

activist investing developments

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Second Generation Advance Notification Bylaws

By Marc Weingarten and Erin Magnor

IN THE SPRING 2005 ISSUE of *Activist Investing Developments*, we wrote about the special bylaw provisions regulating the ability of shareholders to nominate directors or place items on the agenda for consideration at a company's annual or special meeting or by consent, typically referred to as advance notification bylaws ("ANBs").¹ At the time, most ANBs were straightforward. They typically advanced the date by which a shareholder was obligated to notify the company to 60 or 90 days prior to the expected meeting date. These ANBs, or First Generation ANBs, also typically required the proponent shareholder to include in the notification the same basic information about the shareholder, and if applicable the nominees, as required by the proxy rules.

More recently, however, many companies, at the urging of counsel "defending" against activist investors, have adopted new forms of ANBs, or Second Generation ANBs, that demand far more extensive disclosure from, and in some cases purport to establish eligibility qualifications for, proponent shareholders. These ANBs have been expanded to include not only longer advance notice requirements, but also requirements for the completion of company-drafted director nominee questionnaires, submission of broad undertakings by nominees to comply with company "policies," minimum size and/or duration of holding requirements, continuous disclosure of derivative positions, disclosure of otherwise confidential compensation information, and even information regarding shareholders with whom the proponent has merely had conversations regarding the company.

First Generation ANBs were upheld by the courts because they simply provided an orderly procedure for shareholder action that helped to give the company and the other shareholders adequate time to evaluate proposals. We believe that many of the Second Generation ANBs are designed not to elicit the relevant information a company reasonably needs to know months in advance of a proxy contest to ensure an orderly process, but rather to erect barriers in the path of shareholders seeking to exercise their rights in an attempt to disqualify them. We believe such provisions should, and will, be declared invalid when their legitimacy is challenged. Unfortunately, shareholders will be forced to bear the expense of challenging the validity of these provisions—which no doubt was part of the calculus when companies adopted them in the first place.

Advance Notice Periods

In our prior article, we noted that courts had determined that 90-day advance-notice requirements had become commonplace.² Since then, some companies have adopted ANBs requiring notice of 150, or even

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1 See Marc Weingarten, "Advance Notification Bylaws," *Activist Investing*, Spring 2005, http://www.srz.com/Weingarten_Activist_Investing_Developments_2005_Advanced_Notification_Bylaws/.

2 *Mentor Graphics Corp. v. Quickturn Design Systems*, 728 A.2d 25, 42-43 (Del. Ch. 1998).

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180, days prior to the annual meeting (in some cases keyed off the mailing date of the prior year's proxy statement).

It is particularly ironic that these companies, whose common refrain rails against the disruption and distraction they suffer when subject to a proxy contest, lengthen the period during which the contest plays out when adopting such long advance requirements.

We believe that advance notice deadlines of 150 days, and certainly 180 days, are unreasonable and invalid, especially when imposed by companies without staggered boards. At 150 days, incumbent directors are barely more than halfway into their terms; shareholders should be given more time to evaluate their performance before being forced to determine whether to contest their reelection. Notification deadlines so far in advance permit the incumbent board members to operate during half their term free of accountability to the shareholders for their actions—and the temptation to delay taking controversial action until after the notification deadline has passed cannot be overlooked. There is no reasonable basis to argue that a company needs five or six months advance notice of an election contest. Evaluating the qualifications of nominees and the merits of their platforms simply does not take this much time. There is no reason that the concern for an “orderly procedure” that has led the courts to support First Generation ANBs cannot be fully satisfied by a 60- or 90-day notice requirement.

Company-Drafted Questionnaires and Undertakings

Many companies have adopted Second Generation ANBs that require shareholder nominees to complete and submit company-prepared director questionnaires along with the nomination notification. The nominating shareholder is required to request a copy of the questionnaire from the corporate secretary, in effect pushing the advance notification deadline even further back by giving the company even earlier notice of a potential contest.

The questionnaire requirement is generally a pointless waste of time. ANBs already uniformly require a nominating shareholder to include in its notice all information with regard to itself and its nominees that would be required to be disclosed in a proxy statement, which includes information about the nominees' shareholdings, backgrounds and any relationships they may have with the company. The questionnaire generally will yield no additional relevant information. But so long as the company uses the same form for shareholder-proposed nominees as for its own candidates, without adding burdensome or troublesome questions targeted to frustrate shareholder nominations, the questionnaire requirement is merely an annoyance but not legally objectionable.

