DELAWARE CORPORATE LAW BULLETIN

Chancery Court Employs Context-Driven Analysis in Adopting Nuanced Interpretations of DGCL Provisions

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DGCL § 223(a)(1) permits directors to fill board vacancies despite lack of quorum, but not to take other actions, including increasing board size and filling resulting vacancy. DGCL § 271 does not require stockholder approval of corporate transfer of substantially all assets to secured creditors in repayment of defaulted debt.

INTRODUCTION

Oftentimes, an otherwise mundane corporate dispute may devolve into litigation that generates interesting interpretations of aspects of the Delaware General Corporation Law ("*DGCL*") infrequently addressed by the Delaware judiciary. For instance, consider the recent Delaware Court of Chancery ("*Chancery Court*") decision in *Stream TV Networks*, *Inc. v. SeeCubic, Inc*., No. 2020-0310-JTL, 2020 WL 7230419 (Del. Ch. Dec. 8, 2020) ("*Stream TV*"), authored by Vice Chancellor J. Travis Laster.

Stream TV Networks, Inc. ("*Stream*" or the "*Company*"), a company in dire financial straits, found itself unable to repay its considerable debt. To remedy the situation, an independent board committee approved an agreement transferring all Company assets to a new entity controlled by its secured creditors. In consideration of this transfer, the secured creditors waived their rights under defaulted debt while granting Company stockholders an equity interest in the new entity. The family controlling Stream challenged the transfer, questioning whether (i) the committee members were duly elected directors when they approved the transfer agreement, and (ii) stockholder approval was required to validate the asset transfer. To resolve this dispute, Vice Chancellor Laster confronted two somewhat metaphysical questions:

- Under what circumstances is a board of directors lacking sufficient members to constitute a quorum *not permitted* to increase its size and fill vacancies, even though Section 223(a)(1) of the DGCL ("*DGCL § 223*(*a*)(*1*)") provides that "[v]acancies and newly created directorships resulting from any increase in the authorized number of directors . . . may be filled by a majority of the directors then in office, although less than a quorum"?
- Under what circumstances may a corporation transfer all or substantially all of its assets *without stockholder approval*, even though Section 271 of the DGCL ("*DGCL § 271*") provides that a "corporation may . . . sell, lease or exchange all or substantially all of its property and assets . . . when and as authorized by a

resolution adopted by the holders of a majority of the outstanding stock"?

I. FACTUAL BACKGROUND

A. Stream Encounters Extreme Financial Peril

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:

- As stockholders, the Rajans controlled the Company's outstanding voting power through ownership of Class B common stock having 10 votes per share.
- As the sole remaining members of the board of directors ("*Board*"), the Rajans controlled the management of the Company.
- As the senior-most officers, the Rajans controlled the Company's day-to-day operations.

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

- The equity was owned by 52 (not including the Rajans or their affiliates) stockholders ("*Equity Investors*").
- The debt consisted primarily of (i) $50 million of secured senior and junior debt (collectively, "*Secured Debt*"), the repayment of which was secured by a pledge of all Company assets, and (ii) $16 million of trade debt.

While Stream's "technology is promising, even revolutionary," it failed to develop an actual commercial product and lacked sufficient resources to repay its debt. Beginning in 2019, the Rajans, the holders of the Secured Debt ("*Secured Creditors*"), and a representative of the Equity Investors ("*Representative*") held discussions concerning a potential financial "restructuring." One proposal contemplated an agreement ("*Omnibus Agreement*") under which Stream would transfer all its pledged assets to a newly formed company controlled by the Secured Creditors. The Rajans rejected this proposal.

As the Company's fortunes continued to decline during 2020, the Company defaulted on the Secured Debt, fell "months behind" on amounts owing to suppliers and customers, "missed payroll at least once," and "furloughed numerous employees." Under pressure from the Secured Creditors and the Representative, the Rajans, acting by "unanimous written consent" of the Board on March 12 ("*March*

Director Consent"), appointed four new directors independent of both the Rajans and the Company ("*Outside Directors*"). Then, at a May 4 Board meeting, with the Rajans abstaining, three of the Outside Directors voted to authorize formation of a committee of two Outside Directors ("*Resolution Committee*"), having "full power and authority of the full Board of Directors 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 of Directors or any executive of the [C]ompany."

