DELAWARE CORPORATE LAW BULLETIN

Delaware Court Enjoins "Board Reduction Plan" Aimed at Undermining Threatened Proxy Contest

*Robert S. Reder**
*Loren D. Goodman***

Explains that enhanced scrutiny, requiring a compelling justification for electoral manipulations, is the appropriate judicial standard of review

* Robert S. Reder, Professor of the Practice of Law at Vanderbilt University Law School, has been serving as a consulting attorney at Milbank, Tweed, Hadley & McCloy LLP in New York City since his retirement as a partner in April 2011.

** Vanderbilt University Law School, J.D. Candidate, May 2017. Thank you to Professor Reder and the *Vanderbilt Law Review* for the opportunity to participate in this *En Banc* series.

INTRODUCTION

Striking the proper balance between the rights of stockholders and the significant power granted to directors by the Delaware General Corporation Law ("DGCL")[1] has long dominated discussions of corporate governance.[2] Of course, the DGCL gives stockholders relatively few weapons to check directorial prerogatives. Perhaps the most important role granted by the DGCL to stockholders is their franchise to elect the company's directors. And over the years, this right has been cautiously guarded by the Delaware judiciary against attempted manipulations by boards of directors seeking to fend off challenges to their positions.[3] Under such circumstances, the Delaware courts have consistently demanded that incumbent directors justify their actions under the enhanced scrutiny standard promulgated in *Unocal Corporation v. Mesa Petroleum ("Unocal")*,[4] modified to include the demanding compelling justification requirement imposed by *Blasius Industries, Inc. v. Atlas Corp. ("Blasius")*.[5] Simply put, "when facing an electoral contest, incumbent directors are not entitled to determine the outcome for the stockholders. Stockholders elect directors, not the other way around."[6]

---

1. DGCL §141(a) provides that "[t]he business and affairs of every corporation shall be managed by or under the direction of its board of directors." DEL. CODE. ANN. tit. 8, §141(a) (2007).

2. *See* Dodge v. Ford Motor Company, 170 N.W. 668, 684 (1919) (historically noting "[a] business corporation is organized and carried on primarily for the profits of stockholders").

3. *See* Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

4. 493 A.2d 945 (Del. 1985). The Delaware Court of Chancery recently discussed application of enhanced scrutiny under *Unocal* in the context of a board of directors' response to hedge fund activism in *In re Ebix, Inc. Stockholder Litigation*, C.A. No. 8526-VCN (Del. Ch. Jan. 15, 2016). For a discussion of the *Ebix* ruling, see Robert S. Reder & Stanley Onyeador, *Delaware Court Addresses Entrenchment Claims Brought Against Directors Under Activist Hedge Fund Attack*, 69 VAND. L. REV. EN BANC 209 (2016).

5. 564 A.2d 651 (Del. Ch. 1988). *See* MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003) ("To invoke the *Blasius* compelling justification standard of review *within* an application of the *Unocal* standard of review, the [board's actions] only need to be taken for the primary purpose of interfering with or impeding the effectiveness of the stockholder vote in a contested election for directors."). Even prior to the formalized *Blasius* standard, many Delaware Court of Chancery decisions appeared to apply a more stringent standard where directors' actions tampered with the election process. *See e.g.*, Schnell v. Chris-Craft Industries, Inc., 285 A.2d 387 (Del. 1971) (enjoining the board's attempt to amend its bylaws to reschedule Annual Meeting in an effort to avoid a proxy contest); Aprahamian v. HBO & Co., 531 A.2d 1204 (Del. Ch. 1987) (enjoining the board's attempt to postpone Annual Meeting to avoid defeat through proxy contest).