Many companies also now require, as a condition of eligibility, that shareholder-proposed director nominees agree to various undertakings. They may have to sign an agreement that they will not join in voting agreements, that they will not enter into undisclosed indemnification or compensation agreements, and that they will comply with all company policies and guidelines applicable to directors, which may include subjects such as corporate governance, conflicts of interest, confidentiality and stock ownership.

Clearly a nominee should only be required to agree to comply with specific, disclosed policies and guidelines, and not with whatever policies and guidelines may be adopted in the future. But even such a limited undertaking could create dilemmas for a proponent shareholder. A common company policy, for example, requires directors to keep company information confidential, which may present an issue for a nominee proposed by, and especially one who is affiliated with, activist investors. An activist that achieves the election of its nominee to the board often does so on

the basis that the nominee's views will be more aligned with shareholder interests. The activist would like to be able to discuss company matters with that board member, at least to convey the activist's views on the company's conduct. The director will, of course, be required to act in accordance with his or her fiduciary duties and not on the instructions of the activist, and the activist, if privy to material non-public information about the company, would be restricted in trading (and typically would not want such information for that very reason). Discussions between the director and the activist would not make the information public, but might still violate company policy and, the company may argue, could even breach fiduciary duty. In a negotiated settlement, the company may be persuaded to permit this conduct but, at the initial stages, is not likely to agree to modify the undertaking. Company policies regarding trading by directors often raise another issue for activists: whether such policies apply to entities with which the director is affiliated.

But so long as the policies are reasonable and applied equally to all directors, the proponent shareholder and its nominees will be hard-pressed to object, and will have little choice but to sign.

Minimum Holding Periods and Levels of Ownership

Currently, under Rule 14a-8 of the Securities Exchange Act of 1934, in order to be eligible to submit a proposal to be included on a company proxy card, a shareholder must have continuously held, for at least one year prior to the date the proposal is submitted, a minimum of \$2,000 in market value, or 1%, of the company's securities entitled to be voted on the proposal. Such a requirement is justified on the basis that the company is being put to expense and burden (albeit minimal), in including these proposals in its proxy materials, and should not have to do so for frivolous or harassing shareholders with de minimus or short-term holdings. Regardless of the merits of such rationale, it has no applicability where the shareholder utilizes its *own* proxy materials at its *own* expense. Any attempt to establish minimum holding periods or level-of-ownership requirements in ANBs as applicable outside the 14a-8 context should be an invalid and unenforceable limitation on shareholder rights.³ The adoption of such requirements as part of a federally mandated proxy-access regime similarly should have no bearing on shareholders seeking to take action utilizing their own proxy materials.

Disclosure of Derivative Positions

Another common trend in Second Generation ANBs is the adoption of requirements that the nominating shareholders disclose not only their beneficial ownership position but also any derivative positions, such as cash-settled swaps, that they may hold. Such holdings were not historically believed to confer beneficial ownership of any underlying counterparty-held shares, and so did not trigger the filing of a Schedule 13D when the shareholder held less than 5% in physical shares. As a result of the 2008 decision in *CSX Corporation v.*

3 In a proxy contest last year by JANA Partners involving CNET Corporation (*Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch.), *aff'd*, 947 A.2d 1120 (Del. Supr. 2008)), JANA successfully sued to confirm that CNET's ANBs establishing minimum-holding-period and level-of-ownership requirements for shareholder nominations were intended to apply in the 14a-8 context and not otherwise. While the corporate defense bar seized on this opinion, as well as the opinion in *Levitt Corp. v. Office Depot, Inc.* (2008 WL 1724244 (Del. Ch. 2008)), as ominous shareholder-friendly developments in Delaware law, each represented no more than extraordinarily poorly drafted bylaw provisions interpreted to favor shareholder rights.

*The Children's Investment Fund (UK) LLP*⁴, corporate counsel have decried this supposed “loophole” in the 13D rules, and have urged companies to require swap disclosure in their ANBs. These ANBs now include laundry lists of security interests that the shareholder must disclose, including options, swaps, warrants and convertible securities, as well as broad catch-all phrases that seek to capture any economic interest that the company has not specifically named.

