

Stealth Swaps, Stale Pills and Mystery Non-Voting Shareholders

No Parking Rules Still in Effect After 5(%)

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Investors don't like surprises. In recognition of the value of disclosure for operation of the securities markets, federal securities laws require prompt disclosure in a Schedule 13D by shareholders who hold more than 5% of the equity securities of publicly traded entities.¹

Boards of Directors don't like surprises either, and to improve their negotiating power have adopted shareholder rights plans - - - so called "poison pills" - - - allowing shareholders to obtain shares of the target's common stock in exchange for the rights at a favorable price. However, because the rights are not issued to an acquiror whose beneficial holdings exceed a specified percentage (typically between 10 and 20%) of equity ownership, these plans are unacceptably dilutive ["poisonous"] to acquirors, who therefore seek to avoid triggering a pill so as not to swallow its "poison".²

The recent disclosure that two hedge funds, through an equity swap - - - viewed by some as a "loophole" - - -, had acquired more than 20% of the economic value of an issuer's equity without having filed a Schedule 13D apparently occasioned such a surprise for investors and directors alike.³ If applicable law does not mandate filing, and shareholder rights plans track statutory definitions, may an issuer effectively amend its plan to encompass equity swaps? Should the SEC or state legislatures close the loophole by expanding the basis on which disclosure through filing is required?

This article describes the basis for the non-filing "loophole", and examines some of the consequences for would-be acquirors, their stealth-swap counter-parties, and the entities whose pills may now be stale. It takes the form of an imaginary conversation between the lead director of a public corporation and its counsel.

Director: How is the swap effected?

Counsel: The parties ---the acquiror and an investment bank, derivatives dealer, or other counter-party --- enter into an equity swap agreement. The acquiror obtains an economic

return based on performance of the underlying target's securities in return for a fee to the counter-party for effecting the transaction, as well as other payments.⁴ To hedge its position the counter-party may (but need not) hold some or all of the securities swapped: it is short, whereas the acquiror is long.

D: But if the position is over 5%, I thought the holder must file a Schedule 13D⁵ under the federal securities laws?

C: The filing provision applies to "beneficial ownership" of a target's equity securities,⁶ which Rule 13d-3(a) defines as the power (or shared power) to vote, or to dispose of the securities; it does not apply to the underlying economic ownership. The swap involves what some have referred as a "de-coupling", or a separation of voting interest from economic value.⁷

D: Couldn't the acquiror obtain the economic upside with the purchase of a call option?

C: Yes but: a premium would be paid for the call, typically exercisable within a fixed time period, and -- more to the point, -- if exercisable within sixty days it would (under rule 13d-3(d)(1)(i)) be deemed beneficial ownership subject to the reporting requirement.

D: Hence the notion of a "stealth" swap.

C: Exactly.

D: But if the acquiror doesn't have the voting interest, and its counter-party holds the shares, . . . and is entitled to vote . . . isn't the counter-party required to file?

C: Section 13(f)⁸ requires institutional investment managers that exercise investment discretion over at least \$100 million of equity securities to file quarterly Form 13F reports, but with certain exceptions those are due only within 45 days after the end of the calendar quarter.

D: So an equity swap effected within, say, the first ten days of April, need not be reported by the institutional investor for its quarter ending June 30 before mid-August, perhaps four months later?

C: Assuming the institutional investor does not propose to influence or change control of the issuer, that's correct. The delay adds to the stealth quality. And if the person

entitled to make that filing on Schedule 13G should acquire “beneficial ownership” exceeding 10% of the class of equity securities, the initial filing must be made sooner.⁹

D: I appreciate that the acquiror does not have the power to vote, or to dispose of the securities, which are the criteria for “beneficial ownership.” But if counter-parties often hedge their down-side risk in a swap (against the possibility of an increase in share price) by holding the swapped securities, doesn’t the acquiror expect to obtain those securities from the counter-party when he decides to terminate the swap? And if so, doesn’t that constitute conduct covered by the concept of a “group”¹⁰ under federal securities law?

