

# Private Equity Newsletter

DAVIS POLK & WARDWELL

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## What Every Investor Should Know Before Acquiring a Large Stake in a Public Company

Private equity funds, hedge funds and other investors should consider a variety of legal issues before acquiring a large equity position in a public company, to avoid some looming pitfalls down the road. These issues have never been more relevant than today.

Depending on the level of ownership, the investment intent and other circumstances, the acquisition of a large stake in a public company may trigger a number of legal obligations, consequences and/or restrictions on future investment activity under federal or state law or the target's corporate documents, particularly if the investor has an activist agenda. An outline of these issues follows.

### Section 13(d) Filing Obligations

#### *In General*

Any person or group that acquires more than 5 percent of a class of equity securities of a public company is required to make a filing with the SEC (on Schedule 13D or Schedule 13G, as applicable) disclosing its ownership and certain other information. Disclosure for this purpose is based on "beneficial ownership" of shares, which is defined as sole or shared voting or investment power held "directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise" and includes "the right to acquire beneficial ownership within sixty days, including . . . through the exercise of any option or warrant." Disclosure may also be triggered by membership in a "group" that beneficially owns more than 5 percent, as discussed below.

A Schedule 13D must be filed within 10 days of crossing the 5-percent threshold, and amendments disclosing material changes must generally be made the business day following the change. Importantly, Schedule 13D filers are required to disclose their plans regarding the company. A shorter and less onerous filing on Schedule 13G may be made by specified institutional investors (*e.g.*, banks, brokers-dealers, investment companies and advisers) so long as acquisitions are made in the ordinary course of business and without the purpose or effect of changing or influencing the control of the issuer. Additionally, any investor that owns less than 20 percent of the outstanding class of equity securities who has made the investment in the ordinary course (with no control purpose or effect) may file a Schedule 13G. If, however, such investor acquires beneficial ownership of 20 percent or more (regardless of its investment intent) or changes its intent so it does have a control purpose or effect, the investor must file a Schedule 13D within 10 days. Once any such change or this 20 percent threshold is triggered, no further purchases of securities are permitted until the Schedule 13D is filed.

#### *Whether to File a Schedule 13D or 13G*

Whether an investor should file a Schedule 13G or 13D will turn on a number of factors, the principal one of which is whether the purpose or effect of the investment is to change or influence the control of the issuer. Generally speaking, passive investors can file a Schedule 13G, whereas an activist investor, such as one who intends to take affirmative steps to change the composition of the company's board, management or strategic direction (*e.g.*, advocating a sale or divestiture) or otherwise influence management must file a 13D. Investors generally do not file a 13D if they are merely expressing their opinion regarding such matters generally, whether to management or to other investors. However, an investor may decide to file a 13D on facts short of a legal obligation to do so for a number of reasons ranging from the investor's risk appetite in running afoul of its legal obligations (given the subjective nature of the judgments involved) to a wish to signal to the market the investor's desire to seek change (akin to putting up a sign seeking like-minded investors). That being said, filing a Schedule 13D is often viewed as an affirmatively hostile step and will be so perceived by the market and the issuer, unless the investor states in its filing that the shares are being acquired for investment purposes only.

Schedule 13D filings are actively monitored, so an investor should think carefully how to present itself and its investment intentions before filing a Schedule 13D. This is particularly so in the case of a hedge fund or other frequent investor in the public markets that relies on access to management when making and managing its investments. In this regard, we note that issuers may react differently to an investor with an activist reputation (e.g., Carl Icahn or Nelson Peltz) crossing a 5-percent threshold than one that has not established a pattern of activist behavior.

### ***How Some Investors Have Acquired More Than 5-Percent Economic Ownership without a 13D or 13G Filing***

While an investor may acquire up to 4.9 percent of a public company without triggering a 13D or 13G filing requirement, many investors wish to gain further economic exposure to an issuer’s securities without incurring the obligation to make such a filing. The reasons for this can vary, but most often revolve around an investor’s desire to avoid signaling its interest in a particular stock to either the issuer or the marketplace. In such a case, it is broadly accepted on the Street that an investor may increase its economic interest in an issuer’s securities beyond 4.9 percent without the need to make a 13D or 13G filing if it does so via a derivative contract that is both by its terms and in fact cash-settled.

