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Chancery Court Finds Notice to Non-Consenting Stockholders Not a Precondition to an Effective Majority Written Consent

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But cautions that technical compliance with DGCL § 228 does not preclude a judicial examination of the equities underlying stockholder action by written consent

INTRODUCTION

Under § 228(a) of the Delaware General Corporation Law ("*DGCL*"), unless expressly precluded by a corporation's certificate of incorporation, majority stockholders may take immediate action by written consent rather than wait for a formal stockholders' meeting to be called, noticed, and convened by the corporation's board of directors. DGCL § 228(e) offers a measure of protection from majority abuse of power by requiring, when stockholder written consent is "less than unanimous," the corporation to give "prompt notice" of the action to non-consenting stockholders.

An additional wrinkle arises with a corporation whose common stock is registered under the Securities Exchange Act of 1934, as amended ("*1934 Act*"). Rule 14c-2 promulgated by the Securities and Exchange Commission ("*SEC*") under the 1934 Act ("*SEC Rule 14c-2*") mandates that, in connection with corporate action taken by stockholder written consent, a "written information statement ... shall be sent or given [to stockholders] at least 20 calendar days prior to the earliest date on which the corporate action may be taken." Further, Rule 14c-5 ("*SEC Rule 14c-5*") requires the corporation to file a preliminary information statement with the SEC "at least 10 calendar days prior to the date definitive copies of such statement are first sent or given" to stockholders. During that period, the SEC staff has an opportunity to comment on, and potentially delay delivery of, the definitive information statement. The question of whether the information statement-delivery requirements of SEC Rule 14c-2 operate to delay effectiveness of a stockholder consent under DGCL § 228 has long vexed corporate practitioners.

These notice issues were addressed by the Delaware Court of Chancery ("*Chancery Court*") in *Brown v. Kellar,* C.A. No. 2018-0687-MTZ, 2018 WL 6721263 (Del. Ch. Dec. 21, 2018). *First,* Vice Chancellor Morgan T. Zurn considered whether "prompt notice" under DGCL § 228(e) is a condition precedent to an effective written consent or simply a subsequent obligation. Based on the statute's plain language, the Vice Chancellor ruled notice is *not* a condition precedent—that is, absent "unique circumstances." *Second,* the Vice Chancellor opined that a corporation's failure to deliver an effective SEC Rule 14c-2

information statement to stockholders does *not* delay effectiveness of an otherwise valid DGCL § 228 stockholder consent.

Notably, Vice Chancellor Zurn's analysis did not end with her consideration of the technical elements of DGCL § 228 and the impact of SEC Rule 14c-2. Rather, she echoed "the foundational principle" of Delaware law "that inequitable action does not become permissible simply because it is legally possible." Faced with credible allegations of inequitable conduct on the part of the consenting stockholders in their efforts to change the board of directors, the Vice Chancellor refused to grant them summary judgment, opting instead for a trial on the merits to "determine the extent to which . . . alleged inequitable conduct informs the composition of the Board with the benefit of a more developed record."

I. FACTUAL BACKGROUND

A. Majority Stockholders Take Action by Written Consent

Robert Brown ("*Brown*") and William Bartels ("*Bartels*" and, together with Brown, the "*Control Stockholders*") were associated for many years with "merchandising and marketing services company" SPAR Group, Inc. ("*SGRP*" or the "*Company*") in various directorial and management roles, including most recently as Chairman of the Board and Vice Chairman of the Board, respectively. The two men, by virtue of owning in the aggregate a majority of SGRP's shares outstanding, were the "undisputed" Control Stockholders. Exercising that power during the summer of 2018, they issued a series of written consents ("*Stockholder Consents*") purporting to remove an independent director from the SGRP board of directors ("*Board*"), replace him with their preferred candidate, and adopt related amendments to the Company bylaws.

