

Corporate Governance: Super Voting Preferred Stock

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Introduction

A public company's certificate of incorporation generally grants the board of directors authority to issue "blank check" preferred stock up to the number authorized in the certificate of incorporation, on terms to be determined by the board. Recently, a number of companies have used this authority to issue preferred stock with super voting rights for the purpose of influencing the outcome of stockholder votes.

This strategy, which has been used in varying circumstances, implicates stockholder voting rights under state law, the listing rules of the New York Stock Exchange ("NYSE") and Nasdaq and the fiduciary duties owed by directors. Boards considering the use of super voting preferred stock to secure stockholder approval for a proposal would be well cautioned to undertake a careful review of the applicable laws, rules and duties before proceeding.

Key Considerations

Corporate Authority & State Law

A corporation considering the issuance of super voting preferred stock should, as an initial matter, carefully review its bylaws and certificate of incorporation to ensure that it has the requisite power to issue preferred stock on the terms, and in the number, contemplated. Typically in these circumstances, preferred stock is issued as a fraction of a whole preferred share, which renders limitations on the number of preferred shares authorized in the certificate of incorporation largely irrelevant. The constituent documents may also contain limitations on the voting rights that may be granted to preferred stock, and the company's existing capital structure should be reviewed to ensure any new issuance does not violate the terms of existing securities.

Issuers must also consider whether the use of super voting preferred stock could trigger a class voting entitlement under applicable state law. For example, Delaware General Corporation Law (“DGCL”) §242(b)(2) provides that holders of shares of a class of outstanding stock are entitled to vote as a class upon a proposed certificate of incorporation amendment that would “alter or change the powers, preferences, or special rights of the shares of such class so as to affect them adversely.”¹ If the interests of the super voting preferred stockholders diverge from those of the existing common stockholders, there is a risk that any proposed amendment would be subject to a class vote regardless of whether each of the preferred and common stockholders were entitled to vote as a single class under the terms of the designation of preferred stock. Such an entitlement would likely defeat the purpose of issuing super voting preferred stock and could lead to stockholder litigation challenging the results of a vote.

Exchange Listing Rules

Voting Rights Rule

Publicly listed companies should consider the impact of super voting preferred shares under the listing rules of the applicable exchange. Nasdaq Rule 5640 and NYSE Rule 313.00 each provide that voting rights of existing stockholders of publicly traded common stock cannot be disparately reduced or restricted through any corporate action or issuance, including by the issuance of super voting stock.² Practically, these rules require that any issuance of super voting preferred stock not affect the relative voting power of existing stockholders.

20% Rule

Nasdaq Rule 5635(d) and NYSE Rule 312.03(c) each require stockholder approval of any issuance of 20% or more of the common stock (or securities convertible into or exercisable for common stock) or voting power outstanding prior to the issuance, in any transaction other than a public offering, that is for less than the lower of: (i) the closing price of the common stock immediately preceding the transaction; or (ii) the average closing price of the common stock for the five trading days immediately preceding the transaction.³ These rules may limit the amount of convertible super voting preferred stock and the total voting power represented by any new issuance.

Listed companies should take careful note of these rules, as violations may result in delisting from an exchange. Nasdaq published a staff interpretation letter in June 2022

¹ <https://delcode.delaware.gov/title8/c001/sc08/index.html>

² <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/Nasdaq%205600%20Series;>
https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-99

³ <https://listingcenter.nasdaq.com/rulebook/nasdaq/rules/Nasdaq%205600%20Series;>
https://nyse.wolterskluwer.cloud/listed-company-manual/document?treeNodeId=csh-da-filter!WKUS-TAL-DOCS-PHC-%7B0588BF4A-D3B5-4B91-94EA-BE9F17057DF0%7D--WKUS_TAL_5667%23teid-94

addressing the application of the voting rights rule to an issuance of preferred stock that carried enhanced voting power only in connection with a proposal to amend the issuer's certificate of incorporation to effect a reverse stock split.⁴ The staff determined that the voting rights rule was not violated by the issuance because the certificate of designation included a mirror voting mechanic that would not affect the percentage of votes cast for or against the proposal and would serve only to increase the aggregate voting power of the issuer's outstanding capital stock that voted. The NYSE, by contrast, has not published any staff comments or guidance on this issue. Issuers should consider whether to request guidance from the applicable exchange before proceeding with an issuance of super voting preferred stock.

