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Chancery Court Declined to Apply Blasius "Compelling Justification" Standard in Sustaining Board's Rejection of Opposition Slate under "Commonplace" Advance Notice Bylaw

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CHANCERY COURT DECLINED TO APPLY *BLASIUS* "COMPELLING JUSTIFICATION" STANDARD IN SUSTAINING BOARD'S REJECTION OF OPPOSITION SLATE UNDER "COMMONPLACE" ADVANCE NOTICE BYLAW

Vice Chancellor instead applied equitable principles established in Schnell in determining that board afforded dissident stockholders a "fair opportunity" to nominate opposition candidates

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INTRODUCTION

Under § 141(a) of the Delaware General Corporation Law ("*DGCL*"), "the business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors . . . ." In light of this sweeping grant of authority to corporate boards, Delaware courts historically have zealously protected the stockholder franchise—long regarded as "sacrosanct"—and, in particular, the right of stockholders to nominate and vote for directors. For instance, in *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988) ("*Blasius*"), the Delaware Court of Chancery ("*Chancery Court*") famously opined that "[a]ction designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder . . . ." To account for this conflict, when the board acts "for the principal purpose of impeding the exercise of stockholder voting power," the board "bears the heavy burden of demonstrating a compelling justification for such action." Over time, this form of "enhanced scrutiny" has proved a difficult burden for incumbent boards to satisfy.

Stockholders seeking to challenge actions of an incumbent board of directors in connection with a corporate election contest are, therefore, well advised to ask the Chancery Court to invoke the *Blasius* standard of review. However, as noted by Vice Chancellor Joseph R. Slights III in *Rosenbaum v. CtyoDyn Inc.*, C.A. No. 2021-0728-JRS, 2021 WL 4775140 (Del. Ch. Oct. 13, 2021) ("*Rosenbaum*"):

> *Blasius* does not apply in all cases where a board of directors has interfered with a shareholder vote. . . . [C]ourts will apply the exacting *Blasius* standard sparingly, and only in circumstances in which self-interested or faithless fiduciaries act to deprive stockholders of a full and fair opportunity to participate in the matter.

In *Rosenbaum*, Vice Chancellor Slights was confronted with an election contest in which the incumbent board rejected an opposition slate due to failure by proponents to comply with a "commonplace" advance notice bylaw. The Vice Chancellor determined that, under the

facts before him, the limited circumstances calling for application of *Blasius* were not present.

This did not end the Vice Chancellor's inquiry. Rather than accepting the incumbent board's invocation of the deferential business judgment rule, the Vice Chancellor turned to the Delaware Supreme Court's iconic admonition in *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971) ("*Schnell*"), that "inequitable action does not become permissible simply because it is legally possible." Applying this oft-cited principle of equity, the Vice Chancellor observed that "[d]espite the limitations of *Blasius* . . . Delaware courts have reserved space for equity to address the inequitable *application* of even validly-enacted advance notice bylaws." In fact, "[i]t is emphatically the Court's duty to ensure that bylaws 'afford the shareholders a fair opportunity to nominate candidates.' " This in turn provides a dissident stockholder with the opportunity to demonstrate to the court the " 'compelling circumstances' that justify a finding of inequitable conduct."

Against this backdrop, Vice Chancellor Slights scrutinized the conduct of both the dissident stockholders and the incumbent board in connection with the election contest. While finding shortcomings on both sides, the Vice Chancellor concluded the board "afforded the shareholders a fair opportunity to nominate director candidates." On this basis, he denied the dissident stockholders' "request for declaratory and permanent, mandatory injunctive relief . . . ."

I. FACTUAL BACKGROUND

A. CytoDyn Adopts Advance Notice Bylaw

CytoDyn Inc. ("*CytoDyn*" or "*Company*") is a pharmaceutical firm "in the process of developing and commercializing a new drug . . . intended as a treatment for COVID-19, HIV and cancer." In 2018, CytoDyn stockholders adopted Amended and Restated Bylaws which included an advance notice provision ("*Advance Notice Bylaw*"). The Advance Notice Bylaw provided (in part) that a stockholder could nominate "persons for election to the Board of Directors" only by providing "Timely Notice" that included required disclosures concerning the nominating party and the nominees. In particular, the Advance Notice Bylaw required disclosures concerning (i) arrangements with other stockholders who may be supporting election of the nominating party's candidates and (ii) past and proposed future relationships between the nominating party and CytoDyn.

B. CytoDyn's "Complicated Relationship" with IncellDx

Until late May 2020, Dr. Bruce Patterson "served as a consultant for CytoDyn, providing assistance with certain assay tests relating to HIV and COVID-19." Dr. Patterson also was "the founder, Chief Executive Officer and director of" another company, IncellDx, Inc. ("*IncellDx*"). Together with his wife, Dr. Patterson "own[ed] approximately 33.04% of IncellDx." IncellDx itself was a CytoDyn stockholder.