6. Pell v. Kill, 2016 WL 2986496, at *3 (Del. Ch. May 19, 2016).

Earlier this summer, in *Pell v. Kill*, the Delaware Court of Chancery once again affirmed the sanctity of the stockholder franchise.[7] By preliminarily enjoining a plan concocted by a majority of the incumbent directors to thwart a proxy contest threatened by another director—a plan that would eliminate seats held by directors not aligned with the majority—the Court confirmed that actions "designed to interfere with or impede the effective exercise of corporate democracy" will not satisfy *Unocal* enhanced scrutiny unless the directors can demonstrate the compelling justification demanded by *Blasius*.[8] Regardless of whether the number of seats at stake would bestow control of the board, the sincerity of the directors' belief in the necessity and propriety of their actions, or the relative merits of the positions of the competing factions, attempts by an incumbent board to usurp the stockholders' franchise, or otherwise entrench itself, will not survive a judicial challenge absent a compelling justification, an exceedingly difficult burden to carry.

I. FACTUAL BACKGROUND

In March 2015, two NASDAQ-traded companies, Vision-Sciences, Inc. ("*VSI*") and Uroplasty, Inc. ("*Uroplasty*") merged to form Cogentix Medical, Inc. ("*Cogentix*" or the "*Company*"), a Minnesota-based, NASDAQ-traded Delaware corporation that "designs, develops, manufactures, and markets medical device products for specialty medical markets."[9] Although VSI technically was the acquiring company,[10] Uroplasty initially assumed a dominant role: its former stockholders owned 62.5 percent of the outstanding Cogentix shares, its management team absorbed all relevant Cogentix management roles, and its legacy-directors occupied a majority position on the eight-seat Cogentix Board of Directors (the "*Board*").

Notably, the Board was classified into three classes serving "staggered" three-year terms. The initial Board consisted of all five members of the former Uroplasty board and three of the six members of the former VSI board, as set forth in Table I:

7. 2016 WL 2986496 (Del. Ch. May 19, 2016).

8. *Id.* at *34 (quoting MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1127 (Del. 2003)).

9. *Id.* at *4.

10. Technically, the transaction was structured as a reverse-triangular merger in which a subsidiary of VSI merged into Uroplasty, which became a wholly-owned subsidiary of VSI. Following the Merger, VSI formally changed its name to Cogentix.

Table 1

Cogentix Board of Directors (Initial)		
CLASS I (term ending 2016)	**CLASS II** (term ending 2017)	**CLASS III** (term ending 2018)
Pell (VSI)	Kill (Uroplasty)	Paulus (Uroplasty)
Stauner (Uroplasty)	Pegus (VSI)	Roche (Uroplasty)
Zauberman (VSI)	Wehrwein (Uroplasty)	

Heading up the Uroplasty Board contingent was its founder Robert Kill, who also was named CEO of the new company. Across the aisle leading the VSI contingent was its co-founder Lewis Pell. Although Pell agreed initially to step back from any managerial role in the newly-combined companies, he continued to hold considerable sway as Cogentix' second largest stockholder, owning 7.1 percent of the outstanding shares and its largest creditor.

Immediately following the Merger, the dynamic between Kill and Pell soured in the face of poor Company performance and a stock market price that declined by "approximately 75%."[11] Pell outspokenly disagreed with Kill's executive management, Board leadership tactics, and compensation package. Further, as the animosity grew, the other Board members naturally became "aligned to various degrees" with their respective former leaders.[12] Given the legacy-Uroplasty majority, Pell felt their allegiance to Kill prevented these board members from accurately and disinterestedly monitoring his actions.

On February 16, 2016, following numerous internal threats and grievances, Pell penned a letter to the Board listing his complaints. Then, to increase the pressure on the Board, Pell made his criticisms public by attaching his letter to a public Schedule 13D amendment filed with the SEC. Next, he demanded that the Board terminate Kill as CEO and make other "fundamental changes." If that outcome was not freely produced, Pell made clear his willingness to wage a proxy contest to end the Kill group's domination of the Board. This was no empty threat; Pell claimed he already had the support of stockholders owning at least forty percent of the outstanding Cogentix shares and, because the term of one of the legacy-Uroplasty directors was set to expire at the upcoming Annual Meeting of Stockholders, he could use the proxy contest to reelect himself as a Class I director and place like-minded directors in the other two Class I seats, thereby creating a "four-to-four deadlock." And, if a Class II legacy-Uroplasty director followed through on his

11. *Pell*, 2016 WL 2986496, at *8.
12. *Id.* at *1.

