF BANKRUPTCY REORGANIZATION* 194 n.26 (1939).

34. See COLLIER, *supra* note 1, ¶ 0.11.

35. See *In re Johns-Manville Corp.*, 52 Bankr. 879 (Bankr. S.D.N.Y. 1985) (stockholders' meeting would impede reorganization because current directors and creditors were close to a consensual reorganization plan). *In re Potter Instrument Co.*, 593 F.2d 470 (2d Cir. 1979) (reorganization impeded by a stockholder's efforts to destroy his company); *In re Alrac*, 1 B.C.D. 1504 (Bankr. D. Conn. 1975) (equitable stockholders precluded from voting if stockholder's election held). See also *infra* notes 38-43 and accompanying text.

36. See *supra* note 34 and *infra* note 113 (bankruptcy court's power to enjoin outside actions).

37. 111 F.2d 590 (2d Cir. 1940).

policy is paramount and will not be disturbed unless a clear case of abuse is made out. This has been the rule all along in equity receiverships, in ordinary bankruptcy and in proceedings for reorganization under former section 77B of the Bankruptcy Act, [predecessor of Chapter 10] the stockholders are entitled to elect directors who will abide by their wishes, provided of course the directors chosen are not persons who will injure the honest and efficient management of the corporate property.³⁸

In *In re Lionel Corp.*,³⁹ the debtor corporation sought to enjoin its equity security stockholders from compelling a stockholders' meeting in state court. The Bankruptcy Court for the Southern District of New York held that corporate governance issues were best left to state proceedings and that no evidence has been presented that the reorganization proceeding would be impeded by the holding of the annual stockholders' meeting.⁴⁰ The court stated that:

[t]here is no demonstrable reason to deny the share-holders their right to an annual meeting despite the pendency of the reorganization proceeding and it would be an abuse of the Court's power to preclude the [equity shareholders] defendants-respondents herein from resorting as they have, to all available legal remedies including the state court proceeding as a vehicle for asserting their fundamental rights.⁴¹

The rights referred to in *Lionel*, however, are not absolute. The federal circuit courts have upheld the deferment of stockholders' meetings as a reasonable exercise of the bankruptcy court's discretion in the following instances:⁴² where the reorganization was pending final confirmation;⁴³ where the petition was pending review for dismissal;⁴⁴ where the preferred stockholders threatened to seize control of the debtor corporation at the expense of the common stockholders;⁴⁵

38. *Id.* at 592.

39. 30 Bankr. 327 (Bankr. S.D.N.Y. 1983).

40. *Id.* at 329. See *Valley Int'l*, 568 S.W.2d at 686.

41. *Lionel*, 30 Bankr. at 330.

42. See *In re Johns-Manville*, 52 Bankr. 879 (Bankr. S.D.N.Y. 1985). See, e.g., *In re Public Serv. Co.*, 141 F.2d 425 (2d Cir. 1944); *Graselli Chem. Co. v. Actna Explosives Co.*, 252 F. 456 (2d Cir. 1918).

43. See *Johns-Manville*, 52 Bankr. at 881.

44. See *Public Serv.*, 141 F.2d at 426.

45. See *Graselli Chem.*, 252 F.2d at 461.

and where events had taken place which rendered the motion to compel moot.⁴⁶ In each of these circumstances, granting the motion would either have been inequitable or would have interfered with the proper administration of the estate. However, absent such considerations, the bankruptcy court will allow the commencement of a state proceeding or summarily compel a stockholders' meeting where the stockholder has made an appeal directly to the state court.⁴⁷ Often a dissatisfied stockholder will move to compel a meeting while in bankruptcy court instead of commencing a separate action in state court. As a general rule the bankruptcy court's discretion to compel such a meeting rests on the extensive powers of equity with which it is vested.⁴⁸ In *In re Wisconsin Central Railway Co.*,⁴⁹ a district court held:

