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THE (FAILED) FAILING BUSINESS EXCEPTION: STOCKHOLDERS' RIGHT TO VOTE ON ASSET TRANSFERS

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ABSTRACT:

In *Stream T.V. Networks, Inc. v. SeeCubic, Inc.*,[1] the Delaware Supreme Court ("Court") held that section 271 of the Delaware General Corporation Law ("D.G.C.L"), which requires stockholder approval for a Delaware corporation to sell or dispose of substantially all of its assets, did not incorporate a common law "insolvency exception" to this general rule. Put another way, the Court found that absent a certificate of incorporation provision to the contrary, an insolvent corporation's board cannot transfer or sell substantially all the company's assets to one or more of its creditors without the approval of out-of-the-money stockholders. As a result, Delaware corporations can no longer enter into deed-in-lieu transactions or assignments for the benefit of creditors ("ABCs") by simple board approval and now require a majority of stockholders (or a lesser number if so-provided in the certificate of incorporation) to also approve of the transaction. Although in the abstract, this holding seems to further stockholder rights, in practice, the decision will likely impair an insolvent corporation's ability to negotiate an out-of-court solution with its creditors and provide an opening for dissenting stockholders (especially insiders or founders) to extract hold-out value at the expense of the corporation's other stakeholders. And because the decision does not disturb the ability of a corporation's board to put the company into a bankruptcy proceeding, it may incentivize expensive court-supervised liquidations under the Bankruptcy Code over private, less expensive, and more flexible deals with creditors.

At a more general level, the decision also affirms that Delaware is and will remain a strict "contractarian" jurisdiction in matters of corporate law. The Court has made clear that Delaware courts will look no further than the terms agreed to by stockholders within the Certificate of Incorporation (the "Certificate") of a given corporation, if practicable. And if those provisions are internally consistent, unambiguous, and compatible with Delaware General Corporate Law and public policy, courts will strictly adhere to the terms of the Certificate and refrain from reading in the default rule of section 271 (or any other gap-filling statute). This means that when financial distress emerges, creditors of Delaware corporations must be proactive and thoughtful in crafting potential restructuring options to determine whether a proposed restructuring will require stockholder approval or changes to the company's Certificate to mitigate the risk and expense of a stockholder vote.

FACTS:

Stream T.V. Networks, Inc. was a Delaware corporation founded to create and commercialize 3D TVs without the need for 3D glasses. Stream's founders, Mathu and Raja Rajan, along with their parents, held the majority of the company's voting stock. Since 2009, Stream raised approximately $160 million from third-party investors in a combination of debt and equity. In connection with some of these capital raises, Stream pledged all its assets as security for promissory notes it received from its senior secured creditor, SLS Holdings VI, LLC, and its junior secured creditor, Hawk Investment Holdings Limited (collectively, the "Notes").

In 2019, to prevent wide-scale default on the Notes, a stockholder representing 52 of Stream's stockholders attempted to restructure Stream's debts by, among other things, assigning substantially all the company's assets to a new entity, SeeCubic, pursuant to a global restructuring agreement with SLS and Hawk (the "Omnibus Agreement"). However, the Rajan brothers refused to agree to restructure Stream, and negotiations quickly broke down. Thereafter, Stream missed payroll payments, furloughed employees, and received another infusion of capital from Hawk and another investor. On March 9, 2020, SLS alerted Stream that it had defaulted on its debt.

In response to the default, SLS, Hawk, and certain equity investors convinced the Rajan brothers to hire outside directors. Once installed, these new directors hoped to negotiate a resolution with Stream's creditors and investors. The new directors created a Resolution Committee ("Committee"), equipped with "the full power and authority of the full Board of Directors" to resolve any existing or future debt default claims or litigation. Two days later, the Committee approved the Omnibus Agreement, requiring Stream to assign its assets to SeeCubic in exchange for SLS and Hawk discontinuing foreclosure actions. The Omnibus Agreement also provided Stream stockholders, less the Rajan brothers, the right to exchange their Class A common stock for an identical number of shares of SeeCubic's common stock at no cost. The Omnibus Agreement also provided the Rajan brothers with the ability to indirectly own equity in SeeCubic by giving Stream one million shares of SeeCubic's Class A common stock in consideration for the asset assignment.