B. Resolution Committee Pursues Omnibus Agreement

On May 6, the Resolution Committee approved the Omnibus Agreement, which was then signed by 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 its assets to a new entity, SeeCubic, Inc. ("*SeeCubic*"), owned by the Secured Creditors. The Omnibus Agreement also granted the Secured Creditors "a power of attorney to effectuate the transfers." To permit the Equity Investors to "share in the future success of Stream's assets," the Secured Creditors permitted them to exchange their Company shares for an equal number of SeeCubic shares "at no cost to the participating stockholders." In addition, the Omnibus Agreement provided for the transfer of 1 million SeeCubic shares to Stream, benefitting the Rajans through their ownership of Company shares. Stream thereby avoided foreclosure or bankruptcy, either of which likely would have "wiped out" the holdings of the Equity Investors and the Rajans.

Although they had abstained at the Board level, the Rajans immediately "began planning to neutralize" the Omnibus Agreement:

- *First*, exercising their power as holders of a majority of the voting power, the Rajans executed a written consent of stockholders ("*May Stockholder Consent*") purporting to remove three of the Outside Directors, including the two comprising the Resolution Committee. The Rajans later claimed that they signed the May Stockholder Consent on May 6—"before the Resolution Committee approved the Omnibus Agreement"—but there was some evidence that the May Stockholder Consent was signed several days later but "backdated . . . to May 6 in an effort to preempt the Omnibus Agreement."
- *Second*, the Rajans claimed that any Outside Director "who had not formally accepted their offer to join the Board by signing a 'Director Services Agreement' should not be considered a

director." Notably, "[n]o one had informed the Outside Directors that their positions as directors depended on signing any particular documents."

- *Third*, the Rajans claimed that the Outside Directors were never "formally" appointed to the Board but "were merely advisors." They quickly dropped this claim when one of the Outside Directors challenged it as "patently ridiculous."

C. Litigation Ensues

In light of the Rajans' intransigence, the Secured Creditors, the Representative, and the Resolution Committee sought a negotiated resolution. When they "offered to amend the Omnibus Agreement to give the Rajan[s] . . . greater consideration," the Rajans responded by demanding "personal benefits for themselves, including employment, compensation, and indemnification for litigation expenses." Negotiations then "broke down."

On May 11, the Rajans purported to convene a Board meeting at which they passed a resolution "to nullify and void the Omnibus Agreement." They also "refused to take any action to comply with the Omnibus Agreement," sought to change management of various Stream subsidiaries, and "purported to grant . . . a license" to a new entity "to use Stream's technology."

Finally, on September 8, Stream asked the Chancery Court to bar enforcement of the Omnibus Agreement. SeeCubic responded in kind. Vice Chancellor Laster "entered a status quo order and scheduled a hearing on the parties' competing motions for preliminary injunction."

II. VICE CHANCELLOR LASTER'S ANALYSIS

At the hearing, Stream and the Rajans advanced a number of theories to justify invalidating the Omnibus Agreement and the underlying transactions. However, because they failed to establish "a reasonable likelihood of success on the merits," Vice Chancellor Laster denied their motion for a preliminary injunction. Instead, he declared the Omnibus Agreement "valid" and granted SeeCubic "a preliminary injunction preventing Stream . . . from taking any action to interfere with it." In reaching this result, the Vice Chancellor dispatched numerous attacks by Stream and the Rajans on the corporate process leading to approval of the Omnibus Agreement.

