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OF THE
STATE OF DELAWARE

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Re: *Balch Hill Partners, L.P. v. Shocking Technologies, Inc.*
C.A. No. 8249-VCN
Date Submitted: February 4, 2013

Dear Counsel:

Before the Court is another dispute between Respondent Shocking Technologies, Inc. ("Shocking" or the "Company") and a member of its board, Simon Michael ("Michael").[1] Michael is affiliated with Petitioner Balch Hill Partners, L.P. ("BHP"), a shareholder of Shocking. BHP has moved for expedited proceedings with respect to its petition to appoint a receiver or custodian for

[1] *See Shocking Techs., Inc. v. Michael*, 2012 WL 4482838 (Del. Ch. Oct. 1, 2012).

Shocking (the "Petition").[2] Not surprisingly, Shocking opposes BHP's motion for expedited proceedings. It advances two main arguments. First, it asserts that BHP has not stated a colorable claim for the appointment of a custodian under 8 *Del. C.* § 226 or for the appointment of a receiver under 8 *Del. C.* § 291. Second, it contends that BHP should be precluded in its efforts by the doctrine of unclean hands as applied to Michael.

BHP's motion follows Shocking's withdrawal of its own expedited proceeding to compel Michael to attend a meeting of Shocking's board (the "Board") or to dispense with the quorum requirement. Michael refuses to attend a Board meeting as a means of obstructing any Board action with which he disagrees. Although he is just one board member, that tactic is effective because his attendance is needed to obtain a quorum, which is a prerequisite to the Board's approval of a necessary loan to the Company. As it now stands, the Board has five members, including Michael. Although the Company's charter provides for eight board members, two directors have not been appointed by the shareholders that have the contractual right to do so and there has been no necessary agreement

[2] Verified Pet. to Appoint a Receiver or a Custodian of or for Shocking Technologies, Inc.

among various stakeholders empowered to fill the third empty board seat. The other directors are Lex Kosowsky ("Kosowsky"), Gary Kennedy, and James Hogan, all of whom appear to be aligned, and a representative of Littelfuse, Inc. ("Littelfuse"), a significant investor in Shocking.

Both parties agree that Shocking is in financial distress. Without funding in the near future, the Company will likely be forced to file for bankruptcy. Before it withdrew its motion, Shocking attempted to force Michael to attend a board meeting so that a majority of the directors present could ratify a $2 million loan from Littelfuse (the "Littelfuse Loan"). Michael opposed the Littelfuse Loan because it would be secured by all of Shocking's assets and because it would have provided Littelfuse with an opportunity to acquire inexpensively all of Shocking's intellectual property if the Company defaulted on the loan or went into bankruptcy. Michael, on behalf of BHP, countered with his own loan proposal to the Company. His proposal allegedly included the same terms as Littelfuse's offer except that it had a lower interest rate and allowed all of Shocking's stockholders to participate in the loan on a pro rata basis. According to Michael, Kosowsky rejected his offer. As it now stands, both Littelfuse's and Michael's proposals have been withdrawn,

leaving Shocking without any immediate and viable options to meet its funding needs.

The standard for expediting a proceeding is not a difficult one to meet.[3] BHP need only "articulate[] a sufficiently colorable claim and show[] a sufficient possibility of a threatened irreparable injury, as would justify imposing on [Shocking] and the public the extra (and sometimes substantial) costs of an expedited . . . proceeding."[4]

BHP first argues that the appointment of a receiver or custodian is colorable under 8 *Del. C.* § 226(a)(2). The Court is authorized to make such an appointment when:

> The business of the corporation is suffering or is threatened with irreparable injury because the directors are so divided respecting the management of the affairs of the corporation that the required vote for action by the board of directors cannot be obtained and the stockholders are unable to terminate this division.[5]

Shocking does not contest that its financial crisis poses a threat of irreparable harm. However, it argues that the directors are not so divided that they would be

[3] *The Renco Gp., Inc. v. MacAndrews AMG Hldgs. LLC*, 2013 WL 209124, at *1 (Del. Ch. Jan. 18, 2013).
[4] *Giammargo v. Snapple Beverage Corp.*, 1994 WL 672698, at *2 (Del. Ch. Nov. 15, 1994).
[5] 8 *Del. C.* § 226.

unable to obtain a majority vote on funding if a quorum (five board members) appeared at a board meeting. In response, BHP cites various cases for the proposition that a director's refusal to attend board meetings, and thereby exercise "negative control" over the board, is sufficient to find that the Board is hopelessly divided.[6] Those cases and the Board's apparent paralysis in the face of insolvency persuade the Court that BHP has stated a colorable claim that the Board is so divided that it is unable to resolve the Company's financial crisis.

Moreover, BHP has stated a colorable claim that the Company's stockholders are unable to terminate the division. Pursuant to a voting agreement, several of Shocking's stockholders can elect or remove their respective designees to the Board at any time. That setup appears to facilitate the prospect that whatever conflict that might exist between the directors would also exist among shareholders. Shocking argues that its stockholders are not unable to terminate the division on the Board—they simply are unwilling to do so. Shocking is correct that two of its major stockholders have elected not to appoint their respective

[6] *See, e.g.*, *Bentas v. Haseotes*, 769 A.2d 70, 78 (Del. Ch. 2000); *Hoban v. Dardanella Elec. Corp.*, 9 Del. J. Corp. L. 470, 473-74, 1984 WL 8221 (Del. Ch. June 12, 1984).

