Mercier v. Inter-Tel and the Reformulation of the *Blasius* Standard

*By Andrew Carriker**

On August 14, 2007, the Delaware Court of Chancery decided *Mercier v. Inter-Tel, Inc*.[1] One of the more interesting conclusions the court delivered was that the *Blasius* standard should be reformulated "as a genuine standard of review that is useful for the determination of cases, rather than as an after-the-fact label placed on a result."[2] "Such a reformulation," the court said, "would be consistent with prior decisions recognizing the substantial overlap between and redundancy of the *Blasius* and *Unocal* standards, and would have the added benefit of creating a less prolix list of standards of review."[3]

The *Blasius* standard is applied to the action of a board of directors taken "for the primary purpose of thwarting the exercise of a shareholder vote."[4] Even if the board's action is taken in subjective good faith, the board must show that it had a "compelling justification" to take the challenged action.[5] Members of Delaware's judiciary, including Vice Chancellor Strine, who authored the opinion in *Mercier*, have questioned whether a *Blasius* standard need exist at all, when existing standards, particularly the *Unocal* standard, seem to be sufficient for cases that would otherwise be reviewed under *Blasius*.[6] In *Mercier*, the Delaware Court of Chancery attempts to place the *Blasius* standard in the context of the *Unocal* standard.

Facts in *Mercier*

Inter-Tel had been courted by potential buyers since 2005, and since that time a special committee of independent directors had been formed to consider the various proposals the company was receiving. By fall 2006, Inter-Tel's former chief executive officer, Steven G. Mihaylo, the owner of 19% of the company's stock and a private equity partner, had withdrawn an offer to purchase all of the company's stock at $23.25 per share, after Inter-Tel's stockholders voted against a resolution calling on the company's board of directors to sell the company in an auction. In spring 2007, however, Inter-Tel announced that its board had approved a merger agreement with Mitel Networks Corporation at $25.60 per share. The merger agreement contained a no-shop provision that was subject to a "fiduciary out" permitting the board of Inter-Tel to consider an unsolicited alternative proposal that was reasonably likely to lead to a superior proposal.

On June 4, 2007, Mihaylo proposed a transaction in which the company would use a combination of cash on hand and new debt to acquire up to 60% of its own shares at a price of $28 per share. Mihaylo believed that, based on the corporation's expected earnings, Inter-Tel's remaining shares would trade at almost $30 per share. The court refers to this proposed transaction as the "Recap Proposal." Four days later, Mihaylo disclosed his intention to seek control of the board at the next annual meeting if the company's merger with Mitel were to be defeated.

In the weeks preceding the special meeting, major stockholders showed a preference for the Recap Proposal, even though Inter-Tel's special committee tried to explain to stockholders that the Recap Proposal was flawed and that it recommended instead the merger with Mitel. After Institutional Shareholder Services ("ISS") recommended that stockholders vote against the merger and Mitel refused to increase its offer, the special committee realized that if the special meeting were held, the merger, and an adjournment of the meeting to seek the votes required to approve the merger, would almost certainly be defeated.

The special committee then began to consider postponing the meeting. According to the court, the special committee reviewed a number of factors that might occur if the meeting were delayed, including whether the electorate would more closely reflect the actual ownership of the company's shares as of the time of the vote and whether arbitrageurs would buy additional shares that they would be likely to vote in favor of the merger. In addition, the special committee considered whether stockholders would be more inclined to approve the merger because Inter-Tel's earnings were down in its most recent fiscal quarter (and thus Inter-Tel was becoming a less desirable investment to potential buyers) and credit markets were tightening.

On June 29, 2007, before the meeting scheduled for that day had commenced, the special committee postponed the meeting. On July 6, 2007, Inter-Tel announced preliminary results for its second fiscal quarter and disclosed that those results had fallen short of the projections contained in the company's merger proxy statement. That same day, the company also stated that it expected its results for the full fiscal year 2007 to be well below previous estimates.

