

Blasius Industries, Inc. v. Atlas Corp. [Short Version]

564 A.2d 651(1988)

Two cases pitting the directors of Atlas Corporation against that company's largest (9.1%) shareholder, Blasius Industries, have been consolidated and tried together. Together, these cases ultimately require the court to determine who is entitled to sit on Atlas' board of directors. Each, however, presents discrete and important legal issues. [Note: In this short version, I edited out the second case.]

The first of the cases was filed on December 30, 1987. As amended, it challenges the validity of board action taken at a telephone meeting of December 31, 1987 that added two new members to Atlas' seven member board. That action was taken as an immediate response to the delivery to Atlas by Blasius the previous day of a form of stockholder consent that, if joined in by holders of a majority of Atlas' stock, would have increased the board of Atlas from seven to fifteen members and would have elected eight new members nominated by Blasius.

[...]

[Factual Background]

Blasius Acquires a 9% Stake in Atlas.

Blasius is a new stockholder of Atlas. It began to accumulate Atlas shares for the first time in July, 1987. On October 29, it filed a Schedule 13D with the Securities Exchange Commission disclosing that, with affiliates, it then owed 9.1% of Atlas' common stock. It stated in that filing that it intended to encourage management of Atlas to consider a restructuring of the Company or other transaction to enhance shareholder values. It also disclosed that Blasius was exploring the feasibility of obtaining control of Atlas, including instituting a tender offer or seeking "appropriate" representation on the Atlas board of directors.

Blasius has recently come under the control of two individuals, Michael Lubin and Warren Delano, who after experience in the commercial banking industry, had, for a short time, run a venture capital operation for a small investment banking firm. Now on their own, they apparently came to control Blasius with the assistance of Drexel Burnham's well noted junk bond mechanism. Since then, they have made several attempts to effect leveraged buyouts, but without success.

In May, 1987, with Drexel Burnham serving as underwriter, Lubin and Delano caused Blasius to raise \$60 million through the sale of junk bonds. A portion of these funds were used to acquire a 9% position in Atlas. According to its public filings with the SEC, Blasius' debt service obligations arising out of the sale of the junk bonds are such that it is unable to service those obligations from its income from operations.

The prospect of Messrs. Lubin and Delano involving themselves in Atlas' affairs, was not a development welcomed by Atlas' management. Atlas had a new CEO, defendant Weaver, who had, over the course of the past year or so, overseen a business restructuring of a sort. Atlas had sold three of its five divisions. It had just announced (September 1, 1987) that it would close its once important domestic uranium

operation. The goal was to focus the Company on its gold mining business. By October, 1987, the structural changes to do this had been largely accomplished. Mr. Weaver was perhaps thinking that the restructuring that had occurred should be given a chance to produce benefit before another restructuring (such as Blasius had alluded to in its Schedule 13D filing) was attempted, when he wrote in his diary on October 30, 1987:

13D by Delano & Lubin came in today. Had long conversation w/MAH & Mark Golden [of Goldman, Sachs] on issue. All agree we must dilute these people down by the acquisition of another Co. w/stock, or merger or something else.

The Blasius Proposal of A Leverage Recapitalization Or Sale.

Immediately after filing its 13D on October 29, Blasius' representatives sought a meeting with the Atlas management. Atlas dragged its feet. A meeting was arranged for December 2, 1987 following the regular meeting of the Atlas board. Attending that meeting were Messrs. Lubin and Delano for Blasius, and, for Atlas, Messrs. Weaver, Devaney (Atlas' CFO), Masinter (legal counsel and director) and Czajkowski (a representative of Atlas' investment banker, Goldman Sachs).

At that meeting, Messrs. Lubin and Delano suggested that Atlas engage in a leveraged restructuring and distribute cash to shareholders. In such a transaction, which is by this date a commonplace form of transaction, a corporation typically raises cash by sale of assets and significant borrowings and makes a large one time cash distribution to shareholders. The shareholders are typically left with cash and an equity interest in a smaller, more highly leveraged enterprise. Lubin and Delano gave the outline of a leveraged recapitalization for Atlas as they saw it.

Immediately following the meeting, the Atlas representatives expressed among themselves an initial reaction that the proposal was infeasible. On December 7, Mr. Lubin sent a letter detailing the proposal. [...]

Atlas Asks Its Investment Banker to Study the Proposal.

This written proposal was distributed to the Atlas board on December 9 and Goldman Sachs was directed to review and analyze it.