As a prelude to fulfilling its DGCL § 228(e) notice obligations, on July 31st, SGRP filed a preliminary information statement with the SEC ("*Preliminary Statement*") under SEC Rule 14c-2, disclosing the actions taken by the Control Stockholders to remove and replace the independent director. Before expiration of the SEC's ten-day comment period under SEC Rule 14c-5, however, the Control Stockholders filed amended Schedule 13D filings with the SEC, outlining several changes to the bylaws they planned to adopt by stockholder written consent. Claiming these SEC filings "rendered the Preliminary Statement inaccurate," SGRP withheld distributing the Preliminary Statement, and therefore gave notice under DGCL § 228(e) to Company stockholders.

B. Litigation Ensues

Litigation began on September 4th when SGRP brought an action in the Chancery Court challenging the Stockholder Consents and claiming breach by the Control Stockholders of their fiduciary duty of loyalty. Brown responded on September 18th with an action under DGCL § 225 ("*§225 Action*") "to determine the composition of SGRP's board of directors."

SGRP responded by alleging the Control Stockholders' purported removal and replacement of the independent director was "part of a larger, grossly inequitable scheme . . . to improperly divert SGRP's resources to their own purposes and for their sole benefit." Relying on the oft-quoted passage from the Delaware Supreme Court's "seminal" decision in *Schnell v. Chris-Craft*, 285 A.2d 437, 439 (Del. 1971) ("*Schnell*"), SGRP sought a declaration voiding the Stockholder Consents on the basis that "inequitable actions do not become permissible simply because they are legally possible." SGRP also attacked the Stockholder Consents on technical grounds, claiming they were "not yet effective because SGRP did not send the prompt notice to stockholders as required under 8 Del. C. § 228(e) and Rule 14c-2 of the Securities Exchange Act of 1934."

Then, on November 14th, Brown moved for summary judgment on the ground the Stockholder Consents were "technically valid and effective upon delivery," while SGRP's allegations of inequity were "purely collateral to this Section 225 proceeding and cannot be considered as a matter of law."

II. VICE CHANCELLOR ZURN'S ANALYSIS

In ruling on Brown's summary judgment motion, Vice Chancellor Zurn considered both the technical issues raised by SGRP as to the validity of the Stockholder Consents, as well as the equitable issues concerning the Control Stockholders' motivations in pursuing their agenda. While the Vice Chancellor found the Stockholder Consents passed muster under the technical requirements of DGCL § 228, she denied summary judgment in favor of a hearing on the merits of SGRP's equitable claims, noting that "*Schnell* empowers this Court to look at both technicalities and equities."

A. Effectiveness of Stockholder Consents under DGCL § 228

To address the technical issues raised by SGRP, the Vice Chancellor had to consider the impact of DGCL § 228(e) on the

effectiveness of the Stockholder Consents, as well as the interplay between the DGCL provisions and SEC Rule 14c-2.

1. Stockholder Consents Effective Upon Delivery

The parties agreed the Stockholder Consents complied with all aspects of DGCL § 228, except for the notice requirement of DGCL § 228(e). Accordingly, Vice Chancellor Zurn was faced with the question of whether SGRP's failure to provide notice to the Company's minority stockholders under DGCL § 228(e) alone "prevent[ed] an otherwise valid written consent from taking effect."

The Vice Chancellor began by focusing on the plain meaning of DGCL § 228(a), which provides that corporate action by majority stockholder written consent "may be taken without a meeting, *without prior notice* and without a vote[.]" According to the Vice Chancellor, "[t]hat plain language indicates that notice is not a condition precedent to an effective written consent." "By contrast," she noted, "other sections of Section 228 *are* conditions to effective corporate action." Instead, "Section 228(e)'s notice requirement is . . . an additional obligation resulting from that corporate action."

