Litigation Alert

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Second Circuit Provides Guidance on Delegation of Beneficial Ownership in Short-Swing Trading Case Brought Under Section 16 of the Exchange Act

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Key Points

- In a recent precedential decision, the 2nd Circuit held that funds could delegate beneficial ownership to their investment managers, thereby eliminating the funds' disgorgement liability under Section 16(b) of the Securities Exchange Act of 1934. A team of Akin Gump lawyers served as co-counsel on an amicus brief filed by the Managed Funds Association (MFA), which the court cited approvingly in reversing the district court's decision.
- The court's decision provides the first appellate court statement on the continued vitality of contractual delegation of beneficial ownership from a customer fund to its affiliated investment adviser, which has implications for both SEC reporting obligations as well as Section 16(b) liability determinations.
- The 2nd Circuit also limited the scope of prior precedent—the *Huppe* and *Tonga* cases—that had rejected delegation of beneficial ownership from a limited partnership to its general partner under principles of Delaware agency law. In doing so, the court embraced a narrower approach to agency, distinguishing the "state-law-based agency relationships" at issue in those cases from the more limited agency relationship between an investment adviser and its customer fund.
- Finally, the 2nd Circuit rejected the district court's conclusion that an investment management agreement signed by the adviser's control person on behalf of all parties invalidated the delegation of beneficial ownership. The court remanded for further factual analysis as to whether the control person had sufficient control over all parties to terminate the agreement at will.

Alert Executive Summary

On November 23, 2020, the 2nd Circuit issued a significant opinion on Section 16(b) liability in *Packer v. Raging Capital Management LLC.*[1] In *Raging Capital*, the 2nd Circuit found that a fund's delegation of investment and voting authority to its affiliated investment adviser could effectively extinguish the fund's beneficial ownership. Absent beneficial ownership, there can be no liability for disgorgement under Section 16(b).

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In arriving at this conclusion, the court made several crucial statements that provide important guidance to institutional investors on the concept of delegation. First, the court squarely rejected the district court's conclusion that beneficial ownership may not be delegated to a legally separate affiliate.[2] Second, the court rejected the district court's expansive interpretation of agency law, distinguishing prior precedent involving "state-law-based agency relationships."[3] Finally, the court remanded for further findings on whether the investment adviser's control person could have unilaterally amended their investment management agreement, which could potentially nullify delegation of beneficial ownership.[4]

Background

Section 16(b) provides that a statutory insider who earns "short-swing" profits by buying and selling within a six-month period may be required to disgorge those profits to the issuer. The statutory insiders subject to Section 16 include 10 percent beneficial owners, members of a 10 percent beneficial owner group, directors, and executive officers.

Section 16(b) excludes from its purview parties who do not possess "beneficial ownership" of the subject securities. A "beneficial owner" has direct or indirect voting and/or investment power over the securities. Pursuant to the doctrine of "delegation," an investment fund—typically through an investment management agreement (IMA)—can completely surrender its voting and investment power over securities to a separately organized investment adviser. That investment adviser, in turn, exercises its independent judgment to make investment decisions on behalf of the fund. By giving up voting and investment authority and not being able to regain it within 60 days through termination or otherwise, the fund delegates beneficial ownership of its securities to the investment adviser and no longer is a beneficial owner under Section 16.

Packer v. Raging Capital

Appellee Brad Packer, a shareholder of 1-800-Flowers.com, Inc., brought suit under Section 16(b) against (i) a hedge fund, Raging Capital Master Fund Ltd. ("Master Fund"); (ii) its registered investment adviser (RIA), Raging Capital Management (RCM); and (iii) the adviser's managing member, William Martin. The Master Fund had a three-member board of directors, including two independent directors and Martin.

Plaintiff alleged that defendants formed a 10 percent beneficial owner "group" and that they engaged in short-swing trading in the common stock of 1-800-Flowers. Defendants' primary defense was that Master Fund had delegated beneficial ownership to the RIA and that it therefore did not beneficially own any 1-800-Flowers' shares and was not subject to Section 16(b).

On summary judgment, the district court rejected defendants' argument that it had fully delegated beneficial ownership to its investment adviser pursuant to its IMA, and granted summary judgment for plaintiff.[5] The district court ruled that the delegation was not effective to preclude Master Fund's beneficial ownership for three reasons:

- First, even "[a]ssuming the validity of the delegation theory," the district court rejected the validity of Master Fund's delegation because of the "intertwined relationship" among the parties to the IMA—the RIA, Martin and Master Fund.[6] The

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district court concluded that only delegation to an "unaffiliated" third party can be effective, and concluded that the RIA and Master Fund were not truly "unaffiliated parties" because of "the interrelationships among" them.[7]

- Second, the district court more broadly rejected what it called the "delegation theory" because it understood the IMA to make the RIA the Master Fund's agent.[8] The district court believed that the 2nd Circuit's prior decision in *Huppe v. WPCS International Inc*.[9] had "disposed of . . . delegation theories."[10]
- Finally, the district court deemed Martin, who had signed the IMA on behalf of all parties, to have the unilateral power to amend the IMA, including eliminating the delegation to the investment manager.[11]

Consequently, the district court granted summary judgment in favor of plaintiff and ordered the Master Fund to disgorge $4,909,395 in short-swing profits.

