

Delaware Clarifies Standard for Reviewing Board Interference with Election Contests

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In a recent decision (*Coster v. UIP Cos., Inc.* (Del. June 28, 2023)), the Delaware Supreme Court clarified the test applicable to board actions that interfere with the stockholder vote in contested director elections. The Court held that the test under *Blasius v. Atlas Industries, Inc.* (Del. Ch. July 25, 1988), which requires boards to demonstrate a “compelling justification” for actions primarily intended to interfere with stockholder voting in election contests, is properly subsumed within an analysis under *Unocal Corp. v. Mesa Petroleum Co.* (Del. 1985), which evaluates whether the board reasonably perceived a threat and whether the response was reasonable in relation to that threat.

The case arrived before the Delaware Supreme Court with an unusual set of facts and a somewhat odd procedural history. It arose from an issuance of stock by UIP to an employee in order to break a deadlock between two 50% owners, one of whom had sought the judicial appointment of a custodian. On appeal after the Court of Chancery upheld the issuance applying a test of entire fairness, the Supreme Court remanded for consideration of whether the issuance satisfied the *Blasius* test, as well as whether it was inequitable under *Schnell v. Chris Craft Industries, Inc.* (Del. 1971). On remand, the Court of Chancery held that the UIP board had not acted inequitably (thus satisfying *Schnell*) and that, in light of the harm to UIP that would result from appointing a custodian, the board had compelling justifications for the dilutive stock issuance (thus satisfying *Blasius*). This decision led to the current appeal.

Affirming the Court of Chancery’s decision, the Supreme Court took the opportunity to attempt to harmonize the three principal cases requiring enhanced judicial scrutiny of board actions that interfere with contested director elections:

- *Schnell*, prohibiting action by a board which, although meeting legal requirements, attempts to “utilize the corporate machinery and the Delaware Law for the purpose of perpetuating itself in office”; thereby “obstructing legitimate efforts of dissident stockholders in the exercise of their rights to undertake a proxy contest against management”;

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- *Blasius*, which prohibits a board, even if acting in good faith, from acting “for the principal purposes of preventing the shareholders from electing a majority of new directors” unless the board demonstrates a “compelling justification” for impeding the exercise of stockholder voting power; and
 - *Unocal*, which prohibits anti-takeover measures unless the board demonstrates that it had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed” and that the response was “reasonable in relation to the threat posed”—meaning that the response cannot be coercive or preclusive and must fall within a range of reasonable responses.

Various courts and commentators over the years have proposed to unify these standards of review, including, notably, then Vice Chancellor Strine, who in *Chesapeake Corp. v. Shore* (Del. Ch. Feb. 7, 2000) suggested applying *Unocal* “with a gimlet eye for inequitably motivated electoral manipulation or for subjectively well-intentioned board action that had preclusive or coercive effects.” The Supreme Court in *UIP* observed that the *Blasius* “compelling justification” standard was unworkable in practice given that, if a court applied the test to board action, “the outcome was, for the most part, foreordained”—notwithstanding the fact that the UIP stock issuance at issue had been held to satisfy that test.

At last unifying the tests, the Court in *UIP* concluded that when a stockholder challenges board action that interferes with a contested election of directors, the board must prove that (a) it reasonably perceived a threat to corporate policy or effectiveness, which threat must be “real and not pretextual,” with the board’s motivations “proper and not selfish or disloyal”; and (b) “the response to the threat was reasonable in relation to the threat posed and was not preclusive or coercive to the stockholder franchise.” The Court went on to note that even a properly motivated board identifying a legitimate threat must “tailor its response to only what is necessary to counter the threat,” which “cannot deprive the stockholders of a vote or coerce the stockholders to vote a particular way.” It also noted that the threat perceived by the board “cannot be justified on the grounds that the board knows what is in the best interests of stockholders.”

Does the *UIP* decision represent a sea change in how director conduct bearing on contested elections is evaluated by the Delaware courts? Probably not. Delaware courts are likely to continue to take an especially close look—with a gimlet eye—at actions that infringe the stockholder franchise, which, in the words of former Chancellor Allen, is “the ideological underpinning upon which the legitimacy of directorial power rests.” At the same time, the binary nature of the term “preclusive” creates the possibility that defendant directors will argue that actions that make an insurgent’s objective more difficult, but not impossible, are permissible under a *Unocal* standard of review, even if

they might have been unable to prove a compelling justification for those actions. Nevertheless, the Court's emphasis on the "situationally specific" nature of judicial review of board actions interfering with director elections or stockholder votes in contests for corporate control, and its focus on a tailored response, suggest that analyzing board interference with the stockholder franchise under *Unocal*, as prescribed by *UIP*, is unlikely to expand, or contract, the field of play for such interference.

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