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USA: Trends & Developments

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Trends and Developments

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Shareholders' Rights and Shareholder Activism in the USA

Shareholders of public companies must navigate a complex landscape that includes both government regulation and the by-laws of the companies whose shares they hold. Two recent opinions from the Delaware Chancery Court underscore the importance for shareholders of careful timetable management and adherence to advance notice by-laws when making nominations. In addition, rules proposed by the U.S. Securities and Exchange Commission (SEC) concerning the reporting of beneficial ownership have the potential to introduce considerable compliance challenges and impede communication between shareholders. And both developments underscore the ease with which shareholders can "foot fault", whether with regard to company by-laws or SEC regulations.

Advance Notice By-laws: the Devil is in the Details (and Deadlines)

Rosenbaum, et al. v CytoDyn Inc. et al.

CytoDyn is a biotechnology company developing leronlimab, a monoclonal antibody intended as a treatment for COVID-19, HIV and cancer. Sometime around March 2021, CytoDyn investors the Rosenbaum Group, frustrated at the company's failure to secure FDA approval for the therapy, formed CCTV Proxy Group to solicit donations to fund a proxy fight. The Rosenbaum Group also began assembling a director slate that included one of its members, Bruce Patterson. In addition to being a CytoDyn shareholder, Patterson was a consultant to CytoDyn – as well as the CEO and a significant shareholder of IncellDx, a CytoDyn competitor.

Roughly a year earlier (in May 2020), Patterson had proposed to CytoDyn that it acquire IncellDx for as much as USD350 million and hire him in the process. Patterson resigned his consultant position at CytoDyn and waited for CytoDyn's board to vote on his proposal. However, the CytoDyn board did not accept the proposal. Patterson then filed a patent application on behalf of IncellDx for a drug similar to CytoDyn's leronlimab, leading to a patent dispute with CytoDyn.

The Rosenbaum Group filed its director nomination notice including Patterson on 30 June 2021 – the day before CytoDyn's nomination deadline. The following week, CytoDyn's board rejected the nomination notice as "incomplete, false and misleading" for two primary reasons.

First, when asked to identify anyone known to "support [the] nominations", the Rosenbaum Group failed to disclose the existence of CCTV or the identity of CCTV's donors.

Second, the questionnaire asked whether the nominees had "engaged in any 'transaction,' or ha[d] any 'transaction' which currently [was] under consideration or been proposed" in which the nominee would have a "direct or indirect 'material' interest". While Patterson disclosed his former consulting agreement with CytoDyn in

his responses to the questionnaire, he neglected to disclose the patent dispute or his proposal to the CytoDyn board that CytoDyn acquire IncellDx – a proposal that allegedly would present Patterson with a conflict of interest if he were elected a director should the proposal be renewed.

Furthermore, the questionnaire asked whether any nominee can "exert significant influence... over any entities, to the extent that the entity may be prevented from fully pursuing its own separate interests" in a transaction with CytoDyn "even if there are no... anticipated transactions". To this, Patterson simply answered "no", even though he exerted influence over IncellDx, which was in a patent dispute with CytoDyn, as CEO and as a significant stockholder. Notably, however, while Patterson's proposal regarding an acquisition of IncellDx and his status as IncellDx's CEO were not disclosed in the nomination questionnaire, the CytoDyn board was clearly aware of those facts.

In responding to CytoDyn's rejection of its nominations, the Rosenbaum Group argued that the patent dispute and the proposal to acquire IncellDx were not material, and that the role of CCTV and its donors was not required to be disclosed because the names of the full slate of nominees were not known to the donors at the time they made their donations. Furthermore, the Rosenbaum Group stated that it would initiate legal proceedings to compel compliance if CytoDyn did not "honour" the nomination notice by 18 August 2021. The Rosenbaum Group then filed the definitive proxy statement with the SEC, which provided more detail on the issues CytoDyn had noted in its rejection.

The Delaware Court of Chancery denied the Rosenbaum Group's motion for a permanent injunction that would have forced CytoDyn to let the dissident directors stand for election, declaring that the plaintiffs "played fast and loose" in their questionnaire responses. Furthermore, the Court found that, by waiting until the day before the deadline to submit the nomination, the Rosenbaum Group had left itself no time to correct the deficiencies in the nominations before the deadline (even though CytoDyn did not advise the Rosenbaum Group of the deficiencies until approximately one month later).

