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MERGERS AND ACQUISITIONS
A Transactional Perspective
Second Edition

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CHAPTER 10. TAKEOVER DEFENSES AGAINST HOSTILE TAKEOVER BIDS

SECTION 3. *UNOCAL* POST-*QVC*

C. *UNOCAL* AND SHAREHOLDER DISENFRANCHISEMENT

Page 699. *Delete text between section heading and the Problems heading. Insert the following in place thereof:*

***Coster v. UIP Companies, Inc.*, --- A.3d ---- (Del.2023)**

This appeal returns to the Supreme Court following remand. As the Court of Chancery recognized in its latest opinion, "[m]any aspects of the facts of this case were vexingly complicated or unique" and "the case gave rise to many close calls on which reasonable minds could differ."[2] We agree with the court's assessment and appreciate its work to address the issues remanded for reconsideration. We also agree with the court's observation that the dispute has been driven by hard feelings on both sides—the untimely death of Marion Coster's husband, Wout Coster, who could not secure his wife's financial security before his death, and the UIP board's desire to preserve UIP's operational viability after the loss of one of its major stockholders and founding members.*

. . .

I.

. . . UIP Companies, Inc. is a real estate services company founded in 2007 by Steven Schwat, Cornelius Bruggen, and Wout Coster ("Wout").The company operates

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[2] Coster v. UIP Cos., Inc., 2022 WL 1299127, at *14 (Del. Ch. May 2, 2022) [hereinafter *Coster II*].

* [Ed.: In a footnote to a portion of the text that has been omitted, the court explained that:

> For those unfamiliar with the Delaware cases referred to in the opinion that now have shorthand references, Schnell refers to Schnell v. Chris-Craft Industries, Inc. 285 A.2d 437, 439 (Del. 1971), where Justice Herrmann famously wrote 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. Blasius refers to Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, 659–61 (Del. Ch. 1988), where Chancellor Allen wrote that directors who interfere with board elections, even if in good faith, must have a compelling justification for their actions. And Unocal refers to Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985), where 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."]

through various subsidiaries that provide a range of services to investment properties in the Washington, D.C. area. Many of these properties are held in special purpose entities ("SPEs") that UIP owns alongside third-party investors.

Each of the three founders initially controlled a third of UIP's shares. In 2011, Bruggen left UIP and tendered his shares to the Company at no cost. This left Schwat and Wout as half owners of UIP.

In 2013, Wout notified Schwat and Peter Bonnell, a senior UIP executive, that he had been diagnosed with leukemia. Shortly after, the group began negotiations for a buyout in which Bonnell and Heath Wilkinson, another UIP executive, would purchase Wout's shares in the company. Bonnell had previously been promised equity in UIP on multiple occasions. As the prospect for promotion had stalled, Bonnell and Wilkinson had both considered leaving UIP. Therefore, beyond providing Wout with an exit, the buyout was also useful in incentivizing Bonnell and Wilkinson to stay.

Unfortunately, negotiations were unsuccessful. . . . Wout passed away on April 8, 2015, and his widow, Marion Coster ("Coster"), inherited his UIP interests.

Immediately after Wout's death, Schwat and Bonnell continued exploring buyout options with Coster. . . . Negotiations between the parties continued throughout 2016 and into 2017 as Coster sought an independent valuation of UIP.

A.

In August 2017, Coster provided UIP with a $7.3 million valuation and demanded to inspect UIP books and records. Coster followed up with a second inspection demand in October 2017. Then, "[a]fter much back and forth about the adequacy of the documents provided, on April 4, 2018, Coster called for a UIP stockholders special meeting to elect new board members."[15]At this time, UIP had a five-member board composed of Schwat, Bonnell, and Stephen Cox, UIP's Chief Financial Officer. Two seats were vacant due to Wout's passing and Cornelius Bruggen's departure in 2011.

The stockholder meeting took place on May 22, 2018. Coster, represented by counsel, raised multiple motions affecting the size and composition of the board. Predictably, each of Coster's motions failed due to Schwat's opposition. Later that day, the UIP board reduced the number of board seats to three through unanimous written consent.

A second stockholder meeting followed on June 4, 2018. The meeting also ended in deadlock as Schwat and Coster each opposed the other's respective motions. With the deadlock, Schwat, Bonnell, and Cox remained UIP's directors.

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[15] [Coster v. UIP Cos., Inc., 255 A.3d 952, 956 (Del. 2021) (hereinafter *Coster Appellate Decision*)].

B.

