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DELAWARE SUPREME COURT REQUIRES STOCKHOLDER VOTE TO APPROVE COMPANY'S TRANSFER OF PLEDGED ASSETS TO SATISFY DEFAULTED DEBT

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DELAWARE CORPORATE LAW BULLETIN

DELAWARE SUPREME COURT REQUIRES STOCKHOLDER VOTE TO APPROVE COMPANY'S TRANSFER OF PLEDGED ASSETS TO SATISFY DEFAULTED DEBT

Rejects Chancery Court determination that DGCL § 271's stockholder approval requirement is subject to a common law insolvency exception

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INTRODUCTION

Stream TV Networks, Inc. ("*Stream*" or the "*Company*"), a company in difficult financial straits, found itself unable to repay its considerable debt. Repayment of this debt was secured by a pledge of all Company assets to the secured creditors. Facing default and a potential bankruptcy that would wipe out the Company's equity, an independent committee of the Company's board of directors (the "*Board*") approved an agreement transferring the pledged assets to a new entity controlled by the secured creditors. In consideration of this transfer, the secured creditors both (i) waived their rights under the defaulted debt, and (ii) granted Company stockholders an equity interest in the new entity.

The family controlling Stream challenged this transfer in the Delaware Court of Chancery (the "*Chancery Court*"), claiming (among other things) that under (i) Delaware General Corporation Law ("*DGCL*") Section 271 ("*DGCL §271*"), and (ii) the Company's certificate of incorporation (the "*Charter*"), the Company should have sought stockholder approval before completing the transfer. Vice Chancellor J. Travis Laster of the Chancery Court tackled this dispute in *Stream TV Networks*, *Inc. v. SeeCubic, Inc.*, 250 A.3d 1016 (Del. Ch. 2020) ("*Stream TV-I* ").

At common law, corporate boards of directors were barred "from selling the assets of the business without unanimous shareholder approval." As such, "the objection of a single shareholder could thwart the efforts to sell a corporation's assets." To relieve this impediment, the common law rule was reversed by legislative enactment of a predecessor to DGCL §271, which currently provides that

> [e]very corporation may at any meeting of its board of directors. . .*sell, lease or exchange* all or substantially all of its property and assets. . .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. . .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. . ..* (emphasis added).

The Delaware legislature also has adopted a seemingly related provision of the DGCL, Section 272 ("*DGCL §272*"), which currently provides that

> [t]he 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. (emphasis added).

In *Stream TV-1*, Vice Chancellor Laster sought to reconcile whether a corporate board's empowerment under DGCL §272 to "mortgage or pledge" corporate assets without seeking stockholder approval

extended to a sale of those same assets upon foreclosure, despite DGCL §271's stockholder approval requirement. The Vice Chancellor sided with Stream's secured creditors, declaring that "requiring a shareholder vote under Section 271 before a company could otherwise transfer its assets to a creditor 'would be contrary to the plain language of Section 272' and against Delaware public policy." (For a discussion of this and other aspects of *Stream TV-I*, *see* Robert S. Reder, *Chancery Court Employs Context-Driven Analysis in Adopting Nuanced Interpretations of DGCL Provisions*, 74 VAND. L. REV. EN BANC 85 (2021).) However, some eighteen months later in *Stream TV Networks, Inc. v. SeeCubic, Inc.*, No. 360, 2021 (Del. June 15, 2022) ("*Stream TV-II*"), the Delaware Supreme Court reversed and vacated this aspect of the *Stream TV-I* ruling.

I. FACTUAL BACKGROUND

A. Stream's Corporate Structure

Stream "was founded in 2009 to develop and commercialize technology that enables viewers to watch three-dimensional content without 3D glasses." Until March 2020, the Rajan brothers (the "*Rajans*") controlled the Company at all levels of the corporate hierarchy:

1) As stockholders, the Rajans controlled "a majority of Stream's outstanding voting power" through ownership of "19,000,000 Class B shares carrying 10 votes per share. . .." (the "*Class B Shares*").
2) As the sole remaining members of the Board, the Rajans controlled management of the Company
3) And, as the senior-most officers, the Rajans controlled the Company's day-to-day operations.