On May 22, 2020, Dr. Patterson sent a proposal ("*Proposal*") to two members of CytoDyn's board of directors ("*Board*") providing that "CytoDyn would acquire IncellDx for as much as $350 million." The Proposal also contemplated that CytoDyn would hire Dr. Patterson upon completion of the transaction. Upon delivery of the Proposal, Dr. Patterson resigned his consultant position, while "express[ing] excitement regarding his future employment with CytoDyn." Ultimately, the Board rejected the Proposal.

Not long thereafter, Dr. Patterson filed a patent application on behalf of IncellDx with the United States Patent and Trademark Office for "methods for treating certain infections using means similar to" CytoDyn's developmental product. CytoDyn successfully challenged this move by blocking IncellDx's patent application.

C. The Proxy Contest

In March 2021, three CytoDyn stockholders ("*Proponents*"), two of whom had ties to IncellDx, began preparations for a proxy contest to replace certain incumbent members of the Board with a competing slate of nominees ("*Nominees*") at the 2021 Annual Meeting of Stockholders scheduled for October 28 ("*Annual Meeting*"). Proponents engaged in significant email correspondence with other CytoDyn stockholders, which included:

- advice for conducting a proxy contest in compliance with the Advance Notice Bylaw,
- "advocat[ing] for the 'reestablish[ment] [of] a robust cooperative, collaborative, and harmonious scientific and business relationship' between CytoDyn, Patterson and IncellDx,"
- criticizing "the lack of management experience" at CytoDyn, and
- recommending replacing certain Board members via a proxy contest with two candidates, including Dr. Patterson, who "once in place, '. . . would consider merging IncellDx with [CytoDyn] to help give [CytoDyn] immediate credi[bility] and the resources to get the drug approved.' "

Additional communications "solicit[ed] donations to pay for legal fees and advertising to support the effort, which donations would be held by" an entity newly-formed by Proponents, CCTV Proxy Group, LLC ("*CCTV*"), "to fund the proxy contest."

In the meantime, the Board took actions seemingly in preparation for Proponents' proxy contest. *First*, a new "independent" director was added to the Board. *Second*, the Board retained a stockholder who (i) "surreptitiously accessed emails among dissident stockholders and forwarded them to" CytoDyn's CEO, (ii) "attempted to sow discord among the dissident group," and (iii) "monitored Patterson's role in the proxy campaign and the general sentiments of the stockholders . . . ."

D. Nomination Notice Delivered; Litigation Ensues

On June 30, Proponents delivered a "222-page" nomination notice ("*Nomination Notice*") to CytoDyn, purportedly in compliance with the Advance Notice Bylaw, but just "one day before the deadline set by the Advance Notice Bylaw." Although the Board met to discuss the Nomination Notice on two occasions, it was not until July 30 that the Board responded with a letter ("*Deficiency Letter*") notifying Proponents of a variety of deficiencies in the Nomination Notice. Principal among the alleged deficiencies were lack of disclosure concerning (i) the existence and identity of supporters of the Nominees and the role of CCTV (collectively, "*Supporter Disclosure Deficiencies*"), and (ii) the Proposal, a potential future transaction between CytoDyn and IncellDx, Dr. Patterson's patent dispute with CytoDyn, and the intent to name Dr. Patterson as Chief Marketing Officer of CytoDyn (collectively, "*IncellDx Disclosure Deficiencies*").

On August 11, Proponents responded to the Deficiency Letter, both denying that the IncellDx Disclosure Deficiencies "were sufficiently material to require disclosure," and claiming that the Advance Notice Bylaw did not require disclosure of the Supporter Disclosure Deficiencies. Even so, Proponents' response "included a supplemental notice . . . containing additional information that purportedly cured any deficiencies and demonstrated their willingness to disclose all information needed to move forward with their nominees." The Board responded one week later, declaring that the supplemental notice "had not cured the deficiencies," and that Proponents "did not have the right to nominate any candidates . . . at the . . . Annual Meeting."

Litigation between CytoDyn and Proponents followed, with Proponents bringing an action in the Chancery Court on August 24 that sought "a declaration that the Company . . . wrongfully rejected the Nomination Notice and a mandatory injunction compelling the Company to allow [Proponents'] nominees to stand for election." Vice Chancellor Slights ultimately denied Proponents their requested relief, ruling that "[b]y a preponderance of the evidence, . . . [the] Nomination Notice was deficient and there is no basis in equity to excuse this deficiency."

