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In Ruling On Motion To Dismiss, Chancery Court Allows Admission Of Extrinsic Evidence To Resolve Ambiguity In Preferred Stock Certificate Of Designations

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In *Cedarview Opportunities Master Fund, L.P. v. Spanish Broadcasting System, Inc.,* CA No. 2017-0785-AGB (Del. Ch. Aug. 27, 2018), the Court of Chancery granted in part and denied in part the motion of Spanish Broadcasting System ("SBS" or the "Company") to dismiss Plaintiffs' claims, which were based on alleged breaches by the Company of its certificate of incorporation and certificate of designations for its preferred stock, under Court of Chancery Rule 12(b)(6) for failure to state a claim and Rule 12(b)(1) for lack of ripeness. In ruling on one aspect of the Company's motion to dismiss, the Court notably held that the parties should be permitted to admit extrinsic evidence to resolve an ambiguity with respect to the terms governing preferred stock, and in doing so, expressly declined to apply two arguably conflicting principles historically used by Delaware courts in resolving such an ambiguity, the application of which would not necessitate or permit the admission of extrinsic evidence.

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The Plaintiffs brought five claims against the Company, three of which related to the Company's alleged breach of the certificate of designations for the Company's 10 ¾% Series B Cumulative Exchangeable Redeemable Preferred Stock (the "Series B Preferred Stock") (the "Certificate") by impermissibly incurring Indebtedness, as defined in the Certificate, and two of which related to the Company's alleged breach of the Third Amended and Restated Certificate of Incorporation (the "Charter") by unilaterally suspending the rights of the holders of the Company's Series B Preferred Stock ("Series B Holders") in an effort to comply with restrictions on non-U.S. citizenship of stockholders under the Communications Act of 1934, 47 U.S.C. § 151 (the “Communications Act”), and the Charter. The Court denied the Company’s motion to dismiss with respect to three of the Plaintiffs’ five counts: breach of the Certificate by the Company, breach of the Charter by the Company, and a request for a declaratory judgment that Section 10.4 of the Charter is invalid, as-applied. The Court granted in part and denied in part the Company’s motion to dismiss Plaintiffs’ claim for specific performance. The Court granted the Company’s motion to dismiss Plaintiffs’ claim that SBS breached the Certificate’s implied covenant of good-faith and fair dealing.

Defendant SBS is a Spanish-language media and entertainment company. Approximately 94.16% of the Company’s outstanding Series B Preferred Stock was held by Plaintiffs, of which 69.9% are defined as foreign entities under the Communications Act, which the Company claimed is in violation of the Communications Act and the Charter.

Pursuant to the Certificate, Series B Preferred Stock does not entitle Series B Holders to voting rights, unless there is a Voting Rights Triggering Event (“VRTE”). As a result of financial difficulties faced by the Company post-2008, several VRTEs occurred, including the Company’s failure to pay dividends to Series B Holders, the Company’s failure to repurchase shares of Series B Preferred Stock, and the Company’s failure to pay the Company’s $275 million in 12.5% senior notes (“Senior Notes”) when they became due. Following SBS’s failure to pay the Senior Notes when due, and in order to avoid foreclosure, the Company executed a forbearance agreement with the holders of 75% of the outstanding Senior Notes (the “Forbearance Agreement”). The Forbearance Agreement provided that the Senior Notes holders executing the Forbearance Agreement would forbear from exercising their rights under the Indenture governing the Senior Notes in exchange for the receipt of certain payments from the Company, including monthly interest payments, a one-time consent fee, and legal and financial advisor fees.

In November 2017, Plaintiffs filed their initial complaint, claiming that SBS breached the Certificate by impermissibly incurring debt during a VRTE. Under the Certificate, when a VRTE occurs, the Company is prohibited from incurring Indebtedness without the consent of the Series B Holders.