The proposal met with a cool reception from management. On December 9, Mr. Weaver issued a press release expressing surprise that Blasius would suggest using debt to accomplish what he characterized as a substantial liquidation of Atlas at a time when Atlas' future prospects were promising. He noted that the Blasius proposal recommended that Atlas incur a high debt burden in order to pay a substantial one time dividend consisting of \$35 million in cash and \$125 million in subordinated debentures. Mr. Weaver also questioned the wisdom of incurring an enormous debt burden amidst the uncertainty in the financial markets that existed in the aftermath of the October crash.

Blasius attempted on December 14 and December 22 to arrange a further meeting with the Atlas management without success. During this period, Atlas provided Goldman Sachs with projections for

the Company. Lubin was told that a further meeting would await completion of Goldman's analysis. A meeting after the first of the year was proposed.

The Delivery of Blasius' Consent Statement.

On December 30, 1987, Blasius caused Cede & Co. (the registered owner of its Atlas stock) to deliver to Atlas a signed written consent (1) adopting a precatory resolution recommending that the board develop and implement a restructuring proposal, (2) amending the Atlas bylaws to, among other things, expand the size of the board from seven to fifteen members-the maximum number under Atlas' charter, and (3) electing eight named persons to fill the new directorships. Blasius also filed suit that day in this court seeking a declaration that certain bylaws adopted by the board on September 1, 1987 acted as an unlawful restraint on the shareholders' right, created by Section 228 of our corporation statute, to act through consent without undergoing a meeting.

The reaction was immediate. Mr. Weaver conferred with Mr. Masinter, the Company's outside counsel and a director, who viewed the consent as an attempt to take control of the Company. They decided to call an emergency meeting of the board, even though a regularly scheduled meeting was to occur only one week hence, on January 6, 1988. The point of the emergency meeting was to act on their conclusion (or to seek to have the board act on their conclusion) "that we should add at least one and probably two directors to the board ...". A quorum of directors, however, could not be arranged for a telephone meeting that day. A telephone meeting was held the next day. At that meeting, the board voted to amend the bylaws to increase the size of the board from seven to nine and appointed John M. Devaney and Harry J. Winters, Jr. to fill those newly created positions. Atlas' Certificate of Incorporation creates staggered terms for directors; the terms to which Messrs. Devaney and Winters were appointed would expire in 1988 and 1990, respectively.

The Motivation of the Incumbent Board In Expanding the Board and Appointing New Members.

In increasing the size of Atlas' board by two and filling the newly created positions, the members of the board realized that they were thereby precluding the holders of a majority of the Company's shares from placing a majority of new directors on the board through Blasius' consent solicitation, should they want to do so. Indeed the evidence establishes that that was the principal motivation in so acting.

The conclusion that, in creating two new board positions on December 31 and electing Messrs. Devaney and Winters to fill those positions the board was principally motivated to prevent or delay the shareholders from possibly placing a majority of new members on the board, is critical to my analysis of the central issue posed by the first filed of the two pending cases. If the board in fact was not so motivated, but rather had taken action completely independently of the consent solicitation, which merely had an incidental impact upon the possible effectuation of any action authorized by the shareholders, it is very unlikely that such action would be subject to judicial nullification. The board, as a general matter, is under no fiduciary obligation to suspend its active management of the firm while the consent solicitation process goes forward.

There is testimony in the record to support the proposition that, in acting on December 31, the board was principally motivated simply to implement a plan to expand the Atlas board that preexisted the September, 1987 emergence of Blasius as an active shareholder. I have no doubt that the addition of Mr. Winters, an expert in mining economics, and Mr. Devaney, a financial expert employed by the Company, strengthened the Atlas board and, should anyone ever have reason to review the wisdom of those choices, they would be found to be sensible and prudent. I cannot conclude, however, that the strengthening of the board by the addition of these men was the principal motive for the December 31 action. [...] [Court discusses the evidence that leads to this conclusion]

The timing of these events is, in my opinion, consistent only with the conclusion that Mr. Weaver and Mr. Masinter originated, and the board immediately endorsed, the notion of adding these competent, friendly individuals to the board, not because the board felt an urgent need to get them on the board immediately for reasons relating to the operations of Atlas' business, but because to do so would, for the moment, preclude a majority of shareholders from electing eight new board members selected by Blasius. As explained below, I conclude that, in so acting, the board was not selfishly motivated simply to retain power.

There was no discussion at the December 31 meeting of the feasibility or wisdom of the Blasius restructuring proposal. While several of the directors had an initial impression that the plan was not feasible and, if implemented, would likely result in the eventual liquidation of the Company, they had not yet focused upon and acted on that subject. Goldman Sachs had not yet made its report, which was scheduled to be given January 6.

The January 6 Rejection of the Blasius Proposal.

On January 6, the board convened for its scheduled meeting. At that time, it heard a full report from its financial advisor concerning the feasibility of the Blasius restructuring proposal. [...]

