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Memorandum

Delaware Supreme Court: Refines the Standards for Reviewing Board Action That Interferes With Director Elections or Stockholder Voting Rights in Control Contests

July 12, 2023

The Delaware Supreme Court recently affirmed a Chancery Court decision finding that the board of a real estate services company had not acted for "inequitable purposes" and had "compelling justifications" for a stock sale, which diluted plaintiff's 50% ownership interest in the company, broke a director election deadlock, and mooted plaintiff's petition to appoint a corporate custodian. *Coster v. UIP Cos.*, 2023 Del. LEXIS 202 (Del. June 28, 2023) (Seitz, C.J.). The Supreme Court held that the Chancery Court did not err as a legal matter, and its factual findings were not clearly wrong. As to the proper standard of review for stockholder challenges to board action that interferes with director elections or stockholder voting rights in control contests, the Supreme Court folded the three standards of review in this area into a unified standard.

Background and Procedural History

The company had two 50% owners, one was a co-founder and the other was the widow of the second co-founder, and plaintiff in this case. The company provided a range of services to investment properties, many of which were held in special purpose entities. In 2018, plaintiff called for a stockholder meeting, where her multiple motions seeking to affect the size and composition of the board failed due to the co-owner's opposition. A second stockholder meeting also ended in deadlock. Plaintiff then filed a complaint in the Chancery Court seeking the appointment of a custodian under Section 226(a)(1), with "broad oversight and managerial powers," not just to resolve the stockholder deadlock. Viewing such a custodial appointment as a threat to the company's revenue (as it would have given rise to broad termination rights in the company's special purpose entity contracts), the board sold a one-third interest in the company to a key executive who was also a director.[1] This stock sale diluted plaintiff's ownership interest, broke the director election deadlock and mooted the custodian action.

Plaintiff then filed suit seeking to cancel the stock sale alleging that the sale had been effectuated to dilute her voting power in violation of the co-founder's fiduciary duties. In a post-trial opinion, the Chancery Court upheld the stock sale under the entire fairness standard of review, did not consider appointing a custodian as the deadlock was broken and dismissed the action. In the first appeal, the Supreme Court did not disturb the Court of Chancery's entire fairness decision but remanded with instructions to review the stock sale under *Schnell v. Chris*

[1] The stock sale was later deemed by the Chancery Court to fulfill a prior equity commitment to this executive, which encouraged him, as a key employee, to remain with the company.

Craft Industries, Inc., 285 A.2d 437 (Del. 1971)[2] and *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)[3] because entire fairness "is not a substitute for further equitable review under *Schnell* or *Blasius* when the board interferes with director elections."

- In *Schnell*, an incumbent board facing a proxy fight responded by moving up the annual meeting's date and switching it to a remote location. The dissidents alleged that while the board's actions were permitted by the DGCL and authorized by the corporation's governing instruments, they were intended to prevent them from effectively waging a proxy contest. On appeal, the Delaware Supreme Court determined that the board's compliance with legal technicalities was insufficient because the board's actions were intended to prevent the dissidents from being able to wage an effective campaign and were a purposeful manipulation of the electoral machinery that was motivated by their desire to entrench themselves.
- In *Blasius*, an unaffiliated majority of stockholders sought to expand the board and elect a new majority. Plaintiff claimed that the board's creation and filling of two new board positions in response was selfishly motivated to protect the incumbent board from a perceived threat to its control. Chancellor Allen voided the board's action despite finding that the directors acted on their view of the corporation's interest and not selfishly, because "it constituted an unintended violation of the duty of loyalty that the board owed to the shareholders." Chancellor Allen noted that a majority of the stockholders "are entitled to employ the mechanisms provided by the corporation law and the [company's] certificate of incorporation to advance" a view that varies from that of the board, as well as entitled "to restrain their agents, the board, from acting for the principal purpose of thwarting that action."

On remand, the Chancery Court found that the board had not acted for inequitable purposes under *Schnell* and had compelling justifications for the stock sale under *Blasius* because the custodian appointment would harm the company and because the stock sale had been previously planned. Notably, the Chancery Court's compelling justification analysis largely borrowed from the reasonableness and proportionality test in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985),[4] for defensive measures adopted by a board in response to a takeover threat.