Coster filed a complaint in the Court of Chancery seeking appointment of a custodian under 8 Del. C. § 226(a)(1) (the "Custodian Action").[16] Coster's "complaint mainly sought to impose a neutral tie-breaker to facilitate director elections, but it also lodged allegations against Schwat" about the lack of distributions and transparency into the company's affairs.[17] Coster "sought the appointment of a custodian with broad oversight and managerial powers."[18]

Coster's request for a "broadly empowered" custodian rather than one specifically tailored to target the stockholder deadlock "posed new risks to the Company."[19] As the Court of Chancery would later find, "[t]he appointment of a custodian with these powers would have given rise to broad termination rights in SPE contracts and threatened UIP's revenue stream, as UIP's business model is dependent on the continued viability of those contracts."[20] "Facing this threat to the Company," the UIP board decided to "issue the equity that they had long promised to Bonnell." Having conducted its own valuation that "valued a 100-percent, noncontrolling equity interest in UIP at $123,869," the UIP board offered, and Bonnell purchased, a one-third interest in the company for $41,289.67 (the "Stock Sale").[21]

The Stock Sale diluted Coster's ownership interest from one half to one third and negated her ability to block stockholder action as a half owner of the company. The Stock Sale also mooted the Custodian Action. Coster responded by filing suit and sought to cancel the Stock Sale.

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[16] 8 Del. C. § 226 allows for the Court of Chancery to appoint a custodian "upon application of any stockholder ... when ... [a]t any meeting held for the election of directors the stockholders are so divided that they have failed to elect successors to directors whose terms have expired or would have expired upon qualification of their successors."

[17] *Coster I*, at *10; *see* App. to Opening Br. at A94 ("[D]espite the apparent success of the Company in recent years, [Coster] has been denied any distributions from the Company since 2015, the year her husband, a founder, died. Over the same period, Mrs. Coster believes the current Chairman of the Board and President of the Company, Defendant Steven Schwat, has received a generous salary from the Company and is enjoying significant benefit from his 50% stake. Mr. Schwat has further prevented Mrs. Coster from gaining a meaningful view into the Company's financial affairs, and has barred her from any representation on the Board.").

[18] [Coster v. UIP Cos., Inc., 2020 WL 429906, at *10 (Del. Ch. Jan. 28, 2020), *rev'd*, 255 A.3d 952 (Del. 2021) (hereinafter *Coster I*)].

[19] *Coster II*, at *4.

[20] *Id.*

[21] *Id.* at 5.

C.

In its opinion following trial, the Court of Chancery upheld the Stock Sale under the entire fairness standard of review.[23] . . .

D.

In the first appeal, this Court did not disturb the Court of Chancery's entire fairness decision but remanded with instructions to review the Stock Sale under *Schnell* and *Blasius*. As explained in our first decision, while entire fairness is "Delaware's most onerous standard of review," it is "not [a] substitute for further equitable review" under *Schnell* or *Blasius* when the board interferes with director elections:

> In a vacuum, it might be that the price at which the board agreed to sell the one-third UIP equity interest to Bonnell was entirely fair, as was the process to set the price for the stock. But "inequitable action does not become permissible simply because it is legally possible." If the board approved the Stock Sale for inequitable reasons, the Court of Chancery should have cancelled the Stock Sale. And if the board, acting in good faith, approved the Stock Sale for the "primary purpose of thwarting" Coster's vote to elect directors or reduce her leverage as an equal stockholder, it must "demonstrat[e] a compelling justification for such action" to withstand judicial scrutiny.
>
> After remand, if the court decides that the board acted for inequitable purposes or in good faith but for the primary purpose of disenfranchisement without a compelling justification, it should cancel the Stock Sale and decide whether a custodian should be appointed for UIP.[25]

. . .

E.

On remand, the Court of Chancery found that the UIP board had not acted for inequitable purposes under *Schnell* and had compelling justifications for the Stock Sale under *Blasius*. . . . The court found that the threat posed by the Custodian Action was "an existential crisis" that justified the UIP board's actions and "that the Stock Sale was appropriately tailored to achieve the goal of mooting the Custodian Action while also achieving other important goals, such as implementing the succession plan that Wout favored and rewarding Bonnell."[34]

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[23] *Coster I*, at *12.

[25] [*Coster Appellate Decision*] at 953–54 (quoting *Schnell*, 285 A.2d at 439 then quoting *Blasius*, 564 A.2d at 661–62).

[34] [*Coster II,*] at *12–13.

II.

In her second appeal, Coster has challenged the Court of Chancery's ruling on both remand questions. . . .

A.

. . . To frame our analysis, it is helpful to review again the circumstances of Schnell and Blasius. Both cases involved board action that interfered with director elections in contests for control—*Schnell*, a proxy solicitation, and *Blasius*, a consent solicitation.