In response, the Rajan brothers attacked the validity of the Omnibus Agreement, the Resolution Committee, and the outside directors' appointments. Although the creditors, outside directors, and other equity investors attempted to negotiate a resolution with the Rajans, those discussions fell through, leading to litigation.

PROCEDURAL POSTURE:

In September 2020, Stream, at the direction of the Rajans, moved the Delaware Chancery Court ("Chancery Court") for a temporary restraining order to prevent SeeCubic from seeking to enforce the Omnibus Agreement. SeeCubic counterclaimed and third-party claimed for its own injunction. In response, the Chancery Court entered a status quo order and conducted a hearing on the parties' competing motions for preliminary injunctive relief. The Chancery Court

found for SeeCubic and granted injunctive relief on the grounds that the Resolution Committee had the authority to bind Stream to the Omnibus Agreement and that under D.G. C.L. § 271 or the class vote provision in Stream's Certificate, the Omnibus Agreement did not require a stockholder vote for approval.

In January 2021, SeeCubic moved for summary judgment seeking: (i) declaratory judgment that the Omnibus Agreement was valid and binding, (ii) a permanent injunction ordering Stream and the Rajans to comply with the Omnibus Agreement, and (iii) a judgment against the Rajans for converting assets identified in the Omnibus Agreement. In an attempt to delay these proceedings, the Rajans filed Stream for bankruptcy; however, the bankruptcy court dismissed the case as a bad faith filing. In September 2021, the Chancery Court granted summary judgment declaring the Omnibus Agreement to be valid and binding and granted the request for a permanent injunction but denied the conversion claim against the Rajans. Though Stream and the Rajans attempted to modify or stay the permanent injunction pending appeal, the Chancery Court denied their request, reasoning that D.G.C.L. § 271 did not supersede the common law's recognition of the failing business exception to stockholder approval.

HOLDING/REASONING:

The Delaware Supreme Court conducted a *de novo* review of the Chancery Court's decision. Unlike the Court of Chancery, which looked to section 271 and the common law exceptions made available to corporations in other states before analyzing Stream's Certificate, the Court began its analysis with the language of the Certificate itself.

Based solely on the language in the Certificate and the broad authority conferred on corporations by the D.G.C.L., the Court asked whether the Certificate's class vote provision required a vote by the Class B stockholders and answered in the affirmative. Specifically, the Court held the Omnibus Agreement "effects an 'Asset Transfer' that unambiguously triggers a majority vote of the Class B stockholders."

In reaching this conclusion, the Court emphasized the primacy of enforcing the clear, unambiguous language of a Certificate absent a conflict with established Delaware corporate law. Here, the Court found that the Certificate's voting provisions were unambiguous and did not conflict with Delaware corporate law or public policy. Accordingly, the Court reversed the Chancery Court's decision below and affirmed Delaware's "contractarian" public policy in matters of corporate governance.

DISCUSSION:

Although the Court's holding turned on a plain language analysis of the relevant Certificate provisions, the Court also engaged in a lengthy discussion of the common law's "failing business" exception to find that even if such an exception did exist in Delaware before codification of the D.G.C.L., it was not incorporated into the D.G.C.L at inception. This exception,

dating back to the early- to mid-1900s, allowed an insolvent corporation to sell or otherwise dispose of all or substantially all of its assets without the need for a stockholder vote (which prior to the codification of section 271 required *unanimous* stockholder approval) on the theory that out-of-the-money equity holders no longer have any interests to protect. In determining whether this common law exception existed in Delaware law, the Court surveyed treatises and case law from the early 1900s, noting that Delaware courts have never expressly adopted or even addressed the board-only insolvency exception. Further, the Court looked to previous versions of D.G.C.L. § 271 and noted the statute was intended to supersede the preexisting common law requirement of unanimous consent for a sale, a lease, or an exchange of all or substantially all of a corporation's assets. Ultimately, the Court, bolstered by the policy aims of stability and predictability, concluded that when the common law's unanimity requirement was preempted by section 271, so too was the board-only insolvency exception, assuming it ever existed.