Fiduciary Duties

Overlaying each of the above considerations are the directors' fiduciary duties, which generally require directors to act in a manner they reasonably believe to be in the best interests of the company and its stockholders. Board members should carefully consider the purpose behind any issuance of super voting preferred stock as well as its potential impact on existing stockholders. If, for example, the super voting preferred stock is used to obtain approval for corporate action by holders of a minority of the stock and a court finds that the directors did not believe the action was in the best interests of the company and the common stockholders, or if directors had a conflict of interest in approving the issuance, board members may be subject to liability for breach of their duty of loyalty. A breach of fiduciary duty claim is necessarily a fact-intensive inquiry, and the board of directors should be prepared to demonstrate how they carefully considered the potential impact of the issuance of super voting preferred stock before proceeding.

Specific Terms

While the specific terms of the super voting preferred stock have varied by issuer and circumstance, there are certain common provisions that have been used in multiple transactions.

Limited Duration and Applicability

Issuers will often tailor the duration and applicability of super voting preferred stock to a specific objective. For example, the preferred stock will have voting rights only in respect of a single proposal at a specific meeting. The board may reserve the right to redeem the preferred stock at its discretion, or the terms of the preferred stock may include an automatic redemption feature whereby any holders of preferred stock not

⁴ https://listingcenter.nasdaq.com/Material_search.aspx?materials=1841&mcd=SI&criteria=2&cid=69

present in person or represented by proxy at the relevant stockholder meeting will have their shares redeemed immediately prior to the targeted vote or upon approval of the specific proposal.

Mirror Voting

Super voting preferred stock issued for the purpose of obtaining sufficient votes to amend a certificate of incorporation will often include a mirror voting mechanic designed to preserve the relative voting power of common stockholders so as not to violate stock exchange voting rights rules. Typically, the board will either declare a dividend of super voting preferred stock to all common stockholders or the board will issue the super voting preferred stock to a “friendly” stockholder.

If the board declares a dividend of super voting preferred stock, each stockholder will receive a fractional share of preferred stock (which may represent hundreds or thousands of votes) for each share of common stock held as of the record date. The preferred stock cannot be transferred separately from, or voted independently from, the underlying common stock. When the common stockholder casts its vote, the preferred stock associated with its shares of common stock will automatically be voted the same way. The result is that each common stockholder maintains its relative voting power on the proposal so long as it actually votes its shares. When coupled with the redemption of non-voting preferred stock immediately prior to the vote, the number of votes cast in proportion to the total shares entitled to vote may increase dramatically.

Alternatively, the board could issue super voting preferred stock only to one or more “friendly” stockholders. The mirror voting mechanic in this scenario works differently, but achieves the same result. Here, when the holder of the super voting preferred stock casts its vote, the preferred stock is automatically voted proportionately with the vote of the common stockholders writ large. Abstentions are disregarded, and the preferred stock is voted independent of how the particular holder voted its underlying common stock. For example, if 90% of votes by holders of common stock were cast in favor, then 90% of the votes associated with the preferred stock will be cast in favor of the proposal, with the remaining 10% voted against. Since each share of preferred stock has many times the number of votes of each share of common stock, the company is able to obtain the required majority of the outstanding voting power to amend the certificate of incorporation even when less than a majority of the outstanding common stock was voted.

Recent Examples

While most corporate acts requiring stockholder approval may be passed, subject to quorum requirements, by a simple majority of votes cast at a meeting, certain fundamental transactions (e.g., certificate of incorporation amendments) require a majority vote of all outstanding shares entitled to vote on a proposal. For an issuer with a large non-voting stockholder base (often retail stockholders), this voting standard can make it very difficult to amend the certificate of incorporation, as each abstention is effectively a vote against the proposal.

The following are recent examples of companies using super voting preferred shares to achieve a governance outcome where a vote of a majority of the outstanding shares is required.

Reverse Stock Split

In a number of recent cases, publicly listed companies have issued super voting preferred stock to enable the company to satisfy majority voting requirements without actually getting a majority of the shares outstanding to vote.⁵ These issuers sought to adopt certificate of incorporation amendments to effect reverse stock splits to avoid being delisted from an exchange.

Authority to Issue Additional Shares

AMC Entertainment Holdings, Inc. tried, unsuccessfully, to obtain stockholder approval to amend its certificate of incorporation to authorize the issuance of additional shares of common stock. Its proposals failed because AMC could not get holders of a majority of the common stock to vote in favor of the amendment, as required under the DGCL. This failure was attributed to abstentions by AMC's large retail stockholder base. AMC issued super voting preferred stock designed to solve this stockholder abstention issue.