A. Outside Directors Validly Appointed; Omnibus Agreement Duly Authorized

1. Rajans Entitled To Act as Sole Directors

According to Vice Chancellor Laster, the Rajans, as the sole members of the Board when they signed the March Director Consent, had authority to "validly increase[ ] the size of the Board to six and fill[ ] the newly created directorships with the Outside Directors." Although the March Director Consent "lack[ed] . . . technical precision," the Vice Chancellor refused to allow Stream to "take advantage of [the Rajans'] informality to achieve a result that would benefit themselves. Equity regards as done what ought to have been done." In so ruling, the Vice Chancellor rejected three counterarguments offered by Stream and the Rajans:

- *First*, although the March Director Consent expressly characterized each Outside Director as an "Interim Director," that is not a role recognized under Delaware law. Even if a corporation's certificate of incorporation could create such a role, the Company's certificate of incorporation ("*Charter*") did not do so. Thus, upon appointment by the Rajans, "the Outside Directors became directors entitled to serve until their successors' election and qualification."
- *Second*, under Delaware law, any qualification to serve as a director must appear in a corporation's certificate of incorporation or bylaws. However, the Rajans' claim that the Outside Directors' service was conditioned on signing a "Director Services Agreement" was not supported by either the Charter or the Company's Bylaws.
- *Third,* any such qualification, if properly imposed, must be "reasonable." However, Stream sought to impose "unreasonable" qualifications—such as characterizing Outside Directors as "independent contractor[s]" and imposing confidentiality and other obligations "to support the corporation"—more appropriate for employees than for directors subject to fiduciary duties.

2. An Important Caveat

In so ruling, Vice Chancellor Laster noted the litigants' acknowledgement that, when the Rajans signed the March Director Consent "as Stream's only two directors," the Board had no vacancies. That is, the total number of directors then entitled to serve on the Board consisted of only two, the directorships held by the Rajans. Nevertheless, the Vice Chancellor authored a lengthy footnote explaining the resulting complications if there were Board vacancies when the Rajans signed the March Director Consent. In this connection, note that under DGCL § 223(a)(1): "vacancies and newly-created directorships resulting from any increase in the authorized number of directors may be filled by a majority of the directors then in office, although less than a quorum."

Under the default rule adopted by Stream and most Delaware corporations, a board quorum requires a majority of the total "number of directors," that is, total directorships, not directors actually in office. Accordingly, a board of directors with two directorships requires the presence of both directors to act, while a board of directors with five directorships requires the presence of at least three directors to act.

Referencing his opinion in *Applied Energetics, Inc. v. Farley*, 239 A.3d 409 (Del. Ch. 2020), Vice Chancellor Laster offered an illustrative hypothetical. Assume that, although the Rajans were the only duly elected directors when they signed the March Director Consent, the total number of directors then entitled to serve on the Board was five, meaning there were three vacancies and the presence of three directors was required for a quorum. This could have been the case if the Board failed to reduce its size from five to two when former directors resigned or did not stand for reelection when their terms ended. Employing a literal reading, the Vice Chancellor noted, "[a]n advocate might argue that the references to 'newly-created directorships' in . . . Section 223(a)(1) mean[s] that [the Rajans] could have expanded the Board . . . even though they would not have constituted a quorum" in order to add *four* Outside Directors. However, "[t]hat is not a viable interpretation." Rather, DGCL § 223(a)(1)'s reference to "newly-created directorships"

> ensures that a board can act if directors comprising a majority of a quorum expand the size of the board such that they no longer can supply a quorum . . . . Under those circumstances, the directors in office, though now less than a quorum, could fill the newly created directorships. But Section 223(a)(1) does not empower the remaining directors constituting less than a quorum to reduce or enlarge the size of the [b]oard.

In this manner, "if the number of directors in office is less than the number of directors necessary for a quorum . . . [t]o address the resulting risk of deadlock, Section 223(a)(1) . . . authorizes 'a majority of the directors then in office, although less than a quorum' . . . to fill vacancies," but not to do anything else (quoting *Applied Energetics*).

