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Demands To Inspect Corporate Books and Records

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Section 220 of the Delaware General Corporation Law ("Section 220") provides stockholders of a Delaware corporation with the statutory right to access such corporation's books and records, described by the courts as "a powerful right"[1] and "an important part of the corporate governance landscape."[2] Demands to inspect a corporation's stockholder list, usually in the context of a proxy solicitation, are made pursuant to this section. In addition, the Delaware courts have consistently promoted the utilization of Section 220 as a means for stockholders to obtain more detailed information from a company prior to filing a claim, to ensure the existence of facts sufficient to properly make a claim. Despite its utility, Section 220, historically, has seldom been employed for purposes other than to obtain a stockholder list or in the context of derivative suits. Recent developments in Delaware case law, however, suggest a new-found activism and appreciation by stockholders in exercising their Section 220 demand rights in non-traditional manners. Delaware courts have recognized the functional utility of Section 220 to serve as a stockholder's means to (1) secure a forum with the board for purposes of considering suggested reforms, (2) "prepare a stockholder resolution for the next annual meeting, or mount a proxy fight to elect new directors"[3] or (3) confirm the proper execution of board action in accordance with the best interests of the corporation.[4]

In the event that a subject corporation refuses to permit the demanded inspection or fails to respond to such request within five business days, the requesting stockholder has recourse to compel the requisition of such documents by instituting a suit in the Delaware Court of Chancery. Since such action takes the form of a summary proceeding, the matter can be determined expeditiously.

Establishing Proper Purpose

A stockholder making a books and records demand under Section 220 may do so only for a "proper purpose," defined in the statute as a purpose "reasonably related to such person's interest as a stockholder."[5] The burden of proof to demonstrate a proper purpose is on the stockholder, except in the case of a demand for a stockholder list, where the statute shifts the burden of proof to the corporation to demonstrate improper purpose.

While a clear example of a proper purpose is the investigation of alleged mismanagement, the demand cannot be founded solely on "curiosity or a desire for a fishing expedition…"[6] but rather upon specific and credible allegations sufficient to warrant a suspicion of waste and mismanagement.[7] However, the stockholder is not required to prove by a preponderance of the evidence that waste and mismanagement are actually occurring.[8] For example, a stockholder is entitled to inspect books and records related to a merger where it alleges corporate mismanagement and where there is

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some evidence to support such allegation.[9] The courts have held that stockholders may have a legitimate need to inspect the corporation's books and records to value their investment in order to decide whether to buy additional shares, sell their shares, or take other action to protect their investment, particularly where the corporation is private and stockholders do not receive the mandated, periodic disclosures associated with a publicly-held corporation.[10] However, where a demanding stockholder's sole purpose is to value the company as a whole, and not its specific ownership interest, in order to pursue a hostile takeover, such a purpose has been found improper.[11]

In addition, courts have recognized as a proper purpose (1) the ascertaining of the corporation's condition or its affairs so that petitioner can vote and otherwise exercise its rights in an informed manner, (2) determining the reason for the nonpayment of dividends and (3) determining whether or not there are sufficient funds available for the payment of dividends.[12] On the other hand, courts will deny inspection for a purpose purely individual and in no way germane to the relationship of the stockholder to the corporation.[13] For example, inspection was denied where the court found that the purpose was to seek to force a corporation to change its accounting practices, as the accounting problem was personal to the stockholder and in no way impaired the performance of the corporation.[14]

The Delaware courts have long understood that a stockholder's Section 220 demand may serve more than one purpose. In fact, the courts have stated that once a proper purpose has been established, any secondary purpose or ulterior motive of the stockholder becomes irrelevant,[15] reasoning that since a stockholder will often have more than one purpose, the "proper purpose" requirement means that the stockholder's primary purpose must be proper, and any secondary purpose, whether proper or not, is irrelevant.[16] In one example, the court concluded that the desire to solicit proxies for a slate of directors in opposition to management is a purpose reasonably related to the stockholder's interest as a stockholder and any further or secondary purpose in seeking the list, such as seeking to effect an exchange offer or to compel a buyout of the stockholder's investment, was irrelevant.[17] However, where the evidence overwhelmingly established that despite the several purposes recited in its demand, the stockholder's primary purpose for inspection was to place a value on the corporation so that the stockholder could consider whether to increase its offering price in a contested merger and, if so, by how much, the court determined that such primary purpose was not a "proper purpose" within the meaning of Section 220 and the other stated purposes, to the extent they had independent reality, were clearly secondary and subordinate.[18]

Alternatively, however, the identification of existing stockholders who would be willing to purchase shares from the party seeking inspection was held to be a legitimate purpose for inspection of the stockholder list where there was no significant public market for the shares.[19] Similarly, inspection of a stock list is proper where it is sought in order to purchase additional shares of a company's stock from other stockholders. It is not improper because the first shares were purchased as a prelude to a demand for the list.[20] However, demanding an inspection of the stock ledgers for the purpose of securing a list of the stockholders and their addresses for the purpose of commercializing the same was a highly improper purpose.[21]

