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Client Alert

November 2021

Delaware Chancery Court Decision Highlights Newfound Importance of Delivering Nomination Notices Well Ahead of Advance Notice Deadlines

The Delaware Chancery Court's decision in *Rosenbaum v. CytoDyn Inc.*, No. 2021-CV-0728-JRS (Del. Ch. Oct. 13, 2021) provides fresh insight into how courts are likely to view advance notice bylaws in the context of a shareholder activist's nomination of a dissident slate of directors. The case arose following a push by a group of investors to nominate directors and institute changes at CytoDyn, Inc. ("CytoDyn" or the "Company"), a pharmaceutical firm in the process of developing a new drug. Litigation commenced after CytoDyn's Board of Directors (the "Board") rejected the investors' director slate because of disclosure deficiencies in their Nomination Notice. Following a trial, Vice Chancellor Slights ruled that the Board properly rejected the director slate because the investor plaintiffs had "play[ed] fast and loose in their responses to key inquiries embedded in [the Company's] advance notice bylaw." The Court also rebuked the plaintiffs for submitting their Nomination Notice "on the eve of the deadline," leaving no time to fix the disclosure problems highlighted by the Board.

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We have written extensively about how defense law firms have been devising onerous advance notice nomination procedures and 100-plus page nominee questionnaires intended to make it more expensive for shareholders to nominate and easier for companies to allege deficiencies on frivolous technicalities. However, in this case, the Court cited legitimate substantive omissions from the investor group's Nomination Notice and questionnaires, serving as a reminder that shareholders seeking to nominate directors should obtain guidance from advisors specializing in shareholder activism.

The case also serves as a reminder of the newfound importance of submitting nominations as far in advance of the nomination deadline as possible in order to build in enough time for the company to respond to the notice and for the nominating shareholder to address any purported delinquencies prior to the deadline. In many cases, launching a proxy contest by nominating a slate is a last-minute, last-resort initiative

undertaken by the shareholder after discussions have not led to an amicable resolution. From a practical standpoint, delivering a Nomination Notice well ahead of the nomination deadline can significantly impact any ongoing discussions between the shareholder and the company, especially where the nominating shareholder is a 13D filer and has an obligation to promptly disclose the nominations in a 13D amendment. As such, companies, investors and their respective counsel will need to work through this new timing wrinkle with respect to how Nomination Notices are delivered. This can be achieved through, among other things, agreed-upon nomination deadline extensions, and, where the nominating shareholder is not a 13D filer, mutual agreements not to disclose nominations for a period of time following their delivery in order to continue discussions privately.

I. Background

The case arose out of an activist campaign to affect change at CytoDyn, which was in the process of developing a new drug intended to treat COVID-19, HIV and cancer. The drug had not received regulatory approval. An investor group, led by three shareholders (the "Plaintiffs"), sought to replace certain executive members of the Board because they lacked confidence in the directors' ability to obtain FDA approval for this drug. Before choosing their director slate, the Plaintiffs formed CCTV Proxy Group, LLC (short for CytoDyn Committee to Victory) to solicit donations from CytoDyn investors to fund the proxy contest.

The Plaintiffs subsequently assembled a slate of director candidates that included Bruce Patterson, the CEO of IncellDx, Inc. ("IncellDx"). IncellDx is another pharmaceutical firm. Through Patterson, IncellDx had made an offer to acquire CytoDyn for $350 million a year earlier. At that time, Patterson was also employed as a consultant to CytoDyn and he resigned from this position the day the offer was submitted, expressing "excitement regarding his future employment with CytoDyn." After the Board rejected the offer, Patterson filed a patent application on behalf of IncellDx for a treatment that was similar to one of CytoDyn's drugs. The patent submission was successfully blocked by the Company. According to CytoDyn, this patent dispute "was fresh in the minds of Plaintiffs when they submitted their Nomination Notice." Emails produced in discovery also showed that the Plaintiffs were considering merging the Company with IncellDx if their campaign was successful.