Subsequent to the filing of the Plaintiffs’ complaint, the Company suspended all Series B Holders’ rights except the right to transfer shares to a U.S. citizen, claiming that after reviewing the complaint, it learned for the first time that foreign ownership of the Series B Preferred Stock exceeded the limitations on foreign ownership set forth in § 310 of the Communications Act, which establishes a 25% benchmark for foreign ownership in U.S. entities that directly or indirectly control a U.S. broadcasting license.. These limitations were also incorporated into the Charter.

Plaintiffs’ Complaint and Amended Complaint asserted five claims against the Company. In response, the Company filed a motion to dismiss with respect to all five counts for failure to state a claim, and a motion to dismiss for lack of ripeness with respect to Count V.

Regarding Count I, in determining whether Plaintiffs had stated a claim for breach of contract and evaluating whether Plaintiffs allegations satisfied their obligation to establish a breach of a contractual obligation, the Court addressed whether the Company “incurred Indebtedness” during the pendency of a VRTE with respect to the accrued but unpaid interest on the Senior Notes and the accrued but unpaid professional fees associated with the Forbearance Agreement. The Court found that the term Indebtedness was fairly susceptible to different interpretations, and therefore, ambiguous.

The Court noted that Delaware courts have applied two conflicting principles when resolving ambiguities with respect to preferred stock. The first principle, *contra proferentum*, set forth in *Kaiser*

Aluminum Corp. v. Matheson, 681 A.2d 392 (Del. 1996), resolves ambiguities in the certificate of designation in favor of preferred shareholders. The second principle, articulated in *Rothschild International Corp. v. Liggett Group, Inc.*, 474 A.2d 133 (Del. 1984), notes that only express provisions with respect to the rights of preferred shareholders will govern. In the most notable portion of the opinion, the Court, however, declined to apply either principle, and instead, held that the parties should be permitted to admit extrinsic evidence to resolve the ambiguity.

The Court granted the Company's motion to dismiss with respect to Count II, which alleged breach of the Certificate's implied covenant of good faith and fair dealing. The Court held that the implied covenant of good faith and fair dealing applies where a contract lacks specific language governing an issue, and does not contradict the terms of the contract. Here, the Court noted that the Plaintiffs had not identified any hole or gap to be filled by the implied covenant, and thus, it did not apply.

With respect to Count III, which sought specific performance, the Court denied the Company's motion to dismiss with respect to Plaintiff's request that the Court order the Company to respect the Series B Holders' consent rights, noting that the requested relief is a possible equitable remedy for a breach of contract claim on which Plaintiffs could be successful at trial, and which therefore should not be foreclosed. The Court, however, granted the Company's motion to dismiss with respect to the Plaintiff's request for an order requiring the Company to repurchase the Series B Preferred Stock, holding that the Plaintiffs' failure to allege a breach of the Company's buyback obligations precluded specific performance.

Plaintiffs' Counts IV and V concerned the Company's suspension of Series B Holders' rights under the Charter. Count IV alleged that the Company breached the Charter when it unilaterally cancelled the rights of Series B Holders. Because of the "severity of depriving stockholders of fundamental rights," the Court held that Plaintiffs sufficiently pled facts indicating that the Company breached the Charter by "indiscriminately suspending all the rights of the Series B Holders," rather than taking a more tailored approach to bringing the Company back into compliance with the Communications Act and the Charter, and denied the motion to dismiss.

Count V sought a declaratory judgment that Section 10.4 of the Charter, which permitted the suspension of Series B Holders' rights, was invalid, both facially and as-applied. In response, the Company moved to dismiss for lack of ripeness pursuant to Rule 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The Court dismissed Plaintiffs' claim that the provision was facially invalid because they failed to demonstrate how the provision would fail to operate lawfully under any circumstance. On the other hand, the Court denied the Company's motion to dismiss the Plaintiffs' claim that Section 10.4 was invalid as-applied, because it suspended Series B Holders' right to inspect the books of the Company, which pursuant to 8 Del. C. § 200, cannot be restricted by Charter.

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