Often stockholders make a Section 220 demand for stockholder lists for purposes of communicating with other stockholders. Courts have generally recognized this as a proper purpose and granted access to such lists even in the context of a contest for control of the corporation. The purpose of examination is deemed proper where the aim is to enable the stockholder to communicate with other investors to ascertain whether they desire to effect a change in personnel on the board of directors at the next annual meeting and to solicit proxies for that purpose.[22] A stockholder seeking control is not limited to communicating with stockholders through management; he or she has a right to go to stockholders directly, without procedural impediments.[23]

Scope of Inspection

The degree of information attainable pursuant to a Section 220 demand is not without limit.[24] Accordingly, the demand must distinctively identify the documents subject to the inspection request, and demonstrate the association of such documents with the demand's stated purpose.[25] Where a stockholder sought to prove alleged waste in connection with advances made to an affiliate by the corporation, such stockholder was held entitled to copies of internal corporate memoranda, e-mails, letters, minutes and resolutions, or other documents, which reflect the decision-making of the corporation as well as promissory notes, loan agreements, summaries of terms and conditions, or other documentation with respect to advances from the corporation to its affiliate. The courts also allowed the demand for similar documents with respect to any arrangements between the corporation and its related parties.[26]

In the context of analyzing a corporate merger, a stockholder was granted access to (1) certain side agreements between the transacting parties, (2) all minutes, notes, records, memoranda, writings, correspondence, telephone messages or the like that in any way directly or indirectly deal with or discuss the side agreement, merger agreement, or termination payments, (3) press releases related to the merger agreement, (4) documents or records discussing the relationship between the employees of the target corporation after the completion of the merger, (5) all minutes, notes, records, memoranda, writings, correspondence, telephone calls or the like that in any way directly or indirectly deal with or discuss termination payments, (6) regulatory applications related to the merger agreement and (7) the most recent list of stockholders.[27]

Confidentiality of Disclosures

Given the proprietary and/or confidential nature of many documents subject to a Section 220 demand, subject companies frequently object to the provision of such information based on concerns of potential misuse by the demanding stockholders. Accordingly, when these types of objections are asserted, the courts are forced to balance a corporation's right to maintain the confidentiality of its information against the statutory rights of its stockholders to investigate the affairs of such corporation upon a showing of proper purpose.

Recently, the utility of Section 220 as a potent tool available to activist investors was implicated in the widely reported public campaign of certain dissident directors of The Walt Disney Company to oust its chief executive officer, Michael Eisner. In early 2004, Roy Disney, a former Disney director, asserted a Section 220 demand requesting executive compensation information. Disney was willing to provide the requested information, provided it was afforded confidential treatment by the requesting parties. Moreover,

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Disney permitted Mr. Disney to challenge in court Disney's designation of the material provided to him as being confidential if the parties could not mutually agree otherwise. The scope of such confidential treatment was disputed among the parties and ultimately resolved by the Court of Chancery.

The court's decision demonstrated its sensitivity toward the preservation of confidentiality while at the same time acknowledging that the disclosure of any such information could be warranted in the context of a proxy solicitation, albeit in limited form upon demonstration of compelling circumstances.[28] The court acknowledged that "there can be exigent circumstances (e.g., an active election contest) in which time constraints will not allow a stockholder to draft and file a complaint and then deal with issues of confidentiality in the ordinary course." The court stated, "in those limited circumstances, and upon a clear showing, this court will entertain extraordinary applications to remove 'confidential' designations from documents produced as the result of a Section 220 proceeding." The burden on the moving party in such a case, the court stated, is "heavy" and requires "a likelihood that disclosure of information designated 'confidential' is needed to prevent the corporation's proxy materials from being false and misleading in some material respect, or equally compelling circumstances." Where "a substantial burden of that kind is met," the court stated, "it will ordinarily be the case that the corporation's interest in preventing disclosure will be overcome, although the court will be in a position to make that assessment." In all other circumstances, a stockholder making a books and records demand can expect that documents designated as confidential pursuant to a reasonable confidentiality agreement will remain confidential unless the stockholder concludes that grounds exist to initiate litigation and the court in which that proceeding is brought determines to open those documents to the public.

In short, the court concluded, a shareholder who makes a Section 220 demand "for the proper purpose of investigating and seeking to remediate wrongdoing" and receives documents that the shareholder believes show that a corporation's public disclosure is materially false and misleading "is free to use those documents to draft a complaint setting forth such a claim." The documents received pursuant to the Section 220 demand, however, cannot be used by the shareholder who makes the Section 220 demand "for the purpose of being a self-appointed publisher of the Company's proprietary information."

