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# A GUIDE TO AVOID BECOMING AN ACCIDENTAL ACTIVIST INVESTOR

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Shareholder activism is on the upswing. As the New York Times recently reported, this year's contested directors' elections are much bigger than last year's and include six at companies with a market value of more than $1 billion. Moreover, activists have been winning a majority of board elections - 66% so far this year, according to the data provider FactSet SharkRepellent ("As Shareholder Fights Heat Up, Activists Aim at Bigger Targets," New York Times Dealbook, April 16, 2013).

Most shareholder campaigns are undertaken by hedge funds known for their activism, such as Icahn Management LP, Santa Monica Partners Opportunity Fund LP, and Relational Investors, LLC. But it sometimes happens that a normally passive investor will find its interests aligned with an activist and support the activist's efforts to varying degrees.

Such cooperation can be a legal and even reputational minefield for the uninitiated. Companies generally use a wide variety of defensive strategies to oppose "activist investors," many of them executed through defensive or offensive litigation. It is common for target companies to scrutinize the activist investor's securities filings and commence litigation to determine whether any shortcomings in the disclosures or other errors can be alleged. If the target company is successful, the activist and its group of investors can suffer damages including a loss of voting rights as stockholders. Such litigation is not only expensive but can also involve reputational harm where seemingly irrelevant dirty laundry may be aired. Participation in a group with an "activist" investor can also lead to exclusion by other companies who seek cooperative private investors.

Chief among the legal risks for those unaccustomed to swimming in these waters is running afoul of Regulations 13D and 13G, requiring disclosures from investors who have formed or attached themselves to a group that acquires beneficial ownership of more than 5% of any class of publicly traded securities in a public company. An activist novice might in some circumstances find itself deemed a member of such a group without having deliberately "joined." Below, we outline these and other risks that the occasional activist needs to take into account.

## "Group" Formation

A shareholder that is not deliberately joining or forming a "group" with other investors should be careful to avoid communications with any other investor that might result in being considered part of a such a group, i.e., one that holds, in the aggregate, more than 5% of an issuer's equity securities. A group is formed where there is an "agreement" to act together for the purpose of acquiring, holding, voting or disposing of securities of the issuer. The agreement may be informal or may be inferred from circumstantial evidence.

Hedge funds are susceptible to allegations of failing to disclose group formation because they often follow each other's investment decisions closely and purchase the same securities, giving rise to the perception that they have acted in concert. Under certain circumstances, a shareholder may be well advised to expressly disclaim membership in any group in order to thwart allegations of violations of disclosure rules.

Before agreeing to become part of a group, or even engaging in conduct which can be interpreted as group activity, the participants should understand that reputations

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are potentially at stake and one participant's actions may tarnish the reputation of another. Being accused of failing to file Form 13D or disclose the formation of a group – each a violation of securities laws – can have a meaningful impact on the success of a fund manager and can be the basis of allegations of fraud and disgorgement of profits.

## Schedules 13D and 13G

Schedule 13D, also known as "Beneficial Ownership Report" must be submitted to the SEC within 10 days by anyone – including a "group" of investors -- who acquires beneficial ownership of more than 5% of any class of an issuer's publicly traded securities. Schedule 13D must be updated to reflect any material change in the facts disclosed, including the acquisition or disposition of 1% or more of the class of securities that are the subject of the filing. The Schedule 13D is filed with the SEC and is provided to the issuer and each exchange where the security is traded.

Schedule 13G is a similar filing, but reserved for "passive investors," or those who do not intend to "exert control" in respect to a company. Schedule 13G has the same 5% filing trigger as Schedule 13G, but requires an annual filing within 45 days after the end of a calendar year.

There is currently a debate between activist interest and corporate interests about activists' value to issuers and the economy in general. Companies arguing that activists tend to push measures that boost short-term profit at the expense of a company's long-term health are pushing to shorten the filing deadline for Schedule 13G and other reports. Martin Lipton, founder of law firm Wachtell, Lipton Rosen & Katz, recently pressed this point in a November 13, 2012 Conference Board debate with Harvard Law School Professor Lucian Bebchuk.