The Vice Chancellor acknowledged the equitable power of the Chancery Court to deviate from this traditional rule under "unique circumstances" where providing prompt notice to minority stockholders is "of critical importance." Thus, the Chancery Court will find "unique circumstances" when necessary to provide a "shield"—that is, by conditioning effectiveness of a majority written consent on delivery of a DGCL § 228(e) notice—"to protect minority stockholder[s]" opposed to the corporation. On the other hand, the Court would not be so inclined when the "exception would grant the companies a sword with which to delay or thwart written consents by slow-rolling notice to the stockholders. The consequences of withholding notice in those circumstances should be borne by the company, not the stockholders exercising their right to act by written consent." In short, "SGRP cannot nullify otherwise effective written consents by unilaterally withholding notice of those acts."

2. SEC Rule 14c-2 Does Not Preclude Effectiveness

Next, Vice Chancellor Zurn considered whether SEC Rule 14c-2 "provides an independent notice requirement that precludes effective . . . [Stockholder] Consents until notice is given, but at the same time prevents SGRP from giving that notice." From the Vice Chancellor's point of view, SGRP "cannot avoid . . . obligations under

Delaware law . . . by pointing to additional or purportedly conflicting obligations under Rule 14 of the Exchange Act." Rather, "the important policies underlying the internal affairs doctrine [suggest] that the power of the state of incorporation . . . [can]not be lightly overturned."

The Vice Chancellor also pointed to "a more fundamental problem" with SGRP's SEC Rule 14c-2 argument: "[A] rule meant to reinforce management accountability to stockholders [cannot] be used as a tool to indefinitely deprive stockholders of the franchise." Using SEC Rule 14c-2 to avoid giving stockholders notice under DGCL § 228(e) "stands the purpose of corporate and securities law on its head," effectively "pervert[ing] the incentives of both the SEC regulations and Delaware law." As far as the Vice Chancellor was concerned, SGRP could not "justify withholding . . . notice by pointing to perceived conflicts between SEC Rules and Delaware law."

B. Inequitable Conduct an Acceptable Defense in the § 225 Action

Despite her ruling on the technical effectiveness of the Stockholder Consents, Vice Chancellor Zurn denied Brown's motion for summary judgment on the basis that "I cannot wholly exclude, at this time and on an undeveloped record, the . . . defense that alleged breaches of fiduciary duty nullify the written consents and bear on the composition of the Board." In so ruling, the Vice Chancellor "reject[ed] Brown's cramped view of this action" and noted the Chancery Court had in previous DGCL § 225 cases looked beyond technical compliance while applying the equitable principles of *Schnell*, explaining that "Section 225 permits the adjudication of inequitable conduct, as encouraged by *Schnell*, so long as those issues are germane to determining the composition of the Board."

Vice Chancellor Zurn denied Brown's summary judgment request because SGRP asserted "a sufficiently cognizable equitable defense under Section 225" and alleged "inequitable conduct that, once developed, may affect the . . . [Stockholder] Consents and Brown's requested Board composition." Instead, she ordered the parties to "proceed to trial immediately before the Bylaw Action" to allow her to "determine the extent to which Brown's and Bartels's alleged inequitable conduct informs the composition of the Board with the benefit of a more developed record."

CONCLUSION

Vice Chancellor Zurn's opinion in *Brown v. Kellar* clears up potential ambiguity for stockholders seeking to act by majority written

consent under DGCL § 228. Absent "unique circumstances," stockholder consents will be effective for purposes of DGCL § 228 regardless of whether prompt notice to non-consenting stockholders has been given under DGCL § 228(e) and notwithstanding the requirements imposed by SEC Rule 14c-2 on communications with public stockholders of an Exchange Act-registered corporation.

On the other hand, regardless of technical compliance with DGCL § 228, the Vice Chancellor was not prepared to rule on the effectiveness of the Stockholder Consents pending a hearing on the merits of SGRP's claim that removal and replacement of the independent Board member was "part of a larger, grossly inequitable scheme" by the Control Stockholders. *Schnell*'s admonition "that inequitable action does not become permissible simply because it is legally possible" has real teeth when it comes to DGCL § 225 actions seeking judicial confirmation of the proper composition of a board of directors.