Stockholders of Delaware corporations are increasingly availing themselves of the inspection rights granted under Section 220 and successfully causing corporations to furnish requested materials after demonstrating a plausible basis of alleged mismanagement, provided that the demands are sufficiently tailored to the stated purpose requesting only those materials within the limited scope of the stated investigation. Investors are employing information obtained in response to Section 220 demands toward the commencement of litigation and as the foundation of investor activism. Not surprisingly, in response to such increased investor activity, corporations are resisting Section 220 demands that are unsupported by plausible claims of misconduct or involve requests for documentation beyond the proper scope of investigation.

The statutory landscape of Section 220 demands has evolved in a meaningful way since Delaware courts first encouraged its implementation as an information-gathering tool. Section 220 will undoubtedly continue to develop as the most recent trend of investor activism increasingly exploits the boundaries of Section 220 and as the Delaware judiciary mediates the ensuing disputes. ■

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[1] *Disney v. Walt Disney Co.*, 857 A.2d 444, 447 (Del. Ch. 2004).

[2] *Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 571 (Del. 1997).

[3] *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 117 (Del. 2002).

[4] *White v. Panic*, 783 A.2d 543, 557 (Del. 2001).

[5] 8 Del. C. § 220(b).

[6] *Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 568 (Del. 1997).

[7] *Mattes v. Checkers Drive-In Restaurants, Inc.*, 2001 WL 337865 7 (Del. Ch. 2001)

[8] *Thomas & Betts Corp. v. Leviton Mfg. Co*., 681 A.2d 1026, 1032 (Del. 1996).

[9] *U.S. Die Casting & Dev. Co. v. Security First Corp*., 711 A.2d 1220, 1227 (Del. Ch. 1996), aff'd as modified, 687 A.2d 563 (Del. 1997) (finding that the corporation's payment of a termination fee in connection with a merger despite absence of any breach raised plausibility of mismanagement).

[10] *Thomas & Betts Corp. v. Leviton Mfg. Co*., 685 A.2d 702, 703 (Del. Ch. 1995), aff'd, 681 A.2d 1026 (Del. 1996); *State ex rel. Rogers v. Sherman Oil* Co., 31 Del. 570, 117 A. 122 (1922); *Dobler v. Montgomery Celluar Holding Co.*, A.2d, 2001 del. Ch. LEXIS 126 (Del. Ch. Oct. 19, 2001).

[11] *BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc.*, 623 A.2d 85, 88 (Del. Ch. 1992).

[12] *Helmsman Mgt. Servs., Inc. v. A & S Consultants, Inc.*, 525 A.2d 160, 165 (Del. Ch. 1987).

[13] *State ex rel. Foster v. Standard Oil Co.*, 41 Del. 172, 18 A.2d 235 (1941).

[14] *Thomas & Betts Corp. v. Leviton Mfg. Co*., 681 A.2d 1026, 1033 (Del. 1996).

[15] *CM & M Group, Inc. v. Carroll*, 453 A.2d 788, 792 (Del. 1982).

[16] *BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc.*, 623 A.2d 85, 87 (Del. Ch. 1992).

[17] *Credit Bureau Reports, Inc. v. Credit Bureau of St. Paul, Inc.*, 290 A.2d 691 (Del. 1972).

[18] *BBC Acquisition Corp. v. Durr-Fillauer Medical, Inc.*, 623 A.2d 85, 88 (Del. Ch. 1992).

[19] *Thomas & Betts Corp. v. Leviton Mfg. Co*., 685 A.2d 702 (Del. Ch. 1995), aff'd, 681 A.2d 1026, 1034 (Del. 1996).

[20] *Mite Corp. v. Heli-Coil Corp.*, 256 A.2d 855, 856 (Del. Ch. 1969).

[21] *State ex rel. Theile v. Cities Serv. Co.*, 31 Del. 514, 115 A. 773 (1922).

[22] *State ex rel. Foster v. Standard Oil Co.*, 41 Del. 172, 18 A.2d 235 (1941).

[23] *Kerkorian v. Western Air Lines*, 253 A.2d 221 (Del. Ch.), *aff'd*, 254 A.2d 240 (Del. 1969).

[24] *Saito v. McKesson HBOC, Inc.*, 806 A.2d 113, 114 (Del. 2002).

[25] *Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000).

[26] *Dobler v. Montgomery Cellular Holding Co.*, A.2d, 2001 Del. Ch. LEXIS 126 (Del. Ch. Oct. 19, 2001).

[27] *Security First Corp. v. U.S. Die Casting & Dev. Co.*, 687 A.2d 563, 568.

[28] *Disney v. Walt Disney Co.*, 857 A.2d 444, 450 (Del. Ch. 2004).

