

What Del. Justices' Insolvency Ruling Means For Corps.

By **Deborah Reperowitz** (September 1, 2022)

Under Section 271 of the Delaware General Corporation Law, a corporation's board of directors may dispose of all or substantially all of the corporation's assets as the board deems expedient and in the best interests of the corporation so long the disposition is authorized by a majority of the outstanding stockholders entitled to vote thereon.



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In *Stream TV Networks Inc. v. SeeCubic Inc.* in June, the Delaware Supreme Court was called upon to decide whether Section 271 is subject to a common law insolvency exception that would allow the board to dispose of the corporation's assets without stockholder approval if the corporation is insolvent and failing.

The Delaware Supreme Court determined that Section 271 is not subject to a common law insolvency exception, reversing a decision of the Delaware Court of Chancery.

Facts

Stream is a Delaware corporation controlled and owned by the Rajan brothers 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.

Stream's senior secured lender and junior secured creditor held, respectively, a senior and a subordinated junior security interest in all of Stream's assets. Each of the secured creditors was authorized to take control of Stream's assets if Stream defaulted on its obligations to the respective lender.

Stream defaulted on its obligations to its 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, comprised of the Rajan brothers and four independent directors, formed a resolution committee to resolve Stream debt defaults and litigation "without further action being required from the Board of Directors or any executive of the Corporation."

Ultimately, Stream, its secured lenders, and 52 of Stream's stockholders entered into an omnibus agreement under which, in full satisfaction of Stream's obligations to its secured lenders, all of Stream's assets would be transferred to SeeCubic, a newly formed holding corporation established by the lenders.

The Court of Chancery

On Sept. 8, 2020, Stream commenced an action in the Delaware Court of Chancery, seeking

a declaration that the omnibus agreement was invalid and 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.

The court granted in part SeeCubic's motion for summary judgment, holding that the omnibus agreement is valid and enforceable and entering a permanent injunction barring Stream and anyone acting in concert with it from taking action to interfere with SeeCubic's rights under the omnibus agreement.

This decision was entered as a partial final judgment in November 2021, and Stream and the Rajan brothers appealed and moved before the Court of Chancery for an order modifying or staying the permanent injunction, which motion was denied.

The Court of Chancery reasoned 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 of Chancery concluded that a common law insolvency exception to the shareholder vote requirement contained in Section 271 allows directors of an insolvent and failing corporation to sell all of the corporation's assets without shareholder vote or approval.

Among other things, the court noted the interplay between Sections 271 and Section 272 of the Delaware General Corporation Law. 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 reasoned that it would be illogical to require shareholder approval to transfer collateral to a secured creditor in satisfaction of an insolvent corporation's obligations, since under Section 272, absent a contrary provision in a certificate of incorporation, shareholder approval is not necessary to mortgage or pledge a corporation's assets to secure a debt.

Appeal

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

- Whether the charter provision requires Class B stockholder approval and renders Section 271's shareholder voting rule irrelevant;
- Whether, in determining that the charter provision requires stockholder approval of the omnibus agreement, the Court of Chancery erred by examining Section 271 prior to considering the applicability of the charter provision;
- Whether Section 271 superseded any common law insolvency exception, and whether such an exception ever existed under Delaware law; and
- 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, concluding that the lower Court erred by commencing its analysis under Section 271 rather than with a determination of whether the Charter Provision nullifies Section 271's voting rule.

Accordingly, the Delaware Supreme Court began by examining the charter provision, noting that corporate charters are broadly enabling, and may depart from the rules of common law so long as the provision does not conflict with the Delaware General Corporation Law.

Further, the court noted that corporate charters are contracts and under Delaware law, contracts are to be read as a whole, with their terms ascribed their commonly accepted meanings. The Delaware Supreme Court concluded that the charter provision is clear and unambiguous, thus, extrinsic evidence may not be considered in construing the provision.

Ultimately, the court held that the transaction embodied in the omnibus agreement falls within the charter 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 Delaware Supreme Court acknowledged that it need not engage in additional review, it undertook an analysis of the third issue before it and determined that if a common law insolvency exception to the voting requirement contained in Section 271 existed under Delaware law, it was superseded by Section 271's predecessor.

The Delaware Supreme Court rejected the lower court's reliance on authorities and cases that predated Section 271 or were decided in jurisdictions other than Delaware and embarked on its own survey of the law relating to the common law insolvency exception.

First, the court found that no Delaware case has ever expressly addressed or adopted the common law insolvency exception. Then, the court examined Section 271 and its predecessor, Section 64a.

Section 64a required a majority stockholder vote to dispose of all of an insolvent corporation's assets and was enacted to supersede the common law rule that required a unanimous shareholder vote for such dispositions.

The Delaware Supreme Court concluded that when the common law unanimity rule was superseded, any common law insolvency exception to that rule also was superseded.

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 Delaware Supreme Court considered the fourth issue before it. The court recognized Delaware's contractarian philosophy and the importance of stability and predictability in the application of Delaware General Corporation Law, finding that 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 foreclosed the possibility that a common law insolvency exception exists to the voting requirement contained in Section 271, but recognized that since Section 271 is a default provision, a corporation can incorporate a contractual insolvency exception into its certificate of incorporation or charter.

When a corporation is insolvent and failing, fast action often is required to preserve it. Requiring shareholder approval in addition to a board resolution to dispose of all or substantially all of an insolvent 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 align with those 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.

An insolvency exception to Section 271's voting requirement will afford insolvent corporations the agility to take advantage of opportunities to maximize the value of their assets.

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 fiduciary duties and the scrutiny they are under.

Accordingly, if such power is delegated to a 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.

This review should be done regularly regardless of the corporation's solvency and should be insisted upon by 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.

Notably, the Delaware Supreme Court relied upon the charter provision to conclude that the omnibus agreement, which operated to deliver collateral to the designee of Stream's secured creditors, required a shareholder vote.

While the court appears to concur with the lower court's analysis regarding the interplay between Sections 271 and 272 and its discussion of the historical development of Section 271, the Delaware Supreme Court did not expressly rule that Section 271 is inapplicable to

the delivery of mortgaged or pledged corporate assets to a secured creditor.

Accordingly, it is possible there could be further litigation on this issue absent a clear and unambiguous provision to the contrary in a corporation's certificate of incorporation or charter.

Conclusion

In summary, the Delaware Supreme Court unequivocally determined that there is no common law insolvency exception to Section 271. This decision does not prevent corporations from creating a contractual insolvency exception by including one in their certificate of incorporation or charter.

Before doing so, however, a corporation should carefully consider whether it wishes to confer upon its board the power 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 confirm that its 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 deliver collateral to the secured creditor without the necessity of a shareholder vote should the borrower become insolvent.

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