After completing that presentation, Goldman Sachs concluded with its view that if Atlas implemented the Blasius restructuring proposal (i) a severe drain on operating cash flow would result, (ii) Atlas would be unable to service its long-term debt and could end up in bankruptcy, (iii) the common stock of Atlas would have little or no value, and (iv) since Atlas would be unable to generate sufficient cash to service its debt, the debentures contemplated to be issued in the proposed restructuring could have a value of only 20% to 30% of their face amount. Goldman Sachs also said that it knew of no financial restructuring that had been undertaken by a company where the company had no chance of repaying its debt, which, in its judgment, would be Atlas' situation if it implemented the Blasius restructuring proposal. Finally, Goldman Sachs noted that if Atlas made a meaningful commercial discovery of gold after implementation of the Blasius restructuring proposal, Atlas would not have the resources to develop the discovery.

The board then voted to reject the Blasius proposal. [...]

[... **Legal Analysis**]

Plaintiff attacks the December 31 board action as a selfishly motivated effort to protect the incumbent board from a perceived threat to its control of Atlas. [...] The December 31 action is also said to have been taken in a grossly negligent manner, since it was designed to preclude the recapitalization from being pursued, and the board had no basis at that time to make a prudent determination about the wisdom of that proposal, nor was there any emergency that required it to act in any respect regarding that proposal before putting itself in a position to do so advisedly.

Defendants, of course, contest every aspect of plaintiffs' claims. They claim the formidable protections of the business judgment rule. [...] They say that, in creating two new board positions and filling them on December 31, they acted without a conflicting interest (since the Blasius proposal did not, in any event, challenge *their* places on the board), they acted with due care (since they well knew the persons they put on the board and did not thereby preclude later consideration of the recapitalization), and they acted in good faith (since they were motivated, they say, to protect the shareholders from the threat of having an impractical, indeed a dangerous, recapitalization program foisted upon them). Accordingly, defendants assert there is no basis to conclude that their December 31 action constituted any violation of the duty of the fidelity that a director owes by reason of his office to the corporation and its shareholders.

[...]

One of the principal thrusts of plaintiffs' argument is that, in acting to appoint two additional persons of their own selection, including an officer of the Company, to the board, defendants were motivated not by any view that Atlas' interest (or those of its shareholders) required that action, but rather they were motivated improperly, by selfish concern to maintain their collective control over the Company. That is, plaintiffs say that the evidence shows there was no policy dispute or issue that really motivated this action, but that asserted policy differences were pretexts for entrenchment for selfish reasons. If this were found to be factually true, one would not need to inquire further. The action taken would constitute a breach of duty.

In support of this view, plaintiffs point to the early diary entry of Mr. Weaver, to the lack of any consideration at all of the Blasius recapitalization proposal at the December 31 meeting, the lack of any substantial basis for the outside directors to have had any considered view on the subject by that time-not having had any view from Goldman Sachs nor seen the financial data that it regarded as necessary to evaluate the proposal-and upon what it urges is the grievously flawed, slanted analysis that Goldman Sachs finally did present.

While I am satisfied that the evidence is powerful, indeed compelling, that the board was chiefly motivated on December 31 to forestall or preclude the possibility that a majority of shareholders might place on the Atlas board eight new members sympathetic to the Blasius proposal, it is less clear with respect to the more subtle motivational question: whether the existing members of the board did so because they held a good faith belief that such shareholder action would be self-injurious and shareholders needed to be protected from their own judgment.

On balance, I cannot conclude that the board was acting out of a self-interested motive in any important respect on December 31. I conclude rather that the board saw the “threat” of the Blasius recapitalization proposal as posing vital policy differences between itself and Blasius. It acted, I conclude, in a good faith effort to protect its incumbency, not selfishly, but in order to thwart implementation of the recapitalization that it feared, reasonably, would cause great injury to the Company.

The real question the case presents, to my mind, is whether, in these circumstances, the board, even if it *is* acting with subjective good faith (which will typically, if not always, be a contestable or debatable judicial conclusion), may validly act for the principal purpose of preventing the shareholders from electing a majority of new directors. [...]

It is established in our law that a board may take certain steps—such as the purchase by the corporation of its own stock—that have the effect of defeating a threatened change in corporate control, when those steps are taken advisedly, in good faith pursuit of a corporate interest, and are reasonable in relation to a threat to legitimate corporate interests posed by the proposed change in control. Does this rule—that the reasonable exercise of good faith and due care generally validates, in equity, the exercise of legal authority even if the act has an entrenchment effect—apply to action designed for the primary purpose of interfering with the effectiveness of a stockholder vote? Our authorities, as well as sound principles, suggest that the central importance of the franchise to the scheme of corporate governance, requires that, in this setting, that rule not be applied and that closer scrutiny be accorded to such transaction.