director designees. However, BHP has alleged in the Petition that, if those shareholders were to designate directors to the Board, they would refuse to support Kosowsky's agenda. Consequently, if Balch Hill is correct, their addition to the Board would not necessarily alleviate the Board's current impasse over the Littelfuse Loan, if it became available again. Those allegations are sufficient to state a colorable claim that the Company's stockholders are unable to terminate the division among board members. Accordingly, the Petition for a custodian or receiver under 8 *Del. C.* § 226 is colorable.[7]

BHP also seeks the appointment of a receiver under 8 *Del. C.* § 291, which provides:

> Whenever a corporation shall be insolvent, the Court of Chancery, on the application of any creditor or stockholder thereof, may, at any time, appoint 1 or more persons to be receivers of and for the corporation, to take charge of its assets, estate, effects, business and affairs, and to collect the outstanding debts, claims, and property due and belonging to the corporation, with power to prosecute and defend, in the name of the corporation or otherwise, all claims or suits, to appoint an agent or agents under them, and to do all other acts which might be done by the corporation and which may be necessary or

[7] The Court need not address at this time BHP's arguments for appointing a receiver or custodian under 8 *Del. C.* § 226(a)(1). BHP may make those arguments going forward.

> proper. The powers of the receivers shall be such and shall continue so long as the Court shall deem necessary.

Shocking does not contest that it is insolvent in the sense that it cannot pay its obligations in the ordinary course of business.[8] Rather, it contends that the appointment of a receiver would be inappropriate because it would harm—rather than help—the Company. Even if Shocking is insolvent, Delaware case law interpreting 8 *Del. C.* § 291 requires that such relief be warranted—that it would serve a beneficial purpose.[9] In other words, "the plaintiff must demonstrate that appointment of a receiver is necessary to protect the insolvent corporation's creditors or shareholders by showing 'some benefit that such an appointment would produce or some harm it could avoid.'"[10]

BHP argues that appointment of a receiver is appropriate because the Board is unable to accept additional funding to keep it afloat. Moreover, BHP argues that Kosowsky has entrenched himself and will not act in the best interests of the

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[8] "A corporation is insolvent for purposes of Section 291 if either (1) its liabilities exceed its assets, or (2) it is unable to meet its currently maturing obligations in the ordinary course of business." Donald J. Wolfe, Jr. & Michael A. Pittenger, *Corporate and Commercial Practice in the Delaware Court of Chancery* ("Wolfe & Pittenger") § 8.11[d][2], at 8–291 (2012).
[9] *See, e.g.*, *Badii v. Metro. Hospice, Inc.*, 2012 WL 764961, at *7 (Del. Ch. Mar. 12, 2012).
[10] *Id*. (quoting *Pope Invs. LLC v. Benda Pharm., Inc*., 2010 WL 5233015, at *8 (Del. Ch. Dec. 15, 2010)).

Company. According to BHP, the appointment of a receiver would solve these problems. Shocking responds by arguing that BHP has not identified an available funding solution that a receiver could implement. It also asserts that BHP's efforts would actually harm the Company because appointment of someone else to manage the Company would dissuade customers from using the Company's product and result in the Company's default under various agreements.[11]

Under the circumstances, the benefit of appointing a receiver for Shocking depends, at a minimum, upon having a funding offer on the table. For purposes of establishing a colorable claim, the Court is satisfied that it is conceivable that such an offer may be forthcoming, either from Michael (as counsel for BHP suggested would occur) or a third-party bidder (as counsel for Shocking suggested is in the works). If no offer is made, the Court might find it difficult to understand the benefit that a receiver might confer in resolving the Board's impasse over funding.

The Court is also mindful that the appointment of a receiver (or a custodian for that matter) might play nicely into Michael's objective to obtain control over Shocking and displace Kosowsky's leadership. As the Court has noted, the

[11] Resp't's Opp'n to Mot. for Expedited Proceedings 7.

"purpose of the doctrine of unclean hands is to maintain the integrity of the courts of equity and shield them from misuse by litigants whose actions denigrate the very principles of equity the courts are meant to uphold."[12] To the extent that Michael's conduct is motivated by his own self-interest that is inconsistent with the interests of other shareholders generally, there might be some reluctance to allow Michael to obtain through an 8 *Del. C.* § 226 action or an 8 *Del. C.* § 291 action what he could not obtain otherwise through proper directorial or shareholder conduct. Ultimately, equitable factors will be best assessed in the context of an evidentiary hearing. BHP has stated a colorable claim that the appointment of a receiver would serve a beneficial purpose (*i.e.*, resolve the funding impasse) under 8 *Del. C.* § 291.

As noted above, the threat of insolvency is sufficient to raise a possibility of irreparable harm. Accordingly, the Court will grant BHP's motion for expedited proceedings. Given that an 8 *Del. C.* § 226 proceeding is summary in nature,[13] and

[12] *Parfi Hldg. AB v. Mirror Image Internet, Inc.*, 954 A.2d 911, 934 n.83 (Del. Ch. 2008).
[13] Wolfe & Pittenger § 8.09[a], at 8–202.

in light of the Court's schedule, the Court will schedule February 27, 2013, for an evidentiary hearing on the Petition.[14]

IT IS SO ORDERED.

Very truly yours,

/s/ John W. Noble

JWN/cap
cc: Register in Chancery-K

[14] As appointment of a custodian or receiver under 8 *Del. C.* § 226 is a summary proceeding, a hearing within forty-five to sixty days would not be out of the ordinary. This matter, thus, is being advanced by little more than two weeks. Without a reasonably certain source for financing, no good cause for greater urgency has been demonstrated. The Court requests counsel to confer on a schedule for appropriate intervening milestones. Counsel should also explore whether this matter may be fairly addressed on a "paper record."