In August 2022, AMC authorized the issuance of Series A Convertible Participating Preferred Stock of AMC Entertainment Holdings, Inc. (the "AMC Preferred Stock"), which votes together with common stockholders as a single class on all issues with each share of AMC Preferred Stock having 100 votes.⁶ Concurrent with the issuance of AMC Preferred Stock, AMC announced a dividend of depositary shares, AMC Preferred Equity Units ("APEs"), to its common stockholders. Each APE represented an interest

⁵ <https://www.sec.gov/ix?doc=/Archives/edgar/data/0000811240/000119312522064497/d111998d8k.htm>;
https://www.sec.gov/ix?doc=/Archives/edgar/data/0001604191/000110465922122476/tm2231455d2_8k.htm;
<https://www.sec.gov/ix?doc=/Archives/edgar/data/1504167/000155837022014791/tmbr-20221003x8k.htm>.

⁶ https://www.sec.gov/ix?doc=/Archives/edgar/data/1411579/000110465922086144/tm222422d3_8k.htm

in 1/100th of a share of AMC Preferred Stock and was designed to have the same economic and voting rights as a share of AMC common stock.⁷ The AMC Preferred Stock would be automatically convertible into AMC common stock upon stockholder approval of an amendment to AMC's certificate of incorporation, increasing the number of authorized shares of AMC common stock at a rate of 100 shares for each share of AMC Preferred Stock. APE holders would share ratably in the conversion of AMC Preferred Stock to AMC common stock.

The AMC Preferred Stock was held by a depository that agreed to vote all of the AMC Preferred Stock in proportion to the votes of the APE holders. As a result, all of the AMC Preferred Stock would be voted on any proposal in which the APEs are entitled to vote regardless of how many APE shares are actually voted. The AMC Preferred Stock represented over 60% of the shares entitled to vote on any proposal and would therefore satisfy the majority requirement for amending AMC's certificate of incorporation.

Following the initial dividend, APEs have traded at a discount to AMC's common stock. In December 2022, AMC entered into an agreement with Antara Capital LP whereby, among other things, AMC agreed to sell to Antara 106,595,106 APEs.⁸ As a condition of the sale, AMC agreed to call a special stockholder meeting to vote on a proposal to amend AMC's certificate of incorporation to increase the number of authorized shares of common stock and effect a 10-to-1 reverse stock split.⁹

In February 2023, certain AMC stockholders filed a class action complaint seeking to, among other things, enjoin the vote to amend the certificate of incorporation and obtain a ruling that the AMC Preferred Stock was invalidly issued under the DGCL.¹⁰ The parties agreed to allow the stockholder meeting to proceed on March 14, 2023, on the condition that no action would be taken by AMC to amend its certificate of incorporation or authorize additional shares of common stock until after a hearing, which is scheduled for April 27, 2023.

At the March 14 stockholder meeting, the common and preferred stockholders, voting together as a single class, approved the proposals to increase the number of authorized shares and effect a reverse stock split with votes of 88% and 87% in favor, respectively.¹¹ Only 35% of the eligible shares of common stock entitled to vote were present in person or represented by proxy at the meeting. The shares of AMC Preferred Stock voted in

⁷ https://www.sec.gov/Archives/edgar/data/1411579/000110465923007550/tm232700-1_pre14a.htm#tPN1

⁸ https://www.sec.gov/Archives/edgar/data/1411579/000110465922129353/tm2233318d1_8k.htm

⁹ https://www.sec.gov/Archives/edgar/data/1411579/000110465923007550/tm232700-1_pre14a.htm#tPN1

¹⁰ https://www.bloomberglaw.com/public/desktop/document/AlleghenyCountyEmployeesRetirementSystemonbehalfofitselfandalloth/1?doc_id=X1Q6OIOVV782

¹¹ <https://investor.amctheatres.com/newsroom/news-details/2023/AMC-Entertainment-Holdings-Inc.-Announces-Results-of-Special-Meeting-of-Stockholders/default.aspx>

favor of each proposal, either pursuant to specific instruction by holders of APEs or pursuant to the terms of the deposit agreement, represented approximately 58% of the outstanding shares entitled to vote.¹² Consequently, the votes of the AMC Preferred Stock alone were sufficient to pass each proposal without including any votes of the AMC common stock.

Following the successful vote, AMC and the stockholders that sued to invalidate the APEs announced a proposed settlement that would have allowed the APEs to convert while also issuing additional shares of common stock to common stockholders. However, that settlement remains in doubt pending further action by the Delaware court overseeing the class action. This situation continues to develop.

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¹² https://www.sec.gov/ix?doc=/Archives/edgar/data/1411579/000110465923032409/tm239497d1_8k.htm

Please do not hesitate to contact us with any questions.

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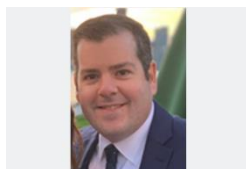
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