

# ACTIVIST INVESTING

## developments

### Advance Notification BYLAWS



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One of the principal threats available to an activist investor against a company that fails to take the actions suggested by the investor is to replace one or more members of the board or to obtain passage of a precatory, or if possible mandatory, shareholder proposal. Either of these actions is generally taken at an annual meeting because, among other reasons, shareholders often lack the power to call special meetings and many corporations prohibit action by less-than-unanimous shareholder consent.

The boards of directors of many corporations, without the necessity of any shareholder approval, have enacted special provisions regulating the ability of shareholders to propose directors or place items on the agenda for consideration at the annual meeting. These provisions typically take the form of "advanced notification bylaws" ("ANBs"), and are justified by their proponents on the basis that they simply provide an orderly procedure for, rather than an impediment to, shareholder action, and assure that the company and the other shareholders have adequate time to evaluate the proposed action. However, by advancing (sometimes dramatically) the date by which an activist shareholder must notify the company of its intention to take action at the annual meeting, these bylaw provisions force shareholders to commence an activist campaign far in advance of the annual meeting, and often foreclose action at that meeting.

Typically, ANBs require that shareholders submit to the board, some fixed number of days in advance of the annual meeting, any proposals or nominees that shareholders propose for consideration at the meeting. In 1998, the Delaware Chancery Court noted that "by-laws mandating a 90 day minimum period of advance notice are commonplace" and that:

a 1998 study by the Investor Responsibility Research Corporation revealed that of 1,922 large publicly traded companies, 880 (46%) have some form of advance notice by-law. Of those by-laws, the most common notice period (adopted by 335 companies) is 50 to 70 days, and the second most common notice period (adopted by 223 companies) is 75 to 100 days.<sup>1</sup>

More recently, several company ANBs have required shareholder proposal notice to be provided 120 days in advance of the date that the company mails shareholders proxy materials for the annual meeting, or effectively a full five months before the meeting.

While ANBs as a general matter are lawful,<sup>2</sup> the Delaware courts have placed limits on the ability of boards to enforce such provisions when they have the effect of frustrating the shareholder franchise.

In one particularly dramatic case of board entrenchment, *Lerman v. Diagnostic Data, Inc.*,<sup>3</sup> a board of directors was challenged in court after it enacted a combination of bylaws that in effect made submission of required proxy information to the board impossible: while one bylaw changed the date of the corporation's annual meeting to sixty-three days after the date on which the bylaw was enacted, another (enacted simultaneously) required that shareholders submit their election nominees to the board at least seventy days in advance of the annual meeting. The Delaware Chancery Court held that a bylaw restricting shareholder access to the control mechanisms of the annual meeting may be impermissible even if enacted in accordance with a board's authority under its own charter and the Delaware General Corporate Law, writing that "inequitable conduct by

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## Advance Notification Bylaws, cont.

management cannot become permissible simply because it is legally possible.<sup>4</sup> The Court also concluded that "a by-law amendment authorizing a change in a fixed annual meeting date to a date to be established by management cannot be put into operation in such a manner that those wishing to wage a proxy fight are required to be in a state of 'shelf-readiness' in order to meet a sudden advancement of the date."<sup>5</sup>

Similarly, in *Schnell v. Chris-Craft*,<sup>6</sup> the board of directors enacted ANBs making shareholder action impracticable at best. Specifically, the board amended the corporation's bylaws so that the board would have discretion to set an annual meeting date at any point during a two-month window, then scheduled the next annual meeting for a date one month in advance of its traditional date, giving insurgents only six weeks, rather than two months, in which to submit proxies to shareholders. Characterizing these measures as "inequitable conduct designed to thwart the efforts of the challenging shareholders," the Delaware Supreme Court held that a board cannot enact bylaws setting a variable date range for its annual shareholder meeting such that selection of a meeting date by the board from within that range could take shareholders by surprise, shortening the time available to prepare an alternative election slate or submit proxy information to the degree that shareholders would have difficulty conforming with submission requirements.

