

Equitable Review in the Delaware Court of Chancery: Revisiting ‘Schnell,’ ‘Blasius’ and the Court’s Role as Equitable Gatekeeper To Protect the Stockholder Franchise

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Delaware law has long held that “inequitable action does not become permissible simply because it is legally possible.” And, when stockholder voting rights are implicated, even good faith actions by a board will not be upheld absent a “compelling justification.” These holdings arose from Delaware’s seminal decisions in *Schnell v. Chris-Craft Industries*, 285 A.2d 437 (Del. 1971), and *Blasius v. Atlas Industries*, 564 A.2d 651 (Del. Ch. 1988).

A string of recent Delaware decisions have reaffirmed the importance of these holdings, and the critical role the Delaware courts play in ensuring that corporate transactions are “twice-tested”—for both legal validity and equitable fairness. These holdings affirm that the demanding standards



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set forth in *Schnell* and *Blasius* are alive and well, particularly when it comes to director actions that burden or interfere with the stockholder franchise.

‘Schnell’ and ‘Blasius’: An Introduction. *Schnell* and *Blasius* form two cornerstones of Delaware law establishing standards for director conduct that affect stockholder voting rights. *Schnell* considered the validity of a bylaw amendment that a board of directors passed in order to

reduce the time available for stockholder insurgents to wage a proxy battle. Finding that the directors’ purposes of self-entrenchment and obstruction of the proxy contest were inequitable, the Delaware Supreme Court invalidated the amendment. While defendants had argued that the bylaw amendment complied with the Delaware General Corporation Law, the court famously noted that “inequitable action does

not become permissible simply because it is legally possible.”

Blasius established the standard Delaware courts use to evaluate director actions that burden the stockholder franchise. In *Blasius*, Chancellor Allen invalidated a board act that stymied a stockholder proposal to add directors to the board. The court found that despite the board’s subjective good faith, its act nonetheless triggered enhanced scrutiny. Delaware courts have since articulated the *Blasius* standard as the following: where directors act for the “primary purpose of thwarting a shareholder vote,” the board bears the burden to show a “compelling justification” for that act.

‘Strategic v. Lee’: A Board’s Rejection of a Stockholder’s Nomination Notice Is Reviewed Not Only for Compliance With the Company’s Bylaws, But Also Under Enhanced Scrutiny To Determine Whether the Board’s Decision Was Equitable. In *Strategic Investment Opportunities v. Lee Enterprises Incorporated, et al.*, C.A. No. 2021-1089-LWW, 2022 WL 453607 (Del. Ch. Feb. 14, 2022), a stockholder of Lee Enterprises sought to nominate two director candidates at Lee’s upcoming annual meeting. Lee rejected the nomination for failing to comply with Lee’s advance notice bylaw. The stockholder, Strategic Investment Opportunities, brought suit challenging the company’s rejection, asserting claims for breach of the bylaws and breach of fiduciary duty.

The parties agreed that whether Strategic had complied with Lee’s bylaws was a question of contract interpretation, but differed as to whether that ended the inquiry.

Strategic asserted that the board’s actions in enforcing the bylaws must be “twice-tested”—once for compliance with positive law and again against the standard of equity. Lee, on the other hand, claimed that if a stockholder fails to comply with the terms of a bylaw, that ends the inquiry unless the stockholder can prove manipulative conduct or “compelling circumstances.”

Vice Chancellor Will agreed with Strategic, holding that “[f]undamental principles of Delaware law mandate that the court ... conduct an equitable review of the board’s rejection of the nomination.” 2022 WL 453607, at *1. Drawing from *Blasius* and *Schnell*, the court applied enhanced scrutiny. The court recognized that

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“inherent conflicts of interest ... arise when a board of directors acts to prevent shareholders from effectively exercising their right to vote either contrary to the will of the incumbent[s]... or to replace the incumbent board members in a contested election.” Id. at *15. Accordingly, subjecting

the board’s action to enhanced scrutiny review—“a context-specific application of the directors’ duties of loyalty, good faith and care” to determine whether the board behaved reasonably—was necessary and appropriate. Id. at *16.

‘Coster v. UIP’: Even After Satisfying the Exacting Entire Fairness Standard, a Transaction That Implicates Voting Rights Must Be Further Reviewed for Fairness Under ‘Schnell’ and ‘Blasius’. The centrality of the *Schnell* and *Blasius* standards came into sharp focus in *Marion Coster v. UIP Companies, et al.*, C.A. No. 2018-0440-KSJM, 2022 WL 1299127 (Del. Ch. May 2, 2022). The *Coster* saga involved a deadlock between the 50/50 owners of a private corporation. Plaintiff Marion Coster sued UIP and its other 50% stockholder, alleging that a sale of stock by the company to an employee (the “Stock Sale”), which diluted both owners and broke the deadlock, was a breach of fiduciary duty subject to entire fairness review. Coster argued further that even if the Stock Sale was technically legal, it was inequitable under *Schnell* and *Blasius*.