In *Schnell*, the incumbent Chris-Craft board faced the prospect of a difficult proxy fight to retain their seats. In response to the threat to their tenure as board members, the board accelerated the annual meeting date and moved the meeting to a more remote location. The director defendants mounted no real defense to the Court of Chancery suit except to argue that their actions did not violate the Delaware General Corporation Law ("DGCL") or Chris-Craft's bylaws and were therefore legal. . . . On appeal, the Supreme Court took a dim view of the board's intentional efforts to obstruct the insurgent's proxy contest. As the Court held, even though the board's actions met all legal requirements, the Chris-Craft board was "attempt[ing] to utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office; and, to that [sic] end, for the purpose of obstructing legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management."[39] In Justice Herrmann's oft-quoted words, "inequitable action does not become permissible simply because it is legally possible."[40] The Supreme Court ordered the Chris-Craft board to reinstate the original meeting date.

In *Blasius*, the Court of Chancery explored how *Schnell* operates in contested election cases, and specifically how *Schnell* was not the end of the road for judicial review of good faith board actions that interfered with director elections. Like *Schnell*, Blasius involved an incumbent board facing a consent solicitation aimed at replacing a majority of the board. Atlas Industries had a staggered board. Only seven of the authorized fifteen board seats were occupied. With a majority of stockholders behind the effort, an insurgent could in one action amend the company's bylaws, increase the board size to fifteen, and elect a new board majority of eight members.

If the Atlas board had acted on a clear day to establish new seats and to fill the vacancies, the circumstances would have been different. But for the Atlas board, the skies were cloudy, and it was raining. It faced a serious consent solicitation. In response, the board added two seats and filled the newly created positions with

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[39] [285 A.2d at 439.]

[40] *Id.*

directors friendly to management. Now, Blasius had to win not one, but two elections to control the board.

. . .

Ultimately, Chancellor Allen concluded that, even if the board acted in good faith, it did not justify its interference with the stockholder franchise. The court did not propose to "invalidat[e], in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote."[53] But the board could not rely on the justification that it "knows better than do the shareholders what is in the corporation's best interest."[54]

B.

In the years since the Supreme Court and the Court of Chancery decided these iconic cases, . . . "[a]lmost all of the post-*Schnell* decisions involved situations where boards of directors deliberately employed various legal strategies either to frustrate or completely disenfranchise a shareholder vote."[57] [Accordingly], the Chancellor was correct in this case to cabin *Schnell* and its equitable review to those cases where the board acts within its legal power, but is motivated for selfish reasons to interfere with the stockholder franchise.

C.

. . .

Blasius [required] a board, even if acting in good faith, to demonstrate a "compelling justification" for interfering with the stockholder franchise. But another standard of review could also apply when the board interferes with the stockholder vote during a contest for control. In *Unocal Corporation v. Mesa Petroleum Company*, this Court noted [that when] stockholders challenge a board's use of anti-takeover measures, the board must show (i) that "they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed," and (ii) that the response was "reasonable in relation to the threat posed."[61] A defensive measure is an unreasonable response in relation to the threat if it is either draconian—coercive or preclusive—or falls outside a range of reasonable responses.[62]

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[53] [*Blasius*, 564 A.2d] at 662.

[54] *Id*. at 663; *see also* Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1124 (Del. Ch. 1990) (rejecting "the notion that the prospect that the shareholders might vote differently than the board recommends can alone constitute any threat to a corporate interest").

[57] Stroud v. Grace, 606 A.2d 75, 91 (Del. 1992).

[61] [493 A.2d] at 955.

[62] *See* Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1367 (Del. 1995).

In Stroud v. Grace, our Court first recognized how both *Blasius* and *Unocal* review were called for in a proxy fight involving a tender offer:

> Board action interfering with the exercise of the franchise often arose during a hostile contest for control where an acquiror launched both a proxy fight and a tender offer. Such action necessarily invoked both Unocal and Blasius. We note that the two "tests" are not mutually exclusive because both recognize the inherent conflicts of interest that arise when shareholders are not permitted free exercise of their franchise. . . .[63]

. . .

In MM Companies v. Liquid Audio, Inc., . . . the Supreme Court applied *Blasius* "within *Unocal*" as the standard of review:

> When the primary purpose of a board of directors' defensive measure is to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors, the board must first demonstrate a compelling justification for such action as a condition precedent to any judicial consideration of reasonableness and proportionately.... To invoke the Blasius compelling justification standard of review within an application of the Unocal standard of review, the defensive actions of the board only need to be taken for the primary purpose of interfering with or impeding the effectiveness of the stockholder vote in a contested election for directors.[68]

Even though the Supreme Court in *Liquid Audio* combined *Blasius* and *Unocal* review, it did not solve the practical problem of how to turn *Unocal's* reasonableness review and *Blasius*' "primary purpose" and "compelling justification" elements into a useful standard of review. The *Blasius* "compelling justification" standard of review turned out to be unworkable in practice. Once the court required a compelling justification to justify the board's action, the outcome was, for the most part, preordained.[69] The Court of Chancery also skirted *Blasius* review by limiting the "primary purpose" requirement and redefining what it meant to be compelling.