Such increased disclosure requirements should not be problematic for shareholder proponents, or objectionable. While such disclosures may provide a company with more information than it would have based on SEC filings alone, the overall consequence of companies learning more about the holdings of proponent shareholders should not significantly affect the ability of proponents to nominate directors or propose business for shareholder meetings.

However, one prominent defense-side law firm has suggested to its corporate clients that they adopt an ANB disclosure requirement for derivatives that we believe has been designed as a trap to disenfranchise shareholders and should therefore be invalidated. Specifically, the bylaw provision requires that, once a shareholder has obtained a certain percentage of economic interest in the company (the drafters suggest 7.5% or 10% as possible threshold amounts), combining long ownership with any derivative or synthetic interest, the shareholder must continuously inform the company of its “interest” level, even if the shareholder at that time has no intention whatsoever of taking governance action. If the shareholder does not comply with the provision, the company will disqualify the shareholder from later seeking to take action at a shareholder meeting.

This provision would require shareholders to review, in advance, the bylaws of every company in which they intend to purchase shares to determine whether they contain any custom-designed ownership-reporting requirement, since failure to do so may result in forfeiture of their rights to nominate directors or propose other corporate action should they later wish to exercise them. If this type of bylaw were valid, shareholders would be subject to a crazy quilt of reporting requirements with differing thresholds at different companies, and forced to comply at a time when they aren't even seeking to take governance action, to avoid forfeiting fundamental shareholder rights. Rather than relying on uniform SEC-mandated disclosure requirements, every company would be making up its own rules and reporting regimes to trap unwary investors. Such provisions should not be upheld.

Acting in Concert

In September 2008, another defense-side firm published sample ANBs for its clients that define the term “Proposing Person” to include any person with whom the proposing shareholder or beneficial owner is “Acting in Concert,” and require proponent shareholders to disclose any such persons. These proposed bylaws provide that a person should be deemed to be Acting in Concert with another person if “such person knowingly acts (whether or not pursuant to an express agreement, arrangement or understanding) in concert with, or towards a common goal relating to the management, governance or control of the Corporation in parallel with, such other person where (a) each person is conscious of the other person's conduct or intent and this awareness is an element of their decision-making processes and (b) at least one additional factor suggests that such persons intend to act in concert or in parallel, which such additional factors may include, without limitation, exchanging information (whether publicly or privately), attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel....A person Acting in Concert with another person shall be deemed to be Acting in Concert with any third party who is also Acting in Concert with such other person.”

The above “Acting in Concert” definition takes the federal securities law definition, which requires an agreement between the parties, and stretches it to cover mere consciousness of each other plus discussion. The plain intention of this provision is to force activist shareholders to disclose the identity of every other shareholder they've spoken to as a “concert party,” or risk forfeiture of their shareholder rights. The provision is intended to chill protected and legitimate shareholder communication, encouraged by the SEC,⁵ and enables companies to disenfranchise shareholders by arguing that adequate disclosure has not been made. The bylaw does nothing to create a more orderly process for shareholder nominations, or serve any other legitimate purpose of the company. Discouraging shareholders from sharing their viewpoints on the management or governance of a company is not a legitimate purpose, and shareholders should have the right to discuss the actions of a company in which they are invested without having to disclose the participants in all such conversations to the company simply in order to be eligible to exercise shareholder rights.

Compensation Information

Several companies have adopted Second Generation ANBs requiring disclosure of compensation arrangements and “any other material relationships” between the nominating shareholder and its affiliates and concert-parties, on the one hand, and its nominees and their affiliates and concert-parties, on the other hand.