ISS later reversed its position and recommended that stockholders approve the merger, and shortly thereafter Mihaylo withdrew his Recap Proposal. At the meeting on August 2, 2007, over 87% of Inter-Tel's outstanding shares were voted, of which almost 72% voted to approve the merger. Of the shares not controlled by Mihaylo, more than 90% of the shares voted were in favor of the merger.

Standard of Review

The plaintiff stockholder sought review of the special committee's postponement of the meeting under the *Blasius* standard.[7] For its part, the special committee sought review of its actions under the business judgment rule.[8] The special committee relied particularly on *In re the MONY Group Inc. S'holder Litig*., a case in which the court declined to apply the *Blasius* standard and instead reviewed the defendant board's actions under the business judgment rule.[9]

The court instead applied "a reasonableness standard consistent with the *Unocal* standard."[10] Under this reasonableness standard, the court required that the board of directors of Inter-Tel (a) identify a "legitimate corporate objective," one that was

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"proper and not selfish," served by its decision to postpone the meeting and set a new record date and (b) show that the board's actions were "reasonable in relation to their legitimate objective" and "did not preclude the stockholders from exercising their right to vote or coerce them into voting a particular way."[11]

Why did the court hesitate to apply the *Blasius* standard? The court discussed four principal objections to use of the *Blasius* standard. First, the trigger for application of the *Blasius* standard, action by a board of directors that has as its primary purpose the disenfranchisement of stockholders, is itself a conclusion and not a method by which to arrive at a judicial determination.[12]

Second, the requirement that the board of directors show a "compelling justification" for its action is too stringent a standard. Even the Delaware Supreme Court has observed that the *Blasius* standard is so strict that it is "applied rarely."[13]

Third, the relationship of the *Blasius* standard to the *Unocal* standard is unclear.[14] Cases involving corporate elections often arise in the context of mergers and acquisitions, and, as a result, judges sometimes must consider whether to apply both the *Blasius* standard and the *Unocal* standard (or either one or the other standard). The court made noticeable reference to *MM Companies, Inc. v. Liquid Audio, Inc*. and *Chesapeake Corp. v. Shore*, two cases in which the respective courts suggested that an analysis under *Unocal* subsumed analysis under *Blasius*.[15] The court explained that the *Unocal* standard at the same time (a) implicitly requires directors to show that they acted for proper reasons (or, in other words, that they did not act for inequitable purposes) and so addresses concerns about the directors' fiduciary duties and (b) compels directors to identify their "legitimate objectives" and to explain their actions as necessary to advance those objectives.[16]

Fourth, while *Blasius* itself concerned the election of directors, certain passages in the opinion suggest that the court in *Blasius* believed its test ought to be applied in any case in which stockholders were allegedly disenfranchised of their voting rights.[17] The court cautioned that the reasoning in *Blasius* carried less force when the matter to be considered by stockholders had little or no bearing on whether directors would continue in office.[18]

But the court did apply the *Blasius* standard—it simply applied the standard in a modified form and in the context of *Unocal*. The court, for example, stated its conclusions with respect to the second prong of the reasonableness standard in the "compelling justification" language of *Blasius*.[19] By looking to the *Unocal* standard for the analytic tool with which to review the special committee's actions, however, the court reformulated the *Blasius* standard as a standard of review that was subsumed within a *Unocal* analysis and that was not an independent standard of judicial review. To the extent that *Mercier* reformulated the *Blasius* standard, perhaps the court may be said to have engaged in "doctrinal pruning" of the relationship between *Blasius* and *Unocal*.[20]

The court saw its analysis as consistent with *Unocal* and the "directional teaching" of such cases as *Liquid Audio*, *Chesapeake*, and *MONY*.[21] Vice Chancellor Strine further observed, "I do not believe that this test should be used as to director conduct not affecting either an election of directors or a vote touching on matters of corporate control. This test is a potent one that should not be used in garden variety situations, when more traditional tools are available to police self-dealing or improperly motivated director action."[22] In addition, Vice Chancellor Strine specifically rejected the idea that the reasonableness standard used in *Mercier* signalled any tolerance for the concept of "substantive coercion."[23]

