Articles + Publications | August 9, 2024

Delaware Supreme Court Strikes Down Unintelligible and Inequitable Bylaws

WRITTEN BY

Mike Swallow | Taylor B. Bartholomew | Christopher B. Chuff | Matthew M. Greenberg

In *Kellner v. AIM ImmunoTech Inc.*, the Delaware Supreme Court affirmed in part and reversed in part the Delaware Court of Chancery's closely watched ruling, which invalidated several provisions in the bylaws of AIM ImmunoTech Inc. (AIM) that had been adopted by the AIM board in response to a proxy contest. In so doing, the Delaware Supreme Court clarified the standards to be applied when analyzing challenges to advance notice bylaws and invalidated the challenged bylaws on both facial and equitable grounds.

Background

In *Kellner*, the Delaware Court of Chancery struck down several provisions of AIM's advance notice bylaws, which had been amended shortly before AIM's annual stockholders meeting in the shadow of a proxy contest. Kellner, an AIM stockholder, sued AIM and its board after his notice of nomination of directors was denied by AIM's board for failure to comply with its recently amended advance notice bylaws.

In analyzing Kellner's claim that the amended bylaws were unlawful, the Delaware Court of Chancery focused on the "Stockholder Associated Person" (SAP) concept used throughout several provisions in the bylaws. SAP was defined to include (i) any person acting in concert with the nominating stockholder with respect to the proposal or the corporation, (ii) any person controlling, controlled by, or under common control with, such stockholder or any of their respective "Affiliates" and "Associates," or a person acting in concert therewith with respect to the proposal or the corporation and (iii) and any member of the immediate family of such stockholder or an "Affiliate" or "Associate" of such stockholder.

With respect to the use of this concept in the "*AAU Provision*," which required disclosure of all arrangements, agreements, or understandings between a SAP and a nominating stockholder relating to a board nomination, the Delaware Court of Chancery stated that the interplay of various terms, including "acting in concert," "Associate," "Affiliate" and "immediate family," created an ill-defined web of disclosure requirements, which amounted to requiring disclosure of certain information that was unnecessary for purposes of a director nomination and was difficult to comply with even with best efforts to do so due to its ambiguity. The Delaware Court of Chancery reasoned that this vagueness gave the board the ability to reject stockholder nominations in its discretion, which had the effect of impeding the stockholder franchise and perpetuating the then-current directors in office. Accordingly, the Delaware Court of Chancery held that this provision was invalid.

SAP was also used in both (i) the "*Consulting/Nomination Provision*," which required disclosure over a 10-year term of any AAUs among each nominating stockholder and a SAP regarding consulting or advising on any investment or potential investment in a publicly traded company or nominations, submissions, or recommendations to appoint, elect, or re-elect the stockholder nominee; and (ii) the "*Known Supporter Provision*," which required disclosure of other stockholders known by any nominating stockholder or any SAP that supported the stockholder proposal. In addition to the problematic use of the SAP concept, according to the Delaware Court of Chancery, the Known Supporter Provision was not linked to any identifiable legitimate corporate objective that would render this disclosure necessary. The Delaware Court of Chancery noted that limiting disclosure to financial support or meaningful assistance in furtherance of the nomination may have rendered this provision permissible, but as drafted, the provision impeded the stockholder franchise. Accordingly, the Delaware Court of Chancery also held that these provisions were invalid.

The "*Ownership Provision*" required disclosure of a nominating stockholder's ownership in AIM stock (including beneficial, synthetic, derivative, and short positions) and the stock of any principal competitor of AIM, and extended the requirements to SAPs, immediate family members, and persons acting in concert with the nominee. The Delaware Court of Chancery noted that these disclosure requirements can serve legitimate corporate objectives if drafted narrowly, but struck down this provision due to the 1,099-word, 13-subpart, single-sentence provision being "indecipherable."

The parties subsequently cross-appealed to the Delaware Supreme Court.