In addition, the Court rejected the Rosenbaum Group's request that the CytoDyn board's actions be held to the enhanced scrutiny standard established in Blasius Industries, Inc. v Atlas Corp, in which directors must show a "compelling justification" for actions intended to "interfere with or frustrate shareholder voting rights". However, the Court declined to make a blanket declaration that any board's rejection of a nomination notice would be subject to the deference afforded by the business judgement rule. Ultimately, the Court ruled that judicial relief was unwarranted since the board's rejection of the dissident nominations rested on the latter's failure to fulfil its obligations under CytoDyn's clearly stated advance notice by-law.

Strategic Investment Opportunities LLC v Lee Enterprises, Inc.

The ruling in Lee echoes the warnings of CytoDyn to nominating shareholders regarding the importance of carefully managing the nomination process. And like CytoDyn, Lee took place against the backdrop of a spurned acquisition.

In October 2021, investment bankers approached hedge fund Alden Global Capital about the possibility of making a takeover bid for Lee, a Midwestern news provider in which Alden and its affiliates held a substantial position. On

22 November 2021, the Monday before Thanksgiving, Alden sent a non-binding proposal to the Lee board, offering to purchase Lee for a 30% premium over the previous day's closing share price.

Alden decided that, in parallel with the proposal, it would nominate a slate of directors, with Alden's affiliate, Strategic Opportunities ("Opportunities"), to be the shareholder of record making the nominations. But Opportunities was only the beneficial owner of its Lee shares; it was not the record holder of the shares. As is the case for the vast majority of publicly held shares in the United States, the record holder was Cede & Co.

As the Thanksgiving holiday approached, Alden asked its broker to move 1,000 shares of Lee stock into record name for Opportunities so that Opportunities could make the director nominations. At the same time, Opportunities requested its nominee questionnaire from Lee's secretary. However, the request was rejected the next day because Opportunities was not yet a record holder and Lee's by-laws only required the secretary to provide forms "upon written request of any stockholder of record within 10 days of such request".

Concerned that the shares might not be transferred in time for Opportunities to receive and complete the nomination questionnaires, Alden prepared and responded to its own questionnaire form, which it would contend was "close enough to any form the [Lee board] would have provided". When the day of the nomination deadline arrived and the shares were still not transferred to Opportunities in record name, Alden then asked Cede to submit the nomination notice and questionnaire to Lee on behalf of Opportunities.

The following week, the Lee board rejected the nomination notice, and then rejected the acquisition proposal the week after that, ironically on the day that Opportunities finally became a record holder. Opportunities sought an injunction from the Delaware Chancery Court to force Lee to let the nominations stand.

The Court ruled against Opportunities, holding that Cede itself was not making the nomination, as it stated in its communication to Lee that it was conveying a nomination "by Opportunities of certain individuals for election", so the nomination was invalid as it was not made by a record holder. Although the Court found that Opportunities submitted "extensive, detailed information about its nominees" to Lee, its doing so did not meet Lee's explicit advance notice by-law requirement that the information be submitted in the form established by Lee.

Unlike in CytoDyn, the Court in Lee found that the elevated standard of review established in Blasius applied, given that Alden's nominations "were part and parcel of Alden's hostile bid to acquire Lee". However, the Court found that, though the Lee board rejected Alden's notice "under the shadow of Alden's bid", there was no manipulative conduct given that the Lee by-laws were "validly enacted" "on a clear day long before Alden surfaced", and had a "reasonable purpose".

In both CytoDyn and Lee, shareholders made what they viewed as attempts to comply in spirit with the relevant advance notice by-laws. In CytoDyn, the Rosenbaum Group filed a proxy statement with the SEC that attempted to correct the deficiencies in its nomination notice identified by the company – but did so without providing a factually complete notice that was accepted by the company within the nomina-

tion deadline. Despite the fact that the original purpose of the advance notice by-law was to provide the board with information in advance of a nomination, and the CytoDyn board was well aware of Patterson's proposal for CytoDyn to acquire IncellDx and his role as IncellDx's CEO, the Court took a formalistic approach to the company's advance notice by-laws.

In Lee, Opportunities hoped that having Cede submit on Opportunities' behalf nominations on forms Opportunities created would substantially meet Lee's advance notice by-law requirements – requirements that Opportunities was unable to meet to the letter by the deadline. In both cases, the Court ruled that the company was well within its rights to reject the nominations based on the nominating shareholder's failure to strictly comply with the requirements of the company's advance notification by-laws.