threat to step down from the Board,[13] Pell also could fill that vacancy at the Annual Meeting and "flip" the Board "to a four-to-three majority in Pell's favor."[14]

Kill and his colleagues feared that Pell would turn the specter of deadlock and, worse, a change in Board control into "increased Board-level influence to the detriment of the Company and its stockholders."[15] When efforts to negotiate a compromise failed, Kill and his colleagues developed a plan (the "Board Reduction Plan") to preempt Pell's practical ability to successfully conduct a "proxy fight" and avoid "shareholder disruption."[16] The Board Reduction Plan would reduce the Board size by using the power of the Uroplasty-dominated Board under Cogentix' Certificate of Incorporation to (a) reduce the number of Class II directors from *three to two* in response to the resignation of the Class II legacy-Uroplasty director and (b) reduce the number of Class I directors scheduled for reelection at the upcoming Annual Meeting from *three to one*.[17] Pell alone would be re-nominated to fill the remaining Class I seat. As Table II demonstrates, this would leave the legacy-Uroplasty directors in a 3 to 2 majority:

Table II

Cogentix Board of Directors (Post-Board Reduction Plan)		
CLASS I (term ending 2019)	**CLASS II** (term ending 2017)	**CLASS III** (term ending 2018)
Pell (VSI)	Kill (Uroplasty)	Paulus (Uroplasty)
	Pegus (VSI)	Roche (Uroplasty)

In advance of the Annual Meeting, on April 25, 2016, Pell filed a motion in the Delaware Court of the Chancery seeking "declaratory and injunctive relief to invalidate the [Board Reduction Plan], to vindicate his rights as a stockholder and board member, to protect the stockholder franchise, and to negate unlawful efforts by the [Kill-

13. Citing his inability "to deal with the conflict within [the] Board" and perceived animosity from Pell, Class II director Wehrwein announced he would soon resign. *Id.* at *11.

14. *Id.* at *2.

15. *Id.* at *14. The record supports this sentiment; according to an email exchange between two legacy-Uroplasty directors, one indicated to the other that "I will never abandon [Kill] in this situation, not because it is [Kill], but because I don't think his leaving would be in the best interests of the shareholders and I don't give into Trump-like bullying ever." *Id.* at *13.

16. *Id.* at *14.

17. Of particular importance to the successful execution of the Board Reduction Plan was the composition of the Board's three-member Nominating Committee. Not only was the committee controlled by legacy-Uroplasty directors, but the Committee's Chair showed particularly strong allegiance to Kill.

aligned] Directors to maintain Board control and suppress opposition."[18] On May 19, 2016—*only one day* before the scheduled Annual Meeting—Vice Chancellor J. Travis Laster granted Pell's motion, pending a trial on the merits, to preliminarily enjoin the Board Reduction Plan.[19]

II. THE CHANCERY COURT'S ANALYSIS

A. Posture: Preliminary Injunction

In deciding to preliminarily enjoin the Board Reduction Plan, Vice Chancellor Laster determined that Pell adequately demonstrated all three of the oft-cited requirements for an injunction: (i) reasonable probability of success on the merits; (ii) threat of irreparable injury absent an injunction; and (iii) balance of equities in favor of injunctive relief.[20] Of particular import to his decision was the likelihood of Pell's success on the merits under the enhanced scrutiny demanded by *Unocal*, further refined in this context by *Blasius'* compelling justification standard, all as discussed in detail below.[21]

With regard to irreparable harm, the Vice Chancellor concluded that failure to enjoin the Board Reduction Plan would directly deprive Cogentix stockholders of their right to elect two Class I directors.[22] Delaware case law has long recognized that disenfranchisement of this nature constitutes irreparable injury,[23] particularly given the questionable efficacy of *ex poste* adjudication or remedies.[24]

Also, the Vice Chancellor concluded that a balancing of the equities supported injunctive relief.[25] The utter lack of foreseeable hardship to the incumbent Board from issuance of an injunction clearly

18. *Pell*, 2016 WL 2986496, at *28.