At trial, Chancellor McCormick concluded that the board’s actions were entirely fair and held that, having satisfied “Delaware’s most onerous standard of review,” the board’s motives were “beside the point.” *Coster v. UIP Cos.*, 2020 WL 429906, at *13-14 (Del. Ch. Jan. 28, 2020).

On appeal, the Delaware Supreme Court reversed. Though the Supreme Court upheld the finding of entire fairness, drawing from *Schnell* the court remanded for a consideration of “the board’s

motivations and purposes for the Stock Sale.” The court stated:

Under Delaware law, “director action[s] [are] ‘twice-tested,’ first for legal authorization, and second [for] equity.” “Stockholders can entrust directors with broad legal authority precisely because they know that that authority must be exercised consistently with equitable principles of fiduciary duty.”

Coster v. UIP Cos., 255 A.3d 952, 960 (Del. 2021) (quoting *Bäcker v. Palisades Growth Capital II, L.P.*, 246 A.3d 81, 96-97 (Del. 2021)).

Furthermore, because the Stock Sale interfered with Coster’s voting rights, under *Blasius*, even if the board acted in good faith, if the board had the “primary purpose of thwarting” Coster’s vote or reducing her leverage as an equal stockholder, the board must show a “compelling justification” for its actions.

On remand, the Chancellor first reviewed whether the Stock Sale was inequitable under *Schnell*. The Chancellor held that in the context of stockholder-franchise challenges, *Schnell* only bars director conduct where the directors had “no good faith basis for approving the disenfranchising action.” 2022 WL 1299127, at *9. The Chancellor concluded that the factual record showed the board’s decision “did not totally lack a good faith basis,” withstanding *Schnell*. Id. at *10.

The court then applied *Blasius*. The court found that the Stock Sale had the primary purpose of mooted Coster’s leverage as an equal stockholder, thereby triggering *Blasius*, but the UIP board had demonstrated a “compelling justification”—avoidance of an existential threat to the corporation

and the retention of an essential employee—and that their actions were properly tailored.

‘Bray v. Katz’: The Board May Not Decide Board Composition in Place of Stockholders. A recent oral opinion from the Court of Chancery presents “a perfect example of the principle articulated in *Schnell*.” *Bray v. Katz*, No. 2022-0489-LWW, transcript opinion, at 25-26 (Del. Ch. June 24, 2022). In *Bray*, a majority of the board of UpHealth had amended the bylaws during a contentious election contest to lower the quorum requirement for stockholder meetings (the “Quorum Amendment”). The purpose of the Quorum Amendment was to prevent a group of stockholders holding 50.3% of the vote from blocking a quorum at the the annual meeting and thereby preventing a vote that would have elected the board’s slate.

Vice Chancellor Will found, at the preliminary injunction stage, that the Quorum Amendment, although legally permissible, was nonetheless inequitable. The court first clarified the standard of review, and held that because the stockholder franchise is affected, the court will first apply *Blasius*; if defendants satisfy *Blasius*, the court would analyze the board’s actions under the *Unocal* “reasonableness” test.

The court found that the Quorum Amendment was primarily intended to interfere with the stockholder franchise, and that the board lacked a compelling justification for doing so. The UpHealth board’s first justification—to prevent the stockholder plaintiffs from introducing their own bylaw amendment—was insufficient. Its second purported

justification—to prevent the plaintiffs from impeding the annual meeting—also failed, because a compelling justification “cannot be that the board wants to make the decision for stockholders on who should be elected.” Tr. at 29. Rather, the decision whether to vote shares or attend a stockholder meeting rests with stockholders. By undercutting the stockholder group’s ability to prevent a quorum, the board had improperly supplanted its own judgment for that of the stockholders.

In reaching its decision, the court invoked *Schnell*’s timeless principle—“that an action is legally authorized does not necessarily mean that it is equitable,” Tr. at 25-26—and preliminarily enjoined the annual meeting.

Conclusion

These recent holdings confirm that regardless of the standard of review applied, that does not end the inquiry for review of board conduct. Rather, Delaware mandates that director actions be “twice-tested” for equitable fairness; and where a board acts for the primary purpose of hindering the stockholder franchise, to determine whether the board had a compelling reason for doing so. If the board fails either level of review, its actions must be undone.

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