In addition to ensuring that dissidents have an adequate period in which to wage a proxy contest, the courts have also invalidated ANBs where, in the circumstances, the period to provide notice to the Company of the dissident's intention was unreasonably short. In *Hubbard v. Hollywood Park*,<sup>7</sup> the court found unreasonable a seven-day period between the board's annual meeting notice to shareholders and the date of proxy material submission required by the

corporation's advance notice bylaw. The court wrote:

An advance notice by-law will be validated where it operates as a reasonable limitation upon the shareholders' right to nominate candidates for director. More specifically, such a by-law must, on its face and in the particular circumstances, afford the shareholders a fair opportunity to nominate candidates.<sup>8</sup>

Although in *Hubbard* the stated purpose of the bylaw was to assure "that stockholders and directors will have a reasonable opportunity to thoughtfully consider nominations and to allow for full information to be distributed to stockholders, along with the arguments on both sides," the court found that such a purpose would be frustrated by the short gap between notice and submission, and that "the by-law's other purpose—to afford adequate time for information and reflection—[could] be achieved by a modest adjustment in the date of the annual meeting, if needed."<sup>9</sup> Commentators have also noted that the *Hubbard* decision would invalidate even an ordinarily reasonable ANB where a corporation's board, after the deadline for shareholder submissions under the ANB, adopts a new corporate policy (whether in good faith or bad) that "if announced before the nomination deadline, would have foreseeably generated controversy and led to the nomination of a dissident slate." In such a situation, the board could be required to waive its guideline if asked to do so by a shareholder group.<sup>10</sup>

While these cases demonstrate that the Delaware courts find a seven-day period so insufficient to prepare proxy materials as to be unreasonably restrictive upon shareholders' voting rights, other decisions indicate that only a few extra days may be

enough to render similar bylaws reasonable. In *Mentor Graphics Corp. v. Quickturn Design Systems*,<sup>11</sup> the Delaware Chancery Court upheld an ANB—by the court's own admission at the "outer limit" of reasonableness—that provided activist shareholders with only ten days time to prepare materials for submission to the board following notice of the corporation's annual meeting.

The most recent decision in this area, on a preliminary basis, seems to permit a corporation to manipulate the timing of its meeting announcement so that the ten-day period to respond can be cut to five business days. In *High River Limited Partnership v. Mylan Laboratories, Inc.*,<sup>12</sup> the Mylan board enacted increasingly aggressive ANBs that were seemingly intended to frustrate shareholders seeking to oust the incumbent board. First, in December 1997, the board enacted a fairly typical ANB requiring that any shareholder's proposal be submitted 60 calendar days in advance of the annual meeting, although for any meeting date announced less than 75 days in advance, shareholders would be given ten calendar days to submit their proposals. In June of 2003, this 60-day advance notice requirement was increased to 120 days. Finally, on February 18 of this year, the board made its ANB even more onerous, in order to forestall expected shareholder revolt over a controversial board-supported merger plan: the board issued a press release moving its annual meeting from its customary July 29 date to October 28, simultaneously amending the ANB to require submission of proposals within ten calendar days of any announcement that the annual meeting would take place more than twenty-five days earlier or later than the anniversary of the previous year's meeting. In this specific case, due to weekends and the Presidents Day holiday, dissident shareholders had only five business days in which to prepare an alternative slate of directors for submission to the incumbent board.

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*"Inequitable conduct by management cannot become permissible simply because it is legally possible."*

## Advance Notification Bylaws, cont.

Shareholders immediately sued to enjoin the board's action. Under applicable Pennsylvania corporate law (and as in Delaware) shareholder election procedures are required to be "fair and reasonable."<sup>13</sup> However, the Pennsylvania federal district court rejected the shareholders' injunction request:

As a threshold matter, it is clear from oral argument that High River will be able to assemble a slate of nominees and meet the deadline established by the amended bylaws... While the court's determination may influence High River's decision making, it will not alter or limit the company's options: With or without an injunction, High River may submit its nominations by next Monday, adhering to the amended bylaws, or it may wait until a later date, relying on expected judicial relief. That the company must make this choice is not a 'harm' flowing from the absence of injunctive relief.<sup>14</sup>

In other words, the court did not find the ANB-mandated five-business-day period *per se* inequitable, although it did not go so far as to find such a restriction reasonable and equitable in the context of the case. Although the Mylan board dropped the shareholder-opposed merger three days after the court's decision, the insurgent may continue to seek to oust Mylan's Board,<sup>15</sup> and the courts may have the opportunity to engage in a full analysis as to the reasonableness of the five-business-day response period.