19. In the face of this injunction, the parties reached a settlement implementing many of Pell's proposals and leaving directors aligned with him in control of the Board. Also, Kill and his chief supporter on the Board resigned their positions at Cogentix. *See* Joe Carlson, *Cogentix Boardroom Battle is Over, But Uncertainty Remains*, STAR TRIBUNE (June 11, 2016), *available at* http://www.startribune.com/congentix-boardroom-battle-is-over-but-uncertainty-remains/382517381/ [https://perma.cc/5GTC-QLUX].

20. Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc., 506 A.2d 173, 179 (Del. 1986).

21. *See infra* Section III.C.

22. *Pell*, 2016 WL 2986496, at *48.

23. *See e.g.*, Third Point LLC v. Ruprecht, 2014 WL 1922029, at *25 (Del. Ch. May 2, 2014); Phillips v. Instituform of N. Am., Inc., 1987 WL 16285, at *11 (Del. Ch. Aug 27, 1987).

24. *See* Packer v. Yampol, 1986 WL 4748, at *11 (Del. Ch. Apr. 18, 1986) ("Harm of that nature must be prevented before a shareholders' meeting in cases where . . . any post-meeting adjudication may come too late.").

25. *Pell*, 2016 WL 2986496, at *48.

was outweighed by the indispensable nature of the stockholder vote.[26] As Delaware courts often have observed, " '[s]hareholder voting rights are sacrosanct.' "[27]

B. Analytical Framework: Unocal *"Enhanced Scrutiny" Supplemented by* Blasius *"Compelling Justification"*

As for the probability of Pell's success on the merits, Vice Chancellor Laster identified the appropriate standard of review as *Blasius*' compelling justification standard, applied not as a separate category of review, but rather "*within* the . . . enhanced standard of judicial review"[28] first articulated in *Unocal*.[29] According to the Vice Chancellor, enhanced scrutiny under *Unocal* is triggered—*in the context of a stockholder vote*—by directorial conduct "affecting either an election of directors or a vote touching on matters of corporate control"—essentially, in those sensitive situations " 'where the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors.' "[30] Given the "subtle structural and situational conflicts"[31] confronting incumbent directors when facing a proxy contest threatening their removal, these conflicts cannot "comfortably permit expansive judicial deference" under the business judgment rule.[32] At the same time, however, these conflicts "do not rise to a level sufficient to trigger" stringent entire fairness review.[33] Thus, where " 'the election machinery appears, at least facially, to have been manipulated, those in charge of the election have the burden' " to justify their actions under the enhanced scrutiny imposed by *Unocal*.[34]

Under *Unocal*, directors typically must satisfy two prongs of a bifurcated test in order to enjoy the benefits of the deferential business

26. *Id.* at *49.

27. *Id.* at *48 (quoting EMAK Worldwide, Inc. v. Kurz, 50 A.3d 429, 433 (Del. 2012)).

28. *See* MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, at *1129-31.

29. *Pell*, 2016 WL 2986496, at *31.

30. *Id.* at *32 (quoting from In re Trados Inc. S'holder Litig., 73 A.3d 17, 35 (Del. Ch. 2013)). The Vice Chancellor also noted that enhanced scrutiny applies beyond situations implicating the replacement of the "entire board." Rather, the existence of any mechanism meant to disenfranchise the stockholder (regardless of whether such disenfranchisement is successful) is enough to trigger enhanced scrutiny.

31. *Id.* at *32–33.

32. *Id.* at *33 (quoting In re Rural Metro Corp. S'holder Litig., 88 A.3d 54, 81 (Del. Ch. 2014), *aff'd sub nom* RBC Capital Markets, LLC v. Jervis, 129 A.3d 816 (Del. 2015)).

33. *Id.* (quoting Aprahamian v. HBO & Co., 531 A.2d 1204, 1206 (Del. Ch. 1987)).

