

Client Alert

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Delaware Court of Chancery Enjoins Annual Meeting in Defense of Stockholder Franchise

The Delaware Chancery Court recently preliminarily enjoined a stockholders meeting in *Bray v. Katz*, No. 2022-0489-LWW (Del. Ch. June 24, 2022) (transcript). The case concerns a board of directors' decision in advance of the upcoming annual meeting to lower the quorum requirement for stockholders meetings; it did so in order to preempt certain stockholders from blocking the election of the company's slate of director nominees. The Court concluded that the board of directors acted with the primary purpose of impeding the exercise of stockholder voting power. Accordingly, the Court determined that the board's actions implicated the heightened *Blasius* standard of review, which requires defendants to demonstrate a "compelling justification" for frustrating the stockholder franchise. In an exacting bench opinion, the Court found that defendants failed to demonstrate any such justification. Vice Chancellor Will's ruling demonstrates the close scrutiny Delaware courts give to corporate acts that entrench the board and disenfranchise stockholders.

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Background

UpHealth Inc. (the "Company") had a nine-person classified board (the "Board") with two co-chairs. Defendant Avi Katz ("Katz"), founder of the Company's SPAC sponsor, GigCapital, served as one co-chair; the other co-chair was legacy UpHealth founder and plaintiff Chirinjeev Kathuria ("Kathuria"). The Company's Class I directors, each serving three-year terms, were up for election at the 2022 annual meeting, originally scheduled for June 28, 2022.

After the Nomination Window Closes, A Majority of the Board Changes the Slate

The Company's advance notice deadline passed on April 25, 2022, without any stockholder proposing any nominees for election.

On May 10, 2022 – after the nomination window closed – the Board held a special meeting that had been called by Katz. At the meeting, Katz

presented a recommendation supported by five other directors to modify the Company's slate. The modified slate re-nominated only one of the Class I directors, and reclassified one Class II and one Class III director as Class I directors who would also be nominated for re-election to the Board. This proposal would have (i) allowed the Board to fill the two vacancies created by the reclassifications directly, rather than stockholders, and (ii) extended the terms of the reclassified directors, if re-elected, to 2025. The Board members present (which did not include Kathuria, who could not attend due to an emergency medical procedure) approved the modified slate that day.

On May 26, 2022, the Board held another meeting but, importantly, did not invite Kathuria and two other non-party directors. At this meeting, the six director defendants voted to approve the Company's proxy statement with the modified slate.

Plaintiffs Form Voting Bloc with Majority Voting Power But is Blocked by the Board

The next day, a disaggregated group of UpHealth stockholders, including plaintiff Jeffrey Bray ("Bray"), the former CEO of a company acquired by legacy UpHealth, entered into a voting agreement that gave Bray majority voting power (50.3%) in the Company.

Also on May 27, Kathuria called a special meeting of the Board, the purpose of which was to schedule a special stockholders meeting to vote on a proposed bylaw amendment that would have allowed stockholders to nominate an alternative slate of directors for the 2022 annual meeting.

At the special Board meeting, five of the seven directors present voted to (i) deny Kathuria's request for a special stockholders meeting, (ii) enforce the current advance notice bylaws against Bray, and (iii) institute a bylaw amendment that lowered the stockholder quorum requirement from majority to one-third.

The lowering of the stockholder quorum threshold had a significant impact on the power of the Bray voting bloc: when the stockholder quorum required a majority presence, the Bray voting bloc could prevent the Company from reaching quorum at the annual meeting. Lowering the quorum requirement to one-third significantly increased the difficulty of preventing a quorum at the annual meeting. Further, because the Company elects directors under a plurality voting standard (where the director nominees with the most votes are elected to the Board, regardless of whether they would be unable to obtain a majority of the votes cast), the Bray voting bloc would be unable to prevent the election of the Company's slate if the one-third quorum was reached despite the bloc representing a majority of the vote.

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The Litigation

Litigation ensued, in which plaintiffs Bray and Kathuria sued six members of the Board for: (1) violating the Company’s bylaws by refusing to allow Kathuria to call a special stockholders meeting, (2) breaching their fiduciary duties by, among other things, lowering the quorum requirement and (3) omitting material information from the Company’s proxy statement and Form 8-K related to the denied stockholders meeting. Plaintiffs moved to preliminarily enjoin the annual meeting.

Days before the annual meeting, the Court granted the preliminary injunction. Vice Chancellor Will found that the plaintiffs had shown a reasonable probability that defendants had breached their fiduciary duties by lowering the quorum requirement and that the other requirements had been met.¹

***Blasius* Applies Before *Unocal* When a Board Seeks to Impede the Stockholder Franchise**

As an initial matter, the Court resolved the standard of review. Plaintiffs and defendants clashed over whether the Board’s acts should be evaluated under *Blasius* or *Unocal*.² *Blasius* demands that board acts taken “for the primary purpose of thwarting the exercise of a stockholder vote” have a “compelling justification.” *Unocal* requires that board acts be “reasonable” and “proportional” given the nature of the threat.