The lengthening advance notification periods in ANBs require that activist investors plan for corporate campaigns far in advance of a scheduled annual meeting date—potentially six to nine months in advance. Given the apparent ability of boards to announce rescheduled meeting dates affording dissidents only a week to give notice of shareholder proposals or board nominations, an activist investor would be well advised to be in a state of "shelf-readiness" with its proposals. ■

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1. *Mentor Graphics Corp. v. Quickturn Design Systems*, 728 A.2d 25, 42-43 (Del. Ch., 1998).
2. See, e.g., DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 25-10 (Lexis, 2003) ("As a general matter, management has the right to... amend bylaws to change its annual meeting date, to set reasonable advance notice provisions for directorial nominees, to fix the annual meeting date, and to determine how much notice of a meeting ought to be given.")
3. 421 A.2d 906 (Del. Ch., 1980).
4. *Id.* at 913.
5. *Id.* at 914. By shelf-readiness, the Court meant "having all papers and filings prepared in advance and on the shelf so as to be able to pull them down and make the deadline once the meeting date is set." *Id.*
6. 285 A.2d 437 (Del. 1971).
7. 17 Del. J. Corp. L. 238 (Del. Ch. Jan. 14, 1991).
8. 17 Del. J. Corp. L. at 258. In *Linton v. Everett*, 23 Del. J. Corp. L. 886 (Del. Ch. July 31, 1997), the court similarly found unreasonable an advance notice requirement (following three years without an annual meeting) that left dissident shareholders with only one week following notice of the next annual meeting to assemble materials for a proxy contest.
9. 17 Del. J. Corp. L. at 260-61.
10. Allen M. Terrell, Jr., *Notice By-Laws and Changing the Annual Meeting Date in Delaware*, 5 No. 5 INSIGHTS 28 (1991).
11. 728 A.2d 25 (Del. Ch., 1998).
12. No. 1:05-CV-0381 (M.D.P.A. February 24, 2005).
13. Pennsylvania Business Corporation Law § 1758(e) (2001).
14. No. 1:05-CV-0381 at 5.
15. *Update 8: Icahn Says Mylan Board Still Must Go*, ASSOCIATED PRESS (Feb. 28, 2005), available at: <http://www.forbes.com/business/feeds/ap/2005/02/28/ap1854187.html>.

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# Activist Fund STRUCTURING



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*Activist strategies face two kinds of liquidity issues that are not as often faced by hedge funds: the fund manager's need to have "patient money" to execute its strategies and legal constraints.*

Utilizing activist or corporate governance investment strategies (which are referred to together below as "activist strategies") in a traditional hedge fund structure has its benefits and presents certain challenges. Fund managers utilizing these strategies usually desire to use their expertise and their fund's influence as a minority shareholder of a company to effect change in the company in order to increase the value of the fund's investment. The techniques an activist manager may use range from talking to management to publicly advocating for change to campaigning to replace management. Funds that focus on corporate governance often will advocate for the nullification or removal of provisions such as poison pills and staggered voting for directors by seeking board resolutions or amendments to a company's governing documents or agreements. Unlike private equity funds and other kinds of "takeover" investors, activist strategies usually do not seek to control a company or necessarily hold an investment for more than a few years.

Among the benefits of the hedge fund structure for activist funds is that the fund manager will have the flexibility to raise funds continuously, rather than for each deal or in a limited window of time (e.g., as private

equity funds do), hedge fund documents provide the fund manager with flexibility to pursue a wide range of companies and activist strategies, and performance compensation is paid based on the market to market value of the portfolio, whether or not positions have been sold. Another benefit is that hedge fund structures are well understood by an activist fund's likely investor base, which can reduce potential delays and obstacles to raising money for the fund (i.e., a unique structure, terms or documents).