Like many publicly traded corporations, CytoDyn's bylaws contain an advance notice provision requiring shareholders to provide notice, by a date certain, of any matter they wish to place on the agenda for the Company's annual meeting, including the election of an alternative director slate. The bylaws also require the submission of questionnaires that required disclosure of several categories of information, including

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information concerning (1) the nominees' potential conflicts of interest and (2) persons known to support the nominations.

On May 24, 2021, the Plaintiffs filed with the SEC an initial Schedule 13D disclosing their ownership interest in the Company's common stock. The Plaintiffs sent their 222-page Nomination Notice to CytoDyn about a month later, on June 30, 2021, and it was received the day before the deadline set by the advance notice bylaw.

The Nomination Notice provided information about the Plaintiffs and their nominees and included answers to the questionnaires. Within the Nomination Notice, however, Patterson was found to have failed to disclose that he and his company previously made a proposal that CytoDyn acquire IncellDx and that the Plaintiffs were contemplating a potential future transaction between the Company and IncellDx. Although Patterson did disclose in his questionnaire that he was the CEO of IncellDx, it was found that he failed to disclose that he controlled and could exert significant influence over IncellDx and he disclaimed the existence of any relationship that could interfere with the exercise of independent judgment in carrying out his responsibility as a director of the Company.

Further, in response to questions asking for the names of persons or entities known to support the nominations, the Plaintiffs stated that they were not aware of any such persons or entities. Notably, the Plaintiffs did not disclose the existence of CCTV, the entity that the Plaintiffs formed to solicit donations from CytoDyn investors to fund the proxy contest. According to Vice Chancellor Slights, the absence of an affirmative response "appears to have been intended to take the Board off the scent of any behind-the-scenes support."

On July 30, 2021, nearly a month after receiving the Nomination Notice, the Company sent a Deficiency Letter to the Plaintiffs. Among other alleged issues, the Board cited the failure to disclose (1) IncellDx's prior offer to be acquired by CytoDyn, (2) Patterson's patent dispute with the Company, and (3) the existence of any supporters of the nominations, including CCTV. Although the Plaintiffs submitted a supplemental Nomination Notice disputing the Company's assertions that the notice was deficient and provided additional information that purportedly cured any deficiencies, the Board responded that the deficiencies were not cured, and the Plaintiffs, therefore, could not nominate any candidates for election.

The Plaintiffs filed suit on August 24, 2021, seeking a declaration that CytoDyn wrongfully rejected their Nomination Notice and a mandatory injunction compelling the Company to allow the Plaintiffs' nominees to stand for election.

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II. The Decision

A. Standard of Review

A unique feature of the Court's opinion was its response to the parties' "very different perspectives of the standard of review" that should be applied. The Plaintiffs argued that the Court should have applied "enhanced scrutiny" to the Board's rejection of the nomination under the Delaware Supreme Court's decision in *Blasius Industries, Inc. v. Atlas Corporation* because the rejection was an act by a conflicted board taken "for the primary purpose of impeding the exercise of stockholder voting power." Conversely, CytoDyn asserted that the more permissive business judgment rule should apply, and that the clear terms of the bylaws—a contract between the Company and its shareholders—should be enforced according to clear terms.

The Court first examined whether it should analyze the Board's conduct under the standard laid out in *Blasius*, which provides that when a board acts "for the primary purpose of impeding the exercise of stockholder voting power," the board "bears the heavy burden of demonstrating a compelling justification for such action." The Court found that a Blasius review was not warranted here because Plaintiffs had played "fast and loose" with their disclosure obligations and left no time to fix any issues; thus, the Board's delay in rejecting the Nomination Notice did not rise to the level of "manipulative" conduct warranting enhanced scrutiny review under *Blasius*.

The Court then held that its determination that *Blasius* did not apply did not mean, as the Company contended, that the Court must default to the deferential business judgment standard. Rather, the Court noted that the Court of Chancery is a court of equity, and pointed to the Delaware Supreme Court's decision in *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) and its progeny, which hold that "inequitable action does not become permissible simply because it is legally possible." Thus, because of the "sacrosanct" nature of voting power and the potential for abuse, it was necessary to closely examine the facts to determine whether there were "compelling circumstances" that militated that equity should step in to override what the bylaws required so as to avoid an inequitable result.

