Delaware Supreme Court Rules That Otherwise Entirely Fair Transaction Does Not Pass Muster When Taken for Inequitable Purpose

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On June 28, 2021, the Delaware Supreme Court reversed a ruling of the Court of Chancery which found that an otherwise "entirely fair" transaction undertaken for an "inequitable purpose" did not trigger fiduciary liability for the defendant directors. The Supreme Court's decision, captioned *Marion Coster v. UIP Companies, Inc.*, No. 49, 2020 (Del. June 28, 2021), confirms that even if a board can prove that a transaction is entirely fair to the company and its stockholders, the transaction may still trigger liability if it was allegedly approved (i) in bad faith or (ii) for the "primary purpose of thwarting" a stockholder's franchise rights.

The dispute centered around UIP Companies, Inc. (the "Company" or "UIP"), a real estate investment services company. Prior to the events giving rise to the dispute, plaintiff Marion Coster held 50 percent of the Company's stock, and Steven Schwat held the other 50 percent. The Company's board was composed of Schwat and two other individuals (not Coster). After a period of failed negotiations for a potential buyout of her shares, Coster called for a special meeting of stockholders in order to elect new directors. However, due to their equal stock ownership, Coster and Schwat deadlocked on the vote.

Coster proceeded to file a lawsuit in the Delaware Court of Chancery pursuant to 8 *Del. C.* § 226(a)(1) seeking "to appoint a custodian to break the stockholder deadlock" in electing new board members (the "Section 226 Action"). Meanwhile, Schwat obtained a third-party valuation of the Company which valued the Company at a number well below the value attributed to the Company during the failed Coster buyout negotiations. Based on that new valuation, the Company's board approved a sale of stock to a third-party entity affiliated with one of the existing board members, thereby effectively mooting the deadlock and the Section 226 Action.

Not so easily defeated, Coster filed a second action (which became consolidated with the first), this time asking the court to "cancel the Stock Sale" because it "interfered with her voting rights and impeded her statutory right to seek court appointment of a custodian."

On review, the Court of Chancery determined that the stock sale was significantly motivated by a desire to moot the Section 226

Action, but that motive was "beside the point" in determining liability. The court reasoned that, since a majority of the board was interested in the dilutive transaction, the relevant inquiry was whether the transaction was "entirely fair" to the Company and its stockholders. The Court of Chancery found that both the process leading to the approval of the transaction and the price were fair, and that the "entire fairness" standard was therefore satisfied. The court dismissed Coster's lawsuit.

On appeal to the Delaware Supreme Court, Coster argued that the Court of Chancery should have considered the context in which the transaction occurred (i.e., that it was a dilutive stock issuance approved by a conflicted board for the purpose of defeating Coster's voting rights and entrenching the existing directors). The Supreme Court agreed, noting that it was "not seriously disputed that the defendants issued the stock … to dilute Coster's UIP ownership interest below 50%, block her attempts to elect directors, and avoid a possible court-appointed custodian."

Citing *Schnell v. Chris-Craft Industries, Inc.*, 285 A.2d 437 (Del. 1971), the Supreme Court explained that a court must, in addition to assessing the fairness of a transaction, determine whether a board acted for inequitable reasons. If a board acts inequitably, directors are liable for breaches of fiduciary duty even if the actions were otherwise legal. The Court further cited *Blasius Industries, Inc. v. Atlas Corp*., 564 A.2d 651 (Del. Ch. 1988), for the principle that a court must also consider whether the board acted for the primary purpose of interfering with a stockholder's statutory or voting rights. Under *Blasius*, if a board's primary purpose is to interfere, then the board must "demonstrate a compelling justification" for its action in order to survive judicial scrutiny. Accordingly, the Supreme Court reversed and remanded the case to the Court of Chancery to review all factual findings consistent with the holdings of *Schnell* and *Blasius*. The Supreme Court reiterated that the Court of Chancery "'may' — not 'must' — appoint a custodian in the event of a deadlock" after considering whether the move will breach any agreements or harm the business.

This ruling of Delaware's highest court is an important reminder to directors and corporate boards that otherwise "legal" action may still trigger fiduciary liability if undertaken for an inequitable purpose. Boards should be especially cautious when proposing an action that may impede a stockholder's exercise of its statutory or voting rights.