The principal challenge in using a hedge fund structure for activist strategies is liquidity. A typical hedge fund may offer investors quarterly liquidity after an initial one-year lockup of their capital, and an investor can usually expect to withdraw most of its capital within one or two quarters after the end of the lockup period. Activist strategies face two kinds of liquidity issues that are not as often faced by hedge funds: the fund manager's need to have "patient money" to execute its strategies and legal constraints.

First, in order for a strategy to be effective, the fund manager will need time to work with a company. This may involve meeting and negotiating with management, coordinating with other investors or working on a transaction such as a merger or spin-off. It may also involve seeking change through a shareholder vote and utilizing the proxy process. When a shareholder vote is a critical part of the strategy, the fund manager generally will need to know in the fourth quarter of the year what the fund's position in the company will be as of the record date for the company's shareholder vote, which often will be in the first or second quarter of the following year. While the company's securities may be liquid, if there is neither enough excess cash nor less critical positions that can be liquidated, fulfilling withdrawal requests

may force the liquidation of a critical investment before completion of the strategy. This forced liquidation can undermine the strategy and have an adverse impact on the profitability of the fund.

Second, an activist fund often may be the beneficial owner of more than 10% of a class of a public company's stock, which, under Section 16 of the Securities Exchange Act of 1934, makes the fund an "insider." An insider that sells securities within six months of its last purchase generally must disgorge to the issuer any profits from the sale. Obviously, a fund will want to avoid a disgorgement of profits. Also, as a result of its interactions with a company, the fund manager may find itself in possession of material nonpublic information (i.e., inside information) about the company. So long as the information remains material and nonpublic, the fund will be restricted from trading the company's securities.

Since activist funds tend to have concentrated positions in a few companies, liquidity constraints in one or a few of a fund's positions can quickly become a liquidity problem for the fund's investors. Depending on the nature of the particular liquidity problem and the size of the fund's position in a company relative to the size of the fund, the fund manager may need the flexibility to limit the amounts investors can withdraw or perhaps prohibit investors from withdrawing the portion of their capital that represents their share of an investment that the fund manager would prefer not to sell or may be restricted from selling. Fortunately, "liquidity management" features that are common to hedge funds such as lockups, limited withdrawal frequency, gates and side pockets, can be adapted for activist funds with relative ease.

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## Activist Fund Structuring, cont.

### LOCKUPS AND WITHDRAWAL FREQUENCY

A threshold issue for any hedge fund is whether to require investors to lock up their capital for a minimum period of time, at least initially. With a lockup, a manager can know that it will have "sticky" money for predictable periods of time and be able to plan ahead to provide liquidity for its investors. Activist managers tend to like lockup periods that are longer than a typical hedge fund may have — lockup periods of 18 months to two years or more are often considered. Lockups can be "hard" (absolute) or "soft" (an investor, if permitted to withdraw during the lockup period, must pay the fund a fee, often 1% to 5% of the amount to be withdrawn). Subjecting each capital contribution to its own lockup period is more common than permitting an investor to make additional capital contributions which are subject to the same lockup period as the investor's initial capital contribution. Hard lockups are sometimes preferred if the fund manager does not want investors to perceive that they have an option to withdraw, even at a price, prior to the end of the lockup period. A few fund managers have considered successive lockups, where capital not withdrawn at the end of the lockup period is subject to another lockup period. However, many activist fund managers find that permitting quarterly or semi-annual withdrawals upon 60 days notice after an initial lockup period is manageable. Disclosures in the fund's offering memorandum describing the time needed to execute an activist strategy and the potential legal constraints on liquidity should help make the case to investors for a relatively long lockup period and less frequent withdrawals.