34. *Id.* at *32 (quoting Aprahamian v. HBO & Co., 531 A.2d 1204, 1207 (Del. Ch. 1987)).

judgment rule.[35] In the context of alleged board interference with a stockholder vote, this test has been modified to clarify that directors have the burden of proving "(i) that 'their motivations were proper and not selfish;' (ii) that they 'did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way;' and (iii) that the directors' actions 'were reasonable in relation to their legitimate objective.' "[36] For its part, *Blasius* clarifies that the directors' justification must satisfy an even higher standard than that required by *Unocal*, requiring a heightened level of "compelling justification."[37] This shift demands that the directors establish a "closer fit between means and ends."[38] *Blasius*' requirement of a compelling justification serves as "a reminder for courts to approach directorial interventions that affect the stockholder franchise with a 'gimlet eye.' "[39]

C. Application of the Standard of Review: Board Reduction Plan Collapses Under Enhanced Scrutiny

1. Enhanced Scrutiny Triggered

Vice Chancellor Laster determined that the Board Reduction Plan triggered *Unocal* review in two respects.[40] First, clearly, the Board Reduction Plan directly "affect[ed] . . . an election of directors" at the Annual Meeting.[41] Second, by eliminating the ability of stockholders to approve a new Board majority and thereby undermining Pell's proxy

---

35. As the Delaware Supreme Court explained in *Versata Enterprises, Inc. v. Selectica, Inc.*, 2010 WL 703062 (Del. Ch. 2010), in the more typical *Unocal* setting where a company is defending against a hostile takeover bid from a third party:

> [U]nder the *Unocal* test, in order to be afforded the protection of the business judgment rule with respect to the adoption of a defensive measure, the 'directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed . . .' [T]hey satisfy that burden 'by showing good faith and reasonable investigation. . . .' The board must also demonstrate that its 'defensive response was reasonable in relation to the threat posed.' As explained in *Unitrin*, a defensive measure is disproportionate (*i.e.*, unreasonable) if it is either coercive or preclusive.'

Versata Enters., Inc. v. Selectica, Inc., 2010 WL 703026, at *12.

36. *Pell*, 2016 WL 2986496, at *36 (quoting Mercier v. Inter-Tel, Inc., 929 A.2d 786 at *810).

37. Blasius Industries, Inc. v. Atlas Corp., 564 A.2d 651, at *660.

38. *Pell*, 2016 WL 2986496, at *36 (quoting *Mercier*, 929 A.2d at *819).

39. *Id.* at *37 (citing the need for "gimlet eye" treatment of inequitably motivated electoral manipulations, originally contemplated in *Chesapeake Corp. v. Shore*, 771 A.2d 293, 323 (Del Ch. 2000)).

40. *See supra* Section III.B.

41. *Pell*, 2016 WL 2986496, at *35 (quoting *Mercier*, 929 A.2d at *811).

contest before it could begin, the Board Reduction Plan "touch[ed] on matters of corporate control."[42]

2. Board Reduction Plan Preclusive and Lacking a Compelling Justification

Turning to the three prongs of the *Unocal* test described above,[43] Vice Chancellor Laster elected not to question the purportedly honest motivation of the incumbent directors to act in the interest of stockholders.[44] Nevertheless, the Vice Chancellor found the Board Reduction Plan was both preclusive and lacking in adequate justification. As such, the Plan did not survive enhanced scrutiny.[45]

a. Preclusion

When directors' action makes a proxy contest "realistically unattainable," it will be considered preclusive.[46] The Vice Chancellor found the Board Reduction Plan made Pill's pursuit of a proxy contest "realistically unattainable" in two distinct ways.[47] First, by reducing the size of Class I from three to two, the Board Reduction Plan "eliminated the possibility of success for two seats."[48] Second, through removal of these seats, the Board Reduction Plan effectively "prevented the stockholders from establishing a new majority" on the Board.[49] Given the staggered class structure of the Board, the stockholders would need to wait until the election at the 2017 Annual Meeting to even have a chance of upending the legacy-Uroplasty majority.

If any sliver of speculation existed regarding the preclusive nature of the Board Reduction Plan, the contemporaneous communications amongst the majority directors proved especially damning. Throughout the Plan's development, Kill admitted in written correspondence his goals of "avoid[ing] any proxy fight,"[50] preventing

42. *Id.* at *35.

43. *See supra* Section III.B.

44. *Pell*, 2016 WL 2986496, at *37 ("I have assumed that the Defendant Directors motives were proper and not selfish.").

45. *See id.* at *38–47 (discussing the preclusion and adequate justification analyses).