The Charter included a provision giving holders of Class B Shares (*i.e.*, the Rajans) a class vote "for the Company to consummat[e] an. . .Asset Transfer" (the "*Class Vote Provision*"). The Class Vote Provision defined "Asset Transfer"—in a manner similar to, but not exactly tracking, the comparable language of DGCL §271—as

> a sale, lease or other disposition of all or substantially all of the assets or intellectual property of [Stream] or the granting of one or more exclusive licenses which individually or in the aggregate cover all or substantially all of the intellectual property of [Stream]. (emphasis added).

B. Stream Suffers Financial Setbacks

To fund operations, Stream raised both equity and debt financing:

1) The equity was owned by "third-party investors" ("*Equity Investors*").
2) The debt consisted primarily of secured senior and junior debt (collectively, "*Secured Debt*"), the repayment of which was secured by a pledge of all Company assets.

Despite its promising technology, Stream failed to develop a commercial product and lacked sufficient resources to repay the Secured Debt. Beginning in 2019, the Rajans, the holders of the Secured Debt ("*Secured Creditors*"), and a representative of the Equity Investors ("*Representative*") held discussions "about restructuring Stream." One proposal, ultimately rejected by the Rajans, contemplated an agreement ("*Omnibus Agreement*") under which Stream would extinguish the Secured Debt by transferring the pledged assets to a newly formed company controlled by the Secured Creditors.

By the end of February 2020, the Company had defaulted on the Secured Debt and "missed payroll at least once." Under pressure from the Secured Creditors and the Representative, the Rajans appointed "four independent outside directors" ("*Outside Directors*") to join them on the Board. Then, at a May 4th Board meeting, with the Rajans abstaining, the Outside Directors authorized formation of a committee consisting of two of the Outside Directors (the "*Resolution Committee*"), having "full power and authority. . .to resolve any existing or future debt defaults or claims, and any existing or future litigation, or threats thereof, on behalf of [Stream], without future action being required from the Board … or any executive of the [C]ompany."

C. Resolution Committee Pursues Omnibus Agreement

On May 6, "the Resolution Committee approved the Omnibus Agreement," which was signed on behalf of the Company, the Secured Creditors, and the Equity Investors. Under the Omnibus Agreement, in exchange for the Secured Creditors waiving their foreclosure rights, Stream transferred the pledged assets to a new entity, SeeCubic, Inc. ("*SeeCubic*"), owned by the Secured Creditors. To provide the Equity Investors with a continuing interest in Stream's assets, the Omnibus Agreement permitted them to exchange Company shares for an equal number of SeeCubic shares "at no cost." In addition, in an effort to placate the Rajans by virtue of their ownership of Company shares, the

Omnibus Agreement provided for the transfer of one million SeeCubic shares to Stream. Stream thereby avoided a foreclosure, and perhaps a bankruptcy, which would have left the Equity Investors and the Rajans with no equity interest in the continuing business.

The Rajans, who were anything but placated, immediately "attempted to neutralize" the Omnibus Agreement. Among other measures, the Rajans signed written consents purporting to remove the Outside Directors and undermine the actions taken to affect the transactions contemplated by the Omnibus Agreement. When the Secured Creditors and the Representative sought to negotiate a resolution with the Rajans, the "brothers pushed for personal benefits" and the "negotiations failed."

D. Litigation Ensues in Chancery Court

At this point, " '[c]reating litigation chaos seemed to be one of the Rajans' strategies." In furtherance of this strategy, on September 8th, Stream asked the Chancery Court to bar enforcement of the Omnibus Agreement. The Secured Creditors and the Representative, acting through SeeCubic, responded in kind with counterclaims. In *Stream TV-1*, based on his analysis of DGCL §271 and the Class Voting Provision, Vice Chancellor Laster "granted SeeCubic's motion for a preliminary injunction" of the actions taken by the Rajans to undo the Omnibus Agreement.

1. DGCL §271 Not Applicable. Tackling the DGCL §271 question first, the Vice Chancellor considered "whether the transfer of Stream's assets to its secured creditors under the circumstances presented constitute[d] a sale or exchange within the scope of Section §271." The Vice Chancellor found the relevant language of DGCL §271 to be "ambiguous" and, applying "principles of statutory interpretation. . .turned to Section 271's legislative history. . .."