Returning to the Vice Chancellor's hypothetical, because a quorum required the presence of *three* directors, the Rajans were limited by DGCL § 223(a)(1) to appointing only *three* Outside Directors to fill the *existing* vacancies. They could take no other action—either at a meeting or *via* unanimous written consent—including expanding the Board to six and filling the resulting vacancy. Therefore, adding a fourth Outside Director required two distinct steps: *first*, the Rajans fill the existing vacancies with *three* Outside Directors, and, *second*, the enlarged five-member board increases its size by one and fills that vacancy with a *fourth* Outside Director.

3. De Facto Directors

Even if the Outside Directors had not been validly appointed, Vice Chancellor Laster explained, "it is reasonably probable that this court would conclude after trial that the Outside Directors were *de facto* directors." As such, their actions, including adoption of the Omnibus Agreement and transfer of the assets, "[we]re valid and bind the corporation for purposes of its interactions with third parties."

Among the factors cited by the Vice Chancellor in support of this proposition were

- the Company and the Rajans "treated the Outside Directors as directors, and all other relevant parties reasonably believed" they were;
- the Rajans invited the Outside Directors to join the Board, they all accepted, and "Stream announced to its investors and employees" that they had joined the Board;
- the Outside Directors attended Board meetings, voted, "received privileged legal advice and confidential information," and were listed in meeting minutes as "Board Members"; and
- the Rajans "held out the Outside Directors as directors to third parties, including when soliciting investments."

4. Outside Directors Not Timely Removed

Even if the Outside Directors were validly appointed, Stream argued, the May Stockholder Consent removed the members of the Resolution Committee from the Board *before* it approved the Omnibus Agreement. Vice Chancellor Laster rejected this contention, pointing to evidence that the Rajans "backdated the May Stockholder Consent to May 6." Thus, the May Stockholder Consent did "not impair the validity of the Omnibus Agreement."

B. Stockholder Approval Not Required To Validate Omnibus Agreement

Alternatively, Stream and the Rajans argued that the Omnibus Agreement was ineffective because it was not approved by Company stockholders as required under *both* (i) DGCL § 271 and (ii) a Charter provision ("*Class Vote Provision*") "requir[ing] the separate approval of holders of a majority of the Class B . . . Stock" for, among other things, an "Asset Sale." Vice Chancellor Laster concluded that neither "applies to the transfer of assets contemplated by the Omnibus Agreement."

1. DGCL § 271 Not Applicable

DGCL § 271 "requires a stockholder vote for a sale of all or substantially all of a corporation's assets." At the outset, the Vice Chancellor noted that the "general rule" at common law giving directors "no power or authority to sell out the entire property of a corporation," even if approved by "a majority or supermajority of the stockholders." However, the general rule was subject to a "widely recognized exception" allowing directors of "insolvent or failing firms" to engage in such a sale. DGCL § 271, adopted in 1917, reversed the common law rule, so long as the sale also is approved by majority stockholder vote. Section 272 of the DGCL ("*DGCL § 272*"), granting directors the power to "mortgage or pledge" corporate assets without stockholder approval, was adopted 50 years later "to clarify that [S]ection 271 . . . does not apply to a mortgage or pledge of assets."

Given that DGCL § 271 did not define "sale" or "exchange," as well as the dearth of relevant case law, "the better course," in the Vice Chancellor's opinion, "is to accept that the language of Section 271 is ambiguous as to whether it applies to transactions like the Omnibus Agreement." Accordingly, he turned to "statutory interpretation." The sources consulted by the Vice Chancellor "distinguish[ ] a 'sale' from a 'foreclosure sale,' " with the latter referring to "[t]he sale of mortgaged property, authorized by a court decree or a power-of-sale clause, to satisfy the debt." While other interpretations were conceivable, the Vice Chancellor deemed it "more accurate to regard SeeCubic as a vehicle for Stream's creditors" and to view the Secured Creditors as "levying on their security" via implementation of the Omnibus Agreement. Thus, "[i]n substance, the . . . Omnibus Agreement functions as a private foreclosure"; that is, "a contractual substitute for the legal proceeding through which [the Secured Creditors] otherwise would have obtained Stream's assets."

