

Activist Investing - Threshold Issues for Funds and Other Investors

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Introduction

Hedge funds and other institutional investors have become increasingly active in pursuing strategies that seek to influence public companies to take actions to increase short and long term value. This activism flows from a number of factors, including:

- an activist fund's belief that the application of its investment philosophy or analytical expertise can identify undervalued assets or areas of change that can increase the value of the fund's investment in the target company;
- a fund's financial resources that enable it to rapidly acquire a significant position in the target company, so that it has both a meaningful financial stake available to profit from the actions proposed as well as the credibility as an important stakeholder to cause the target's management to engage in discussions with the fund;
- the tendency, once one fund goes public with an activist agenda, for other funds and stockholders to publicly or privately support the first fund, thus amplifying the influence of the first fund; and
- the fact that activist funds have often succeeded in causing target companies to make some or all of the changes suggested by the activists, creating an impression that activism is a successful technique for effecting change and potentially increasing shareholder value.

Activist activity can take a variety of forms, most typically including private discussions with the target company or publicly disclosed letter writing campaigns designed to put public pressure on the target company to make changes in strategy or add new directors to the company's board. It can also escalate to include proxy contests to replace some or all of the directors and, occasionally, litigation. Because most activist funds are not interested in becoming the owner of, or in acquiring a control position in, the target company, it is not typical for the activist to initiate a tender offer or other proposal to buy the company.

Whatever the means of seeking to influence the target company, however, there are numerous legal and corporate

governance issues that are essential for activist funds (and those that would follow on their coattails into an activist situation) to consider in building a stake position, avoiding legal liability and avoiding giving the target company an effective tool to hinder or block the activist activity. Summarized below are some of the principal considerations applicable to activist investors acquiring stake ownership positions in the target company. The application of the guidelines to real-life situations can be nuanced and complex and requires careful analysis of the actual facts and circumstances in each case, but the following discussion will serve to identify some of the principal considerations.



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Building the Stake Position – Disclosure and Limits

Many activist funds desire to acquire the largest stock position possible before approaching target management or publicly disclosing their ownership position. There are a number of legal requirements that will trigger disclosure of a stockholder's position in a public company having securities registered under the Securities Exchange Act of 1934 (Exchange Act). Generally, these rules will apply to securities of companies traded on the New York Stock Exchange, other national securities exchanges and the NASDAQ National and Small Cap Markets. In addition, there are a number of legal and governance issues that can delay the acquisition, or limit the size, of the stock ownership position that can be acquired by a fund.

5% Ownership Report on Schedule 13D

Rule 13d-1 under the Exchange Act generally provides that any person who becomes, directly or indirectly, the beneficial owner of more than five percent of a class of voting securities registered under the Exchange Act is required to report that ownership position on a Schedule 13D within 10 days of becoming a greater than five percent beneficial owner.¹ "Beneficial ownership" is defined to include the ability, directly or indirectly, to exercise power over the voting or disposition of the security in question. If an activist fund has the right to acquire beneficial ownership of a security of a company it seeks to influence (for example, by exercise of an option), it will normally be considered the beneficial owner of such security.²

The Schedule 13D requires, in addition to disclosure of the shares held by the reporting person, information about the reporting person, its control persons and plans or proposals relating to the target company, including plans to change management or the board of directors. The Schedule also requires disclosure of contracts and arrangements with respect to any securities of the issuer (not just the securities that are the subject of the Schedule 13D), including but not limited to arrangements relating to the voting of securities, finders fees, loan or option arrangements, puts or calls or divisions of profits or loss. One issue of potential relevance to investment funds is the extent to which these provisions contemplate or may be deemed to require the disclosure of hedging arrangements (including short sales, derivatives and swaps) and, if so, the extent of such disclosure relating to any such existing arrangements.

In addition, once a person has filed a Schedule 13D, any material change in the information contained in the Schedule is required to be promptly reported in an amendment to the Schedule 13D.³

"Group" Issues

The Schedule 13D disclosure requirements also apply when two or more persons agree to act together for the purpose

of acquiring, holding, voting or disposing of equity securities of an issuer. In such a case, the "group" formed is deemed to have acquired beneficial ownership of all equity securities beneficially owned by each member of the group.

The impact of this concept is that when two or more persons acting in concert own more than five percent of the voting securities of an issuer, even if each of them separately owns less than five percent, the group will be treated as having a Schedule 13D filing requirement. Funds owning stock of a target company therefore have to be sensitive to the types of communications they have with other funds who own stock in the target company, as there is always the risk that the target company or the Securities and Exchange Commission could conclude that the communications among funds could be considered as sufficient to form a group, resulting in a group filing obligation involving the individual funds which may have concluded that they were each below the five percent reporting threshold. Case law has held that a person has to have beneficial ownership of at least some amount of the equity securities in question to be a member of a group, so if a fund has no beneficial ownership of equity securities, it cannot be a member of a group.⁴

Schedule 13F Reports

Rule 13f-1 under the Exchange Act generally requires every institutional investment manager which exercises investment discretion over at least \$100 million of publicly traded equity securities to report on a Schedule 13F public securities positions it holds as of the end of every calendar quarter. The report is due 45 days after the end of each quarter.