As the instant case shows, providing stockholders of an insolvent corporation with the ability to block a deal struck with the company's creditors may incentivize obstructionist and dilatory tactics with no real downside for the opposing stockholders at the expense of the company's creditors.

For example, the Rajans leveraged their positions as Stream's COO, CEO, and majority holders of the outstanding Class B voting stock to further their own ends and not necessarily those of Stream's other stockholders and creditors. First, the Rajans drafted a written consent of stockholders, hoping to remove the outside directors. When that proved unsuccessful, the Rajans attempted to undermine the directors by, among other things, litigating over whether the outside directors formally accepted their positions. Then, the Rajans took more aggressive strategies, attempting to alter the management structure of Stream's subsidiaries and even removing intellectual property from a Stream facility in Europe.

When a corporation is insolvent, stockholders who are not likely to recoup any value from a deal struck with creditors may be less willing to authorize the transaction. Here, the voting provisions of Stream's Certificate—designed and implemented by the Rajans to cement their control over the company—effectively gave the Rajans a veto over the desires of Stream's board and the other parties to the Omnibus Agreement. *Stream*'s lesson is clear: creditors of Delaware corporations would be well-served to include a review and analysis of the corporation's Certificate before making credit decisions to ensure their options will not be constrained or hijacked if the corporation's prospects falter.

Stream also reinforces Delaware's strict "contractarian" approach to matters of corporate governance and that Delaware courts will adhere to the unambiguous terms of the Certificate before reading in statutory requirements from the D.G.C.L. In the instant case, Stream's Certificate required a majority of Class B stockholder approval for a "disposition" of the corporation's intellectual property. As the terms of the Omnibus Agreement clearly called for the disposition of these assets as part of the restructuring, the corporation was bound to the

provisions of its Certificate. Had Stream's board and creditors' recognized this issue earlier, they could have attempted to amend the Certificate and, with that, removed any stockholder voting requirement for asset transfers when the corporation is insolvent or devised a different strategy that would meet with stockholder approval. Looking forward, it is clear that Delaware courts will strictly construe contracts absent some patent ambiguity or violation of public policy, leaving corporations in charge of determining, for themselves, who can vote on an asset transfer.

WHAT DOES THIS MEAN FOR YOUR BUSINESS?

This decision will seriously affect closely held corporate governance schemes, which might fall victim to a similar quasi-unanimity requirement as did Stream. In practice, this decision may cause closely held corporations to move away from restructuring through assignments for the benefit of creditors or deeds-in-lieu of foreclosure and incentivize them to take a more conventional approach to bankruptcy proceedings. Relatedly, creditors seeking to negotiate a restructuring with an insolvent Delaware corporation should familiarize themselves with the company's Certificate and stock voting provisions (or lack thereof) to determine at the outset whether a proposed transaction will require stockholder approval. And in those instances where the Certificate is silent on voting requirements for asset dispositions, Creditors need to be mindful that Delaware courts will apply the default rule of section 271, and require a stockholder vote.

If you or your company is interested in taking steps to alleviate the present or future effects of financial instability and ensure that those interested in the company's true success are capable of effectuating change, contact Royer Cooper Cohen & Braunfeld.

[1] *Stream T.V. Networks, Inc. v. SeeCubic, Inc.*, 2022 Del. Lexis 177 (DE. 2022).

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