Applying this reasonableness standard to the facts of the case, the court found that the special committee acted out of a good faith concern that the merger with Mitel was in the best interests of Inter-Tel's stockholders and that, if the special meeting were held as scheduled and the merger failed to gain approval, the advantages of the merger would be irretrievably lost.[24] After discussing the effects of changing the meeting's record date—primarily how moving the record date could allow arbitrageurs to buy additional shares at a price below the merger consideration—the court found that changing the record date "did not unfairly tilt the odds" against Mihaylo or any other stockholder who opposed the merger.[25] What determined the outcome of the meeting was that ISS and Inter-Tel's stockholders who held stock on both record dates came to view the merger "as the value-maximizing option."[26] Postponement of the meeting and the setting of a new record date, furthermore, neither precluded Inter-Tel's stockholders from freely choosing to reject the merger nor coerced those stockholders into approving the merger.[27] The court concluded its analysis by emphasizing that the "compelling justification" test originating in *Blasius* ought to be replaced in this case with a "legitimate objective" test. But, in deference to the authority of *Liquid Audio* and other cases that "seem to give continuing life to the compelling justification usage," the court made an explicit determination that the special committee "demonstrated a compelling justification for its action, even if that standard applies."[28]

Portnoy v. Cryo-Cell

Whether *Mercier's* reformulation of the *Blasius* standard becomes widely adopted by the judiciary in Delaware remains to be seen. Vice Chancellor Strine has, however, already had the opportunity to comment on the reformulated standard. In *Portnoy v. Cryo-Cell International, Inc*., stockholder David Portnoy proposed a rival slate of directors to that proposed by the management of Cryo-Cell International, Inc.[29] In the course of trying to have the management's slate of directors elected at the company's annual meeting of stockholders, the chief executive officer of Cryo-Cell, Mercedes Walton, entered into an agreement with stockholder Andrew Filipowski to add Filipowski to the board in exchange for his support of the management's slate of directors. Walton further agreed with Filipowski that, should management's slate be elected, Walton would ensure that the board be expanded and that a designee of Filipowski be added to the board. At the annual meeting, Walton extended the meeting until she was certain that the management's slate of directors had secured election, although she did not explain the delays to stockholders in attendance.

The court considered Portnoy's first claim, that Walton and the other incumbent directors of Cryo-Cell violated their fiduciary duties when Walton agreed with Filipowski to provide

a seat on the company's board in exchange for Filipowski's support of management's slate of directors, to be a charge of "vote buying" and applied the analysis of *Schreiber v. Carney*.[30] The court noted that the "method for addressing behavior influencing the conduct of a corporate election" that was used in *Mercier* resembled the *Schreiber* test. In both tests, the initial question was whether the board acted with proper motivation. With regard to the second step in each test, the court suggested that the standard in *Mercier* (whether the board's actions were reasonable in relation to their legitimate objective) was more useful than the test of entire fairness in Schreiber.[31]

Portnoy's final complaint was that Walton acted inequitably in her conduct of the annual meeting.[32] In finding that Walton improperly delayed during the meeting without being honest about why she was stalling, the court cited *Mercier* for the test that requires a showing that Walton's actions were "motivated by a good faith concern for the stockholders' best interests, and not by a desire to entrench [herself]."[33] The court distinguished the case at hand, which involved "an actual election of directors, in which the insiders delay because they believe the stockholders are making a mistake in choosing new leadership," from the circumstances presented in *Mercier*.[34] Rather than reverse the election altogether, however, the court ordered that the company promptly hold a special meeting at which a new election would be held and presided over by a special master.[35]

CONCLUSION

The court in *Mercier* presents a somewhat circumscribed holding.[36] Its discussion of the relationship between the *Blasius* standard and the *Unocal* standard, however, represents a significant contribution to the Delaware courts' struggle (as Vice Chancellor Strine characterizes it in *Chesapeake*) to place the *Blasius* standard within the framework of a *Unocal* analysis, when *Unocal* would otherwise govern.[37] Even as the court acknowledges that it is bound by precedent to speak in the language of *Blasius*, the court's reformulation of *Blasius* reflects its dissatisfaction with a broad application of that standard and its preference for the *Unocal* standard of review.