46. *See* Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586, 603 (Del. 2010).

47. *Pell*, 2016 WL 2986496, at *38.

48. *Id.*

49. *Id.*

50. *Id.* at *14.

Pell from "calling the shots,"[51] and otherwise avoiding the euphemistically-termed "shareholder disruption."[52]

b. Lacking in Justification

As noted above,[53] a board's actions triggering *Unocal* review in the context of a stockholder election must be "sufficiently tailored to achieve a legitimate aim."[54] Even assuming the Board's actions were not preclusive, Vice Chancellor Laster found the three justifications proffered by the Kill-aligned directors fully lacking. The primary justification was an idealistic desire to transform the Board into an appropriately functioning, disinterested, and independent entity. The Vice Chancellor considered this motivation "illegitimate"; no matter how well-meaning, "the belief that directors know better than stockholders is not a legitimate justification when the question involves who should serve on the board of a Delaware corporation."[55] Simply stated, " '[t]he notion that directors know better than stockholders about who should be on the board is no justification at all.' "[56]

Beyond their primary justification, the Pill-aligned directors also cited cost-cutting and efficiency considerations to justify the Board Reduction Plan. The Vice Chancellor made quick work of this line of defense, discounting these ancillary motivations as "embellished for the purposes of litigation" and "built around grains of truth."[57] Noting the rare mention of cost and efficiency in the record before him, particularly when compared to Kill's oft-referenced goal of preserving control of the Board, the Vice Chancellor labelled these justifications "pre-textual."[58] Even assuming cost was a consideration, the Vice Chancellor noted that the Board Reduction Plan was not the only means to achieve cost-reduction. Similarly, the efficiency justification lacked logical merit; reducing the size of the Board logically would not relieve the dysfunctional dynamic between Pell and Kill.[59]

---

51. *Id.* at *15.

52. *Id.* at *14.

53. *See supra* Section III.B.

54. *Pell,* 2016 WL 2986496, at *40.

55. *Id.* at *42 (quoting Esopus Creek Value LP v. Hauf, 913 A.2d 593, 602 (Del. Ch. 2006)).

56. *Id.* (quoting Mercier v. Inter-Tel, Inc., 929 A.2d 786 at *811).

57. *Id.*

58. *Id.* at *44.

59. The Vice Chancellor suggested the possibility of a different outcome had the Kill faction "acted on a clear day." In other words, had the Board Reduction Plan been promulgated *before* Pell threatened his proxy contest, it might have survived challenge. Similarly, absent the explicit contemporaneous record illustrating the proxy-avoidance purpose of the Board Reduction Plan, the secondary justifications might have been adequate. Here, however, the Board Reduction Plan

CONCLUSION

While *Pell v. Kill* does not break new ground, Vice Chancellor Laster's analysis provides important insight on the relationship between *Unocal* and *Blasius*. Rather than providing an independent standard for reviewing purported directorial interference with the stockholder franchise, the Vice Chancellor explained, *Blasius*' compelling justification standard is applied "*within* the . . . enhanced standard of judicial review."[60] Short of entire fairness, this conflated standard places a burden on defendant directors among the most difficult to carry.

Thus, within the context of board of director elections, manipulative moves by incumbent directors directly affecting the stockholder franchise or otherwise touching on corporate control will trigger enhanced scrutiny. For their actions to pass muster, the incumbents have the burden of proving their actions were unselfish, non-preclusive, and non-coercive and the means pursued were compellingly justified by the ends sought to be accomplished. Where the record establishes that directors acted systematically to forestall a threatened proxy contest through manipulation of the electoral process, a Delaware court generally will find these actions failed to satisfy enhanced scrutiny. Under these circumstances, the court will likely conclude that injunctive relief is necessary to prevent further damage to the stockholder franchise.

---

was an express defensive measure in anticipation of a specific proxy contest, thereby "compromis[ing] the essential role of corporate democracy in maintaining the proper allocation of power between the shareholders and the Board." *Id.* at *47 (quoting MM Companies, Inc. v. Liquid Audio, Inc., 813 A.2d 1118, at *1132).

60. *See supra* note 5.