C: The acquiror may have the expectation to obtain the securities swapped from his counter-party, but if he has no right to compel their return there is no violation. In a transaction involving Sears in Canada¹¹, a hedge fund attempting to cast a vote against a pending buyout offer sought to unwind its equity swap, obtain the shares, and thereby “re-couple” the right to vote with its economic value. But in the interim the counter-party had become involved as dealer-manager for Sears in the transaction, and refused to return the swapped shares, in effect retaining the vote and frustrating the acquiror’s expectation. Clearly the concept of a “group,” which requires only an understanding and need not be in writing, is highly relevant to the analysis of whether filing is required. But the swap itself, with no further understanding, should not warrant a conclusion that a group was formed.

D: What if the same counter-party deals repeatedly with the acquiror, whose expectations are consistently met, i.e., the swapped securities are always returned to the acquiror?

C: Certainly a counter-party in a potentially litigious matter would be best advised to avoid any pattern that, in retrospect, would persuade a trier of fact that there was an arrangement amounting to “group” action. In earlier days that action would be deemed unlawful “parking”, for which violators who did not file were fined, or charged criminally.¹² A similar conclusion could be reached today, so for swap counter-party providers it may be prudent to heed a revised adage: “no [pattern of] good deeds go unpunished.”

D: I read that two hedge funds recently surfaced with a 21% position in CNET Networks, Inc. through the use of stealth swaps.

C: An SEC filing indicated that Jana Partners LLC held approximately 12% of CNET's voting stock and a separate approximately 5% non-voting economic interest. Another participant reported an approximately 2% voting interest and a separate approximately 3% non-voting economic interest.

D: Were there any implications regarding a shareholder rights plan?

C: Following these disclosures CNET adopted its own shareholder rights plan. In any skirmish, there are reputational and legal factors, and Jana's type of response should generally be anticipated. Its press release criticized CNET's adoption "of an increasingly outdated unpopular entrenchment mechanism . . . and continues a pattern of hiding behind legalities . . ." ¹³

D: Jana's actions may be indicative of future trends. Does our Board have to be concerned about being surprised by these stealth swaps, as long as our poison pill is already in effect?

C: I've not taken a survey but suspect that many, perhaps most rights plans follow closely (as does yours) the definitions of beneficial ownership set forth in Section 13(d), which the stealth swap acquiror legitimately avoids. Your corporation's shareholders rights plan contains so called "flip in" and "flip over" provisions. An acquiror would not want to trigger the "pill" and swallow its "poison" which permits all shareholders --- other than the acquiror --- to acquire rights which would dilute the acquiror's position. But if an acquiror were to utilize the equity swap mechanism and legitimately avoid filing, your Board would be surprised.

New Medicine or New Rules?

D: But if we overcome the PR hurdle, can we effectively amend our existing plan to protect against stealth swaps?

C: Could the plan be amended to cover a shareholder whose stock ownership is

below the pill trigger (say, 15%), but potentially exceeds that amount when combined with the economic value embedded in the equity swap? I'm not aware of any company that has sought that remedy, or of authority to the contrary. If there is reason for a Board to believe it is protecting against an increase of voting ownership, such an amendment could conceivably pass muster and revive a pill which, in a swap market environment, has grown stale and may no longer timely provide the protection it was originally designed to achieve. The drafting challenge must be approached with a rifle, not a shotgun, so as to avoid unintended coverage. The amendment would narrowly define the pill "trigger" to address a shareholder whose beneficial holdings, when aggregated with the derivative's economic value, exceed the specified cap.

D: If that drafting exercise should prove too difficult, should the SEC or state legislatures amend the law to proscribe these stealth swaps or at least mandate their disclosure?

C: Several foreign jurisdictions have taken that route, which some scholars also favor.¹⁴ In contrast, entrepreneurs would argue that those who search for and uncover opportunities in under-valued companies should be rewarded. I tend to agree with the view that a sufficient case for legal intervention has not yet been made, and with the admonition to "regulate cautiously and carefully".¹⁵ Bear in mind that Section 203 of the Delaware General Corporation law does currently prohibit a business combination with an "interested shareholder", defined as the owner of 15% or more of the voting stock, for a period of three years.

D: But if an interested shareholder takes over a majority of the Board through a proxy contest, it could seek a combination with an unaffiliated third party, right?

C: Correct, if the new (replacement) Board can muster the necessary percentage of votes for a combination it supports, arguably it should succeed. But ironically the same "loophole" of beneficial ownership (no power to vote) which insulates the acquiror from filing also prevents it from voting.

D: What about the swap counter-party, whose vote exceeds its "empty" economic interest.¹⁶ Is this what "shareholder democracy" has come to?