Endnotes

1 929 A.2d 786 (Del. Ch. 2007).

2 *Mercier*, 929 A.2d at 788.

3 *Id.*

4 Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651, 660, 662 (Del. Ch. 1988).

5 *Blasius*, 564 A.2d at 661.

6 William T. Allen, et al., *Function over Form: a Reassessment of Standards of Review in Delaware Corporate Law*, 56 Bus. Law. 1287, 1311-1316 (2001). *See also, e.g.*, Chesapeake Corp. v. Shore, 771 A.2d 293, 323 (Del. Ch. 2000) ("Given this interrelationship [*sc*. between *Blasius* and *Unocal*] and the continued vitality of *Schnell v. Chris-Craft*, one might reasonably question to what extent the *Blasius* 'compelling justification' standard of review is necessary as a lens independent of or to be used within the *Unocal* frame.").

The *Unocal* standard of review derives from *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), as interpreted by *Unitrin, Inc. v. American General Corp.*, 651 A.2d 1361 (Del. 1995), and requires that, if the board of directors of a target company takes defensive measures in the face of an unsolicited bid for control, the board must have reasonably perceived that the proposed takeover was a threat to the corporation's effectiveness and policy, and the board's defensive measures must have been reasonable in response to the threat, any defensive measure that precludes or coerces stockholder choice being unreasonable.

7 *Mercier*, 929 A.2d at 804-05.

8 *Id.* at 805. The business judgment rule is "a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

9 853 A.2d 661 (Del. Ch. 2004). In *MONY*, the board of directors had postponed a meeting at which stockholders were to vote on a proposed merger. The board had postponed the meeting so that stockholders could be provided additional information and so that the electorate would more closely reflect the actual ownership of the company's stock. The directors were disinterested in the transaction (they would lose their seats on the board if the merger were completed), and the postponement had no preclusive or coercive effect and did not disenfranchise stockholders of their voting rights.

10 *Mercier*, 929 A.2d at 810.

11 *Id.* at 810-11.

12 *Id.* at 806.

13 *Id.* at 806 (citing Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996)).

14 *Id.* at 806-07.

15 *See* MM Cos., Inc. v. Liquid Auto, Inc., 813 A.2d 1118, 1131 (Del. 2003) ("This case presents a paragon of when the compelling justification standard of *Blasius* must be applied within *Unocal*'s requirement that any defensive measure be proportionate or reasonable to the threat posed."); *Chesapeake*, 771 A.2d at 323 ("If *Unocal* is applied by the court with a gimlet eye out for inequitably motivated electoral manipulations or for subjectively well-intentioned board action that has preclusive or coercive effects, the need for an additional standard of review is lessened.").

16 *Mercier*, 929 A.2d at 806-08.

17 *Id.* at 808-09; *Blasius*, 564 A.2d at 660 ("[A] decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That is, of course, true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority.").

18 *Mercier*, 929 A.2d at 808.

19 *Id.* at 788 ("Recognizing, however, that the Supreme Court's recent decision in *Liquid Audio* continued to employ the 'compelling justification' language of *Blasius* within the context of an appropriate *Unocal* review of director conduct that affects a corporate election touching on corporate control, I also find that directors fearing that stockholders are about to make an unwise decision that poses the threat that the stockholders will irrevocably lose a unique opportunity to receive a premium for their shares have a compelling justification—the protection of their stockholders' financial best interests—for a short postponement in the merger voting process to allow more time for deliberation.") and 813 ("I will apply the analysis I have outlined, which I believe is consistent with the direction the teaching in *Liquid Audio* logically leads, but will also expressly set forth whether I conclude that the Inter-Tel Special Committee has demonstrated a compelling justification for its actions.").