[W]ho the members of the Board of Directors are, and what the rights of the stockholders may be as between themselves with respect to the election of the Board of Directors, is not a matter which, of itself, affects adversely the administration of the debtor's estate. The debtor's estate will function, and the bankruptcy proceedings continue, regardless of who may comprise the board of directors
...⁵⁰

The U.S. Bankruptcy Court in *Lionel* specifically addressed the issue of the appropriate forum for the issuance of an order to compel a stockholders' meeting. In denying a motion to enjoin the state action, the court found that corporate governance issues should be relegated to a state forum and that the bankruptcy court should not entertain such issues.⁵¹ In *Saxon*, the bankruptcy court itself recognized that the Delaware Court of Chancery was the proper forum.⁵² The *Saxon* court noted that the bankruptcy court's primary focus was upon the administration of the debtor's estate and not corporate governance.⁵³

46. See *Bailey v. Proctor*, 160 F.2d 78 (1st Cir. 1947).

47. There is a growing trend toward bringing § 211 and like actions in the state forum because it is recognized that these courts focus upon and are more familiar with applicable state corporate law. *Valley Int'l*, 568 S.W.2d at 686.

48. See *supra* note 11.

49. 94 F. Supp. 165 (D. Minn. 1950).

50. *Id.* at 1672.

51. See *Lionel*, 30 Bankr. at 329. See also *Saxon*, 488 A.2d at 1302; *Valley Int'l*, 568 S.W.2d at 686.

52. See *In re Saxon Indus.*, 39 Bankr. 49, 50 (Bankr. S.D.N.Y. 1984).

53. See *Saxon*, 488 A.2d at 1300.

However, in order to ensure against interference with the bankruptcy court's duties, the bankruptcy court may require the party to move for leave of court to pursue the state action. This ensures that the administration of the estate will not be unduly hampered.⁵⁴ Also, the directors must be approved by the court after election by the stockholders.⁵⁵ Even though the bankruptcy court has the equitable power to compel a stockholders' meeting, its expertise is centered on the administration of the debtor estate. It has little experience in dealing with issues concerning corporate democracy. Thus, when a plaintiff seeks to compel a stockholders' meeting, the proper forum in which to commence the action is the state court. The state court is not only familiar with the intricacies of state corporate law, but it is also the forum in which issues of corporate governance may be given primary consideration.

B. *Stockholder's Prima Facie Case to Compel Meeting*

One of the fundamental tenets of corporate law is that the stockholder has the right to select representation of his interests on the board of directors.⁵⁶ In *Algeran, Inc. v. John J. Connolly*,⁵⁷ the stockholders sought to compel a meeting over the corporate director's objection that the corporation did not have sufficient resources to prepare financial records. Vice-Chancellor Hartnett of the Delaware Court of Chancery stated, "[T]he annual meeting of stockholders for the purpose of electing directors is one of the few avenues available for a corporate stockholder to enable him to have a say in the destiny of his corporation."⁵⁸ If the mere pendency of a bankruptcy proceeding precludes the holding of a stockholders' meeting for the purpose of electing directors, the corporation may be run by directors who do not adequately represent the stockholders.⁵⁹ Since the stock-

54. See *Johns-Manville*, 52 Bankr. at 884. See also *infra* note 113 (power to enjoin outside actions which interfere with administration of the debtor estate).

55. See *In re Lifeguard Indus.*, 37 Bankr. 3 (Bankr. S.D.N.Y. Ohio 1983) (bankruptcy court refused to install new management because it appeared that they had no real understanding of immediate problems facing the business, i.e., financial conditions). COLLIER, *supra* note 1, ¶ 0.15. This may seem like "shareholder's rights in a vacuum," but the directors play a key role in drafting and adopting the reorganization plan, whereas the stockholders only vote approval or disapproval.

56. See 5 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2025 (rev. perm. ed. 1980).

57. No. 6557 (Del. Ch. Oct. 5, 1981).

58. *Id.* at 2.

