Stradley Ronon

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Shareholder Approval Is Required Under Delaware Law to Sell All or Substantially All of an Insolvent and Failing Corporation's Assets

Under Delaware General Corporation Law (DCGL) 8 Del. C. §271, a corporation's board of directors may sell, lease or exchange all or substantially all of the corporation's property and assets as the board deems expedient and in the best interests of the corporation so long the sale, lease or exchange is authorized by a majority of the outstanding stockholders of the corporation entitled to vote thereon. The Supreme Court of the State of Delaware recently was called upon to decide whether Section 271 is subject to a "common law insolvency exception" that would allow the board to sell, lease or exchange all or substantially all of the corporation's assets without stockholder approval if the corporation is insolvent and failing. The Supreme Court of Delaware determined that Section 271 is not subject to a "common law insolvency exception," reversing a decision of the Delaware Court of Chancery.

Facts

Stream TV Network, Inc. (Stream) is a Delaware corporation essentially controlled and owned by Mathu Rajan, his brother Raja Rajan and their parents, who hold a majority of Stream's Class B common stock and a majority of Stream's outstanding voting power. Stream's charter contains the following Class B voting provision:

> For so long as shares of Class B Voting Stock remain outstanding, in addition to any other vote or consent required herein or by law, the affirmative or written consent of the holders of a majority of the then-outstanding shares of Class B Voting Stock, voting as a separate class, shall be necessary for the Corporation to consummation [sic] an Acquisition or Asset Transfer.

(the Charter Voting Provision). Stream's senior secured lender held a senior security interest in all of Stream's assets, and Stream's junior secured creditor held a subordinated security interest in all of Stream's assets. Each of the senior and junior secured creditors was authorized to take control of Stream's assets in the event Stream defaulted on its obligations to the respective lender. By February 2020, Stream had defaulted on its obligations to its senior and junior secured lenders, missed payroll, furloughed workers and defaulted on its trade debt, and in March 2020, its senior secured lender filed a complaint against Stream seeking foreclosure and other relief.

Stream's board was comprised of the Rajan brothers and four independent outside directors. At a board meeting on May 4, 2020, a Resolution Committee was formed to resolve Stream debt defaults and claims, as well as actual and threatened litigation "without further action being required from the Board of Directors or any executive of the Corporation." Following negotiations, Stream, the senior and junior secured lenders and 52 of Stream's stockholders

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entered into an agreement pursuant to which, in full satisfaction of the obligations to the secured lenders, all rights, title and interest in and to all of Stream's assets would be transferred to SeeCubic, a newly formed holding corporation established by the lenders (the Omnibus Agreement). Additionally, Stream and its Class A common stockholders, except the Rajan brothers, were to receive certain rights under the Omnibus Agreement.

The Court of Chancery

On Sept. 8, 2020, Stream commenced an action in the Court of Chancery of the State of Delaware, seeking a declaration that the Omnibus Agreement was invalid. Stream moved for a temporary restraining order to bar SeeCubic from enforcing the Omnibus Agreement. SeeCubic filed counterclaims and third-party claims against the Rajan brothers, requesting expedition and a temporary restraining order that would prevent Stream from interfering with its rights under the Omnibus Agreement. In December 2020, the Court of Chancery held that it was reasonably probable that the Omnibus Agreement was a valid, binding, enforceable agreement and entered a preliminary injunction barring Stream and anyone acting in concert with it from taking any action to interfere with SeeCubic's rights under the Omnibus Agreement.

In September 2021, the Court granted in part, SeeCubic's motion for summary judgment, holding that the Omnibus Agreement is valid and enforceable and converting the preliminary injunction into a permanent injunction. The Court subsequently granted a motion filed by Stream and the Rajan brothers to have the decision on SeeCubic's summary judgment motion entered as a partial final judgment. On Nov. 12, 2021, Stream and the Rajan brothers appealed the decision, and on the same day, they moved before the Court of Chancery for an order modifying or staying the permanent injunction.

On Dec. 2, 2021, the Court of Chancery issued a 34-page opinion in which it denied the motion seeking to modify or stay the permanent injunction. The Court reasoned that the Omnibus Agreement was valid and binding and that a common law insolvency exception operated to eliminate any requirement that the Omnibus Agreement was subject to a shareholder vote. The Court began its analysis with an exhaustive review of Section 271, including a comprehensive review of Section 64a, Section 271's predecessor. Section 271 provides in relevant part:

> Every corporation may at any meeting of its board of directors or governing body sell, lease or exchange all or substantially all of its property and assets, including its goodwill and its corporate franchises, upon such terms and conditions and for such consideration, which may consist in whole or in part of money or other property, including shares of stock in, and/or other securities of, any other corporation or corporations, as its board of directors or governing body deems expedient and for the best interests of the corporation, when and as authorized by a resolution adopted by the holders of a majority of the outstanding stock of the corporation entitled to vote thereon.