20 Allen et al., *supra* note 6, at 1311. Allen et al. further suggest that the *Blasius* standard be eliminated altogether "as a 'stand-alone' review doctrine." *Id.* at 1312.

21 *Mercier*, 929 A.2d at 788, 810.

22 *Id.* at 811.

23 *Id.* at 811 (citing Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 n.17 (Del. 1989)). The court in *Paramount* refers to "substantive coercion" as one category of threat that "some commentators" have suggested is

posed by a hostile offer. "Substantive coercion" is "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value." *Paramount*, 571 A.2d at 1153 n.17 (citing Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus. Law., 247, 267 (1989)).

24 *Mercier*, 929 A.2d at 813. The court noted that the special committee did not act "perfectly," however. *Id*. at 814. Elsewhere in the opinion, for example, Vice Chancellor Strine stated that he was "troubled" by the special committee's failure to disclose that, had the meeting occurred as scheduled, the merger would almost certainly have been rejected and that one factor in setting a new record date was that it would enable arbitrageurs to make additional purchases of Inter-Tel's stock that could be voted at the special meeting. *Id*. at 819-20.

25 *Id.* at 816.

26 *Id.* at 817.

27 *Id.* at 817-18.

28 *Id.* at 818-19. The court continued, "In the corporate context, compelling circumstances are presented when independent directors believe that: (1) stockholders are about to reject a third-party merger proposal that the independent directors believe is in their best interests; (2) information useful to the stockholders' decision-making process has not been considered adequately or not yet been publicly disclosed; and (3) if the stockholders vote no, the acquiror will walk away without making a higher bid and that the opportunity to receive the bid will be irretrievably lost."

29 940 A.2d 43 (Del.Ch. 2008).

30 *Id*. at 66 (citing Schreiber v. Carney, 447 A.2d 17, 25-26 (Del Ch. 1982)). Under *Schreiber*, if the plaintiff can show that the object or purpose of the action was to defraud or in some way disenfranchise other stockholders, the arrangement is illegal per se. Even if the arrangement is not found to have been motivated by fraudulent, disenfranchising, or otherwise inequitable intent, the arrangement is a voidable transaction subject to a test for intrinsic fairness.

31 *Cryo-Cell*, 940 A.2d at 70 n.167.

32 *Id.* at 76.

33 *Id.* at 77 (citing *Mercier*, 929 A.2d at 807).

34 *Id.* at 78 n. 188 (citations omitted):

> In a recent decision, this court held that directors had not breached their fiduciary duty by postponing a vote on an arms-length merger before a meeting was convened. The directors believed that they would lose the vote if it was held that day but had reason to believe that stockholder sentiment was changing, especially in view of changes in the economy's credit markets. A delay ensued during which it was clear to both sides that they needed to continue to press their case, pro and con the merger. As noted in that decision, when directors advocate an affirmative vote on a transaction, they are supposed to do so because they believe in good faith that the transaction will benefit the stockholders. That context is importantly distinct from an actual election of directors, in which the insiders delay because they believe the stockholders are making a mistake in choosing new leadership. In the former case, directors who face no risk of removal are asking for more time to make their case that a non-self-dealing transaction should receive approval. In the latter case, the directors are trying to insulate themselves from ouster, by forcing the insurgents to continue the fight beyond when the election was supposed to be held.

35 *Id.* at 82.

36 *Mercier*, 929 A.2d at 787:

> I conclude that well-motivated, independent directors may reschedule an imminent special meeting at which the stockholders are to consider an all cash, all shares offer from a third-party acquiror when the directors: (1) believe that the merger is in the best interests of the stockholders; (2) know that if the meeting proceeds the stockholders will vote down the merger; (3) reasonably fear that in the wake of the merger's rejection, the acquiror will walk away from the deal and the corporation's stock price will plummet; (4) want more time to communicate with and provide information to the stockholders before the stockholders vote on the merger and risk the irrevocable loss of the pending offer; and (5) reschedule the meeting within a reasonable time period and do not preclude or coerce the stockholders from freely deciding to reject the merger.

37 *Chesapeake*, 771 A.2d at 317.