The Court Folds *Blasius* into *Unocal*

On appeal from the remand decision, the Supreme Court sought to reconcile *Schnell*, *Blasius* and *Unocal*. The Court explained that "[w]hen a stockholder challenges board action that interferes with the election of directors or

[2] *Schnell* stands for the proposition that "inequitable action does not become permissible simply because it is legally possible and management cannot inequitably manipulate corporate machinery to perpetuate itself in office and disenfranchise the stockholders." Under *Schnell*, board actions are "twice tested." First for legal authorization, and second to determine whether the board action was equitable.

[3] *Blasius* has applied in cases where directors facing a stockholder vote took steps allegedly taken for the primary purpose of interfering with the stockholder vote. *Blasius* established the well-known corporate doctrine that "directors who interfere with board elections, even if in good faith, must have a compelling justification for their actions." In other words, directors cannot interfere with a stockholder vote merely because they believe, even in good faith, that the stockholders will vote wrong.

[4] In *Unocal*, "the Supreme Court used an enhanced standard of review to decide whether the directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and that the board's response was reasonable in relation to the threat posed."

a stockholder vote in a contest for corporate control, the board bears the burden of proof." The Court then identified a two-part analysis that considers:

- **The nature of the threat.** The Court stated that "[f]irst, the court should review whether the board faced a threat "to an important corporate interest or to the achievement of a significant corporate benefit. The threat must be real and not pretextual, and the board's motivations must be proper and not selfish or disloyal." The Court cautioned that "the threat cannot be justified on the grounds that the board knows what is in the best interests of the stockholders."
- **Whether the board's response to the threat was reasonable, proportionate, and not preclusive or coercive.** The Court stated that "[s]econd, the court should review whether the board's response to the threat was reasonable in relation to the threat posed and was not preclusive or coercive to the stockholder franchise. To guard against unwarranted interference with corporate elections or stockholder votes in contests for corporate control, a board that is properly motivated and has identified a legitimate threat must tailor its response to only what is necessary to counter the threat." The Court stated that "[t]he response to the threat cannot deprive the stockholders of a vote or coerce the stockholders to vote a particular way."

The Supreme Court stated that "[a]pplying *Unocal* review in this case with sensitivity to the stockholder franchise is no stretch for our law." Noting that on remand the Chancery Court conducted a "careful review" of the board's actions that "gathered the many strands of precedent," the Court affirmed the Chancery Court's decision and highlighted its conclusions that:

- **The board faced a threat to the company's existence through a deadlocked stockholder vote and the risk of the appointment of a custodian with "broad powers."** The Chancery Court described the threat as an "existential crisis." The Chancery Court held that on balance the board was properly motivated in responding to the threat, explaining that the board had acted in good faith to advance the company's best interests by rewarding and retaining an essential employee through the stock sale, implementing a succession plan favored by one of the company's founders, and mooting the custodian action to avoid risk of default under key contracts.
- **The board responded reasonably and proportionately to the threat posed when it approved the stock sale and mooted the custodian action.** The Chancery Court held that the stock sale "was appropriately tailored to achieve the goal of mooting the Custodian Action" while retaining the essential employee and implementing the succession plan.
- **The board's response to the existential threat posed by the stockholder deadlock and custodian action was not preclusive or coercive.** The Supreme Court explained that while the stock sale effectively foreclosed plaintiff from perpetuating the deadlock, the new three-way ownership of the company presented a potentially more effective way for plaintiff to exercise actual control. The Supreme Court pointed out that plaintiff could cast a swing vote at stockholder meetings or ally herself with either

> one of the company's other owners in the future. The Supreme Court concluded that "[a] realistic path to control of [the company] negates the preclusive impact of the Stock Sale."

While commentators have long debated the continued strength of *Blasius*, this decision signals that the Court no longer views it as a standalone precedent, having noted that "precedent and practice" show that *Blasius* has and can be "folded into *Unocal* review" and by further omitting its "compelling justification" language from the Court's formulation of its standard. Indeed the Court acknowledges that "*Blasius* first applied that enhanced review by requiring a board, even if acting in good faith, to demonstrate a 'compelling justification' for interfering with the stockholder franchise" before offering *Unocal* as "another standard of review [that] could also apply when the board interferes with the stockholder vote during a contest for control." The Court took the view that this folding can occur while accomplishing the same ends, *i.e.*, enhanced judicial scrutiny of board action that interferes with a corporate election or a stockholder's voting rights in contests for control. However, it remains to be seen whether the "legitimate threat" language the Court uses in *Coster* is as strong as the "compelling justification" required under *Blasius*.

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