The Court concluded that a "common law insolvency exception" to the shareholder vote requirement contained in Section 271 was applicable to allow directors of an insolvent and failing corporation to sell Stream's assets without shareholder vote or approval.

In its December 2020 decision granting SeeCubic's request for a preliminary injunction, the Court of Chancery considered the interplay between Sections 271 and Section 272 of the DGCL. Section 272 provides:

> The authorization or consent of stockholders to the mortgage or pledge of a corporation's property and assets shall not be necessary, except to the extent that the certificate of incorporation otherwise provides.

The Court determined that interpreting Section 271 to require a shareholder vote for the transfer of an insolvent corporation's assets to its secured creditors would create a conflict with Section 272. The Court reasoned that since Section 272 makes clear that, absent a provision in a certificate of incorporation to the contrary, shareholder approval is not necessary to mortgage or pledge assets of a corporation to secure a debt, it would be illogical to require shareholder approval to transfer collateral to a secured creditor in satisfaction of an insolvent corporation's

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obligations. Moreover, if shareholder approval is required to transfer collateral to a secured creditor, the value of a security interest in collateral would be undermined. Finally, the Court observed that given the prevalence of security interests and the fact that Section 271 and its predecessor have been in effect since 1917, the issue of whether Section 271 applies to the transfer of an insolvent corporation's assets to its secured creditor in satisfaction of its obligations would have arisen, but it has not.

Finally, the Court of Chancery summarily addressed the Charter Voting Provision, stating that the provision "tracks the text of Section 271 and warrants the same interpretation" — namely, that the Omnibus Agreement does not implicate the Charter Voting Provision.

Appeal

On appeal, the following four issues were presented to the Supreme Court of Delaware:

1. Whether the Charter Voting Provision unambiguously requires Class B stockholder approval and renders Section 271's shareholder voting rule irrelevant.

2. Whether, in determining whether the Charter Voting Provision requires stockholder approval of the Omnibus Agreement, the Court of Chancery erred in its analysis by examining Section 271 prior to considering the applicability of the Charter Voting Provision.

3. Whether Section 271 superseded any common law insolvency exception and whether such an exception ever existed under Delaware law.

4. Whether the Court of Chancery's decision would upset Delaware's contractarian focus and the predictable application of Section 271.

The Supreme Court considered the first and second issues simultaneously. First, the Court determined that the Court of Chancery erred by commencing its analysis with an examination of Section 271, concluding that instead, the analysis should commence with a determination of whether the Charter Voting Provision renders Section 271's shareholder voting rule irrelevant. Accordingly, the Supreme Court began by noting that corporate charters are "broadly enabling" and may depart from the rules of common law so long as a charter provision does not conflict with the DGCL. The Court went on to note that corporate charters are contracts subject to the general rules of contract construction. Under Delaware law, contracts are to be read as a whole, and terms are to be given their commonly accepted meanings. The Supreme Court concluded that the terms of the Charter Voting Provision are clear and unambiguous, and therefore, extrinsic evidence may not be considered in construing the provision. Reading the Charter Voting Provision and the Omnibus Agreement together, the Supreme Court determined that the transaction embodied in the Omnibus Agreement falls within the Charter Voting Provision, and an affirmative vote of the holders of a majority of the then-outstanding shares of Class B stock is necessary to consummate the Omnibus Agreement.

While the Supreme Court acknowledged that it need not engage in any additional review, it undertook an exhaustive analysis of the third issue before it and determined that any common law insolvency exception to the shareholder voting requirement contained in Section 271 that may have existed under Delaware law had been superseded by Section 271's predecessor. In reviewing the Court of Chancery's application of the insolvency exception, the Supreme Court noted that the Court of Chancery relied on authorities and cases that either predated Section 271 or were decided in jurisdictions other than Delaware. The Supreme Court reasoned that the Court of Chancery's reliance on the cited authorities and cases was misplaced and embarked on its own exhaustive survey of the law relating to the common law insolvency exception. First, the Supreme Court examined the case law throughout the United States addressing the insolvency exception and found that no Delaware case has ever expressly addressed or adopted the insolvency exception. Then, the Supreme Court examined Section 271 and its predecessor, DGCL Section 64a.

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Section 64a made it easier for a board to sell, lease or exchange all or substantially all of the corporation's assets by imposing a *majority* stockholder vote in favor of the sale of all assets of a corporation. Section 64a was enacted to supersede the common law rule that required a *unanimous* shareholder vote in favor of such sales.

The Supreme Court left open the question of whether a common law insolvency exception existed under Delaware law prior to the enactment of Section 64a, concluding that when the common law unanimity rule was superseded by Section 64a, so too was any insolvency exception to that rule. The Court noted that this conclusion is reinforced by the plain language of Section 271, which is not ambiguous and does not contain any exceptions.