In this connection, the Vice Chancellor explained that the common law rule requiring stockholder unanimity for transfers of substantially all of a corporation's assets "was subject to an insolvency exception" that permitted "boards to transfer all or substantially all of an insolvent company's assets to creditors without shareholder approval." Next, the Vice Chancellor found "no indication that the General Assembly intended to restrict or eliminate authority that already existed at common law, such as the power of the directors of an insolvent and failing corporation to sell it assets" when it adopted the predecessor to DGCL §271. He further determined that the inclusion in DGCL §271 "of specific acceptable forms of consideration that *did not include* 'forgiveness of debt[]' supported allowing an insolvent or failing firm to

transfer all or substantially all of its assets to creditors." (emphasis added). Finally, "because Section 272 does not require a shareholder vote for the pledging of corporate assets as collateral. . ., requiring a shareholder vote under Section 271 before a company could otherwise transfer its assets to a creditor 'would be contrary to the plain language of Section 272' and against Delaware public policy."

On this basis, Vice Chancellor Laster opined that DGCL §271 "did not apply to the Omnibus Agreement because Stream was insolvent, its stockholders no longer had a 'meaningful interest in the firm,' and the secured creditors were entitled to its assets." As such, "[u]nder the DGCL, the Omnibus Agreement did not require a stockholder vote."

2. Class Vote Provision Not Applicable. Vice Chancellor Laster found that, because the language of the Class Vote Provision "was 'parallel' to Section 271," it "warranted the same interpretation as Section 271": the Company was not required to "obtain stockholder approval under the Class Vote Provision to transfer mortgaged or pledged assets to the secured creditors who hold security interests in those assets." Moreover, given their familiarity with DGCL §271, "[i]f the drafters of the Class Vote Provision wanted to require a class vote before a secured creditor could foreclose on pledged or mortgaged assets, then the definition of 'Asset [Transfer]' should have referred to that type of transaction." But it did not.

* * *

Next, SeeCubic asked Vice Chancellor Laster to make his preliminary ruling permanent. In September 2021, the Vice Chancellor granted summary judgment to SeeCubic, declaring the Omnibus Agreement to be "valid and binding" and converting "the preliminary injunction into a permanent injunction." The Rajans appealed to the Delaware Supreme Court, which reversed and vacated the Vice Chancellor's ruling.

II. THE SUPREME COURT'S ANALYSIS

The Supreme Court agreed with the Rajans that Vice Chancellor Laster's *Stream TV-1* analysis was "upside down." Rather than following the Vice Chancellor's lead in focusing at the outset on DGCL §271, the Supreme Court found the Class Vote Provision to be the right place to start. The Supreme Court then concluded that (i) DGCL §271 did not serve "as an interpretative guide in construing" the Class Vote Provision, (ii) "the plain and ordinary meaning" of the Class Vote Provision required a class vote of holders of Class B Shares to authorize the Omnibus Agreement, and (iii) even if a "common law insolvency exception"

existed at common law, the enactment of a predecessor to DGCL §271 "superseded any such common law exception. . .."

A. DGCL §271 Not a Guide for Interpretation of the Class Vote Provision

The Supreme Court recognized that "the DGCL does outrank a corporation's charter such that a charter provision is invalid if it conflicts with a provision of the DGCL." However, the Supreme Court also took note of precedent in which "this Court held that [DGCL] Section 102(b)(1) bars only charter provisions that would 'achieve a result forbidden by settled rules of public policy.' " Because the Class Vote Provision did not fall into this category, the Supreme Court proceeded to analyze "whether the Class Vote Provision requires a vote of the Class B stockholders."

In this regard, the Supreme Court focused on whether the transactions contemplated by the Omnibus Agreement constituted an "Asset Transfer" for purposes of the Class Vote Provision. Specifically, the Supreme Court noted that the "Asset Transfer" definition referred to "a sale, lease *or other disposition*" of Stream's assets, "a meaning that is different, and broader, than" DGCL §271's reference to "sell, lease *or exchange*. . .." (emphasis added). Based on this difference in terminology, the Supreme Court saw "no need to look to Section 271 as an interpretative guide" for the Class Vote Provision: the drafters of the Class Vote Provision " 'could have simply tracked the language of the statute,' but did not."