The Vice Chancellor found that both standards applied. *Blasius* applied first: where a board’s actions are taken “for the primary purpose of interfering with the stockholder franchise, there is a shift from ‘reasonableness’ to ‘compelling’ which ‘requires that the directors establish a closer fit between means and ends.’”³ And, if defendants met the burden posed by *Blasius*, they would then need to satisfy the “reasonableness and proportionality standard” stated in *Unocal*.

The Board Sought to Impede the Stockholder Franchise

The Court granted the preliminary injunction on *Blasius*.

The Court found that the Board acted with the primary purpose of impeding the exercise of stockholder voting power. It observed that the quorum amendment, which changed “the machinery of the election

¹ The Court declined to grant an injunction on the basis of plaintiffs’ other claims, reasoning that they had not demonstrated a reasonable likelihood of success on the bylaw violation claim, and the disclosure claim was moot.

² *Blasius Industries Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

³ Op. at 19 (citing *Pell v. Kill*, 135 A.3d at 787).

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midstream,” was intended to impede a group of stockholders from exercising their franchise rights. Defendants’ argument, that they had actually enhanced the franchise by preventing the majority of stockholders from disenfranchising minority stockholders, actually made it “self-evident” that the quorum requirement was primarily intended to interfere with the stockholder franchise.

Defendants Failed to Establish a Compelling Justification

The Court then moved to the second prong of the *Blasius* analysis, which examines whether the Board had a compelling justification for burdening the stockholder franchise. The Court found that it did not.

A compelling justification is an “onerous” standard to meet, requiring an “appropriately close fit between the means and the ends of the directors’ actions.”⁴ The Court found that there was no sufficiently close fit between the burden defendants placed on plaintiffs’ vote and the defendants’ first purported justification—to prevent plaintiffs’ proposed bylaw amendment.

The Court also dismissed defendants’ alternative justification: to prevent plaintiffs from impeding the annual meeting. A compelling justification “cannot be that the board wants to make the decision for stockholders on who should be elected.”⁵ As the Court recognized, ““under Delaware law, a stockholder has the final decision whether or not to vote his shares,”⁶ as well as the right not to attend a meeting. Plaintiffs’ only method to prevent the Company’s modified slate from being elected was to not show up at the meeting and prevent the quorum. Undercutting plaintiffs’ “last option” would effectively supplant the Board’s judgment for stockholders’ preferences.

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Takeaways

- The *Blasius* standard is implicated when a board acts with the primary purpose of interfering with the stockholder vote, and courts will examine whether such acts have a compelling justification.
- A compelling justification cannot be that the board wishes to supplant its own judgment regarding board composition in place of stockholders’ judgment.

⁴ Op. at 26-27.

⁵ Op. at 29.

⁶ Op. at 28 (citing *Wis. Inv. Bd. v. Peerless Sys.*, 2000 WL 1805376, at *1 (Del. Ch. Dec. 4, 2000)).

- Even if the board satisfies the *Blasius* test and presents a compelling justification, the Court will go on to examine whether the board’s acts are “reasonable and proportional” to the threat posed under *Unocal*.
- The Court will examine evidence of directors’ entrenchment motives. In *Bray*:
 - By changing the Company slate after the nomination deadline passed, the Board would have been able to nominate five of nine directors, constituting a majority of the Board.
 - The Court also found additional evidence that defendants’ actions “may have stemmed from an entrenchment motive.” Defendant Katz moved his spouse from Class II to Class I, which would have extended her term by two years, and the next year he intended not to renominate one of the founders of UpHealth, who had given Bray a proxy over her votes. The Court also cited to text messages between Katz and a co-defendant stating that Katz did not want to give time for Kathuria to “pull some stupid proxy fight[.]”⁷
- While the Board’s reduction of the quorum requirement was legally permissible, this case presented “a perfect example of the principle articulated in *Schnell v. Chris-Craft Industries*: the fact that an action is legally authorized does not necessarily mean that it is equitable.”

Conclusion

This decision illustrates that the Delaware Chancery Court will vigilantly safeguard the stockholder franchise. A Delaware board of directors should be cautious before changing the machinery of a corporate election midstream, as the Court will look past mere legality to determine whether the action was equitable.⁸

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⁷ Demonstrating that text messages are increasingly valuable sources to discover critical evidence.

⁸ Op. at 25-26.

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