This interpretation of “beneficial ownership” under Section 13 does, however, merit a note of caution. Specifically, while it is generally accepted practice that derivative securities that are cash-settled (either actually or by their terms) do not constitute “beneficial ownership” of the subject securities, for Section 13 purposes, this view has never been tested in the courts, and there are arguments against this view that could be advanced that might either prevail in some courts or at the very least survive a motion to dismiss. This means that any case challenging this activity may have settlement value and is therefore more likely to be brought. Accordingly, it would be advisable, absent other factors, to avoid taking actions that may generate publicity or otherwise lead to scrutiny with respect to the investor’s positions.

### ***Running with the Pack and Risks of Becoming a Member of a “Group”***

Subject to the reporting and proxy rules we discuss below, an investor may generally talk to other investors and management about its investment in a company. However, if the investors coordinate activities or agree to act with other investors in connection with acquiring, holding, voting or disposing of the company’s securities, the investors would be deemed to have formed a “group.” There are a number of adverse consequences that must be considered before taking any action that risks forming a group, including the following:

- » if the group owns more than 5 percent of the issuer, each member of the group or the group jointly must file and keep current a Schedule 13D or 13G reporting the group’s ownership.
- » if the group owns more than 10 percent, each member of the group will become subject to Section 16 and its “short-swing profit” disgorgement rules [even if the member, by itself, owned less than 10 percent (although members’ transactions are matched only with their own transactions and not those of other members)]. This is a serious risk, as it subjects the investor to liability if it purchases and sells issuer securities within six months if the price of the security is higher on the sale date than on the purchase date, even if no actual profit is earned. Additionally, under Section 16, no member of the group will be permitted to take short positions in the issuer’s securities while the group exists or continues to own more than 10 percent.
- » as a reputational, regulatory and, perhaps to a somewhat lesser extent, liability matter, the investor and the other group members may be tagged with responsibility for the other group member’s conduct, particularly if matters become adversarial with the issuer.

In light of these risks, when meeting with management, a large investor that is not prepared to become a “group” with Investors X and Y should take care not to suggest or imply that it is acting in concert or coordinating activity with them in seeking change, although the investor should feel free to note that it has spoken with those investors and they agree with the investor’s views.

A complete discussion of the case law interpreting when investors have formed a group for Section 13 purposes is too voluminous for us to discuss here. We would, however, note that Brian Breheny, chief of the SEC’s Office of Mergers and Acquisitions has expressed concern about rumored concerted activity among hedge funds in an issuer’s securities (without a “group” 13D filing) and noted that the staff will aggressively pursue violations of Section 13(d) if it becomes aware of them.

### ***Heightened Risks during Proxy Season***

If an investor were to start an active campaign to replace or elect its own slate of directors or to support or oppose another shareholder’s resolution in relation to an issuer, the investor must comply with the proxy rules which, among other things, require that the investor must file a proxy statement with the SEC if it solicits the support of more than 10 other shareholders. Even if it were not undertaking a proxy campaign, there is some risk under the proxy rules if it is actively talking to more than 10 other investors against or in favor of a matter that is the subject of an upcoming shareholder vote. Whether conversations with other investors will run afoul of these restrictions will usually require an analysis of the specific facts, so consultation with counsel is advisable.

### **Section 16 Risks to a 10-percent Holder**

An issuer’s directors and officers, as well as beneficial owners of more than 10 percent of any class of its registered voting equity securities, are subject to (a) reporting requirements, (b) recoverability of “short-swing profits” realized from trades in those securities and (c) restrictions on short sales in those securities.<sup>1</sup>

Section 16 imposes two different “beneficial ownership” standards, depending on the purpose of the ownership calculation. First, for purposes of determining whether a holder has crossed the 10-percent threshold, the beneficial ownership standards are the same as set forth in Section 13(d) of the Exchange Act that we discussed above. For all other purposes under Section 16, beneficial ownership of securities means having or sharing a direct or indirect pecuniary interest in those securities. The term pecuniary interest is broadly defined as the opportunity, directly or indirectly, to profit, or share in any profit, derived from a transaction in the subject securities, including the right to acquire an issuer’s securities through the exercise of a derivative instrument or synthetic derivative interest relating to the issuer’s securities.