To the extent the shareholder has nominated a purportedly independent person to serve as a director, such a disclosure requirement at least would serve to confirm the nominee's independence from the nominating party. However, where the shareholder-nominee is admittedly affiliated with the nominating party (as when an activist hedge fund nominates a principal of the fund), such a requirement serves no legitimate corporate purpose. This information has never been required to be disclosed under the federal proxy rules, and is never disclosed by companies with respect to their outside directors. The proponent could offer to disclose the information in confidence to the company, on the off chance that the company had some legitimate need to know it, but, in one recent case, company counsel rejected such a proffer stating that it specifically intended to make the information public in its proxy materials. Such a response makes clear that the requirement was inserted for no corporate purpose other than to discourage an activist from nominating an affiliated party, or suffer public disclosure of private financial information. This matter is now the subject of litigation.⁶

Conclusion

Unlike First Generation ANBs, which simply require shareholders to submit proposals a reasonable time before the meeting and disclose only that information which is otherwise required by the proxy rules, Second Generation ANBs are being drafted with a different agenda in mind: controlling the ability of shareholders to nominate directors or to propose business. While some of these provisions serve legitimate purposes in promoting an orderly process, many are nothing more than thinly-veiled attempts to disqualify shareholder proponents. As eager defense-side counsel generate ever-more-ingenuous provisions intended to strip shareholders of their fundamental rights, activists will be forced, at their own expense, to bring litigation to have these provisions declared invalid, while companies use the corporate treasury to defend them. Hopefully, the courts will send a message to these companies that shareholder rights are not to be gamed away. ■

4 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

5 See Exchange Act Release No. 31326, Regulation of Communications Among Shareholders (Oct. 16, 1992).

6 *Springbok Capital Onshore, LLC v. Tunney*, No. 4358 - VCL (Del. Ch. filed Feb. 11, 2009).

Proxy Contest Settlement Agreements: An Overview

By David E. Rosewater and Nicholas Tomasetti

ALTHOUGH INTENSE PROXY CONTESTS are what attract attention in activist situations, most potential contests are resolved in advance of a fight through settlement agreements. Settling a potential contest allows both the activist investor and the company to avoid significant drains on their resources—both time and money—while at the same time providing additional mutual benefits.

Such agreements typically have four basic components: (a) the actions to be taken by the company, (b) the standstill agreement of the activist, (c) the other agreements made by the activist for the benefit of the company, which can be further broken down into issues relating to securities purchases and issues related to corporate governance and (d) other material terms. This article explores these basic components, and also addresses some of the most common issues and considerations that arise in connection with such agreements.

Company Actions: Board Seats and Other Strategic or Governance Concessions

The goal of activist investors in a proxy contest is to enhance shareholder value by obtaining seats on the target company's board of directors and/or effecting changes in the company's policies. However, the mere grant of board seats in a settlement agreement leaves open certain issues that can significantly impact the effectiveness of those board seats for the activist's purposes or create loopholes for the company to disenfranchise the new directors in various ways, should they choose to do so.

Typical issues include the appointment of the new board members to various committees and how quickly the activist's selected appointees will take office after the settlement agreement is concluded. The issue of appointment to committees is obviously important because of the critical nature of the work done by a number of them, such as the audit, compensation and governance committees. Without a commitment on the part of the company to appoint the activist's candidates to the board's various committees, it is under no obligation to do so—and given that most settlements are for only a small minority of seats on the board, it may well choose to bypass those members for committee appointments. In fact, under state corporate law, it is often the case that a much wider range of board decisions can be delegated to board committees than is commonly done, if the board so chooses. Therefore, having the right to have a seat on future committees is necessary to avoid the possibility of being disenfranchised altogether on certain issues.

With respect to the timing of director appointments, it is common for the target company to seek to delay the appointment of the activist's nominees until at, or immediately following, the next annual meeting rather than concurrently with execution of the settlement agreement. Because the annual meeting may not occur for weeks, or even months, after the settlement, this can create a problem for activists, as much can be done or undone by the company during that period, without input from the new board members. Although a frequently offered reason for delayed appointments is that companies prefer not to embarrass existing board members by forcing them to resign to make room for activist nominees, this problem can be resolved by the company agreeing to expand the board temporarily to add an activist's nominees, and then returning it to the original size for the next annual meeting election.

Other issues to consider when a director is appointed in a settlement agreement include whether the activist investor has the right to appoint a replacement director in the event that their appointed director steps down or becomes incapable of continuing service, and under what circumstances, if any, the activist-appointed director will be required to resign entirely from the board.