Vote-Buying Raises Questions Under Anti-Fraud Rules

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Various significant corporate actions, including mergers, substantial stock issuances and liquidations, as well as the election of directors, require a shareholder vote. Activist investors, who may, in fact, be the catalysts for the matters coming before the shareholders for a vote, obviously have a significant stake in the outcome. The nature and complexity of their holdings in the subject company, including through the use of derivatives, may raise questions about whether they really are "shareholders" entitled to vote. Some of these questions are quite novel, with no clear answers under current law.

A recent example of the unsettled nature of this area of law can be found in the controversy over the Mylan Laboratories and King Pharmaceuticals merger, which has since been called off over the entities' inability to agree upon terms. In July of 2004, Mylan agreed to acquire King at a substantial premium in a stock for stock transaction that required the approval of both King and Mylan shareholders. Hedge fund Perry Corp., a supporter of the deal, disclosed in November of 2004 that it owned seven million shares of King stock and, in a separate November filing, disclosed that it owned 26.3 million shares of Mylan stock (or 9.89% of the outstanding stock) in which it had hedged its position. Shortly thereafter, Carl Icahn, who had previously disclosed ownership of 9.78% of Mylan's outstanding shares and his opposition to the merger, filed a complaint in Pennsylvania district court that named Perry Corp. and its president, as well as Mylan and its chief executive officer, as defendants.

The complaint alleged that Perry and other unspecified defendants (investors who had engaged in the same activities but whose identities were unknown) had violated the anti-fraud provisions of Rule 10b-5 of the Exchange Act, because their acquisition of Mylan's stock had "no legitimate investment purpose" but was made solely in order to affect the outcome of the shareholder vote on the King merger. Icahn also alleged that Perry and Mylan had made false and misleading statements in their public disclosures in violation of Rule 10b-5 by failing to adequately disclose what the complaint called a "vote-buying scheme" and that the voting rights of Icahn and other Mylan shareholders had been rendered "illusory" as a result.

The complaint also accused Perry of violating Rule 13d-1 of the Exchange Act by only "cursorily" mentioning the hedging transactions and failing to disclose their full impact, including that Perry had essentially only purchased a voting interest in the stock and was motivated to vote in favor of the merger "without regard to whether it believes the merger will be good or bad for Mylan and its legitimate shareholders." Further, the complaint charged Perry and Mylan with concealing this conduct and stated that Perry had only disclosed its activities after the press had uncovered them.

Finally, Icahn's complaint alleged that Perry and the other defendants had engaged in fraud against and attempted dilution and disenfranchisement of Mylan's other shareholders through the vote-buying scheme, through their actions to conceal their lack of any real economic interest in the Mylan stock and through fraudulent attempts to hold themselves out as "legitimate shareholders in Mylan."

While Perry's actions were seen as troubling,[1] it was nonetheless generally observed that Icahn's claims were not supported by clear legal precedent.[2] Perry's lawyers asserted confidently in their motion to dismiss that "there does not appear to be a single decision finding that the federal securities laws or state law prohibit the transactions challenged by Plaintiff, nor does any federal statute or rule prohibit Perry Corp.'s conduct. Moreover … alleged 'vote-buying' agreements are entirely permissible under state law."[3]

The permissibility of vote buying in certain instances can be traced in large part to the case of *Schreiber v. Carney*.[4] Prior to *Schreiber*, courts in Delaware and elsewhere had generally held shareholder vote buying in any form to be unlawful *per se*.[5] The plaintiffs in *Schreiber* were challenging the vote of a large shareholder of Texas International in favor of a merger where the shareholder had been given a company loan so that it could exercise warrants and thus avoid negative tax consequences of the merger. This arrangement was conditional upon the approval of a majority of the other shareholders after apparently full disclosure of the relevant facts. Rejecting plaintiffs' argument that such an arrangement was illegal *per se* under its past decisions, the Delaware Chancery Court noted that:

> Vote-buying, despite its negative connotation, is simply a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror.[6]

The court in *Schreiber* explained that many of the previous decisions finding vote buying unlawful were based upon the notions that a stockholder has the right to rely upon the independent judgment of other stockholders, and there exists a sense of duty between stockholders; thus, any agreement entered into for personal gain, whereby a stockholder separates his voting right from his property right, was considered a fraud upon this community of interests. The *Schreiber* court, however, noted that because the vote-buying agreement in that case removed the only impediment to a transaction that other shareholders favored, it in fact furthered the interests of those other shareholders. The court went on to observe that earlier characterizations of vote buying as illegal *per se* were founded upon policy considerations that had become "outmoded as a necessary result of an evolving corporate environment" and that courts generally had abandoned the idea that shareholders were entitled to the "personal judgment" of other shareholders.