#### ***Reporting Requirements***

Section 16(a) of the Exchange Act requires that directors, officers and >10-percent holders must file with the SEC (a) a Form 3 disclosing the amount of all such securities beneficially owned by them, (b) a Form 4 reporting any changes in ownership before the end of the second business day following the day the change occurred and (c) a Form 5 to disclose at year-end certain transactions that were exempt from earlier reporting requirements (such as gifts).

#### ***Recoverability of Profits***

Section 16(b) provides that the issuer of equity securities can recover any “short-swing profits” realized by any director, officer or >10-percent beneficial owner from any purchase and sale, or sale and purchase, of those securities within any period of 6 months (including by way of derivative instruments). When applying this rule, it is important to note that actual profit is not necessary. Rather, purchases and sales are arbitrarily “matched” for purposes of Section 16 so as to create a recoverable “profit.” For example, a >10 percent beneficial owner that purchases a share at \$20, sells that share at \$18, and purchases another share at \$16, will have its purchase

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<sup>1</sup> Exemptions from these rules apply to certain market-making activities of dealers and certain types of arbitrage transactions.

at \$16, and sale at \$18 “matched” to create a recoverable “short swing profit,” regardless of the timing or other circumstances of the transactions. The justification for this outcome is the desire to discourage corporate “insiders” from trading on inside information. Note also that the rule employs a strict liability standard; actual misuse of, or intent to misuse, inside information is irrelevant.

### ***Restrictions on Short Sales***

Section 16(c) bars persons that are subject to Section 16 from selling equity securities of the issuer if that person (a) does not own the securities sold, or (b) owns those securities and does not make delivery of them against that sale within 20 days, or mail them within 5 days of that sale. As applied to synthetic sale positions (*e.g.*, an open put position), those positions must be fully covered through actual physical ownership of securities at all times while the position is outstanding.

### ***Potential Section 16 Risks to Certain Investors with Long Derivative Positions***

We described earlier how certain investors may increase their economic interest in an issuer’s securities beyond 4.9 percent without the need to make a 13D or 13G filing if they do so via a derivative contract that is, both by its terms and in fact, cash-settled. We also described how this legal position has not been blessed by the SEC or the courts and may be subject to legal challenge, so public awareness creates meaningful legal risks. Similar legal issues apply to an investor with a 9.9-percent ownership interest in a public company and greater economic exposure through cash-settled derivative securities, except that the legal risks are higher so the theoretical cost of publicity is likewise greater.

For example, if Hedge Fund, LLC beneficially owns 9.9 percent of an issuer’s common stock, it is a counterparty to a cash-settled derivative instrument giving it economic exposure to an additional 5 percent of that stock, and it thereafter elects to become activist and switch from a Schedule 13G to a Schedule 13D, the risk of a Section 16 lawsuit (and “short-swing” profit disgorgement) increases materially for several reasons. First, filing a Schedule 13D is often a newsworthy event. Further, Schedule 13D requires the filing person to describe all “contracts, arrangements, understandings or relationships . . . with respect to securities of the issuer, including . . . loan or option arrangements, puts or calls . . . division of profits or loss,” which clearly requires a description of any cash-settled derivative. Such news coverage and the description of derivative instruments in the Schedule 13D (and a > 10-percent economic exposure to the issuer’s common stock) risks eliciting scrutiny from the SEC or the Section 16 bar, which we know to monitor Schedule 13D filings for possible lawsuits to file. Additionally, once a holder acknowledges an intent or purpose of changing or influencing the control of the issuer by filing a Schedule 13D, the issuer may have an incentive to seek to impose Section 16 liability on that holder. As a result, Hedge Fund, LLC should be cautious in these circumstances before becoming activist and switching from a 13G to a 13D filing, as the level of information and attention in the marketplace may increase materially and the number of parties with incentives to challenge the filer’s Section 16 interpretation may also increase.