Thus, even where a fund or fund family has not yet crossed the five percent Schedule 13D threshold (or the \$56.7 million Hart-Scott-Rodino threshold discussed below), the target company and the public could become aware of the fund manager's position in the company by virtue of the Schedule 13F filing. While it is possible to request confidential treatment from the Securities and Exchange Commission for such positions, the granting of confidential treatment is not assured, so the timing of a fund's stock acquisition strategy needs to be considered in light of this reporting requirement.

Forms 3 and 4; Short Swing Profit

The beneficial owner of more than 10 percent of a class of equity securities of a public company with securities registered under the Exchange Act is also required to file a separate report under Section 16 of the Exchange Act on a Form 3 within 10 days of becoming a 10 percent beneficial owner, and is required to report any change in that ownership on a Form 4 within two business days of any purchase or sale. More important to an activist investor than this reporting requirement (since the investor will have already reported its five percent initial position in a

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Schedule 13D), is that being a 10 percent beneficial owner (an “insider”) generally means that any purchase and sale of a target company’s equity securities within six months of each other while an insider can be “matched” and any profit can be required to be disgorged to the target company.

Funds will normally keep careful track of their ownership positions in an issuer to avoid this issue, but if several funds individually owning less than 10% are deemed to be a “group,” that will expose “insider” profits made by one fund - even if not over the 10% ownership threshold by itself - to disgorgement. This suggests another reason for funds to be sensitive to the nature of and extent to which they interact with other funds or shareholders involved in activist activity with respect to a commonly identified target company.

Hart-Scott-Rodino

The Hart-Scott-Rodino Antitrust Improvements Act (HSR Act), which often is thought of in the context of requiring antitrust regulatory clearance for the acquisition of one company by another, can also have application to the acquisition of voting securities of a corporation.

In general, the acquisition of voting securities of a company by a fund which, when added to securities already owned by such fund, exceeds \$56.7 million in value requires notice to the target company and prior governmental clearance under the HSR Act. Normally, a fund holding 10 percent or less of the outstanding voting securities with passive intent can take advantage of an “investment exemption” to the filing and clearance requirement. However, where a fund is acting with other than a passive intent, as would likely be the case if the fund intends to seek to effect change in the policies of the target company, it is likely such exemption will not be available. This requires a filing with the U.S. regulatory authorities and formal notification to the target company, which means that the target company will become aware of the fund’s ownership position at the \$56.7 million level and the fund will have to clear the HSR waiting period (typically up to 30 days after filing with the regulatory authorities) before the fund can purchase shares which would result in ownership exceeding the \$56.7 million threshold.

While the “group” concept from Rule 13d under the Exchange Act does not apply in the HSR context, and funds within a family (e.g. onshore and offshore investment vehicles) may be treated as different persons for HSR purposes (meaning that each fund may separately be able to purchase up to \$56.7 million without making an HSR filing), the antitrust authorities take very seriously any failure to file when required, and the fines for a violation can be as high as \$11,000 per day of the violation.⁵

As a result, prior to reaching the \$56.7 million threshold, activist investment funds need to consider carefully whether their activities (including prior contact with the issuer and

communications with other funds) could be considered as invalidating investment intent and the potential for a claim the fund has violated the HSR Act.⁶

State Law Statutes

Many states have various laws applicable to the acquisition of beneficial ownership of voting securities of corporations incorporated in such state that could impede an activist investor. Examples include:

- control share statutes - which take away voting rights of stock beneficially held by a person or group which crosses certain ownership thresholds (typically 20%) unless the other stockholders vote to restore such voting rights; some statutes permit the company to buy in the shares at a formula price if voting rights are not granted
- business combination statutes – which bar a person or group from engaging in certain transactions (including mergers and selective resales of stock back to the issuer) if specified ownership thresholds (typically 15%) are crossed without prior board approval
- anti-greenmail statutes – which can require a person or group crossing certain ownership percentages without board approval to disgorge any profit made in selling the stock, whether to the company or a third party.

Again, activist investors will normally keep careful track of their own ownership positions, but the laws of states do have different provisions and thresholds, and issues can arise where relationships with other shareholders, if construed to constitute “group” activity, could lead to a claim these statutes have been triggered.

Poison Pills

Many public companies have also adopted poison pill rights plans that provide that if an “acquiring person” or group exceeds a specified beneficial share ownership (typically 10-20%) all stockholders other than the acquiring person or group can purchase stock at a 50% discount to market price, resulting in significant dilution for the acquiring person.