Vice Chancellor Laster turned next to "the legislative history" of DGCL § 271 and "its position in the broader context of the DGCL." Based on this inquiry, he concluded "that the General Assembly did not intend for the statute to govern a transfer of assets by a failing firm." Because "the common law did not prohibit the board of directors of an insolvent or failing firm from transferring its assets to creditors," a

Delaware board had such authority, and "the General Assembly did not need to establish that point by statute . . . . Section 271 does not apply to that transactional setting."

At this point, the Vice Chancellor faced a conundrum: must a corporation, consistent with the literal language of DGCL § 271, "obtain stockholder approval . . . before a creditor can foreclose on its security interest, even though the corporation did not need to obtain stockholder approval [by virtue of DGCL § 272] to grant the security interest"? As a matter of "public policy," "interpreting Section 271 as applying to a creditor's efforts to levy on its security would undercut the value of the security interest" itself. Moreover, this "mischievous and harmful" interpretation "would be contrary to the plain language of Section 272, which states that such authorization 'shall not be necessary.' " Finally, "[t]he absence of cases implicating the issue indicates that virtually no one thinks that Section 271 would apply in that context."

To counter this interpretation, Stream argued "that the Omnibus Agreement is more than a foreclosure equivalent" because the Secured Creditors permitted Stream stockholders to participate in SeeCubic's equity. The Vice Chancellor had none of this: because "Section 271 does not cover the worst case transaction for Stream—a foreclosure involving all of its assets—it logically does not apply to a lesser included alternative that provides greater benefits to Stream and its stockholders."

2. Class Vote Provision Not Applicable

Because the Class Vote Provision closely "tracks" DGCL § 271, Chancery Court precedent dictates that "the same outcome" should pertain. 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.

C. Resolution Committee Did Not Breach Their Fiduciary Duties

As a last resort, Stream and the Rajans argued that the Omnibus Agreement was "void because the members of the Resolution Committee breached their fiduciary duties by approving" the transaction. Because neither of the two more rigorous Delaware judicial standards of review (entire fairness or enhanced scrutiny) was applicable, Vice Chancellor Laster invoked "the default standard of review . . . the business judgment rule." Given the absence of any evidence rebutting the business judgment presumption—Stream did not try to establish "that either member of the Resolution Committee was interested in the Omnibus Agreement or lacked independence from someone who was," or "acted in bad faith or for an improper purpose"—Stream's argument that the members of the Resolution Committee breached their fiduciary duty in approving the Omnibus Agreement "lacks merit."

CONCLUSION

In *Stream TV*, Vice Chancellor Laster addressed aspects of the DGCL which previously had received scant attention in the Delaware courts. Employing a context-driven approach to statutory interpretation, the Vice Chancellor arrived at nuanced explanations of two provisions of the DGCL whose language, read literally, might have produced different results:

- Under DGCL § 223(a)(1), the remaining directors (though less than a quorum) may fill vacancies on a board of directors, but may not take any other action (whether at a meeting or via unanimous written consent) that boards generally are authorized to take, including creating and then filling new board seats. Because there apparently were no Board vacancies when the Rajans acted, in their capacities as the sole directors, to appoint the Outside Directors, the actions that flowed from that appointment—establishment of the Resolution Committee, approval of the Omnibus Agreement, and transfer of the Company's assets—were valid. The Rajans had no justifiable basis to challenge those arrangements.
- Under DGCL § 272, a board of directors (or duly established committee) does not need stockholder approval to pledge or mortgage corporate assets, even substantially all corporate assets, as security for the corporation's debt. Moreover, consistent with a Delaware common law exception for failing or insolvent corporations, stockholder approval is not required under DGCL § 271 for a sale of those assets upon foreclosure. On this basis, the Vice Chancellor concluded that the arrangements contemplated by the Omnibus Agreement were, in effect, a private "foreclosure sale" not subject to the stockholder approval requirements of DGCL § 271. Company stockholder approval was not required to transfer the Company's assets to SeeCubic under the Omnibus Agreement.