The court in *Schreiber* also distinguished previous cases by noting that the facts in each earlier case indicated that fraud or disenfranchisement was the obvious purpose of the challenged voting agreement. Therefore, the court stated, voting agreements should not be considered illegal *per se* unless "the object or purpose is to defraud or in some way disenfranchise the other stockholders." In one case where such "disenfranchisement" was alleged, *IXC Communications v. Cincinnati Bell*,[7] the Delaware Chancery Court clarified its position by writing that such disenfranchisement would not be found where a majority of shareholders could still vote independently to defeat a proposed corporate transaction.

Vote-Buying Raises Questions Regarding Anti-Fraud Rules, continued from page 2

Against this backdrop, Icahn's complaint clearly sought to place Perry's actions outside of the protection of *Schreiber*, stating that Perry's conduct constituted a fraud against Mylan's shareholders and was an attempted disenfranchisement of Mylan's shareholders. Perry's motion to dismiss, however, rejected both of these claims. With respect to the charge of fraud, Perry argued that Icahn's complaint only presented vague, conclusory allegations of fraud, which were not pled with sufficient particularity. Perry's motion went on to state that even "if Perry Corp. turns out to be wrong regarding the legality of its transactions in Mylan stock, at most the Complaint alleges a dispute regarding an unsettled area of securities law" and, given the complexity of determining whether its conduct was indeed unlawful, Perry could not have possessed fraudulent intent. With respect to Icahn's charges of shareholder disenfranchisement, Perry's motion stated that the activities complained of in no way prevented the majority of Mylan's shareholders from casting their votes or rejecting the merger.

Perry's motion also noted that where courts have found vote-buying arrangements impermissible, it is due to "coercion, intimidation, or enticement by the corporation's own management, or where corporate management uses corporate funds of the entity holding the vote to purchase votes to support a transaction favored by management." Unlike corporate management or even a majority shareholder, Perry argued, it owed no fiduciary duty to the other Mylan shareholders and was free to vote in its own economic interest.

Recent support for this principle can be found in *Hewlett v. Hewlett-Packard Company*.[8] Here, the Delaware Chancery Court determined that, where the management of Hewlett-Packard had allegedly induced a large shareholder, Deutsche Bank, to switch its vote in favor of Hewlett's merger with Compaq Computer using the promise of future business, plaintiffs had stated a case sufficient to prevent dismissal. The *Hewlett* court noted that, while "shareholders are free to do whatever they want with their votes, including selling them to the highest bidder," management, on the other hand, may not use corporate assets to buy votes "unless it can be demonstrated, as it was in *Schreiber*, that management's vote-buying activity does not have a deleterious effect on the corporate franchise." *Hewlett* explicitly restricted *Schreiber's* "fraud" and "disenfranchisement" review for vote buying to actions by management or other fiduciaries, reaffirming a minority shareholder's freedom to act as a purely self-interested economic agent free from such review.

The current case law, therefore, creates a quandary for those troubled by the type of hedging activities complained of by Icahn. Investors like Perry are not members of management or even majority shareholders, meaning that courts have not held their vote-buying arrangements to the same level of scrutiny as in *Schreiber* and *Hewlett*. The only identity such investors have under the current case law is as shareholders, and as noted above the courts have given shareholders the freedom to act purely in their own self-interest in utilizing the shareholder franchise.

Icahn sought to identify a new character in the legal analysis of vote-buying arrangements, one that is neither management nor a legitimate shareholder but rather an interloper in the corporate process that unfairly disadvantages a company's "true" shareholders. While current case law appears to allow shareholders to sell their votes to the "highest bidder," Icahn asked that scrutiny be given to whom, exactly, this "highest bidder" is and what his or her motives are. While the presumed corollary of a shareholder's ability to sell a vote for any reason might be that others can buy it for any reason, Icahn argued, in effect, that to allow this or situations like the Mylan merger would lead to the type of fraud and disenfranchisement that the courts have sought to prevent. Significantly, the Icahn complaint did not limit its criticism to the specific activities of Perry, noting instead that Perry's actions are "classic examples of the kinds of manipulative arrangements that arbitrageurs and hedge funds are increasingly employing, outside of the public's awareness and without effective regulation or oversight, to generate profits at the expense of ordinary shareholders." Unfortunately, the death of the King-Mylan merger, coupled with the dismissal of Icahn's complaint at his own request, means that the question of whether courts will recognize this new class of corporate actors and prevent them from using hedging as a means to buy votes will have to be answered on another day. ■

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[1] Andrew Ross Sorkin, "Nothing Ventured, Everything Gained," *The New York Times*, Dec. 2, 2004. It was noted in *The New York Times* that this new tactic "has emerged from the shadows of the hedge fund industry, igniting outrage among some investors and corporate governance experts," while *The Wall Street Journal* commented that "there's something disquieting about the Perry transaction and others of its ilk," and that it "perverts the incentives in a transaction."