### SIDE POCKETS

Side pockets — or "special investment accounts" — have been gaining in popularity as hedge funds have sought to hold greater amounts of illiquid or hard to value assets (e.g., distressed investments, private placements). A special investment account is often referred to as a private equity fund inside of a hedge fund. It is a mechanism built into a fund's documents, which tracks an

illiquid or hard-to-value investment in a memorandum account, apart from the hedge fund's liquid assets. Typically, the fund manager must designate an investment as a special investment at the time the investment is made. Only the investors who were investors in the fund when the special investment was made participate in the special investment. The special investment is held at fair value (usually cost, unless a reliable mark-up or write down is possible), and performance compensation is paid only after there is a realization or deemed realization of the special investment. Importantly, the portion of an investors' capital held in special investment accounts cannot be withdrawn until each special investment is realized or deemed to be realized (e.g., privately placed securities become freely tradable). A fund manager may reserve the ability to designate 10% to 20% of the value of the fund's assets as special investments.

Activist funds invest in liquid securities — the opposite of the types of securities for which side pockets have been traditionally used. However, special investment accounts can be adapted to help deal with the liquidity needs of an activist fund. First, an activist fund can permit a position that the fund manager wishes to hold for a longer term be designated as a special investment (*i.e.*, that the fund manager does not want to sell before a certain event occurs, such as a shareholder vote or merger). Second, the activist fund can permit a special investment to be designated by the fund manager at any time (e.g., if a position eventually exceeds 10% of the company's stock and, therefore, cannot be sold because of short-swing trading liability, or if the fund manager comes to possess inside information). Side pockets modified in this manner can provide a fund manager substantial flexibility for managing liquidity.

### GATES AND SUSPENSIONS

A "gate" provision is a right the fund manager can have to limit withdrawals on any withdrawal date to not more than a stated

percentage of a fund's net assets — often 10% to 25%, depending on how frequently investors have a right to withdraw capital. Gates are a very common feature in hedge funds of almost all strategies. Imposing a gate slows a potential "run on the fund" by forcing investors to wait until the next regular withdrawal date to receive the unfulfilled balance of their withdrawal requests. While imposing a gate is likely to be viewed by investors as a negative event, one hopes that it will not carry the same stigma as suspending redemptions and will give the fund manager breathing room to get liquidity in the portfolio and work with its investors.

Suspending withdrawals for all investors is another possible option, if the fund's documents permit suspensions in the event that liquidity is a concern, which is not always the case. (Fund documents sometimes permit suspensions only in circumstances where outside factors such as market disruptions prevent a fund from fulfilling withdrawal requests.) However, suspensions should be a last resort, because the investor market will, in all likelihood, interpret a suspension as a sign of a fundamental management problem.

### CONCLUSION

The hedge fund structure is well-suited for activist investment strategies. The structure is generally well-accepted in the marketplace, and it is relatively easy to adapt features common in hedge funds that use long-term strategies or hold illiquid assets to serve the needs of an activist investment program. ■

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*Fortunately, "liquidity management" features that are common to hedge funds such as lockups, limited withdrawal frequency, gates and side pockets, can be adapted for activist funds with relative ease.*

## When To Switch A 13G FILING TO A 13D FILING



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*Most activist investors at some point will face the question of whether, and if so when, they are required to file a Schedule 13D with the SEC for an investment position for which a 13G has previously been filed.*

Most activist investors at some point will face the question of whether, and if so when, they are required to file a Schedule 13D with the SEC for an investment position for which a 13G has previously been filed. The easy answer is that the filing must be made when the position is no longer held for investment but instead is held with the purpose or effect of changing or influencing control of the issuer. The hard part is in determining when this occurs.

Any person who, after directly or indirectly acquiring beneficial ownership of any class of registered equity securities (or certain unregistered equity securities), is directly or indirectly the beneficial owner of more than 5% of that class, must file a Schedule 13D with the SEC within 10 days.<sup>1</sup> A Schedule 13D requires detailed disclosure, including information regarding the background of the investor, the purpose of acquiring the stock and arrangements with the issuer. Schedule 13D also requires prompt updates in the event of material changes.