There is a broad range of strategic alternatives and/or policy changes for activists to push for and which they choose to pursue is based on very fact-specific circumstances. Strategic alternatives that are often proposed include stock buybacks, leveraged recapitalizations, sale of all or part of the company, and special dividends. Policy changes can range from basic issues of corporate governance, such as forming a board committee to review certain practices, separation of the CEO and chairman roles, and revising standards for calling special meetings, to a more aggressive change such as agreeing to begin a search for a new chief executive officer. The settlement agreement will typically set forth the parameters of what, how and when changes or alternatives will be effectuated.

Standstill Duration

The duration of the "standstill" period (i.e., the period during which an activist agrees to refrain from certain activities with respect to influencing the control and/or policies of the issuer) varies by agreement. The first issue to be resolved is whether its termination will be event-driven or time-driven. For example, an event-driven termination would be where the standstill period lasts only so long as certain agreed-upon conditions are in effect, such as until the activist's nominees are no longer board members. However, a time-driven termination (i.e., one with a definite expiration date) is often preferred by the activist because it allows the activist to consider its alternatives again at a discernible point in the future, for example, in the event that company performance has not, in the activist's view, sufficiently improved. Conversely, a standstill running for a potentially infinite period (e.g., for so long as an activist has directors appointed to the target's board) could diminish the influence of the activist with respect to shaping the company's policies and, by extension, its performance.

Assuming that the standstill period selected is one with a definite, non-event driven termination, the obvious question is the length. Activist investors in this situation generally keep an eye towards the future, namely, they want to keep the doors open for resurrecting the proxy contest at some point in the future in the event that the target company does not make prudent decisions and/or improve its performance. A typical time frame is one year, sometimes more, usually expiring shortly before the deadline for the giving of notice to bring director nominations prior to the company's next annual meeting (or, in the event of a two year period, the annual meeting that is scheduled to occur in two years). Thus, the duration language regarding the standstill period often tracks the requirements in a target company's advanced notice bylaws regarding the delivery by a stockholder of a notice of intent to nominate directors.

Standstill Types

Typically, there are two types of "standstill" provisions that can impact upon the activist investor: the share ownership standstill and the corporate governance standstill. Although a standstill agreement need not include both prohibitions, often both will be present. Share ownership standstill provisions

will often prohibit the investor from acquiring any voting securities of the target company, with limited exceptions that are typically negotiated items and fact-specific, but which may permit the entry into swap agreements as well as the ability of the activist to acquire up to a certain percentage of the target company's stock (e.g., 10%).

Corporate governance standstill provisions are often more cumbersome than share ownership provisions insofar as there are more variables regarding what may or may not be included as "prohibited conduct." Such standstills can encompass such prohibited conduct as: seeking to control the management or policies of the target company, attempting to get additional board representation and submitting any proposals or participating in the solicitation of the company's proxies. Otherwise prohibited actions may sometimes be permitted in the event that the company enters into certain "material transactions," such as a merger or asset sale in excess of a certain dollar amount. Often, activists will seek to ensure that the standstill provision does not prohibit its right to publicly criticize or oppose a transaction that could seriously alter the status of the business.

Additional prohibitions that often appear in corporate governance standstill provisions include publicly announcing or attempting to publicly affect a merger or related transaction involving the company and forming or joining in a "group." As stated above, the actual details of a corporate-governance standstill provision will depend on the facts and circumstances at hand.

Other Material Provisions

In addition to the duration of the agreement and the restrictions to be placed on both the company and the activist, there are other important provisions that routinely appear in such agreements. Key factors of any settlement agreement include restrictions on the sale or other transfer of the company's securities, non-disparagement clauses, remedies provisions and expense-reimbursement clauses.

Transfer restrictions generally prohibit the activist from transferring any of its securities without the prior written notice of the target company. This prohibition is often drafted to include certain exceptions, such as transfers to controlled affiliates, private transfers that would not result in a transferee holding more than a certain percentage of the target's stock, and with respect to certain tender offers or public repurchase offers.

A provision regarding remedies for breach of the agreement is another one that is often crafted with particularity. Properly drafted, it provides that, in the event of such a breach, either or both parties are entitled to the same remedies, whether at law, in equity or both.