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[63] *Stroud*, 606 A.2d at 92 n.3 (internal citations omitted); *see also Unitrin*, 651 A.2d at 1379–80 (noting use of *Blasius* and *Unocal* in contests for corporate control).

[68] [MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003).]

[69] *See* [Chesapeake Corp. v. Shore, 771 A.2d 293, 323 (Del. Ch. 2000)] ("In reality, invocation of the *Blasius* standard of review usually signals that the court will invalidate the board action under examination. Failure to invoke *Blasius*, conversely, typically indicates that the board action survived (or will survive) review under Unocal."); William T. Allen et. al., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1314 (2001) ("[T]he post-*Blasius* decisions surfaced the reality that a sorting mechanism was needed to insulate from the severe 'compelling justification' test, situations where directors took direct action to influence the electoral process, but in a

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D.

In *Unocal*, the Supreme Court remarked that "our corporate law is not static."[88] Experience has shown that *Schnell* and *Blasius* review, as a matter of precedent and practice, have been and can be folded into *Unocal* review to accomplish the same ends—enhanced judicial scrutiny of board action that interferes with a corporate election or a stockholder's voting rights in contests for control. When *Unocal* is applied in this context, it can "subsume[ ] the question of loyalty that pervades all fiduciary duty cases, which is whether the directors have acted for proper reasons" and "thus address[ ] issues of good faith such as were at stake in *Schnell*."[90] *Unocal* can also be applied with the sensitivity *Blasius* review brings to protect the fundamental interests at stake—the free exercise of the stockholder vote as an essential element of corporate democracy.

. . . When a stockholder challenges board action that interferes with the election of directors or a stockholder vote in a contest for corporate control, the board bears the burden of proof. First, 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. As Chancellor Allen stated long ago, the threat cannot be justified on the grounds that the board knows what is in the best interests of the stockholders.

Second, 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 board's response to the threat cannot deprive the stockholders of a vote or coerce the stockholders to vote a particular way.

Applying Unocal review in this case with sensitivity to the stockholder franchise is no stretch for our law. . . .

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manner that was consistent with their legitimate authority. ... The elements of the *Unocal/Unitrin* analysis therefore gave courts the tool to answer the predicate question to the application of *Blasius*—did the directors act with the primary purpose of disenfranchisement?").

[88] 493 A.2d at 957.

[90] [Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 807 (Del. Ch. 2007).]

E.

In our first decision, we highlighted facts in the Court of Chancery's first decision that might have led to the conclusion that the board acted for selfish reasons. But we recognized that the court had made findings inconsistent with this result and remanded to allow the Court of Chancery to reconsider its decision in light of our first opinion. On remand the court did as requested. The court found that there was "more to the story" than contained in its first opinion.[98] It supplemented the earlier factual findings with the following:

- "Without making any meaningful effort to negotiate board composition, Plaintiff filed a complaint in this Court seeking the appointment of a custodian;"
- "Plaintiff's request for custodial relief was extremely broad. Plaintiff did not present a tailored request for relief that targeted the stockholder deadlock. Rather, she asked the court to empower a custodian to 'exercise full authority and control over the Company, its operations, and management;'"
- "The threat of a court-appointed custodian so broadly empowered posed new risks to the Company. The appointment of a custodian with these powers would have given rise to broad termination rights in SPE contracts and threatened UIP's revenue stream, as UIP's business model is dependent on the continued viability of those contracts;"
- "Facing this threat to the Company," the UIP board "identified a solution" to issue equity "long promised to Bonnell" that "implent[ed] a succession plan" proposed "on a clear day;"
- The Stock Sale would "moot the Custodian Action and eliminate the risks the appointment of a custodian posed to UIP" and would "eliminate the stockholder leverage that Plaintiff was using to try to force a buyout at a price detrimental to the Company;"
- The UIP board's motives were not "pretexts for entrenchment for selfish reasons" or "post-hoc justifications;" and
- "[T]hese were genuine motivations for their actions that stood alongside the more problematic purposes that [Coster I] identified and the Appellate Decision collected."