### **Hart-Scott-Rodino Antitrust Improvements Act (“HSR Act”)**

The HSR Act also imposes filing obligations on investors that acquire large stakes in public companies. An investment resulting in ownership of voting securities or assets with an aggregate value of more than \$56.7 million (increasing annually based on changes in gross national product) generally triggers notification requirements with the Federal Trade Commission and the Department of Justice. In calculating the \$56.7 million or other percentage amounts, the HSR Act only looks to outstanding voting securities and disregards derivatives such as warrants and non-voting convertible preferred stock (until exercised or converted). Once a filing is made, the target company is notified and must make a responsive filing. The investor may not cross the \$56.7 million threshold until it receives DOJ or FTC clearance. The waiting period is typically 30 days (15 days for an all-cash tender offer), subject to early termination.

There are two key exceptions to the above requirement: First, an acquisition of 10 percent or less is exempt if the acquisition is made by a passive investor, solely for the purpose of investment. Certain passive institutional investors may acquire up to 15 percent. Passivity is a vague standard, however, and potentially activist investors have relied on this exception. An investor will lose this exception under HSR if, among other things, it has certain governing responsibilities such as board representation or the right to designate a

board representative. An investor would also not be able to rely on the exception if it is a direct competitor of the target company, which would include a private equity or hedge fund that owns a majority stake in a business that is acquiring a direct competitor. Second, the HSR rules applicable to partnerships (including LLCs) are such that the ownership positions of even affiliated partnerships or LLCs often may not be aggregated even if they act in concert or have the same general partner or manager, because partnerships and LLCs are treated as affiliated entities only if they share the same 50-percent owner (*i.e.*, they have the right to 50 percent or more of either the profits or assets upon dissolution of the LLC or partnership involved). Because hedge funds generally are structured as LLCs or partnerships and parallel funds typically do not have the requisite overlapping ownership, a series of related hedge funds could, in theory, each acquire a 9.9-percent position (assuming the investment exception is available) without ever having to make an HSR filing.

## Other Requirements/Laws

Investors should also consider laws such as anti-takeover statutes enacted in some states that prohibit large shareholders from effecting a “business combination” transaction with a target for some period of time, with exceptions, such as prior board or shareholder approval. An investor should also consider the company’s corporate organizational documents, such as its charter and bylaws, which may contain certain provisions such as fair price provisions and notice and supermajority requirements. The regulatory framework applicable to the investor and/or target company should also be reviewed. For example, investors affiliated with bank holding companies are generally subject to limitations on acquiring voting securities of certain companies that are non-banks under the Bank Holding Company Act.

Finally, an investor should determine whether a company has a shareholder rights plan (“poison pill”) in effect that will be triggered when a specified number of shares is acquired, making it difficult for an investor to acquire an influential stake in the company or accomplish corporate change without incumbent board support. Issues such as “group” membership may be a factor when determining whether an investor will be considered an acquiring person for purposes of a rights plan. A company looking to shield itself from attack by an activist investor, on the other hand, may consider the effectiveness of enacting a rights plan, which has been demonstrated as one possible way to thwart an attack. At the very least, a well-drafted rights plan may have a “chilling” effect on group activities.

This newsletter provides a general overview of a variety of complex legal issues, so we recommend that an investor considering a significant investment in a public company consult counsel on these and other issues to determine what impact, if any, they may have on the investor’s strategy.

## Conclusion

With investor capital reaching an all-time high and M&A merger activity higher than it has been since 2000, investors are acquiring increasingly large investment stakes in public companies. Before such investments are made, however, investors should carefully consider the legal and regulatory pitfalls that may lay before them.

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*This memorandum is a summary for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice.*