However, such investors who do not wish to file a 13D may be eligible instead to file a short-form statement on Schedule 13G, which requires only basic information and in most cases must only be updated periodically. This is made possible by certain exemptions from

the 13D filing requirements which turn in part on the purpose of the investment. The first such exemption is available to certain classes of institutional investors, including registered brokers, registered investment companies and registered investment advisors, when the investor "has acquired such securities in the ordinary course of his business" and "not with the purpose nor with the effect of changing or influencing the control of the issuer, nor in connection with or as a participant in any transaction having such purpose or effect."<sup>2</sup>

The second exemption is available to any other type of investor, provided that such investor is not directly or indirectly the beneficial owner of 20% or more of the class of stock and has "not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect."<sup>3</sup> However, an investor who has filed a 13G loses its eligibility to use this form and must file a 13D within 10 days if it still holds more than 5% of the class and has "acquired or holds the securities with a purpose or effect of changing or influencing control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect."<sup>4</sup> Additionally, the investor may not vote or direct the voting of such securities and may not acquire additional equity securities of the issuer or any controlling person from the time that the securities are acquired or held with such purpose or effect until 10 days have passed since the filing of the 13D.<sup>5</sup>

The key question, therefore, in determining whether an investor who has filed a 13G must switch to a 13D, leaving aside ownership percentage thresholds, is substantially the same as the initial analysis required to

determine whether an investor may file a 13G rather than a 13D: Does the investor hold the securities with the purpose or effect of changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect, or merely for investment purposes?

The clearest example of a control purpose is when an investor intends to obtain outright control over a company or to assist others in doing so, such as planning an offer to purchase the company or an attempt to gain majority control of a company's board.<sup>6</sup> However, other seemingly more benign activities, including the type of "shareholder activism" practiced by many large investors today, may also be deemed to demonstrate an intent to change or influence the control of a company, depending on the particular facts and circumstances.

An early case that demonstrates the type of fact-specific analysis applied to determine whether a control purpose exists is *Transcon Lines v. A.G. Becker Inc.*<sup>7</sup> Here the district court traced the history over several years of meetings, phone calls and memos relating to the purchase and holding by a group of investors of an equity stake in Transcon in order to determine whether such investors had made materially misleading statements in a Schedule 13D where they claimed not to have a control purpose in their investment.<sup>8</sup> As evidence of this control purpose, Transcon pointed to past discussions among the defendant investors and with others regarding using their influence as large shareholders to influence the management of the company.

The court in *Transcon* discussed the decision of the Second Circuit in *Gulf & Western Industries, Inc. v. Great Atlantic & Pacific*

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## When To Switch A 13G Filing To A 13D Filing, cont.

*Tea Company, Inc.*,<sup>9</sup> another case where it was alleged that an investor, Gulf & Western, had failed to disclose a control purpose as required under 13D. The *Transcon* court noted that the appeals court in *Gulf & Western* had found that a control purpose existed based on the following analysis:

The court considered a number of circumstances in determining whether defendant in fact intended to acquire control, among them the following: defendants' "well-established practice of eventually acquiring firms in which it initially purchased only a small percentage of the outstanding shares," the fact that its financial commitment to purchase plaintiff's shares "represents the largest single commitment in G&W's history", and the fact that Gulf & Western's management believed that plaintiff was "such an 'overpriced' and 'run-down' corporation ... that it could not possibly succeed as an 'investment'" and that in management's view "much of A&P's difficulty is attributable to its present management."<sup>10</sup>

The *Transcon* court contrasted this set of facts with those before it, noting both that the defendants in the current case were minority investors with no history of acquiring control of companies after an initial minority investment and that, while the defendants viewed *Transcon's* management as "unimaginative" and capable of improvement, their plans consisted of merely "making suggestions and attempting to influence management to adopt policies that will improve *Transcon's* performance"<sup>11</sup> and therefore no control purpose requiring disclosure existed.

It is clear today that even minority investors with no plans to acquire a majority interest in a company can be deemed to have a control purpose. In *Egghead.com v. Brookhaven*,<sup>12</sup> the district court noted that

even an intent to gain minority representation on a board of directors could constitute an intent to control the issuer under certain circumstances. Here again, however, the specific facts of the situation may lead to varying conclusions. This is demonstrated in a recent SEC release proposing a new rule requiring companies to include shareholder nominees for director in their proxy materials in certain circumstances.<sup>13</sup> Here the staff of the SEC stated its belief that under certain circumstances, including when investors are long-time holders of the stock, the formation of a security holder group solely for the purpose of nominating a director and soliciting activities for that nominee should not be viewed as control activities.