[2] See, *e.g., id.* ("Lawyers say it all appears perfectly legal, but should it be?") and Sorkin ("It is hard to judge how strong Mr. Icahn's suit is, legal experts said, because he has entered novel legal territory.")

[3] Memorandum of Law in Support of Richard C. Perry and Perry Corp.'s Motion to Dismiss, January 13, 2005, 2005 WL 221905, at 7.

[4] 447 A.2d 17 (Del. Ch., 1982).

[5] See, *e.g., Macht v. Merchants Mortgage & Credit Co.*, 194 A. 23 (Del. Ch. 1937); *Hall v. Isaacs*, 147 A.2d 602 (Del. Ch. 1958); *Chew v. Inverness Mgt. Corp.* 352 A.2d 426 (Del. Ch. 1976).

[6] *Schreiber*, at 23.

[7] 1999 WL 1009174 (Del. Ch. 1999).

[8] 2002 WL 549137 (Del. Ch. 2002).

Implications and Considerations of Section 16 for Activist Investors

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An important provision of the securities laws that requires the attention of all investors, but especially activist investors, is Section 16 ("Section 16") of the United States Securities Exchange Act of 1934, as amended (the "Exchange Act"). Section 16 was enacted by Congress to deter and punish insider trading. The application of Section 16 is onerous since it is a strict liability statute that imposes liability regardless of whether or not one actually has inside information or even access to it. While Section 16 is divided into numerous sections, investors are most affected by three parts.

Reporting Obligations Under Section 16(a)

Among other things, Section 16(a) requires directors and executive officers of a public company and beneficial owners of more than 10% of a class of voting equity securities registered under Section 12 of the Exchange Act ("10% holders") to report promptly their initial ownership of these equity securities, as well as any derivative securities that can be exercised, exchanged or converted into these equity securities, and any changes in the reported ownership information. Initial reports are filed on Form 3 within 10 days of becoming a director, reporting officer or 10% holder, and most changes are required to be filed on Form 4 within two business days of the acquisition, disposition or other reportable change that triggers the filing requirement. (There is also a Form 5 that must be filed within 45 days after the end of a fiscal year, to the extent that there any previously unreported transactions.)

Profit Disgorgement Under Section 16(b)

Of greater concern for these Section 16 "insiders" are the requirements under Section 16(b) to disgorge any profits earned from the purchase and sale (or sale and purchase) of any reported security held for less than six months. Adding bite to this penalty, courts calculate the "profits" to be disgorged pursuant to Section 16(b) in an onerous manner, whereby all possible profits are recovered by matching the lowest purchase price paid in the matchable six-month period against the highest sale price in that period.[1] In this way, it is irrelevant for purposes of the calculation whether an insider actually profited from its transactions and, as a result, insiders affected by the provision frequently have to disgorge more money than they ever earned from the trades in question.[2] For example: an investor who purchased 100 shares of a company's stock at \$2, sold those 100 shares at \$1 per share, purchased another 100 shares of the same company's stock four months later at \$10 per share only to sell them a month later at \$5, would in reality have lost \$600 over the course of six months, but under the Section 16(b) method of profit calculation, that investor would be forced to disgorge a "profit" of \$300.

Hedging Prohibitions of Section 16(c)

Another consequence of Section 16 is the prohibition on selling securities of the public company if the seller either does not own the security, a so-called "short sale," or, if the security is owned, the seller does not deliver the security against the sale within 20 days. In this way, Section 16 insiders are limited in their ability to hedge risk.

Determination of Being Subject to Section 16

Given the consequences of being subject to Section 16, it is important to determine whether or not an insider is subject to the statute and, if so, how to avoid becoming subject to the profit recapture provisions of Section 16(b).

All directors and executive officers of a company with voting equity securities registered under Section 12 of the Exchange Act are subject to the provisions of Section 16, regardless of the percentage of the securities owned. This can have implications for activist investors to the extent that they take seats on the board of directors of a public company. Not only are the directors themselves subject to Section 16, but the activist investor entity can be deemed a director itself through the "director-by-deputization" doctrine.[3] This doctrine states that an entity that places a person on the board of directors, barring appropriate Chinese wall procedures, can itself be deemed a director for Section 16 purposes. Thus, an activist investor that owns less than 10% but succeeds, by proxy contest or negotiation, in having its designee placed on the board, may be exposed to liability.