II. THE VICE CHANCELLOR'S ANALYSIS

A. Framing the Issue

Early on in his analysis, Vice Chancellor Slights framed the precise issue before him. He noted that Proponents "wisely" were not challenging the original adoption of the Advance Notice Bylaw, inasmuch as it (i) "was adopted on the proverbial 'clear day' " long before Proponents began their proxy contest, (ii) was "parsed . . . carefully" by Proponents "before submitting their Nomination Notice," and (iii) "serve[s] an indisputably legitimate purpose." He also observed it was "wise" that Proponents did not challenge the reasonableness of the terms of the Advance Notice Bylaw, given that its terms "comport with bylaws our courts have characterized as 'commonplace.' " Rather, the Vice Chancellor explained, Proponents "instead focus on the Board's application of the Advance Notice Bylaw following [Proponents'] allegedly timely Nomination Notice."

B. Standard of Review

Before turning to the substance of the dispute, Vice Chancellor Slights tackled a familiar gating issue: selection of "the applicable standard of review" to govern his analysis. In this connection, the Vice Chancellor noted "a twist that suggests the law in this area may not be as settled as one would think, particularly given the density of our jurisprudence in the 'advance notice bylaw' space . . . ."

- For their part, Proponents urged a "*Blasius* review" inasmuch as "the Board has 'act[ed] for the primary purpose of preventing the effectiveness of a shareholder vote.' " Under this approach, "*Blasius* applies as the default standard whenever a board of directors deprives the stockholders of their right to elect directors through the wrongful enforcement of an advance notice bylaw."

- In response, the Board viewed the dispute as "nothing more than a straightforward 'contractual analysis,' arguing that since the bylaws represent a contract between the Company and its stockholders," Proponents "cannot achieve the remedy they seek because they have not performed the contract they seek to enforce." In support of this position, the Board cited the Delaware Supreme Court's declaration in *BlackRock Credit Allocation Income Trust v. Saba Capital Master Fund, Ltd.*, 224 A.3d 964 (Del. 2020), that "advance notice bylaws are commonplace and are interpreted using contractual principles." At most, the Board argued, application of "the deferential business judgment rule" would be appropriate.

Vice Chancellor Slights "reject[ed] both approaches":

- *First,* Vice Chancellor declined to apply *Blasius*, declaring that Proponents sought "to extend *Blasius* beyond its intended limits." Noting that *Blasius* is intended to be used only "sparingly," he explained that *Blasius* may not be invoked "in the absence of evidence that the Board's response was the product of 'manipulative conduct.' " While finding fault with some aspects of the Board's delayed response to the Nomination Notice, the Vice Chancellor did "not see adequate evidence of such conduct . . . to relieve [Proponents] of their burden to demonstrate compliance with the terms of the Advance Notice Bylaw."
- *Second,* while the Vice Chancellor agreed that the Advance Notice Bylaw was a contract to be interpreted as such, he found that the Board's invocation of business judgment rule protection "stretches basic propositions of our law too far." When it comes to an issue "regarding the most 'sacrosanct' of stockholder rights—voting power . . . . the board does not act simply as an arms-length contracting party; board members are fiduciaries and, in the context of an advance notice bylaw, they are fiduciaries confronting a structural and situational conflict."

Having rejected each party's preferred approach, Vice Chancellor Slights adopted an intermediate approach, recognizing that *Schnell* "reserved space for equity to address the inequitable *application* of even validly-enacted advance notice bylaws." Under this approach, "[t]he inquiry ultimately focuses on whether the by-law, *as applied in these circumstances*, has afforded the shareholders a fair opportunity to nominate director candidates." This left Proponents with the burden of "proving there are 'compelling circumstances' that justify a finding of inequitable conduct."

C. Application of Schnell

In seeking equitable relief, Proponents attacked the Board's delay in responding to the Nomination Notice, and then "hitting [Proponents] with the Deficiency Letter in which the Board outlined deficiencies almost too numerous to count." This, Proponents argued, was "all the Court needs to invoke *Schnell* as a basis to override the Board's rejection of the Nomination Notice." Vice Chancellor Slights disagreed, explaining that Proponents "ignore the fundamental nature of the materially deficient disclosures in their Nomination Notice."

Before considering the two key deficiencies identified by the Board in the Nomination Notice, the Vice Chancellor thought it "useful to explore the context in which the Nomination Notice was submitted and then considered by the incumbent Board." Proponents were not taken unawares; in fact, they knew the Advance Notice Bylaw empowered the Board to disregard noncomplying nominations. Proponents also were well aware that the Advance Notice Bylaw imposed a deadline for submitting nominations but did not provide any process to cure deficiencies. Despite all this, Proponents "play[ed] fast and loose in their responses to key inquiries embedded in the [A]dvance [N]otice [B]ylaw" and "inexplicably elected to submit their Nomination Notice on the eve of the deadline." Had Proponents submitted their notice earlier, they may have had "a stronger case that the Board's prolonged silence upon receipt of the [Nomination N]otice was evidence of 'manipulative conduct.' " However, by submitting their Nomination Notice at "the last minute," Proponents became "obliged to submit a compliant notice." Unfortunately, the Vice Chancellor concluded, "[t]hey did not do so."