Beneficial Ownership Reporting: Potential Complications Ahead

While beneficial ownership was insufficient under the Lee by-laws to enable shareholders to nominate directors, beneficial ownership is the standard the SEC looks to with respect to its ownership reporting requirements. In February 2022, the SEC proposed amendments to the rules governing those requirements in an effort to "modernise" them and "improve their operation and efficiency".

Some of the proposed changes are fairly straightforward, such as the provisions to tighten the deadlines for reporting beneficial ownership of a covered class of equity security on Schedule 13D and Schedule 13G. For example, while current rules require the initial Schedule 13D filing to be made within ten days after a person acquires beneficial ownership of more than 5%, the filing period would shorten to five days under the proposed rules.

Other proposed changes broaden the scope of who is considered a beneficial owner, deeming holders of certain derivative securities settled exclusively in cash to be beneficial owners, even though holding the derivative security does not convey voting or investment power over the covered class of equity security. The SEC argues that this change would reflect the incentive and ability of the holders of those derivative securities to, under certain circumstances, influence or control the issuer of the underlying securities.

"Group" definition

However, the proposed rule changes that may have the greatest potential impact on shareholders are those regarding what constitutes a "group" for the purposes of beneficial ownership reporting, given the potential of these changes to impose significant compliance challenges on shareholders. When shareholders are acting as a "group", their beneficial ownership is aggregated for purposes of determining if the 5% threshold has been crossed for purposes of Section 13(d), as well as the 10% threshold for Section 16(b) – the short swing profits rule. Generally, under SEC rules and relevant case law, a group has historically been deemed to be present when two or more shareholders "agree" to act together for the purpose of acquiring, holding, disposing or voting of an issuer's securities.

The SEC maintains that, under a plain reading of the relevant statutes, "an agreement is not a necessary element of group formation". The proposed rule changes thus include provisions clarifying that, depending on facts and circumstances, two or more shareholders would be presumed to be a group if they "act as" a group for the purpose of acquiring, holding or dispos-

ing of securities, whether any express or implied agreement between them to do so exists. Furthermore, the proposed rule changes include a provision that deems a group to exist when one person conveys to another advance, non-public information regarding an upcoming Schedule 13D filing, and the second person subsequently makes an acquisition based on that information.

In the SEC's view, these proposed rule changes regarding what constitutes a group would bring the beneficial ownership reporting requirements closer to Congress' intent and help reduce negative market effects stemming from information asymmetry. However, these changes as written could well create uncertainty among shareholders regarding the facts and circumstances that constitute "acting as" a group.

The provision regarding the sharing of non-public, advance information regarding upcoming Schedule 13D filings is likely to require shareholders to track the holdings and activities of the other shareholders with which they communicate in the ordinary course much more thoroughly and closely than they do now. In an attempt to address some of these concerns, the proposed rule changes exempt shareholders who are acting together "without the purpose or effect of changing or influencing control of the issuer". Even with this exemption, however, the practical effect of these proposed amendments would likely be a stifling of ordinary course communications among shareholders and the expenditure of significant resources and energy in an attempt to ensure compliance amidst uncertainty.

Even if the SEC's proposed changes regarding what constitutes a group for the purposes of beneficial ownership reporting are ultimately dropped, the proposed changes, along with the Delaware Chancery Court rulings involving advance notice by-laws, underscore the importance for shareholders of maintaining an approach to compliance that is rigorous and responsive to heightened scrutiny and the possibility of significant change in the rules going forward.

Schulte Roth & Zabel LLP is widely regarded as the dominant global law firm for activist investing. From offices in New York, Washington, DC and London, the firm's lawyers offer sophisticated knowledge of market practices and unparalleled expertise in all areas related to activist investing. SRZ has more than 30 years' experience in advising clients on more than 1,000 shareholder activism matters. The team assists with all matters relating to activism, including campaign strategies, corporate governance, proxy rules, trading and affiliate rules, Sections 13 and 16 compliance, antitrust regulations, federal and state securities and corporate laws, tax and regulatory issues and litigation. The firm helps clients navigate applicable law and regulations on a global scale, and provides guidance on both the strategic and tactical levels in everything ranging from running proxy contests, consent solicitations or withhold campaigns, to calling special meetings or engaging in exempt solicitations and partnering with management and corporate boards to effectuate high-level changes that make a significant impact.

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