59. See *Saxon*, 488 A.2d at 1300; *Bush Terminal*, 78 F.2d at 665 ("[T]he right of stockholders to elect a board of directors should . . . be carefully guarded and

holders are the true owners of the corporation, they are the real parties in interest. They should be given a chance to express their views as to the terms and conditions of the reorganization plan.⁶⁰ This may be most efficiently accomplished by the election of directors who will represent their interests.

As the arbiter of such affairs, the Delaware Court of Chancery in *Saxon* was called upon to weigh all of the considerations concerning the motion to compel the stockholders' meeting. Under Delaware Corporation Law section 211(c)⁶¹ the court of chancery is empowered to summarily compel a stockholders' meeting for the purpose of electing directors once a *prima facie* case has been established.⁶² A party seeking to compel a meeting must prove stockholder or director status and that the last meeting had been held more than thirteen months earlier.

Once the motion to compel has been granted, the directors of the corporation must hold an election promptly.⁶⁴ Each moment the stockholders' interests are not represented, the possibility exists that the interests of the true owners of the company have been detrimentally affected.⁶⁵ Although the court of chancery has held that the chancellor may hold the directors in contempt of court if they fail to obey a summary order,⁶⁶ not all delays in holding the annual meeting are inexcusable. In *Tweedy, Browne & Knapp v. Cambridge*

protected . . . for the board is the representative of the stockholders.). See also *Linahan*, 111 F.2d at 592; *Valley Int'l*, 568 S.W.2d at 686.

60. See *Bush Terminal*, 78 F.2d at 664.

61. See *supra* notes 28-31, 36, 38 and accompanying text.

62. See *Coaxial Communications, Inc. v. CNA Fin. Corp.*, 367 A.2d 994 (Del. 1976); *Meredith v. Security Am. Corp.*, No. 6606 (Del. Ch. Nov. 17, 1981); *Savin Business Mach. Corp. v. Rapifax Corp.*, 375 A.2d 469 (Del. Ch. 1977); *Tweedy, Browne & Knapp v. Cambridge Fund, Inc.*, 318 A.2d 635 (Del. Ch. 1974); *Prickett v. American Steel & Pump Corp.*, 251 A.2d 576 (Del. Ch. 1969); *In re Jackson*, 81 A. 992 (Del. Ch. 1911). See also *supra* note 15 (other jurisdictions utilizing a similar procedure).

63. Certainly stock ownership would provide standing as a stockholder. See *infra* note 87 and accompanying text.

64. See *Coaxial Communications*, 367 A.2d at 998. "Given the importance of an annual meeting of stockholders in the administration of corporate affairs 'prompt' relief is essential under § 211." In *Coaxial*, the court found the federal litigation to be so complex in nature that prompt and complete justice of the stockholder's issue was frustrated. *Id.* See generally *Savin Business Mach.*, 375 A.2d at 472; *Tweedy, Browne & Knapp*, 318 A.2d at 637.

65. *Meredith v. Security Am. Corp.*, No. 6606 (Del. Ch. Nov. 17, 1981) (company's financial status was "in a situation . . . where rapidly developing events are placing shareholder investment [sic] in grave danger").

66. See *In re Jackson*, 81 A. 992, 993 (Del. Ch. 1911) (power established in this case).

Fund, Inc.,⁶⁷ the court of chancery found that "if there are mitigating circumstances explaining the delay or failure to act, they can be considered in fixing the time of the meeting or by such other 'appropriate' order authorized by § 211(c)."⁶⁸

Every stockholder has the right to seek judicial redress to ensure compliance with section 211. This section does not distinguish between large and small stockholders, and it is immaterial that those seeking to compel the meeting are in opposition to the current management.⁶⁹ With the *prima facie* case established, "there would appear no need to adduce further facts in connection with the petitioner's application under the statute."⁷⁰ The stockholders' right to have a meeting is "virtually absolute."⁷¹ The fact that the corporation faces bankruptcy has little relevance with regard to section 211 rights. Even in bankruptcy, the corporation exists as a viable entity and the stockholders' right to representation remains paramount.⁷²