After its additional fact findings, the Court of Chancery gathered the many strands of precedent and conducted a careful review of the UIP board's actions. The Chancellor found that the UIP board faced a threat—which the court described as an "existential crisis"—to UIP's existence through a deadlocked stockholder vote and the risk of a custodian appointment. Although the court thought that some of the board's reasons for approving the Stock Sale were problematic, on balance the court held that the board was properly motivated in responding to the threat. According to the court, the UIP board acted in good faith "to advance the best interests of UIP" by "reward[ing] and retain[ing] an essential employee," "implement[ing] a succession

[98] *Coster II*, at *3.

plan that Wout had favored," and "moot[ing] the Custodian Action to avoid risk of default under key contracts."[106] The court also relied on its earlier finding that the UIP board issued UIP stock to Bonnell at an entirely fair price.

The Court of Chancery also found that the UIP board responded reasonably and proportionately to the threat posed when it approved the Stock Sale and mooted the Custodian Action. As it held, "in the exceptionally unique circumstances of this case," without the Stock Sale, the possibility that a custodian appointed with broad powers would jeopardize key contracts caused an existential crisis at UIP. The Stock Sale, the court held, "was appropriately tailored to achieve the goal of mooting the Custodian Action" while implementing the succession plan and retaining Bonnell.[108] And the court noted that there were more aggressive options that could have been, but were not, pursued to break the deadlock.

*Finally, the board's response to the existential threat posed by the stockholder deadlock and custodian action was not preclusive or coercive. Although the Stock Sale effectively foreclosed Coster from perpetuating the deadlock facing UIP, the new three-way ownership of the company presented a potentially more effective way for her to exercise actual control. As the Court of Chancery noted, Schwat and Bonnell are not bound to vote together, meaning Coster could cast a swing vote at stockholder meetings.[110] As an equal one third owner with the two other stockholders, Coster can join forces with either one of UIP's other owners "at some point in the future."[111]A realistic path to control of UIP negates the preclusive impact of the Stock Sale.

. . .

III.

The judgment of the Court of Chancery is affirmed.

NOTES AND QUESTIONS

1. If the case had been decided under the original *Blasius* compelling justification standard, what would the result have been?

2. What does the court mean by its reference to "clear day" actions? How would such actions be analyzed?

3. When does the *Coster* standard apply rather than the business judgment rule?

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[106] *Id*. at *10.

[108] *Id*. at *11–12.

[110] *See Coster II,* at *13 ("Bonnell could switch sides tomorrow and unite with Plaintiff to Schwat's detriment. The record reflects that Schwat and Bonnell have disagreed on a number of business decisions").

[111] Air Prod. & Chemicals, Inc. v. Airgas, Inc., 16 A.3d 48, 115 (Del. Ch. 2011).

4. Given the apparent ability of courts to use the *Schnell* doctrine to police incumbent interference with the shareholder franchise, is the *Coster* standard necessary?

5. In *Coalition to Advocate Public Utility Responsibility, Inc. v. Engels*,[1] the directors of Northern States Power Company (referred to by the court as N.S.P.) tried to manipulate the corporation's bylaws to prevent an insurgent director candidate—one Alpha Smaby[2]—from being elected:

> 4) N.S.P. has historically elected Directors each year for a one-year term. In February of 1973, there were 14 Directors. At the Board of Directors' meeting of February 28, 1973, the Board of Directors considered in detail a proposed draft proxy soliciting statement which contemplated the continuation of the 14 member Board. These draft materials made direct and substantial reference to Alpha Smaby and urged the shareholders to reject her candidacy. . . .
>
> 6) Subsequent to the February meeting, the exact date is not known at this time, it was decided by the Directors of N.S.P. to reduce the number of Directors from 14 to 12 and to classify the Directors in groups of four for election to staggered terms of one, two and three years. Without the changes, just over 7% of the vote would be sufficient to elect one Director under the cumulative voting provision, but after the changes about 20% of the vote would be required. There was good reason to believe that Alpha Smaby might control up to 9% of the voting shares. Although the above changes were not formally approved by the Board of Directors until a special meeting was called on March 27, 1973, the proposed changes were submitted to the SEC approximately one week prior to the Board's formal approval.
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> 7) N.S.P. candidly admits that such changes were not proposed because of long-term business considerations but that the changes were specifically aimed at the candidacy of Alpha Smaby. It is

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[1] 364 F. Supp. 1202 (D. Minn. 1973)

[2] According to Wikipedia:

> Alpha Sunde Smaby (February 11, 1910–July 18, 1991) was an American politician and teacher.
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> Born in Sacred Heart, Minnesota, Smaby graduated from University of Minnesota and Winona State University. She then taught school and then worked for Cargill, Inc. Smaby served in the Minnesota House of Representatives from 1965 until 1969 and was a Democrat. During the 1968 United States Presidential campaign, Smaby was a delegate to the Democratic Party Convention and supported United States Senator Eugene McCarthy. Smaby died of cancer in Saint Paul, Minnesota.