Generally, the standstill agreement, by making concessions that both can live with, is an efficient way for both an activist investor and a target company to resolve a proxy fight in its early stages. As is the case with any agreement, compromise will play the most crucial role in the outcome of standstill agreement negotiations. Whether or not the overall terms are more or less favorable to one party will often depend simply on how much leverage that party has with respect to the proxy campaign. While this article covers the most common provisions in such agreements, they should be viewed largely as the backbone to an agreement, the details of which should be fleshed-out and negotiated based on the facts and circumstances at hand. ■

Swaps and Section 16: Reporting and Liability Issues

By Eleazer Klein and Adriana F. Schwartz

TOTAL RETURN, CASH-SETTLED EQUITY SWAPS, or "TRSs," have been used by activist investors to build their economic exposure in target companies in addition to, or in lieu of, taking a direct ownership stake in the target.¹ The use of these derivatives can give rise to complex issues for activists who find themselves subject to Section 16 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Where the potential for becoming a Section 16 insider exists, investors should understand how their TRS positions and the complexity of these instruments can impact their reporting obligations under Section 16(a), along with their potential for Section 16(b) profit disgorgement liability, lest they stumble into reporting delinquencies and/or liability exposure.

Section 16 of the Exchange Act applies to "insiders" of any issuer, which term includes (i) any beneficial owner² of more than 10% of a class of voting equity securities that is registered under Section 12 of the Exchange Act and (ii) any executive officer or director of any issuer with a class of voting equity securities that is registered under Section 12 of the Exchange Act.

Typically, investors limit their beneficial ownership of an issuer's equity securities to stay below the 10% threshold of Section 16. However, Section 16 can be implicated even in instances where an investor does not take any action to put itself over the 10% threshold. For example, an investor can become a greater-than-10% owner as a result of an issuer buyback of securities and unwittingly find itself subject to Section 16. Here, the investor may only become aware that it has become a greater-than-10% beneficial owner when the issuer publicly discloses the buyback, at which point the investor will immediately become subject to Section 16 and must file a Form 3 to disclose its holdings in the issuer's equity securities within ten days.

Additionally, if an activist investor successfully nominates a representative for election to the board of directors of a

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1 It should be noted that in light of the June 2008 decision in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*, et al., 562 F. Supp. 2d 511 (S.D.N.Y. 2008), there is uncertainty with respect to whether investors are required to include the shares underlying their TRS positions in their beneficial ownership calculations for purposes of Section 13 and Section 16 of the Exchange Act. The court in *CSX* found that the investors beneficially owned, under Rule 13d-3(b), the shares of common stock referenced by their TRSs which were purchased and held by their TRS counterparties to hedge their TRS exposure, because they accumulated and used their swap positions in the equity of CSX Corporation "with the purpose and effect of preventing the vesting of beneficial ownership...as part of a plan or scheme to avoid the reporting requirements of Section 13(d)." *Id.* at 553. This case is currently under appeal to the United States Court of Appeals for the Second Circuit.

2 For purposes of Section 13(d) and (g) and determining whether a person is subject to Section 16 as a greater-than-10% beneficial owner of securities, "beneficial owner" is defined under Rule 13d-3(a) as any person who, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise has or shares "voting power and/or investment power with respect to such security." Beneficial ownership can also be found under Rule 13d-3(b) as discussed in footnote 1 above.

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target, the investor could become subject to Section 16 if it is shown that the investor’s director-nominee serves as its deputy on the board (a so-called “director by deputization”). In such a case, the investor itself could also be treated as a director of the issuer for purposes of Section 16. Finally, the June 2008 decision in *CSX Corporation v. The Children’s Investment Fund Management (UK) LLP, et al.*³ resulted in the investor defendants being deemed to beneficially own the shares of common stock referenced by their TRSs, which were purchased and held by their TRS counterparties to hedge their TRS exposure, thereby putting them over the 10% threshold of Section 16.⁴

The potential Section 16 implications for insiders with TRS positions that were entered into without contemplating or structuring the transaction with the consequences of Section 16 in mind can be severe.⁵ Accordingly, investors need to educate themselves on how to report TRSs and the kinds of transactions and terms that can have the potential to create profit disgorgement liability under Section 16(b).

Reporting Swaps Under Section 16(a)

In a typical TRS between an investor and a bank counterparty, upon the settlement of the TRS, the investor agrees to pay to the counterparty an amount equal to the market price of the shares of common stock underlying the TRS at the time of entering into the TRS (the “reference price”) and the counterparty agrees to pay to the investor an amount equal to the market price of those shares of common stock at the time the TRS is settled (the “settlement price”). The transaction is the economic equivalent of the investor buying these shares of common stock at the reference price and then selling those shares back to the counterparty at the settlement price.