While the stockholders' right to such a meeting has been found to be virtually absolute, the motion to compel a stockholders' meeting may nonetheless be denied if the party opposing the meeting presents an adequate affirmative defense. Similar to the considerations facing the bankruptcy court in determining whether there is interference with the administration of the estate, consideration of a stockholder's motion to compel a meeting entails an evaluation of the facts and circumstances. Moreover, this evaluation is similar to that employed when an application is made for injunctive relief.⁷³ In the absence of irreparable harm to the debtor corporation, the section 211 order should be allowed.⁷⁴

67. 318 A.2d 635 (Del. Ch. 1974).

68. *Id.* at 637. See also *In re Tonopah United Water Co.*, 16 Del. Ch. 26, 139 A. 762 (1927) (timeliness of stockholder meeting postponement date).

69. See *Coaxial Communications*, 367 A.2d at 998.

70. *J.P. Griffin Holding Corp. v. Mediatrics*, No. 4056 (Del. Ch. Jan. 30, 1973). Delaware courts do not always adhere to this holding, but close reading of the case law reveals that the finding of an affirmative defense is quite rare. See *infra* notes 82-94 and accompanying text.

71. See *Coaxial Communications*, 367 A.2d at 998. See also *Prickett*, 251 A.2d at 578.

72. See *supra* note 29 and accompanying text.

73. The opinion of the *Saxon* court fell short of delineating a legal standard with which to measure an affirmative defense, but noted that Delaware case law has never denied a motion to compel. The court did, however, rely on *In re Lionel*, which requires the finding of irreparable harm to uphold an injunction to bar such a meeting. See *Lionel*, 30 Bankr. at 327.

74. Once a *prima facie* case is established under § 211, the opposing party must raise an affirmative defense to enjoin the meeting. *Id.* at 327.

In *Saxon*, the Delaware Supreme Court was convinced that the alleged harm claimed by the corporation was "too ethereal" to constitute an adequate affirmative defense.⁷⁵ *Saxon* had asserted, *inter alia*, that Alco Standard would walk away from the dealing table if a stockholders' meeting was held and a proxy fight ensued.⁷⁶ *Saxon* also noted that the expenses of the proxy fight would be burdensome, the potential for loss of key personnel would be high, and that the possibility existed that *Saxon's* credit would be curtailed.⁷⁷ The court, treating these concerns as an assertion of an affirmative defense, found that the cases presented by *Saxon* for support were readily distinguishable.⁷⁸

The situation in *Saxon* was quite unlike that in *In re Potter Instrument Co.*⁷⁹ In *Potter*, the major stockholder and ex-officer/chairman of the board became frustrated with the debtor company and tried to destroy it by compelling a stockholders' meeting which would in effect force the liquidation of the debtor. Since the plaintiff was the leading stockholder, he could alter previously confirmed rehabilitative debt agreements. The bankruptcy court found a significant threat to the creditors and denied the motion.⁸⁰ However, it was not the aim of *Saxon's* stockholders to destroy or otherwise act to the detriment of the corporation. They sought to protect legitimate interests concerning the pending bankruptcy proceeding. Citing an extensive line of Delaware cases, the *Saxon* court held that "Delaware law does not presume that shareholders act contrary to their own best interests."⁸¹ Where there was no evidence to the contrary, the court found that a stockholder's motive was immaterial.⁸²

The concerns of the *Saxon* court also differed greatly from those of the bankruptcy court in *In re Alrac Corp.*⁸³ The *Alrac* court postponed the time of the stockholders' meeting because, under a confirmed reorganization plan, the ownership of the corporation would be radically changed.⁸⁴ Under the terms of the *Alrac* arrangement, the

75. *Saxon*, 488 A.2d at 1303.