Alpha Sunde Smaby, https://en.wikipedia.org/w/index.php?title=Alpha_Sunde_Smaby (last visited July 25, 2017).

> clear to the Court that the changes were instigated in an attempt to make her effort to win a seat on the Board more difficult and, in fact, were done to frustrate her efforts.
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> . . .
>
> Plaintiffs concede that the actions of the defendants do not violate any state statutory law but argue that the manipulation of the corporate machinery by insiders for the sole purpose of frustrating the candidacy of a minority shareholder . . . is a breach of the insiders' fiduciary duty to the minority shareholders. Plaintiffs rely heavily on . . . Delaware cases which basically stand for the proposition that actions by insiders, although otherwise lawful, may be enjoined if they act to injure the rights of minority shareholders. In [*Schnell v. Chris-Craft Industries*, 285 A.2d 437 (Del.Supr.1971),] the Delaware Supreme Court held that management's efforts to use the corporate machinery and Delaware law for the purpose of perpetrating itself in office and obstructing legitimate efforts of the dissident stockholders in the exercise of their rights to undertake a proxy contest against management was impermissible. The insiders had advanced the date of the stockholders' meeting in an effort to frustrate the efforts of minority shareholders who desired to wage a proxy contest. The actions of the insiders were enjoined despite the fact that they were in compliance with the company by-laws and applicable Delaware law. The basis for these opinions rests on the fiduciary duty imposed on Directors and Officers of a corporation to deal fairly and justly with the corporation and all of its shareholders including minority shareholders. The Officers and Directors of N.S.P. are in a fiduciary relationship with the minority shareholders and as such owe them a duty to deal with them fairly and in good faith.
>
> In the instant case, the actions of the insiders, if not unfair, were certainly questionable in light of their fiduciary obligation to the plaintiff shareholders. Not only did the defendants change the rules in the middle of the game, but they refused to disclose the existence of the changes when approached by the plaintiffs. Both of these actions served to frustrate the plaintiff shareholders' legitimate efforts to run for the Board of Directors and may well be a breach of fiduciary duty. . . .

Both of the changes made by the N.S.P. board were permitted by statute. So why did the court invalidate them? Would the *Blasius* court have reached the same result? Would the *Coster* court have reached the same result?

Suppose that one month after the 1973 annual shareholder meeting the N.S.P. board amended the company's bylaws to effect a reduction in the number of directors and to classify the board effective with the 1974 annual shareholder meeting. Would the court enjoin those changes? Would the *Blasius* court have enjoined those changes? Would the *Coster* court have enjoined those changes?

6. In *Portnoy v. Cryo-Cell Int'l, Inc.*,[3] the incumbent directors feared losing a proxy contest and took a variety of steps intended to ensure their victory. One of those steps involved a deal pursuant to which a large shareholder—one Andrew Filipowski—agreed to support the incumbent board provided that the board would include the shareholder on its slate of candidates and—if successful in winning the proxy contest—would increase the number of board members from six to seven and appoint a crony of the shareholder to fill the resulting vacancy. Then Vice Chancellor Leo Strine explained that:

> As defined by Vice Chancellor Hartnett in his important decision in *Schreiber v. Carney*, "[v]ote-buying . . . is simply a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror." . . .
>
> To say that the law of corporations has struggled with how to address the subject of so-called "vote buying" is no insult to judges or corporate law scholars, the question of what inducements and agreements may legitimately be forged to cement a voting coalition is doubtless as old as the concept of a polity itself. For these very real-world reasons, *Schreiber* refused to say that any sort of arrangement involving the exchange of consideration in connection with a stockholder's agreement to vote a particular way was forbidden vote buying. Indeed, distinguished scholars have anguished (the adjective I take away from their work) over how to deal with such arrangements, with most concluding that flat-out prohibitions are neither workable nor of utility to diversified stockholders. . . .
>
> To deal with these complexities, *Schreiber* declined to find that vote buying was, in the first instance, per se improper. Rather, *Schreiber* articulated a two-pronged analysis. In the first instance, if the plaintiff can show that the "object or purpose [of the vote buying was] to defraud or in some way disenfranchise the other stockholders," the arrangement would be "illegal per se." Putting this in terms that I think are truer to the way our corporate law works, what I take from this is that if the plaintiff proved that the arrangement under challenge was improperly motivated, then the arrangement would be set aside in equity, irrespective of its technical compliance with the DGCL.[157] That is, in keeping with the traditional vigilance this court has displayed in ensuring the fairness of the corporate election process, and in particular the process by which directors are elected, purposely inequitable

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[3] 940 A.2d 43 (Del. Ch. 2008).