Finally, the Supreme Court considered the fourth issue placed before it. The Court recognized Delaware's contractarian philosophy and focused on the importance of stability and predictability in the application of DGCL, finding that allowing a common law insolvency exception to Section 271 that was never applied by a Delaware court would not advance these fundamental goals.

Analysis

The Delaware Supreme Court has foreclosed the possibility that a common law insolvency exception exists with respect to the shareholder voting requirement contained in Section 271. Therefore, absent a provision in a corporation's certificate of incorporation that clearly and unambiguously provides otherwise, the consent of a majority of shareholders entitled to vote on the issue will be required in order for a board of directors to sell, lease or exchange all or substantially all of the assets of a corporation. This is the case regardless of whether the corporation is failing and insolvent or thriving and profitable.

The Supreme Court's elimination of the possibility of a common law insolvency exception to Section 271 may not be dire. It simply defers to corporations, the decision of whether to include an insolvency exception to the voting requirement contained in Section 271 in their governance scheme.

As a corporation is insolvent and failing, fast action often is required to preserve value and "stop the bleeding." Requiring shareholder approval in addition to a board resolution to enter into an assignment for the benefit of creditors or other agreement for the sale, lease or exchange of all or substantially all of an insolvent and failing corporation's assets may frustrate the corporation's ability to avail itself of opportunities to maximize the value of its assets for the benefit of its creditors. Moreover, absent an insolvency exception, shareholders whose individual interests may not be aligned with the interests of the corporation and its creditors may withhold votes for self-serving reasons, potentially pushing the corporation into bankruptcy or an alternative restructure that is costly in terms of time and money and potentially risky in terms of achieving success. Since the Supreme Court merely determined that a *common law* insolvency exception to Section 271 does not exist and because Section 271 is a default provision, a corporation can include a carefully drafted insolvency exception into its certificate of incorporation, and it will have the advantage of a *contractual* insolvency exception despite the Supreme Court's ruling.

Incorporation of an insolvency exception to the voting requirement contained in Section 271 will eliminate the roadblocks that could arise from requiring majority shareholder approval of a transaction at a time when shareholders' individual interests may diverge from the interests of the corporation and its creditors. Eliminating these roadblocks may afford a corporation the agility to take advantage of opportunities to maximize the value of its assets for the benefit of its creditors should it become insolvent and failing. However, corporations must be cautious when delegating such power to their board since the board may lack the skill set to unilaterally make such decisions, or directors may be hesitant to act without a shareholder vote, given their duties and the scrutiny they are under. Accordingly, if such power is delegated to a corporate board, the corporation must periodically scrutinize the composition of its board with this delegation in mind to ensure that board members are capable of understanding the corporation's financial condition, evaluating the corporation's options and making and acting upon independent, well-reasoned decisions that are in the best interest of the corporation in the event the corporation becomes insolvent and is failing. This should be done regularly before the corporation becomes insolvent and is failing and should be equally important to directors so that they can dutifully discharge their fiduciary obligations and shareholders so that the remaining value, if any, of their investment can be preserved.

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Finally, the Supreme Court's decision may impact secured creditors. The Supreme Court noted the Court of Chancery's analysis regarding the interplay between Sections 271 and 272 with seeming approval, and in its discussion of the historical development of Section 271, the Supreme Court stated: "Section 272 clarified that Section 271 does not apply to mortgages or pledges of corporate assets." From this statement, it appears indisputable that Section 271 does not apply to the delivery by an insolvent corporation of collateral to a secured creditor. The Supreme Court, however, did not expressly rule upon this issue. Instead, it relied upon the Charter Voting Provision to conclude that the Omnibus Agreement, which operated to deliver collateral to the designee of Stream's secured creditors, required a shareholder vote. Accordingly, it is possible there could be further litigation on this issue absent a clear and unambiguous provision in a corporation's charter that the delivery of mortgaged or pledged corporate assets to a secured creditor does not require a shareholder vote.

In summary, the Delaware Supreme Court's ruling unequivocally establishes that under Delaware law, there is no common law insolvency exception to Section 271. This decision does not prevent corporations from including an insolvency exception to Section 271 in their certificate of incorporation, thus creating a contractual insolvency exception. Before including such a provision in its certificate of incorporation, a corporation should carefully consider whether it wishes to confer upon its board the right to dispose of all or substantially all of its assets without a shareholder vote. If it chooses to confer such a right on its board, it should regularly assess the composition of its board to be sure that the board is capable of properly exercising this right in the event the corporation becomes insolvent and failing. Additionally, at least until it is definitely settled that the voting requirement of Section 271 is inapplicable to the transfer of assets to a secured creditor, secured creditors would be wise to consider requesting an express provision in a corporate borrower's certificate of incorporation that permits the board to sell, lease or exchange to the secured creditor its collateral without the necessity of a shareholder vote.

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