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Board Motives Matter: Delaware Supreme Court Remands Dilutive Stock Sale Case

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The following case should serve as a cautionary tale for directors of Delaware corporations when taking actions that may disenfranchise stockholders, especially in the election of directors.

The Delaware Supreme Court (the Court) held in *Marion Coster v. UIP Companies, Inc.*, No. 49, 2020 (Del. June 28, 2021) that even if an interested board satisfies its burden of proving that a dilutive stock issuance is entirely fair (Delaware's most onerous standard of review), such issuance may still be subject to judicial review for breach of fiduciary duty if it was allegedly approved (i) for inequitable reasons or (ii) in good faith but for the primary purpose of interfering with corporate democracy without a compelling justification to do so—in which case such issuance may be subject to cancellation.

IN DEPTH

The plaintiff in the case on appeal, Marion Coster (Coster), was the holder of 50% of the stock in UIP Companies, Inc., a Delaware corporation (the Corporation), with the other 50% owned by Steven Schwat, a director of the Corporation (Schwat). After failing to finalize terms for a buyout of Coster's stock by Peter Bonnell (Bonnell), an employee and director of the Corporation and a friend of Schwat, Coster called for a special meeting of stockholders in order to elect new directors. The board of directors was composed of Schwat, Bonnell and Stephen Cox (Cox), also an employee of the Corporation.

Due to the equal stock ownership, the stockholders deadlocked on the vote to elect directors, leaving Schwat, Bonnell and Cox to continue as holdover directors. Coster then petitioned the Delaware Court of Chancery to appoint a custodian to break the deadlock, pursuant to 8 *Del. C.* § 226(a)(1) (the Custodian Action). As the Custodian Action was pending, Schwat obtained a third-party valuation of the Corporation, which valued the Corporation at $123,869—significantly less than the approximately $4,250,000 valuation ascribed during the Coster buyout negotiations. The board of directors then approved, by unanimous written consent, a stock sale to an entity owned by Bonnell, amounting to one-third of all outstanding stock of the Corporation (the Stock Sale), in exchange for $41,289.67—thereby ending the stockholder deadlock and mooting the Custodian Action. In response, Coster filed a second action to cancel the Stock Sale, alleging that the dilutive Stock Sale interfered with her voting rights and impeded her statutory right to seek court appointment of a custodian.

The Court of Chancery found that the Stock Sale was significantly motivated by a desire to moot the Custodian Action, but that such motives were "beside the point" in reviewing the Stock Sale. The Court reasoned that, since a majority of the board (Schwat and Connell) were interested in the Stock Sale, the only relevant inquiry was whether the defendant carried its burden of proving that the Stock Sale was entirely fair to Coster in terms of price and process—Delaware's most onerous standard of review. The Court of Chancery held that the price had been set after a fair (but less than optimal) process and that the price, based on the third-party valuation, was fair. Having determined that the Stock Sale was entirely fair, the Court of Chancery declined to reach Coster's argument that the Stock Sale was approved for inequitable reasons or, alternatively, in good faith but for the primary purpose of interfering with her voting rights without a compelling reason to do so. The Court of Chancery dismissed the Custodian Action.

On appeal to the Court, Coster argued that the Court of Chancery should have reviewed not just the fairness of the Stock Sale, but also the context in which the Stock Sale occurred—a conflicted board approving a dilutive stock issuance for the purpose of defeating Coster's voting rights (and the leverage that came from the exercise of those rights), entrenching the existing board and interfering with her statutory right to petition for court appointment of a custodian. The Court agreed.

The Court held that a determination that the Stock Sale was entirely fair did not end judicial review. Rather, the Court of Chancery should have considered Coster's alternative arguments that the board approved the Stock Sale for inequitable reasons (under the *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) line of cases) or in good faith but for the primary purpose of interfering with Coster's voting rights and leverage as an equal stockholder without a compelling reason to do so (under the *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) line of cases).