76. Another stockholder at the time of the *Saxon* trial had positioned himself to solicit proxies. *Id.* at 1302 n.6.

77. *Id.* at 1302.

78. *Id.* at 1301.

79. *In re Potter Instrument*, 593 F.2d 470 (2d Cir. 1979).

80. *Id.* at 474-75.

81. *Saxon*, 488 A.2d at 1301.

82. *Id.* at 1302.

83. 1 B.C.D. 1504 (Bankr. D. Conn. Oct. 22, 1975).

84. *Id.* at 1502.

creditors were to get sixty percent of the debtor corporation's stock.⁸⁵ In essence, the stockholders seeking to compel the meeting would eventually become minority stockholders. The prejudice in allowing the compelled meeting clearly outweighed any stockholders' rights. The creditors had a vested equitable right in the stock and would have been shut out of the voting if the meeting had been held immediately.⁸⁶ In the *Saxon* bankruptcy proceeding, the reorganization plan was only under consideration and not yet confirmed.⁸⁷ The Supreme Court also found that the claim of threatened harm (i.e., the proxy fight) was based on mere speculation and was not supported by any material evidence.⁸⁸

Delaware courts have not been receptive to the presentation of affirmative defenses. In *Prickett v. American Steel & Pump Corp.*⁸⁹ the chancery court held that a receiver *pendente lite* could compel a stockholders' meeting once a *prima facie* case was established.⁹⁰ Under a district court order, the receiver was to exercise the broad powers of management and also was able to take actions as a stockholder. The receiver, therefore, had standing to compel a meeting.⁹¹ In *Tweedy*, the corporation claimed that it would be inequitable to compel a meeting before stockholders received the management's proxy materials and had time to compare them with previously submitted solicitations. The chancellor held that the defense of untimeliness to the motion to compel an annual meeting lacked substance, i.e., there were no mitigating circumstances present to explain the delay.⁹² The Delaware Supreme Court in *Coaxial Communications, Inc. v. CNA Financial Corp.*⁹³ held that the pendency of another proceeding in another jurisdiction was not a sufficient basis to stay the motion to compel the meeting.⁹⁴ In *Meredith v. Security America Corp.*,⁹⁵ the court

85. *Id.*

86. *Id.* As part of a confirmed plan, the creditors were entitled to shares of the debtor's stock. They had an equitable right to it, but until the plan was implemented, they did not have any legal rights to the shares. If the Alrac stockholders could compel the meeting, they could elect directors who would not be representative of the complete stockholder population which included the soon-to-be stockholders.

87. *Saxon*, 488 A.2d at 1301.

88. *Id.* at 1302-03.

89. 251 A.2d 576 (Del. Ch. 1969).

90. *Id.* at 578.

91. *Id.*

92. *Tweedy, Browne & Knapp*, 318 A.2d at 637.

93. *Coaxial Communications*, 367 A.2d at 994.

94. *Id.* at 997.

95. No. 606 (Del. Ch. Nov. 18, 1981).

of chancery found that "the fact that financial information needed by the management in order to solicit proxies under Securities Exchange Commission regulations is unavailable provides no defense to an action to compel a shareholder's [sic] meeting under § 211."⁹⁶ One month later the same court also held that "financial hard times" and pending state liquidation were not an effective bar to a section 211 proceeding.⁹⁷

It has been only where the instituted action attempted to advance the scheduled date of a meeting, rather than compel one *de novo*, that the motion has been denied. In such a situation a stockholder's conduct toward previously scheduled meetings is also determinative.⁹⁸ Courts in other jurisdictions have been as equally inclined to deny motions to compel as have the Delaware courts.⁹⁹ Barring the relatively infrequent successful showing of an affirmative defense, the establishment of a *prima facie* case will compel a prompt meeting of stockholders.