Control purpose analysis becomes even more unclear outside of contests for board control. One area of particular uncertainty is in the context of proxy contests relating to a proposal. The SEC in 1998 noted that it was unable to provide extensive guidance as to when a 13G filer who supports or engages in a proxy contest, even in reliance on an exemption to the disclosure requirements of the proxy rules, will be required to file a 13D.<sup>14</sup> The SEC noted that a number of factors would have to be considered in such cases, including whether the proposal at issue is likely to change or influence control of the company, whether the investor "by its nature" seeks to control companies and whether the activity is undertaken in opposition to a management proposal or in support of a shareholder proposal.<sup>15</sup> With respect to tender and exchange offers, the SEC has expressed the view that Schedule 13G is not available to risk arbitrageurs to report share purchases made after the public announcement of a tender or exchange offer in order to later tender the shares, saying that such purchases are made "in connection with" control transactions.<sup>16</sup>

Given the potential difficulty of making the

determination regarding a control purpose in some cases and given that no evidence of an intention to avoid the disclosure requirements is required to establish a violation, failure to switch to a 13D when required is a potential trap for the activist investor. The penalties for serious or repeated violations can include losing the right to vote any stock in excess of 5%, loss of profits and even criminal sanctions.<sup>17</sup> The investor's subjective intention will not be dispositive — the Court or the SEC is likely to consider the investor's actions, in hindsight, as evidencing its purpose, regardless of claims to the contrary. Investors may be well advised to switch their 13G to a 13D as soon as, based on their conduct, a third party would reasonably conclude that they no longer hold their investment passively and intend to change or influence the control of the issuer. In view of the risk of switching late, as well as the waiting period following a switch for purchasing or voting shares, erring on the side of an earlier filing also is prudent. ■

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1. Rule 13d-1(a), Securities Exchange Act of 1934.
2. Rule 13d-1(b), Exchange Act. Observers have noted that the "ordinary course of business" requirement adds little to the requirements of the rule and the central focus of the SEC is the "control purpose" element, making the subjective elements of the rule substantially similar to those of Rule 13d-1(c). See, e.g., THOMAS R. STEPHENS, ESQ., BENEFICIAL OWNERSHIP REPORTING: SCHEDULES 13D AND 13G, B.N.A. CORPORATE PRACTICE SERIES No. 68, AT A-39.
3. Rule 13d-1(c), Exchange Act.
4. Rule 13d-1(e), Exchange Act.
5. *Id.* In addition, investors relying upon Rule 13d-1(c) for 13G eligibility lose such eligibility for so long as they beneficially own 20% or more of the class and may not vote or direct the voting of such securities

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**When To Switch A 13G Filing To A 13D Filing, cont.**

- and may not acquire additional equity securities of the issuer or any controlling person from the time that such threshold is crossed until 10 days after a 13D is filed. Rule 13d-1(f), Exchange Act.
6. STEPHENS, at A-40.
  7. 470 F. Supp 356 (S.D.N.Y.1979)
  8. Prior to 1998, Schedule 13G was not available to "passive" investors outside of the categories listed in Rule 13d-1(b) and such investors would instead file a 13D stating that no control purpose existed, as some "passive" investors still do today. Although defendants here filed a Schedule 13D, the central question of whether a control purpose existed is the same as is raised in determining whether an investor is ineligible to file on Schedule 13G due to the existence of a control purpose.
  9. 476 F.2d 687 (2d Cir. 1973).
  10. *Transcon*, at 378.
  11. *Id.*
  12. 194 F. Supp. 2d 232 (S.D.N.Y 2002).
  13. Exchange Act Release No. 34-48626 (Oct. 17, 2003).
  14. Exchange Act Release No. 34-39538 (Jan. 12, 1998).
  15. *Id.* at 24.
  16. Faith Colish, SEC No-Action Letter (Mar. 24 1980).
  17. STEPHENS, at A-3.

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