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Bäcker v. Palisades Growth Capital II, LP: Corporate Coups, Deception, and Walking Away

The Delaware Supreme Court reminds us that if corporate directors engage in deception on their road to corporate control, they may never make it to their destination, and that sometimes the best defense is to leave the table.

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On January 15, 2021, the Supreme Court of Delaware issued a decision invalidating a "boardroom coup" when a father and son breached their fiduciary duties by "affirmatively deceiving" their fellow board member. *See Bäcker v. Palisades Growth Cap. II, L.P.*, 246 A.3d 81(Del. 2021). *Bäcker* reminds us that notwithstanding board members' adherence to the procedural requirements associated with conducting board business—as codified in statutes, bylaws and articles of incorporation—directors may still be held liable for breaching fiduciary duties if these procedures are deceptively employed.

The Coup

Alex Bäcker ("Alex") founded and originally served as the Chief Executive Officer of QLess, Inc. The QLess Board of Directors removed Alex from his CEO position following employee reports that he created a toxic work environment. While Alex no longer served as CEO, he was still the majority owner of QLess's common stock which controlled two board seats. Alex sat in one seat, and his father Richard Bäcker sat in the other. Plaintiff Palisades Growth Capital II, L.P. owned a majority of QLess's Series A preferred stock, and controlled one board seat, occupied by Palisades Growth Capital's Partner Jeff Anderson. The majority owner of the Company's Series A-1 preferred stock controlled one seat as well. QLess also had one independent board member. Therefore, in the midst of searching for a new CEO in September 2019, there were five QLess board members.

Collectively, the board members settled on Kevin Grauman as the new CEO and Grauman was scheduled to be installed during a November 15, 2019 board meeting. On September 30, the Series A-1 board member unexpectedly resigned and on the morning of November 14, QLess's independent board member resigned as well. These resignations whittled QLess's board down to the two Bäckers and Anderson, effectively giving the Bäckers majority control.

Before the November 15 board meeting, Alex affirmatively deceived his fellow board members by misrepresenting that he wanted Grauman to join the board, indicating that Grauman was performing well as the new CEO, and sending a number of communications which indicated that Grauman was already on the board. At the November 15 board meeting, however, the Bäckers unveiled their hidden agenda to *inter alia*, fire Grauman as CEO and re-hire Alex as CEO and CFO. Anderson attended the November 15 board meeting and upon learning of the Bäckers' scheme, remained at the meeting and dissented from every action proposed and passed by the Bäckers.

The Coup Thwarted

The Court of Chancery invalidated the board's actions at the November 15 meeting, explaining that "there must be some affirmative deception before equity will intervene; if the Bäckers had simply acted in secret to plot their coup d'etat without any affirmative action to mislead the other members of the Board, Plaintiff's call to equity would rest on softer ground." *Bäcker*, 246 A.3d at 93.

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The Supreme Court of Delaware upheld the Chancery Court's ruling noting that "inequitable action does not become permissible simply because it is legally possible." *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971). Under Delaware law, "director action[s] [are] 'twice-tested,' first for legal authorization, and second [for] equity." *In re Invs. Bancorp., Inc. S'holder Litig.*, 177 A.3d 1208, 1222 (Del. 2017) (quoting *Sample v. Morgan*, 914 A.2d 647, 672 (Del. Ch. 2007)).

Planning for the Next Coup

There are a number of take always from this decision:

1. This is just the latest example of the Delaware courts invalidating board actions due to inequity. *See Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1077-78 (Del. Ch. 2004) ("In general, there are two types of corporate law claims. The first is a legal claim, grounded in the argument that corporate action is improper because it violates a statute, the certificate of incorporation, a bylaw or other governing instrument, such as a contract. The second is an equitable claim, founded on the premise that the directors or officers have breached an equitable duty that they owe to the corporation and its stockholders."); *Adlerstein v. Wertheimer*, 2002 WL 205684, at *8–9 (Del. Ch. 2002) (invalidating a board action to terminate the CEO and issue stock to destroy the CEO's voting control, where the board members operated in secret to negotiate terms of the dilutive transaction while keeping the CEO deliberately uninformed); *Koch v. Stearn*, 1992 WL 181717, at *5 (Del. Ch. 1992) (invalidating board actions terminating a CEO where a fellow director tricked the CEO into attending a board meeting by circulating a special meeting notice that was silent with respect to considering the CEO's removal), *overruled on other grounds by Klaassen v. Allegro Dev. Corp.*, 106 A.3d 1035, 1047 (Del. 2014).

2. Defenses have to be raised at trial. The Bäckers raised a "participation defense" before the Supreme Court arguing that "notwithstanding any deceit that may have been involved in calling a meeting, the actions taken will not be invalidated where the deceived director remains at the meeting and participates throughout." *Bäcker*, 246 A.3d at 107. But the Supreme Court did not reach the merits of this participation defense, as the Bäckers did not raise it at the lower court. Had the Bäckers properly raised the participation defense at the Chancery Court, Palisades may not have prevailed because Anderson remained at the meeting after he realized he had been deceived.

3. The type of meeting may not matter. The Supreme Court also did not opine on whether the November 15 meeting was a regular meeting or a special meeting. While regular meetings typically do not require board members to receive notice of the meeting, special meetings typically do. *Klaassen*, 106 A.3d at 1043–44. Neither regular nor special meetings typically require notice of the meeting's purpose unless so specified in the bylaws. The Supreme Court found that when a board member employs affirmative deception to achieve quorum at a board meeting, it is immaterial whether the meeting is a regular meeting or a special meeting. The Court "disagree[ed] with the Bäcker's suggestion that equity provides no remedy where a director has the misfortune of being tricked into attending a regular, as opposed to special, board meeting." *Bäcker*, 246 A.3d at 106.

4. A claim for inequitably using deception to reach a quorum is likely available in other jurisdictions. "[U]nder Delaware law the duty of candor imposes an unremitting duty on fiduciaries, including directors . . . to 'not use superior information or knowledge to mislead others in the performance of their own fiduciary obligations.'" *City of Fort Myers Gen. Emp.s' Pension Fund v. Haley*, 235 A.3d 702, 718 (Del. 2020) (quoting *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1283 (Del. 1989)). Outside of Delaware, a majority of states have adopted the Model Business Corporations Act ("MBCA"), which alludes to this notion in its section on standards of conduct for directors. The MBCA notes that "[i]n discharging board . . . duties, a director shall disclose . . . to the other board . . . members information not already known by them but known by the director to be material to the discharge of their decision-making or oversight functions. . . ." *See* Model Bus. Corp. Act § 8.30(c).

Know When to Walk Away

What would have been the reasonably prudent course of action for Anderson upon realizing that the Bäckers had deceived him in order to reach a quorum? In hindsight, Anderson might have been better off to object to the meeting when he first

realized the Bäckers' deception, and then leave the meeting to avoid any "participation defense." Fortunately for Anderson, the Bäckers failed to timely raise the participation defense at the trial court.

The *Bäcker* decision thus confirms that when corporate fiduciaries seek to make a play for power, they must do so without deception. On the other hand, also *Bäcker* demonstrates that if you are the subject of this deception, the most powerful weapon you may have in your arsenal may be your decision to walk away.

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