C. Ramifications of Saxon

The Supreme Court of Delaware's holding in *Saxon* attempts to remedy a growing problem frequently encountered in bankruptcy proceedings, i.e., the conflict of interests between creditors or tort plaintiffs and corporate stockholders.¹⁰⁰ In dealing with this conflict of interest, the *Saxon* court found that the stockholders' right to adequate and responsible representation on the board of directors must be preserved.¹⁰¹ "[I]nsolvency did not divest the stockholders of their right to elect directors."¹⁰² The Supreme Court recognized that a bankruptcy proceeding does not bar the assertion of a stockholder's right. The motion to compel was merely an instrument to ensure adequate stockholder representation on the board of directors. The stockholder, through this representation, should play an integral role in maintaining the survival of the corporation through difficult

96. *Id.* at 5.

97. *See* *Algeran, Inc. v. Connolly*, No. 6557 (Del. Ch. Oct. 5, 1981).

98. *See* *Savin Business Mach. v. Rapifax Corp.*, 375 A.2d 469 (Del. Ch. 1977) (repeated postponements of meetings to accommodate the stockholder).

99. *See In re Lionel Corp.*, 30 Bankr. 327 (Bankr. S.D.N.Y. 1983); *Valley Int'l Properties v. Los Campeones*, 568 S.W.2d 680 (Tex. 1978).

100. *Saxon*, 488 A.2d at 1302.

101. *Id.*

102. *Id.*

times. This includes the right to replace management whose past practices are frequently the cause for the reorganization.¹⁰³

In a recent decision, *In re Johns-Manville*,¹⁰⁴ the Bankruptcy Court for the Southern District of New York followed the rationale put forth by *Saxon* but refused to allow the stockholders' meeting upon the showing of an adequate affirmative defense.¹⁰⁵ *In re Johns-Manville* dealt with a factual situation quite similar to the one facing the *Saxon* court, except that liability arose from a combination of tort victims/creditors. At the time the meeting was sought, the current directors and creditors were reviewing a finalized reorganization plan.¹⁰⁵ The court, in denying authorization, allowed counsel to be appointed *nunc pro tunc*.¹⁰⁷ It enjoined the Delaware action holding that the stockholders' meeting at that time would needlessly waste the estate's resources, and jeopardize the reorganization process.¹⁰⁸

The Bankruptcy Court for the Southern District of New York distinguished the *Johns-Manville* case from *Saxon* on several grounds. First, the stockholders in *Johns-Manville* did not move for leave to initiate the Delaware action, an action which would have certain impact on the pending bankruptcy proceeding. In *Saxon* and *Lionel* this same bankruptcy court had allowed the stockholder to bring the action after it was found to not impede the reorganization proceedings.¹⁰⁹ Second, the court found that the circumstances mitigated against granting the motion to compel because of the proximity of reaching a consensual debtor/creditor agreement.¹¹⁰ The court in *Johns-Manville* was convinced that the stockholders' action was a timed and deliberate move to "enhance and elevate its role over those other constituents who are statutorily stayed from dealing with *Johns-Manville* in a non-Chapter 11 setting" ¹¹¹ As evidence of this

103. See JACKSON REPORT, *supra* note 29, at 64.

104. 52 Bankr. 879 (S.D.N.Y. 1985). See also *infra* note 108 and accompanying text.

105. *In re Johns-Manville*, 52 Bankr. 879 (Bankr. S.D.N.Y. 1985).

106. *Id.* at 883.

107. *Id.* at 880. In its motion to retain counsel *nunc pro tunc*, the *Johns-Manville* equity committee sought funds not only to compel a stockholder's meeting but also to proceed with a proxy fight.

108. See *id.* at 888 (court noted that the parties were negotiating in good faith and appeared to be able to reach a consensual rather than court imposed agreement if allowed to continue).

109. See *In re Saxon Indus.*, 39 Bankr. 49 (Bankr. S.D.N.Y. 1984); *In re Lionel Corp.*, 30 Bankr. 327 (Bankr. S.D.N.Y. 1983).