Having set the contextual background, Vice Chancellor Slights turned to his analysis of the Supporter Disclosure Deficiencies and the IncellDx Disclosure Deficiencies.

1. Supporter Disclosure Deficiencies

The Advance Notice Bylaw required disclosure of information regarding all those known to "support" the nominations through "agreements, arrangements, or understandings." Proponents argued they were not obliged to disclose CCTV's activities in support of the proxy contest because Proponents' slate of nominees was not "disclosed to the so-called 'Gifting Persons' " when they made their donations to CCTV. As such, these contributions were not "support" for the nominations because the specific nominees were not known yet.

The Vice Chancellor rejected this argument on multiple grounds:

- *First,* adopting "a common-sense reading" of the Advance Notice Bylaw, the Vice Chancellor found that by answering "no" to the question whether anyone supported their nominations, Proponents relied on a strained reading of the bylaw. If Proponents had "at least paid lip service to the fact that their proxy campaign was receiving outside support, they might have had a stronger argument that the Board should have sought clarification or more details." But due to their "facially disingenuous response," the Board reasonably assumed Proponents "were purposefully trying to hide who was behind the scenes supporting their efforts."
- *Second,* "the canon of construction resolving ambiguities in bylaws in favor of stockholders' rights" was of no avail to Proponents. Not only was "[t]here no ambiguity in the Advance Notice Bylaw," but Proponents' "proffered (and apparently litigation-driven) construction . . . would have the Court interpret the Bylaw in a way that stretches credulity."
- *Third,* the record contained evidence that some "supporters" actually knew the identity of specific nominees before they contributed and, therefore, contrary to Proponents' position, they were supporting specific nominees.
- *Fourth,* adopting Proponents' construction "would foment bad policy" by rendering advance notice bylaw provisions "useless." In other words, permitting proxy contest proponents to circumvent disclosure of their supporters by delaying identification of their formal slate "until just before they submitted their nomination notice" would create "perverse incentives" inconsistent with Delaware law.

The Vice Chancellor's bottom line was that Proponents "elected to say nothing of supporters, preferring instead to withhold information based on an unreasonable interpretation of their disclosure obligations under the Advance Notice Bylaw." Thus, "[u]nder these circumstances, the Board was justified in rejecting the Nomination Notice and refusing to recognize [Proponents'] Nominees on this basis alone."

2. IncellDx Disclosure Deficiencies

Proponents claimed the IncellDx Disclosure Deficiencies were of no import because the transaction contemplated by the Proposal never was consummated and no potential future transaction between IncellDx and CytoDyn was under consideration. Again, Vice Chancellor Slights observed that Proponents "would have the Court focus on only part of the picture." The Vice Chancellor believed "a reasonable

stockholder would want to know" about Nominees' ties to the Proposal and intentions relating to a future transaction along those lines. He further opined that the Board legitimately suspected that certain Nominees "were keen on revisiting" the transaction contemplated by the Proposal. In fact, Proponents failure "to appreciate the presence of that elephant in the room" by making these disclosures, reflected "either reckless indifference or deliberate gamesmanship."

* * *

Finally, the Vice Chancellor found that Proponents' submission of supplemental disclosures to the Nomination Notice following receipt of the Deficiency Letter "came too late":

> The fundamental nature of the omissions, and the "eve of" timing of the Nomination Notice's submission, leave no room for *Schnell*-inspired equitable principles to override the decision by the Board to reject the Nomination Notice. Even though the Board delayed in responding to the Nomination Notice, given the nature of the omissions, they rejected it on reasonable grounds. There was no manipulation; there was no inequitable conduct.

CONCLUSION

Vice Chancellor Slights' *Rosenbaum* opinion reaffirmed that Delaware courts aim to protect stockholder voting rights. Although the *Blasius* "compelling justification" standard of review will be invoked only "sparingly"—that is, in cases of "manipulative conduct" or "inequitable conduct"—the equitable standards illuminated in *Schnell* and applied subsequently by Delaware courts in myriad circumstances are adequate for the Chancery Court to protect the "sacrosanct" stockholder voting right. A dissident stockholder who can demonstrate " 'compelling circumstances' that justify a finding of inequitable conduct" retains a potent tool to attack unreasonable actions taken by a corporate board of directors under the guise of exercising its rights under a "commonplace" advance notice bylaw.

Unfortunately for Proponents, the Vice Chancellor found "their Nomination Notice fatally incomplete." And because it was "submitted on the eve of the deadline, the Nomination Notice did not provide 'Timely Notice' " as required by the Advance Notice Bylaw. Under these circumstances, the Board "was justified in rejecting the Nomination Notice. . . . [N]either the bylaws nor equity justify the extraordinary remedy" sought by Proponents.