The other category of person subject to Section 16 is a 10% holder (*i.e.*, a beneficial owner or more than 10% of a voting equity security registered under Section 12 of the Exchange Act). Beneficial ownership is determined in accordance with the standards set forth in Section 13 of the Exchange Act. Section 13 basically defines beneficial ownership as having investment and/or voting power over the securities or having the ability to obtain this investment and/or voting power within 60 days.[4]

It should be noted that under this definition, possession of a derivative security (*e.g.*, an option, warrant, right or similar instrument that is exercisable for, or convertible or exchangeable into, the equity security) that is not exercisable within 60 days would not confer beneficial ownership under Sections 13 and 16. However, in an exception that has clear implications for activist investors, if the derivative security is acquired with the purpose or effect of changing or influencing the control of the issuer, then the person is deemed to own the underlying equity securities immediately, regardless of whether or not the derivative security is exercisable within 60 days.[5] Whether or not a derivative security is acquired "with the purpose or effect of changing or influencing the control of the issuer" requires careful analysis because of both the Section 13 and Section 16 consequences for investors.

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One other area of Section 13 necessitating thorough consideration for investors because of its effect on Section 13 and Section 16 is that of formation of "groups." Section 13(d)(3) of the Exchange Act states that when two or more persons work together as a group "for the purpose of acquiring, holding or disposing of securities of an issuer," then the holdings of the group are aggregated for purposes of determining whether or not the 5% threshold and, by implication, the Section 16 10% threshold, have been crossed. Whether or not a group has been formed is very fact-specific, and when questions arise, counsel should be consulted in making a determination.

Consequences of Being Subject to Section 16(b)

From an activist investor's perspective, once it has been concluded that the investor is subject to the provisions of Section 16, either because it is a director-by-deputization or because the investor alone or as part of a group is a 10% holder, the investor must plan carefully to avoid being forced to disgorge potentially significant amounts of actual or deemed profit pursuant to Section 16(b).

Interestingly, being deemed – or conceding that the investor is – a director-by-deputization can provide potential exemptions from the reach of Section 16(b), by use of the provisions of Rule 16b-3, which exempts certain transactions between an issuer and its directors and officers.[6] The ability to use this rule is limited and must be considered cautiously.

The simplest way to avoid Section 16(b) profit disgorgement is to assure that there are no matchable purchases and sales within a six-month period. In order to understand fully how this works, investors need to be aware that if the reason they are subject to Section 16 is because they are 10% holders, then the transaction that puts them over the 10% threshold is not a matchable transaction for Section 16(b) purposes.[7] Understanding this means that as long as 10% holders do not purchase any additional securities after they cross the 10% threshold, then their sales will not have any purchase to match against, yielding no Section 16(b) profit recapture problem.

In the event that a 10% holder is forced to sell securities within six months of a matchable purchase, the insider can limit its exposure to Section 16(b) profit recapture by structuring its transactions in multiple steps, with the first step designed to sell just enough stock to bring its holdings below 10%, with any required profit disgorgement being paid, and by subsequently disposing of the remainder as a non-insider no longer subject to Section 16(b). Provided that the different steps are sufficiently separated (e.g., by having each sale to a different purchaser and not being part of a single planned distribution), the courts should uphold this means of minimizing exposure to the disgorgement requirement.[8]

Unorthodox Transaction Doctrine

One of the most troubling situations faced by activist investors that are unable to avail themselves of any of the above-mentioned solutions occurs when they have engaged in a campaign to have an issuer pursue a sale transaction, and their campaign has succeeded. In the case where the investor has crossed the 10% threshold and continued to purchase additional securities, the investor may be faced with a situation in which it will be forced to dispose of the securities in the transaction within a period of less than six months after the investor's matchable acquisition of issuer securities, despite a desire to wait six months to avoid Section 16(b) liability.

While there is no easy answer to this dilemma, it is worth considering the possible application of the so-called "unorthodox transaction doctrine," also known as the "pragmatic approach." Although the majority of Section 16(b) cases are decided objectively, using the purely mechanical criteria discussed earlier, a line of cases provides an alternative "pragmatic" approach for insider purchases and sales that are considered by the courts to be undertaken as part of larger transactions that are "borderline" or "unorthodox" in their nature.

The unorthodox transaction doctrine is based on the principle that, in certain cases, investors may be forced to enter into a transaction where the application of the Section 16(b) profit disgorgement analysis would yield unfair results that do not bolster the purpose of Section 16 by preventing abuse of presumptive access to inside information. The first and most significant case to analyze potential Section 16(b) liability from a pragmatic perspective is *Kern County Land Company v. Occidental Petroleum Corporation*.[9] In *Kern County*, a 10% holder's tender offer for the stock of an issuer drove the target company into completing a defensive "white knight" merger, whereby the 10% holder and other stockholders were permitted to convert their stock in the target into stock of the surviving entity. In considering whether or not it was proper to apply Section 16 liability or take a more pragmatic approach, the Court considered various factors including "the possibility of inside information being available to [the investor] by virtue of its stock ownership or the potential for speculative abuse of such inside information by [the investor]," whether the investor or the target "engineered" the merger, the extent of the investor's participation in meetings or negotiations related to the acquisition, and whether the investor's voting power would be necessary for stockholders to approve the merger after its presentation to stockholders by the board.[10] In a case decided soon after, *American Standard Inc. v. Crane Co.*, the Second Circuit Court of Appeals summarized unorthodox transactions not leading to Section 16(b) liability as being those where the "tender offeror…does not have access to inside information about the target company by virtue of his position as a 'beneficial owner,' coupled with an inability, as further evidenced by the vote on the merger, to affect the course of the target company."[11]