1. *Why the deferential business judgment rule does not apply to board acts taken for the primary purpose of interfering with a stockholder's vote, even if taken advisedly and in good faith.*

A. *The question of legitimacy.*

The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. Generally, shareholders have only two protections against perceived inadequate business performance. They may sell their stock (which, if done in sufficient numbers, may so affect security prices as to create an incentive for altered managerial performance), or they may vote to replace incumbent board members.

It has, for a long time, been conventional to dismiss the stockholder vote as a vestige or ritual of little practical importance. It may be that we are now witnessing the emergence of new institutional voices and arrangements that will make the stockholder vote a less predictable affair than it has been. Be that as it may, however, whether the vote is seen functionally as an unimportant formalism, or as an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve consideration not present in any other context in which directors exercise delegated power.

B. *Questions of this type raise issues of the allocation of authority as between the board and the shareholders.*

The distinctive nature of the shareholder franchise context also appears when the matter is viewed from a less generalized, doctrinal point of view. From this point of view, as well, it appears that the ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, 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, of course, is 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. A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of *the corporation's power* over its property, or with respect to *its* rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation. [...]

2. *What rule does apply: per se invalidity of corporate acts intended primarily to thwart effective exercise of the franchise or is there an intermediate standard?*

Plaintiff argues for a rule of *per se* invalidity once a plaintiff has established that a board has acted for the primary purpose of thwarting the exercise of a shareholder vote. [...]

A *per se* rule that would strike down, in equity, any board action taken for the primary purpose of interfering with the effectiveness of a corporate vote would have the advantage of relative clarity and predictability. It also has the advantage of most vigorously enforcing the concept of corporate democracy. The disadvantage it brings along is, of course, the disadvantage a *per se* rule always has: it may sweep too broadly.

In two recent cases dealing with shareholder votes, this court struck down board acts done for the primary purpose of impeding the exercise of stockholder voting power. In doing so, a *per se* rule was not applied. Rather, it was said that, in such a case, the board bears the heavy burden of demonstrating a compelling justification for such action.

In *Aprahamian v. HBO & Company*, the incumbent board had moved the date of the annual meeting on the eve of that meeting when it learned that a dissident stockholder group had or appeared to have in hand proxies representing a majority of the outstanding shares. The court restrained that action and compelled the meeting to occur as noticed, even though the board stated that it had good business reasons to move the meeting date forward, and that that action was recommended by a special committee. [...]

[Discussion of the second case was omitted]

In my view, our inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a shareholder vote, counsels against the adoption of a *per se* rule invalidating, in equity, every board action taken for the sole or primary purpose of thwarting a shareholder vote, even though I recognize the transcending significance of the franchise to the claims to legitimacy of our scheme of corporate governance. It may be that some set of facts would justify such extreme action. This, however, is not such a case.

3. Defendants have demonstrated no sufficient justification for the action of December 31 which was intended to prevent an unaffiliated majority of shareholders from effectively exercising their right to elect eight new directors.

The board was not faced with a coercive action taken by a powerful shareholder against the interests of a distinct shareholder constituency (such as a public minority). It was presented with a consent solicitation by a 9% shareholder. Moreover, here it had time (and understood that it had time) to inform the shareholders of its views on the merits of the proposal subject to stockholder vote. The only justification that can, in such a situation, be offered for the action taken is that the board knows better than do the shareholders what is in the corporation's best interest. While that premise is no doubt true for any number of matters, it is irrelevant (except insofar as the shareholders wish to be guided by the board's recommendation) when the question is who should comprise the board of directors. The theory of our corporation law confers power upon directors as the agents of the shareholders; it does not create Platonic masters. It may be that the Blasius restructuring proposal was or is unrealistic and would lead to injury to the corporation and its shareholders if pursued. Having heard the evidence, I am inclined to think it was not a sound proposal. The board certainly viewed it that way, and that view, held in good faith, entitled the board to take certain steps to evade the risk it perceived. It could, for example, expend corporate funds to inform shareholders and seek to bring them to a similar point of view. But there is a vast difference between expending corporate funds to inform the electorate and exercising power for the primary purpose of foreclosing effective shareholder action. A majority of the shareholders, who were not dominated in any respect, could view the matter differently than did the board. If they do, or did, they are entitled to employ the mechanisms provided by the corporation law and the Atlas certificate of incorporation to advance that view. They are also entitled, in my opinion, to restrain their agents, the board, from acting for the principal purpose of thwarting that action.

I therefore conclude that, even finding the action taken was taken in good faith, it constituted an unintended violation of the duty of loyalty that the board owed to the shareholders. [...]