[157] See Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 439 (Del.1971) (holding that "inequitable action does not become permissible simply because it is legally possible") . . . .

conduct in the accumulation of voting power will not be tolerated. Even when a vote buying arrangement cannot be found, in the first instance, to be motivated by a fraudulent, disenfranchising, or otherwise inequitable intent, *Schreiber* concluded that "because vote-buying is so easily susceptible of abuse it must be viewed as a voidable transaction subject to a test for intrinsic fairness."

Subjecting an agreement to add a potential insurgent to a management slate to the *Schreiber* intrinsic fairness test would, in my view, be an inadvisable and counterproductive precedent. If one takes a judicial standard of review seriously, as the members of this court do, the decision to subject all such arrangements to the entire fairness standard could result in creating litigable factual issues about a large number of useful compromises that result in the addition of fresh blood to management slates, new candidates who will tend to represent actual owners of equity and might therefore be more independent of management and more useful representatives of the interests of stockholders generally. . . .

. . . If the only arrangement at issue is a promise to add a potential insurgent to the management slate in exchange for the insurgent's voting support, then the arrangement is subject to stockholder policing in an obvious, but nonetheless, potent form. That policing occurs at the ballot box itself.

Here, to be specific, the Cryo-Cell stockholders went to the polls knowing that Filipowski had been added to the Management Slate. Those stockholders also knew that Filipowski had contracted to vote the Filipowski Group's shares for the Management Slate. Although it was not publicly disclosed that Filipowski's agreement to vote for the Management Slate had been conditioned on his addition to that Slate, and that the incumbents had added Filipowski to the Management Slate in exchange for his support, that inference was, I think, unmistakable to any rational stockholder. . . .

In expressing concerns about over-breadth in this area, this decision echoes concerns voiced by the Supreme Court and this court about the difficulty of applying the compelling justification test articulated in *Blasius* in a manner that works sensible results.[162] But like those decisions, this decision is rooted in the premise that the *Schnell* doctrine, authorizing this court to set aside conduct that is inequitably motivated

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[162] See, e.g., Williams v. Geier, 671 A.2d 1368, 1376 (Del.1996) ("Blasius' burden of demonstrating a 'compelling justification' is quite onerous, and is therefore applied rarely.") . . . .

> and that unfairly tilts the electoral playing field, is itself a potent tool of equity.

Why shouldn't *Blasius* apply to vote buying? If *Blasius* had been applied, what compelling justification—if any—could the incumbent board have put forward to justify the deal with Filipowski?

Would *Coster* apply to vote buying? If *Coster* had been applied, what arguments could the incumbent board have put forward to justify the deal with Filipowski?

Strine's opinion in *Portnoy* can be seen as part of a larger trend in Delaware corporate law towards judicial deference to informed, non-coerced shareholder votes. The leading example of that trend is *Corwin v. KKR Financial Holdings LLC*,[4] in which the Delaware Supreme Court held that the business judgment rule was the proper standard of review for a merger between a target corporation and a minority shareholder that was approved by a fully informed, non-coerced vote of the disinterested shareholders. "When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk taking than it promises in terms of benefits to them." Put another way, *Corwin* posits that informed, disinterested, non-coerced shareholders—rather than plaintiffs' lawyers or courts—should have the last word on the merits of a transaction.

7. Some courts have suggested that *Blasius* should be limited to proxy contests involving director elections:

> *Blasius* anticipates a defensive measure in response to a threat to corporate control. Beyond this, its application has been largely limited to disputes over the election of directors. Accordingly, "courts will apply the exacting *Blasius* standard sparingly, and only in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter." Of particular significance here, "the reasoning of *Blasius* is far less powerful when the matter up for consideration has little or no bearing on whether the directors will continue in office."[5]

Is there a good reason for not applying *Coster* to issue contests?

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4 125 A.3d 304 (Del. 2015).

5 In re Bear Stearns Litig., 870 N.Y.S.2d 709, 733 (N.Y. Sup. 2008) (citations and footnote omitted).

Teacher's Notes

Facts: UIP's two sole and equal shareholders were deadlocked and could not elect new directors. Shareholder Marion Coster (widow of one of the founders who had inherited the shares) filed a petition in the Delaware Chancery Court requesting appointment of a custodian for the corporation. In response, UIP's board of directors approved an issuance of stock to a UIP employee, which diluted Coster's voting power in the corporation to one third. Coster then sued, claiming that the board breached its fiduciary duties. The two actions were consolidated. After trial, the Court of Chancery found that the stock sale was entirely fair. Coster appealed. The Supreme Court reversed and remanded with instructions to conduct further equitable review of stock sale under *Schnell* and *Blasius*. The Court of Chancery again entered judgment in favor of defendants. Coster again appealed.