Most poison pills expressly use the same concepts for beneficial ownership and group status discussed above, so funds need to be careful that discussions and contacts with other shareholders not be seen constituting a “group” exceeding the relevant ownership threshold. Indeed, in the recent proxy contest involving Bally’s Total Fitness, Bally’s asserted that certain alleged concerted activity by two activist funds holding more than the triggering percentage under Bally’s rights plan may have resulted in the triggering of the poison pill.⁷

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Advance Notice Provisions

For many activist investors, one of the greatest sources of leverage is the threat of a proxy contest to replace some or all of the target company's board of directors. Where a target has not restricted the ability of stockholders to act by written content in lieu of a meeting or to call special meetings of stockholders, it may be possible to commence such a proxy contest at the time of the activist's own choosing. More typically however, companies will have restricted such actions, so that the insurgent will only be able to run a proxy contest once a year, at the annual stockholders meeting. Moreover, many companies have adopted advance notification by-law provisions, which require a stockholder of record to provide advance notice (typically 60 to 90 days, but sometimes longer) of its intention to nominate a candidate for director (as well as any other actions a stockholder might want to bring up at the meeting).

The impact of such a provision is two-fold. First, if an insurgent decides it wants to run a proxy contest after the advance notice time period has passed, it is out of luck until the following year's annual meeting. Second, an advance notice provision will give the issuer and, if it decides to disclose the activist's demand publicly, the public, notice of the activist's intentions well before the meeting, potentially limiting the activist's ability to acquire a significant stake in the stock of the company before surfacing publicly.

Insider Trading Issues

Finally, any activist scenario likely envisions discussions with the target company about its business prospects and willingness to implement the activist's proposals or alternatives to such proposals.

Rule 10b-5 under the Exchange Act generally makes it illegal to trade in securities while in possession of material non-public information obtained from an issuer. Moreover, an issuer may have its own disclosure obligations under Regulation FD of the Exchange Act if it selectively discloses confidential information to a third party, unless that person contractually agrees to keep any information it receives confidential. Because of these concerns, companies will often insist that an activist fund sign a confidentiality or standstill agreement before it is willing to engage in conversations with the fund.

As a result, an activist might find its ability to trade into or out of a position in the target company to be restricted for a period of time after engaging in substantive discussions with the company. One possible way to address this issue would be for the company to agree to a specified outside date after which either the activist is free to disclose any information it deems material or the issuer is obligated to disclose such information. The likelihood of a company agreeing to such provisions is uncertain, however, which means that an activist fund could potentially find itself

restricted from trading for some period of time if it engages in substantive discussions with the target company.

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¹ Investors acquiring and holding voting securities without the purpose or effect of influencing the control of the target company are permitted, in lieu of filing a Schedule 13D, to report the acquisition on a Form 13G that requires less information. Rule 13d-1(c). Many funds not engaged in activist activity routinely utilize the Schedule 13G filing format. However, this alternative will generally not be available to a fund which intends to seek to influence the target company.

² Normally, a person is only considered the beneficial owner of securities it owns or has the right to acquire beneficial ownership of (for example, pursuant to exercise of an option) within 60 days. However, where a person acquires a derivative security (like an option) with the purpose or effect of changing or influencing the control of a company, that person will be deemed to be the beneficial owner of the underlying security even if it cannot be acquired within 60 days. Rule 13d-3(d).

³ The regulations applicable to amendments to Schedule 13D specifically state that the acquisition or disposition of beneficial ownership of one percent or more of the class of securities is deemed material. However, this does not necessarily mean that changes of less than one percent are not considered material, and as such the fund will need to consider how often it needs to amend the Schedule 13D to report additional purchases and sales.

⁴ See, e.g., *Rosenberg v. XM Ventures*, 274 F. 3d 137 (3rd Cir. 2001).

⁵ See Federal Trade Commission press release and consent decree filed at www.ftc.gov/opa/2005/09/durus.htm, where the Federal Trade Commission assessed a \$350,000 civil penalty against a fund manager for a failure to make a required HSR filing where the fund apparently could not avail itself of the investment exemption.

⁶ A similar issue arises where a fund may already own more than \$56.7 million of voting securities in the target company acquired in reliance on the investment exemption and subsequently determines to take an activist position. There is a risk that the regulatory authorities could examine the history of the fund's activities in connection with its prior purchases and conclude, based upon communications with the target company, other stockholders or otherwise, that some of those earlier purchases were done at a time when the fund did not, based upon its historical activity, have passive intent.

⁷ See the Form 8-K filed by Bally's Total Fitness Holding Corporation on January 10, 2006 for a description of the actions Bally's suggested support the existence of a group for purposes of its poison pill rights plan, as well as the Delaware "business combination" statute applicable to Bally's.