110. See *Johns-Manville*, 52 Bankr. at 888.

111. *Id.* at 887.

disruptive conduct, the court pointed to a stockholder's affidavit which stated that it was not dissatisfied with the day-to-day operations of the management but merely with the soon to be confirmed reorganization plan.¹¹² In this respect, *Johns-Manville* differs from *Saxon* because the Delaware Supreme Court refused to look toward a stockholder's motive in compelling a meeting.¹¹³

Finally, the *Johns-Manville* court noted that in the *Saxon* case, if leave from the Bankruptcy Court had not been secured, the *Saxon* court under Delaware Code section 303(a)¹¹⁴ would have given deference to bankruptcy law. Moreover, pursuant to this same section, the Delaware court would likely effectuate any soon to be confirmed reorganization plan regarding Johns-Manville.¹¹⁵ Confident that Johns-Manville had made out an adequate affirmative defense (enough to satisfy section 211(c)), the bankruptcy court enjoined the Delaware action.¹¹⁶ The court determined that this was simply a case where the free exercise of stockholders' rights would have obstructed the reorganization proceeding.

Only when circumstances mitigate against the full exercise of stockholders' rights will the court refuse to compel a stockholders' meeting. In weighing the conflicting interests of the tort victim/creditor who is seeking claim satisfaction, against those of the stockholder who is concerned with maintaining a viable corporation, the

112. *Id.*

113. *See Saxon*, 488 A.2d at 1301.

114. *See* DEL. CODE ANN. tit. 8, § 303(a) which provides in pertinent part: Reorganization under a statute of the United States; effectuation.

(a) Any corporation of this State, a plan of reorganization of which, pursuant to any applicable statute of the United State [sic] relating to reorganizations of corporations, has been or shall be confirmed by the decree or order of a court of competent jurisdiction, may put into effect and carry out the plan and the decrees and orders of the court or judge relative thereto and may take any proceeding and do any act provided in the plan or directed by such decrees and orders, without further action by its directors or stockholders. Such power and authority may be exercised, and such proceedings and acts may be taken, as may be directed by such decrees or orders, by the trustee or trustees of such corporation appointed in the reorganization proceedings (or a majority thereof), or if none be appointed and acting, be designated officers of the corporation, or by a Master or other representative appointed by the court or judge, with like effect as if exercised and taken by unanimous action of the directors and stockholders of the corporation.

115. *Johns-Manville*, 52 Bankr. at 889.

116. *Id.* The bankruptcy court under 28 U.S.C. § 959(a) and 11 U.S.C. § 105(a) of the Bankruptcy Code is allowed to enjoin all actions which obstruct the administration of the estate.

court will give deference to a stockholder's rights. This appears to be a just result because for the full satisfaction of claims it is preferable to have a viable corporation. Adequate representation on the board will ensure that the stockholder will not be required to bear the risk of loss when the corporation in which he has invested enters into bankruptcy proceedings. Tort and creditor claims should not be funded at the expense of the stockholder. Although stockholders' interests may be diverse or disorganized, the management still must be held accountable.

III. CONCLUSION

The Delaware Supreme Court in *Saxon* reaffirmed the basic notion of stockholders' rights in a corporate democracy. Accordingly, suits to compel stockholders' meeting for the purpose of electing directors are appropriately relegated to the state forum. The primary focus should be upon corporate governance and the expertise needed to resolve corporate matters exists in state court. While the bankruptcy court may be vested with the power to compel stockholders' meetings, it has little experience in dealing with the intricacies of state corporate law. In Delaware, as in other jurisdictions,¹¹⁷ a *prima facie* case will be established upon a showing of stockholder or director status and a delay in the holding of the annual meeting for a period in excess of thirteen months. In the absence of an adequate affirmative defense by the debtor, the motion to compel will be summarily granted. The pendency of a bankruptcy proceeding does not affect the maintenance of a corporate democracy.

Mark A. Cleaves

117. See Walsh, *supra* note 15, at 183-84.