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Different courts have applied different standards in determining the applicability of the unorthodox transaction doctrine. Factors that appear to be required in order to have the doctrine applied include a lack of access to inside information, an inability to influence the timing of the transaction and the transaction being involuntary, as evidenced by a lack of support for the transaction by the insider.[12] The last factor would preclude an insider from voting in favor of the transaction and, presumably where applicable, would require the insider to vote against it. Obviously, a strict determination of whether or not a disposition is voluntary could pose problems for an activist investor with real power to influence the company it invests in. Other factors considered have been the relationship of the parties, with hostile relations bolstering the argument that the "possibility of speculative abuse" through cooperation is highly unlikely.[13]

As can be seen from the factors considered by the courts, the application of this doctrine is extremely fact-specific and the courts will be reluctant to apply it in the absence of clear evidence to support it. As a result, this pragmatic approach has rarely been applied by the courts and the continued viability of the pragmatic approach to Section 16(b) liability is unclear. Although the doctrine is still referenced in cases decided as recently as 2003, the doctrine was largely shaped over 20 years ago, during a particularly fertile period for activist investors. A mention of the doctrine from the early 1990s also indicates potential judicial distaste for the progeny of *Kern*, as it warns that few transactions should be considered truly "unorthodox" for purposes of Section 16(b).[14]

As with many of the securities laws that form the context within which activist investing is conducted, the applicability of Section 16 is very technical in nature and investors should tread carefully when its rules are implicated. ■

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[1] *Smolowe v. Delendo Corp.*, 136 F.2d 231, 239 (2d Cir.), *cert. denied*, 320 U.S. 751 (1943). The Smolowe method for profit calculation requires two steps. First, a court must find the highest price per share at which a sale subject to §16(b) took place. Then, within the six months before and after that sale, the court must find the cheapest price at which a "matching" quantity of stock was purchased. "Profit" then equals the quantity of the matched stock in question multiplied by the difference between the sale and purchase prices thus derived.

[2] *Id*. ("Had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so.")

[3] See *Blau v. Lehman*, 368 U.S. 403 (1962); *Feder v. Martin Marietta Corp.*, 406 F.2d 260 (2d Cir.), *cert. denied*, 396 U.S. 1036 (1970).

[4] Exchange Act Rule 13d-3.

[5] Exchange Act Rule 13d-3(d)(1)(i).

[6] See SEC *amicus curiae* brief filed in *Dreiling v. American Express Travel Related Services Co., Inc.*, No. 04-35715 (April 5, 2005), 25-26; 351 F. Supp. 2d 1077 (W.P. Wash 2004).

[7] As determined by the Supreme Court in *Foremost-McKeeson, Inc., v. Provident Securities Co.*, 423 U.S. 232 (1976), transactions are matchable for Section 16(b) purposes only if both the purchase and sale being matched occurred while the person was already a 10% holder. The transaction that puts a person over the 10% threshold occurs at a time that the person is not yet a 10% holder. This decision has been codified in Rule 16a-2(c) ("The transaction that results in a person becoming a 10% beneficial owner is not subject to section 16 of the Act").

[8] See, *e.g.*, *Reliance Electric Co. v. Emerson Electric Co.*, 404 U.S. 418, 419-20 (1972), *Reece Corp. v. Walco National Corp.*, 565 F. Supp. 158 (S.D.N.Y 1981).

[9] 411 U.S. 582 (1973).

[10] *Id.* at 599.

[11] 510 F.2d 1043, 1054 (2d Cir. 1974), *cert. denied*, 421 U.S. 1000 (1975).

[12] See, *e.g.*, *Kay v. ScienTex Corp.*, 719 F. 2d 1009 (9th Cir. 1983); *Morales v. Gould Investors Trust*, 445 F. Supp. 1144 (S.D.N.Y. 1977), *aff'd mem.*, 578 F. 2d 1369 (2d Cir. 1978); *Steel Partners II, L.P. v. Bell Industries, Inc.*, 315 F. 3d 120 2d Cir. 2002); *Heublein, Inc. v. General Cinema Corp.*, 722 F. 2d 29 (2d Cir. 1983).

[13] *Colan v. Prudential-Bache Securities, Inc.*, 577 F.Supp. 1074, 1083 (N.D. Ill. 1983).

[14] *Colan v. Mesa Petroleum Co.*, 951 F.2d 1512, 1523 (9th Cir. 1991).