## Schedule 13D Disclosures

Required information disclosures in Schedule 13D include:

- The background, identity, residence and citizenship of, and the nature of the beneficial ownership by, the person and all other persons by whom or on whose behalf the purchases have been or are to be effected.

- The source and amount of funds or other consideration used or to be used in purchasing the securities. If any of the purchase price includes funds or other consideration borrowed or otherwise obtained for the purpose of acquiring, holding or trading the security, include a description of the transaction and the names of the parties involved. If the source of funds is a loan made in the ordinary course of business by a bank, as defined in Section 3(a)(6) of the Exchange Act, the filer does not need to disclose the name of the bank.

- If the purpose of the purchases or prospective purchases is to acquire control of the business of the issuer of the securities, include any plans or proposals which the reporting persons may have to liquidate the issuer, sell its assets, merge it with any other persons or make any other major change in its business or corporate structure.

- The number of shares which are beneficially owned by, and the number of shares which there is a right to acquire, directly or indirectly, from the person and each associate of that person, giving the background, identity, residence and citizenship of each such associate.

- Descriptions of any contracts, arrangements or understandings with any person regarding any securities of the issuer, including joint ventures, loan or option arrangements, puts or calls, guarantees of loans, guarantees against loss or guarantees of profits, division of losses or profits, or the giving or withholding of proxies. The disclosure must also include the names of the persons who have entered into the contracts, arrangements or understandings." (Source: Practical Law).

## Issuer's Legal Arguments and Challenges

Target companies often use litigation as a defensive or offensive tactic to thwart activists' efforts. An issuer that resists an activist's agenda/actions will be looking for any violations of applicable laws by the activist investor, including:

(i) failure to comply with Section 13(d) of the Securities and Exchange Act of 1934 the "'34 Act") and the rules and regulations promulgated thereunder

  - includes noncompliance with timely filing Schedule 13D or failing to convert a Schedule 13G into a Schedule 13D
  - also includes failure to disclose the formation of a "group"

(ii) failure to timely make a required filing with the Federal Trade Commission under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR"),

  - HSR contains a filing requirement prior to the acquisition of voting securities of an issuer valued in excess of $70.9 million in

the aggregate, based on total current value at the time of acquisition.

(iii) violations of state takeover management statutes, fair price statutes, and control share statutes, and;

(iv) violations of the short swing trading prohibitions of Section 16(b) of the ’34 Act.

## Short-Swing Profits

Section 16(b) of the ’34 Act requires “insiders” – those who hold more than 10% of an issuer’s equity securities – to disgorge to the issuer any profit resulting from any sale and purchase or purchase and sale of such issuer’s equity securities within a six-month period (the “short-swing period”). Section 16 and its related rules are complex and have been the subject of numerous interpretive letters from the SEC. For example, a holder may become an “insider” without purchasing any additional securities due to a stock buyback. Accordingly, any investor whose direct and indirect holdings are close to 10% should pay careful attention to the 16(b) rules.

## Proxy Contests

Proxy contest participants must complete Schedule 14A, which requires disclosure of the backgrounds of the various participants, including those who finance the campaign. Activist investors’ efforts often culminate in engaging in a very public proxy contest involving battles of mud-slinging press releases that contain allegations of violations of law, failure to lead a company, and other allegations that can cause reputational harm. Members of activist groups should be aware that such reputational damage could spread to them, regardless of their innocence or lack of participation in the proxy contest.

## If You Dare, Prepare!

The risks identified in this article should not dissuade investors from aligning themselves with – or even agreeing to invest alongside -- activist investors acting on compelling reasons to seek a change of management, strategy, or practice. It is essential to be aware of these risks, however, and of the compliance duties that such alliances may entail.

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