As the Court explained, Delaware law has long recognized that inequitable action does not become permissible simply because it is legally possible. Therefore, director action affecting the stockholder franchise is twice-tested—first for legal authorization and second for equity. Since the stockholder franchise is the ideological underpinning upon which the legitimacy of directors' managerial power rests, Delaware courts will carefully review board actions designed to interfere with the effective exercise of corporate democracy by stockholders, especially in director elections.

The *Schnell* line of cases stand for the proposition that directors may not act to frustrate the efforts of stockholders to elect new directors by engaging in transactions that are designed and pursued for the primary purpose of diluting the votes held by the insurgent stockholders. According to the Court, if Coster's allegations prove true—that an interested board approved the Stock Sale to disenfranchise her rights as a stockholder and to entrench themselves in office by thwarting the Custodian Action—under *Schnell*, the Court of Chancery need not go any further to find a breach of fiduciary duty.

However, under the *Blasius* line of cases, even if the board acted in good faith (in which case *Schnell* would not apply), if the Stock Sale was approved for the primary purpose of interfering with Coster's rights as a stockholder, it will survive judicial scrutiny only if the board can demonstrate a compelling justification for its actions.

Accordingly, the Court of Chancery's holding that the Stock Sale was entirely fair was no substitute for further equitable review based on Coster's allegations that an interested board approved the Stock Sale to interfere with her voting rights. The case was remanded for further proceedings.

Additional Note: In a footnote, the Court explained that it was not considering or ruling on whether the "reasonableness and proportionality test" of *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985) applied in this case since it was not argued by the parties. This may be a signal to the parties and the Court of Chancery that the board may also have to satisfy its burden under *Unocal* enhanced scrutiny given the facts of this case. The Court held in *Unocal* that when a board's action is a defensive measure taken in response to a threat to corporate policy and effectiveness which touches upon issues of control, the board must prove that such action is proportionate and reasonable in relation to the threat posed. In *MM Cos., Inc. v. Liquid Audio, Inc.*, 813 A.2d 1118 (Del. 2003), the Court held that if, in the context of such a hostile contest for control, the primary purpose of the board's action is to interfere with or impede the effective exercise of the stockholder franchise in a contested election for directors, then the board, in addition to its burden under *Unocal*, must first overcome the burden of demonstrating a compelling justification for such action. Meaning that in the rare instances where *Blasius* standard of review applies (rare because a plaintiff must first show that the board action was for the primary purpose of stockholder disenfranchisement), compelling justification will need to be shown either independently, in the absence of a hostile contest for control, or within the *Unocal* standard of review when the board's action is taken as a defensive measure (as a condition precedent to any judicial consideration of reasonableness and proportionately).

TAKEAWAY

This case was based on its particular facts: the Stock Sale occurred after buyout negotiations failed between two equal stockholders; the stockholders were deadlocked and the defendants desired to eliminate plaintiff's ability to block stockholder action, including the election of directors, and the leverage that accompanied that blocking power; a majority of the board was interested in the Stock Sale; the Stock Sale was to an employee-director who was also friends with the defendant and was aligned with the defendant on neutralizing the threat to control of the Company, effectively entrenching the holdover board; and the third-party valuation of the Company on which the Stock Sale was based was sought only after the filing of the Custodian Action. According to the Court, these facts alone support a finding of breach of fiduciary duty, but the case was remanded to the Court of Chancery to make its own factual findings in light of the Court's holding. However, it is less certain that the Court would have reached the same conclusion if the sale were to an unaffiliated and independent party or if the sale would not directly affect the voting control.

Unique facts notwithstanding, this case serves as another important reminder to boards of directors that simply because an action is legally permissible does not mean that it will avoid equitable review by the courts. Boards should be cautious when proposing an action that may impede a stockholder's exercise of its statutory rights, especially when facts and circumstances suggest that the primary purpose of that action is to interfere with corporate democracy or entrench the existing board.

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