C: In this context, at least, yes. To the extent “re-coupling” does not occur, the swap counterparty professional may, despite strong views to the contrary, abstain from voting with the acquiror so as to counter any charge of “group” formation. Remember that Section 203, poison pills and the SEC filing requirements all reach participants in a group, i.e. swap counter-parties with an understanding to act in concert.

D: A review of our corporation’s rights plan would be in order, together with those of potential targets. In this climate our corporation may want to obtain the benefits of stealth through some toe-holds of our own.

C: In that event, we’d also want to see what percentage of the shares of a target, or your own corporation, could be acquired in today’s depressed market before a filing would be needed under the Hart-Scott-Rodino Act, which has a \$63.1 million threshold.¹⁷

D: Would we --- or an acquiror of our shares --- have to be concerned about the short swing (profit recapture) provisions under the securities laws if it did not have the vote or the right to dispose?

C: Good question. Beneficial ownership of more than 10% of any class of any equity security under Section 16 of the Exchange Act is determined by the Section 13(d) beneficial ownership rules, but once that threshold is reached, the reporting and profit recapture provisions are applicable to security-based equity swap agreements as well. And if an investor is deemed to constitute a group with its counter-party, filing requirements mandated under both sections 13 and 16, and the consequences of a failure to file, would be applicable.¹⁸

D: I think you’re telling me to assume that, for both sides of “the Street”, “No Parking” rules remain in effect.

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FOOTNOTES:

1. Securities Exchange Act of 1934, Section 13(d). All references in this article are to the Exchange Act and the rules promulgated thereunder, unless otherwise stated.
2. *See* for a primer on plan design, EDWARD D. HERLIHY, TAKEOVER LAW AND PRACTICE 2007 in CONTESTS FOR CORPORATE CONTROL 2008: CURRENT OFFENSIVE & DEFENSIVE STRATEGIES IN M&A TRANSACTIONS, 229 (Practicing Law Institute 2008).
3. Andrew Sorkin, *A Loophole Lets a Foot in the Door*, N.Y. Times, January 15, 2008 at 1, available at <http://www.nytimes.com/2008/01/15/business/15sorkin.html>.
4. A typical agreement might provide for interim payments of appreciation or depreciation of the shares and a finance fee during the term the swap is outstanding.
5. Section 13(d)(1).
6. Rule 13d-3(b) provides that any person who uses an arrangement with the purpose or effect of divesting such person of beneficial ownership shall be deemed to be the beneficial owner.
7. Henry T.C. Hu & Bernard Black, *The New Vote Buying; Empty Voting and Hidden (Morphable) Ownership*, 79 S. Cal. L. Rev. 811 (2006).
8. *See* Rule 13f-1(c) for the definition of “Section 13(f) securities”.
9. Rule 13d-1(b)(2).
10. Section 13(d)(3) refers to “two or more persons [who] act . . . for the purpose of acquiring, holding or disposing of securities of an issuer”; Rule 13d-5(b)(1) encompasses “two or more persons [who] agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer”.
11. Hu & Black, *supra* note 7, at 839; based on Jesse Eisinger, *In Canada, a Face-off Over Sears*, Wall St. J., April 12, 2006 at C1.
12. The consequences of a failure to file could involve administrative SEC proceedings (Cease and desist orders, §21C(a); disgorgement, §21C(e); and money penalties §21(d)(3); Civil Judicial Proceedings, injunctive relief, §21(d)(i); and Criminal Proceedings §32(a)). *See* SEC v. Bilzerian, 814 F. Supp. 116 (D.D.C. 1993)(Disgorgement in the amount of \$33,140,000).
13. Jana Partners LLC. Press Release, January 14, 2008, filed as Exhibit 1 to Schedule 14A (File Number 001-33915).
14. Hu & Black, *supra* note 7, at 907-08; *see also* Hu & Black at 840-41 (discussion of the social virtues of stealth).
15. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. Pa. L. Rev. 1021, 1093 (2007).
16. Hu & Black, *supra* note 7, at 828 n.32 (discussion of Perry Corp.’s Schedule 13D as to Mylan

Laboratories, Inc.).

17. Federal Trade Commission Announces Revised Jurisdictional Thresholds for Filings, January 18, 2008, *available at* <http://www.ftc.gov/bc/hsr/hsr.shtm>.

18. *See supra* note 12.