Ultimately, the same facts that led the Court to conclude that *Blasius* did not apply (i.e., that "Plaintiffs had waited until the last minute to submit their Nomination Notice") also led the Court to conclude that there was no basis to deviate from the clear terms of the bylaws. Thus, the Court reviewed the facts based upon contract principles, and analyzed whether the Nomination Notice complied with the Company's advance notice bylaws.

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III. The Court's Holding

Strictly applying the terms of the advance notice bylaws, the Court found the Nomination Notice "fell short of what was required" in two ways. First, the Court held the Nomination Notice did not sufficiently disclose "who was supporting [P]laintiffs' proxy contest" financially. And second, the Nomination Notice failed to disclose that the Plaintiffs' nominees "might seek to facilitate a future IncellDx/CytoDyn combination" if the campaign was successful—information the Court found to be "material" to a reasonable investor. Because the Court determined the Nomination Notice was deficient, it ruled that the Plaintiffs could not succeed on the merits of their claims.

IV. Key Takeaways

A. Timing of Nomination Notice Submission

Central to the Court's holding was its perception that the Nomination Notice was submitted to the Company without enough time for the Board to advise the Plaintiffs of any deficiencies. The Plaintiffs submitted their Nomination Notice on the eve of the deadline established by the Company's bylaws. In the Court's view, the decision to submit the Nomination Notice so close to the deadline "without leaving time to fix deficient disclosures" was an error that affected the outcome of the decision, and ultimately the success of the campaign. Although the Board waited almost a month after receiving the Nomination Notice to send a Deficiency Letter, the Court did not find the Board's actions to be dilatory or "manipulative" given the Plaintiffs' initial failure to submit the Nomination Notice earlier. Thus, the opinion suggests that if the Plaintiffs had submitted their Nomination Notice sufficiently in advance of the deadline—leaving time to cure any perceived deficiencies—the outcome of the case could have been different.

B. Disclosing Financial Backers

The *CytoDyn* decision serves as a reminder to shareholder activists that most advance notice bylaws and questionnaires will require disclosure related to the financial backers of the activist campaign. Vice Chancellor Slights found that the Board correctly rejected the Nomination Notice because the Plaintiffs failed to disclose the existence of CCTV. The Court explained that by not answering questions asking for information about those known "to support nominations," the Plaintiffs "essentially were advising the Company and its stockholders that they had no support or funding for their campaign," which the Court viewed as "facially disingenuous." The Court held that financial supporters should have been disclosed in response to these questions and that the Board was justified in

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rejecting the Nomination Notice and refusing to recognize the Plaintiffs' nominees on this basis alone.

C. Disclosing Material Conflicts of Interest

The *CytoDyn* decision also serves as a reminder that most advance notice bylaws and questionnaires will require disclosure related to any past, current or future proposals, arrangements or understandings by or between the nominating shareholder and the nominees on the one hand and the company on the other hand in order to allow the company to identify potential material conflicts of interest. A year earlier, Patterson submitted to CytoDyn a proposal urging it to acquire IncellDx. Fast forward to when the nomination was submitted, emails showed that if the campaign was successful, Patterson would consider a "CytoDyn/IncellDx merger post-election." Patterson even declared to other shareholders in an email that "The takeover is starting!," and "this is the beginning of getting the deal I sent to you consummated!!" The Court found that this information was material, explaining that "a reasonable stockholder would want to know that certain of Plaintiffs' Nominees were tied to a past proposal" pursuant to which CytoDyn would acquire IncellDx. In addition, the Court believed a reasonable shareholder would want to know that Patterson "may seek to facilitate a renewed proposal along the same lines as the previously rejected proposal before casting her vote in an election where potentially conflicted nominees were on the ballot." As a result, the Court ruled that the failure to disclose Patterson's previous proposal and the potential for a future transaction justified the Board's rejection of the Nomination Notice.

D. Hiring Specialized Advisors

This case emphasizes the importance of shareholders seeking to nominate directors to try to avoid nominating on the eve of the nomination deadline and to obtain guidance from advisors specializing in shareholder activism.

Please contact the Olshan attorney with whom you regularly work or one of the attorneys below if you would like to discuss further or have questions.

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