Holding: The Court merged the *Blasius* and *Unocal* standards. Accordingly, when a shareholder challenges a corporate board's action that interferes with the election of directors or a stockholder vote in a contest for corporate control, a two-step standard should be used to determine whether the board's action was inequitable.

First, can the board show that it 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. The board's motivations must be proper and not selfish or disloyal. The threat cannot be justified on the grounds that the board knows what is in the best interests of the stockholders.

Second, was the board's response to the threat was reasonable in relation to the threat posed? In applying the second step, the board action will be inequitable per se if it was preclusive or coercive to the shareholder franchise.

The Supreme Court concluded that the UIP board's dilutive sale was a reasonable response to the existential threat posed by the deadlock between its two existing stockholders and Coster's efforts to obtain appointment of a custodian.

NOTES AND QUESTIONS

1. Unlike *Unocal*, under which issues of the board's motivation and good faith are highly relevant, *Blasius* liability can arise even when the board is acting in good faith. As the Delaware Chancery Court has pointed out, the *Blasius* standard is so demanding that deciding that *Blasius* "applies comes close to being outcome-determinative in and of itself."[6]

2. Some commentators contend that *Blasius* is about changes effected by the board in the heat of the moment during a proxy contest or takeover bid. The Delaware courts have made clear that "[a]n inequitable purpose is not necessarily synonymous with a

[6] Chesapeake Corp. v. Shore, 771 A.2d 293, 320 (Del. Ch. 2000).

dishonest motive." Instead, it is conduct intended to "preclude effective stockholder action or to snatch victory from an insurgent slate on the eve of the noticed meeting."[7]

3. The trigger is some element of shareholder disenfranchisement.

4. The problem with *Blasius* is "that *Blasius* is simply an unworkable standard of review, as once a court triggers *Blasius*, it would seem impossible for the directors to provide a compelling justification for disenfranchising their shareholders."[8] The problem with *Schnell* is that, like all such equitable doctrines, it uses "each equity chancellor's conscience as a measure of equity," which is "as arbitrary and uncertain as measuring distance by the length of each chancellor's foot."[9]

5. You may wish to consider this question simultaneously with numbers 2 and 4. I love this case. In *CAPUR*, the court held that otherwise lawful actions by insiders can be held invalidated as inequitable where they injure the minority shareholders. Management must deal with the minority fairly and in good faith. Accordingly, management could not put the changes into effect. I take it that the *Coster* court would have reached the same result on these facts.

It has always seemed to me that *Schnell* and *CAPUR* provide courts with more than adequate tools to deal with management conduct that tries to change the rules in the middle of the game, which is the pertinent inequity. Hence, for example, I doubt whether either *CAPUR* or *Schnell* would preclude a board from making the sort of changes at issue in *CAPUR* months in advance of the next annual shareholder meeting.

6. *Blasius* probably was not invoked because vote buying does not necessarily interfere with the franchise. The other shareholders still get to vote and have little room to complain if the deal is disclosed. One might quote Brandeis's quip about sunlight and electric light here.

7. Because their continued incumbency is not at stake in an issue proxy contest, the board has a less pronounced conflict of interest. As then-Chancellor Strine observed in *Mercier*:

> Here's a news flash: directors are not supposed to be neutral with regard to matters they propose for stockholder action. As a matter of fiduciary duty, directors should not be advising stockholders to vote for transactions or charter changes unless the directors believe those measures are in the stockholders' best interests. And when directors believe that measures are in the stockholders' best interests, they have a fiduciary duty to pursue the implementation of those measures in an efficient fashion. That does not mean, of course, that directors can use

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[7] Stahl v. Apple Bancorp, Inc., 579 A.2d 1115, 1121 (Del. Ch. 1990).

[8] Mary Siegel, The Problems and Promise of "Enhanced Business Judgment", 17 U. Pa. J. Bus. L. 47, 81 (2014).

[9] Lonchar v. Thomas, 517 U.S. 314, 323 (1996).

inequitable means that dupe or dragoon stockholders into consenting. But it does mean that directors can use the legal means at their disposal in order to pursue stockholder approval, means that often include tools like the ability to set and revise meeting dates or to adjourn a convened meeting.[10]

[10] Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d 786, 808–09 (Del. Ch. 2007).