The 2nd Circuit rejected each of the bases on which the district court concluded that Master Fund's IMA was not effective to extinguish its beneficial ownership:

First, the 2nd Circuit rejected the district court's finding that the delegation theory failed because defendants were not "unaffiliated parties." The court rejected the district court's use of "generalized wording such as 'intertwined' or 'not unaffiliated'" to bring defendants within the ambit of liability under Section 16.[12] Such a broad reading of these terms was not consistent with precedent limiting application of Section 16, a strict liability statute, to its literal terms. The 2nd Circuit explained that "[i]t would not be consistent with these principles to accept the District Court's first reason for rejecting Master Fund's delegation of voting and investing authority to RCM."[13]

Critically, the 2nd Circuit further rejected the district court's interpretation of the term "unaffiliated parties." Adopting the argument provided in the MFA amicus brief, the court found that the word "unaffiliated" in the context of effective delegation of beneficial ownership "means a distinct legal entity, as opposed to the fund's general partner."[14] Because the Master Fund and the RIA "are completely distinct corporate entities whose relationship is governed by strict contractual terms"—the IMA—they were "unaffiliated" as that term is used in the Section 16 Treatise.[15] The 2nd Circuit therefore rejected the district court's interpretation of "unaffiliated parties" to preclude delegation of beneficial ownership from the Master Fund to the RIA.

In so holding, the 2nd Circuit limited the reach of its prior decisions in *Huppe* and *Analytical Surveys, Inc. v. Tonga Partners, L.P.*[16] to "state-law-based agency relationships."[17] Both *Huppe* and *Tonga* involved investment funds organized as limited partnerships, which attempted to delegate beneficial ownership to their investment adviser general partners. Under Delaware law, because of the agency relationships inherent in these limited/general partnership structures, the funds could not effectively delegate investment discretion and voting discretion to their general partners in a manner that would deprive the limited partnerships of beneficial ownership.[18]

In contrast to *Huppe* and *Tonga*, the corporate structure at issue in *Raging Capital* did not implicate "comparable state-law-based agency" relationships because Master Fund and RCM "are both distinct corporations," and the district court "did not rule that the corporate veil could be pierced."[19] The court further found that "making an

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investment adviser a customer's agent for the specified purpose of carrying out the adviser's traditional functions for a customer does not make the adviser an agent for all purposes."[20] Consequently, *Tonga* and *Huppe* do not apply to preclude delegation of beneficial ownership where the investment adviser and customer fund are distinct corporate entities.

Finally, the 2nd Circuit addressed the district court's conclusion that Master Fund's delegation of beneficial ownership was ineffective because Martin had "authority to *amend* the IMA" because "he had *signed* it on behalf of all four parties to the agreement."[21] Because the district court concluded that Martin "could, presumably, revise, amend, or abrogate [the IMA] with a few strokes of a pen," the district court concluded that he could eliminate any delegation of beneficial ownership in the termination provision.[22]

The 2nd Circuit rejected the district court's conclusion, on summary judgment, that Martin could unilaterally amend the IMA. As the court explained, "[a]uthority for an individual to sign a document on behalf of an entity [] does not necessarily carry with it authority to commit those entities to making changes in, or terminating, that document."[23] The 2nd Circuit found that the district court could not determine that Martin had such authority on a motion for summary judgment, as there were disputed facts regarding whether Martin could alter the IMA on behalf of all signatories.

This opinion has significant ramifications for investment advisers with respect to their Securities and Exchange Commission (SEC) filing protocols and internal processes.

[1] *Packer v. Raging Capital Mgmt., LLC*, Nos. 19-2703, 19-2852, 2020 WL 6844063 (2d Cir. Nov. 23, 2020).

[2] *Id.* at *4.

[3] *Id.* at *5.

[4] *Id.* at *7.

[5] *Packer on behalf of 1-800-Flowers.com, Inc. v. Raging Capital Mgmt., LLC ("Raging Capital E.D.N.Y.")*, No. 15-cv-5933, 2019 WL 3936813, at *3 (E.D.N.Y. Aug. 20, 2019), *vacated and remanded*, 2020 WL 6844063 (2d Cir. Nov. 23, 2020).

[6] *Id.* at *5.

[7] *Id.*

[8] *Id.* at *4.

[9] 670 F.3d 214 (2d Cir. 2012).

[10] *Raging Capital E.D.N.Y.*, 2019 WL 3936813, at *3.

[11] *Id.* at *5.

[12] *Raging Capital*, 2020 WL 6844063, at *4.

[13] *Id.*

[14] *Id.* at *4 (internal citations omitted).

[15] *Id.* at *4 n.12 (citing to Br. for Amicus Curiae at 26.)

[16] 684 F.3d 46 (2d Cir. 2012).

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[17] *Raging Capital*, 2020 WL 6844063 at *5.

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] *Id.*

[22] *Id.* at *4 (citing *Raging Capital E.D.N.Y.*, 2019 WL 3936813, at *4 n.5, *5).

[23] *Id.* at *5.

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