Analysis

On appeal, the court first distinguished between a facial "validity" challenge and an "enforceability" challenge to advance notice bylaws. With regard to the former, the court noted that, under Delaware law, bylaws are presumed to be valid and, to overcome that presumption, a challenger must show that the bylaws are not authorized by the Delaware General Corporation Law, inconsistent with the corporation's certificate incorporation, or are otherwise prohibited. Even if facially valid, however, bylaws may still be inequitable and may therefore be unenforceable if they are imposed in order to inequitably impede the stockholder franchise and perpetuate the current board of directors in office. This analysis is known in Delaware as "twice-testing." In this regard, the court noted that the Delaware Court of Chancery below instead utilized enhanced scrutiny review when assessing whether the challenged bylaws were "facially valid" and sought to clarify the applicable standards.

Except for the Ownership Provision, which the court determined to be "unintelligible" as a matter of facial validity, the court determined that AIM's advance notice bylaws were all facially valid, contrary to the Delaware Court of Chancery's ruling.

The court then analyzed the enforceability of the remaining bylaw provisions by looking to the two-part enhanced scrutiny test derived from *Coster v. UIP Companies, Inc*. The first part of this test looks to whether a real, nonpretextual threat exists to an important corporate interest or to the achievement of a significant corporate benefit. Additionally, the board's motivations must be proper and not selfish or disloyal. The second part of the test considers whether the board's response to the threat was reasonable in relation to the threat posed and not preclusive or coercive to the stockholder franchise. To pass judicial scrutiny under this part, the board must tailor its response to appropriately meet the level of the threat without depriving stockholders of a vote or coercing them to vote a certain way.

The court found that AIM's bylaw amendments and the board's desire to promote transparency in board elections was a legitimate corporate objective; however, the court found that AIM's board was motivated by its desire to perpetuate itself in office and preclude the nominating stockholders from challenging the board's composition.

The court shared the Delaware Court of Chancery's concern with the definition of SAP, noting that in order to comply with the AAU Provision, the nominator would be required to gather information about AAUs between a potentially limitless class of third parties and individuals unknown to the nominating stockholder. The court agreed with the Delaware Court of Chancery's findings that this provision served as a "tripwire" in order to block board nominations.

The Consulting/Nomination Provision suffered a similar fate. The court agreed with the Delaware Court of Chancery's characterization of the provision as "draconian." According to the court, disclosure of additional AAUs among vague categories of SAPs across a 10-year lookback period was only marginally useful and gave the board discretion to reject notices based upon subjective interpretations of the requirements.

With respect to the Known Supporter Provision, the court found that the use of SAP in the Known Supporter Provision again sought information that went beyond a nominator's personal knowledge and required disclosure of an ill-defined web of supporters.

Because the AAU, Consulting/Nomination, and Known Supporter Provisions were found to have been created for an improper purpose, each of these provisions were held to be unenforceable by the court.

Conclusion

The court's decision highlights the importance of crafting bylaws that serve to achieve a legitimate corporate purpose. Advance notice bylaws help facilitate the disclosure of information that corporate boards can use to make knowledgeable recommendations regarding nominees and help stockholders to make well-informed votes. However, when bylaws are difficult to comply with and serve little value in promoting proper corporate objectives, Delaware courts will view those provisions as an attempt to impede the stockholder franchise and protect their own positions. Corporations should avoid using vague definitions that resemble the SAP definition that was at the heart of the *Kellner* decisions and can also result in vague disclosure requirements that may not be reasonably available to a nominating stockholder. Finally, corporations should also be mindful that enhanced scrutiny review is triggered even when bylaws are adopted on a "clear day" if the board seeks to enforce those objectionable bylaws during a proxy contest.

RELATED INDUSTRIES + PRACTICES

- Business Litigation
- Corporate
- Delaware Court of Chancery Litigation
- Health Care + Life Sciences
- Private Equity
- Securities Litigation