B. Charter Required a Class Vote of Class B Shares to Authorize the Omnibus Agreement

This, in turn, led the Supreme Court "to the key inquiry—the meaning of 'other disposition' " as utilized in the definition of Asset Transfer but not separately defined in the Class Vote Provision. After consulting numerous secondary sources, the Supreme Court found no ambiguity, concluding that "the plain meaning of 'other disposition' includes the transactions contemplated in the Omnibus Agreement." And "[w]hen the contractual provision is clear and unambiguous, the court will give the provision's terms their plain meaning." In essence, "the assignment of all rights, title, and interest in Stream's assets is a 'disposition' because it effects a 'relinquishing of property' in consideration for a resolution, settlement, or determination of" the Secured Creditors' claims against Stream. As such, the "transactions set forth in the

Omnibus Agreement unambiguously effect a 'disposition' as that term is commonly used," thus "triggering the Class B Vote Provision."

C. Common Law Insolvency Exception Did Not Survive Enactment of DGCL §271

Finally, the Supreme Court addressed Vice Chancellor Laster's determination that, at common law, "a board-only insolvency exception existed, despite the lack of any precedent in Delaware." The Supreme Court acknowledged "that the weight of treatise authority, supported by cases from various states, supports the existence, at least in the early part of the twentieth century, and at least in certain jurisdictions, of certain common-law rules governing sales of all assets, including. . .[i]f a corporation is insolvent, then a sale of all assets may be made by the directors without stockholder approval." On the other hand, the Supreme Court noted, "no Delaware case expressly addresses or adopts the board-only insolvency exception."

Rather than reaching a definitive conclusion, the Supreme Court reasoned that, "[e]ven if we were to determine that a board-only insolvency exception was part of our common law at one time, the pivotal question is whether it survived the enactment of" the predecessor to DGCL §271. For the Supreme Court, the answer to this "pivotal question" was a resounding no. Based on the "plain language" of DGCL §271, "which contains no exceptions and is not ambiguous," the Supreme Court concluded that "the better view is that, when the common law unanimity rule was superseded" by the enactment of DGCL §271, "so too was any insolvency exception to that rule." Further, because "a 'board only' insolvency exception is inconsistent with a statutory default majority vote rule. . .we conclude that Section 271 was intended to occupy the field and that no such insolvency exception survives, assuming *arguendo*, that it existed in the first place." To conclude otherwise "would foster uncertainty and potential inconsistency in a context where predictability is crucial for corporations that have availed themselves of Delaware law."

CONCLUSION

The seemingly conflicting terminology of DGCL §271 and DGCL §272 presents a conundrum for corporate planners. While DGCL §272 clearly empowers a corporate board of directors—without seeking stockholder approval—to pledge corporate assets (and even all of its assets) to secure its debt, the stockholder approval requirement of DGCL §271 would seem to impose a significant impediment on the secured

creditor's ability to effect repayment of the debt *via* a private foreclosure action. In *Stream TV-1*, Vice Chancellor Laster—relying on a Delaware common law insolvency exception—reasoned that because DGCL §272 does not require stockholder approval *for a corporate pledge of* substantially all assets, stockholder approval should not be required under DGCL §271 *for the sale* of those assets upon foreclosure. The Vice Chancellor declared, as a matter of "public policy," that "interpreting Section 271 as applying to a creditor's efforts to levy on its security would undercut the value of the security interest[]" itself.

In *Stream TV-1I*, the Delaware Supreme Court rejected the Vice Chancellor's context-driven approach. Rather than focus on the relevant DGCL sections, the Supreme Court rested its decision primarily on the "plain and ordinary meaning" of the terminology employed in the Class Vote Provision. Specifically, inclusion of the broad concept "sale, lease *or other disposition*" in the Asset Transfer definition distinguished the Class Vote Provision from the more narrowly drawn concept utilized in DGCL §271: "sale, lease *or exchange*." (emphasis added). For the Supreme Court, the transfer of Stream assets pursuant to the Omnibus Agreement in satisfaction of debt owed to the Secured Creditors fell neatly within the more expansive Class Vote Provision.

Rather than stopping here, the *Stream TV-II* Court also rejected Vice Chancellor Laster's incorporation of a common law insolvency exception into DGCL §271. Concerned that "reading Section 271 to embody a common law exception that was never the basis of a single holding by any Delaware court" would not promote "stability in our DGCL"—a goal of "paramount importance" for the Supreme Court. Thus, the Delaware Justices declared, "there presently is no insolvency exception embedded in Section 271." Unfortunately for the Secured Creditors, the "stability" promoted by *Stream TV-II* left them without a remedy for foreclosing on the pledged assets. Going forward, creditors may have to forego taking a security interest in "all or substantially all" of a corporate debtor's assets or insist on pre-approval from stockholders as a condition to making the loan.