Section 16(a) imposes reporting obligations on insiders of an issuer with respect to their holdings and transactions in the issuer’s “equity securities”, which term includes “derivative securities” such as TRSs. The SEC has not proscribed any one method of reporting TRSs for purposes of Section 16(a). Instead, it has said that any manner that provides an adequate description of the instrument is appropriate.⁶ In order to be “adequate,” the following information must be included: “(1) the date of the transaction; (2) the term; (3) the number of underlying shares; (4) the exercise price (i.e., the dollar value locked in); (5) the non-exempt disposition (acquisition) of shares at the outset of the term; (6) the non-exempt acquisition (disposition) of shares at the end of the term (and such earlier dates, if any, where events under the equity swap cause a change in a call or put equivalent position); (7) the total number of shares held after the transaction; and (8) any other material terms.”⁷

Swaps and Section 16(b) Profit Disgorgement Liability

Section 16(b) requires insiders to disgorge to the issuer any profit derived from any sale and purchase or purchase and sale of an issuer’s equity securities within a period of less than six months (the “short-swing period”). In order to determine the amount of disgorgable profits under Section 16(b), it is therefore necessary to determine when a “sale” or “purchase” is deemed to have occurred under Section 16. For insiders subject to Section 16, the entry into of a TRS by a long party generally is deemed to be a purchase of the number of shares of common stock to which the TRS relates at a price equal to the reference price. The settlement of a TRS by the long party generally is deemed to involve (i) the termination of a derivative security, which is exempt from



Section 16(b)⁸, (ii) the purchase of the underlying common stock at a price equal to the reference price, which is generally exempt from Section 16(b)⁹ and (iii) a non-exempt sale of the underlying common stock at a price equal to the settlement price.

Interim Settlements and Rollovers

While the principles above may appear straightforward, numerous questions arise with respect to the application of the Section 16(a) reporting guidelines and the principles underlying Section 16(b) when dealing with transactions in TRSs due to their complexity. For example, some TRSs provide for interim settlements, such as quarterly, prior to the final settlement date of the TRS. These interim settlements generally will be required to be reported as a settlement of the TRS and an entry into of a new TRS position and may be matchable transactions for purposes of Section 16(b).¹⁰ Additionally, it is common for a long party to a TRS to decide

3 562 F. Supp. 2d 511 (S.D.N.Y. 2008).

4 Id.

5 Subsequent to the CSX decision, a Section 16(b) profit disgorgement action was brought against the investor defendants to recover any short-swing profits they may have realized as Section 16 insiders. The total disgorgable profits realized by the investors on their short-swing transactions, which were predominately comprised of transactions in TRSs, was alleged to be as much as \$137.6 million. The action was settled for a total of \$11 million.

6 SEC Release No. 34-37260, § IV. H (May 31, 1996).

7 Id.

8 Rule 16b-6(b).

9 Id.

10 SEC Release No. 34-34514 (Aug. 10, 1994), fn 106, and SEC Release No. 34-37260 (May 31, 1996), fn 142. This will be the case to the extent that an interim settlement causes a change in an insider’s call or put equivalent position.

to continue its economic exposure to the issuer's stock upon the expiration of the TRS by "rolling over" the TRS with its counterparty on its settlement date (by settling its existing TRS and simultaneously entering into a new TRS). This likely will result in a non-exempt sale at the time that the existing swap is settled and a non-exempt purchase at the time the new swap is entered into. Presumably, if the settlement and new execution of the TRS are done simultaneously, the Section 16(b) sale at the settlement and purchase at the rollover will have the same price for Section 16(b) matching purposes¹¹ and will not create profit disgorgement issues by themselves. However, if the insider has effected or will effect any other Section 16(b) sale or purchase within the preceding or subsequent six months, the profit disgorgement rules may be implicated.

It is not uncommon when building a swap position to enter into multiple TRSs with expiration dates that succeed each other by periods of less than six months. It is important to note that the Section 16 purchase that occurs at the rollover of one swap will be matchable with the Section 16 sale or sales that occur upon the settlement of TRSs that take place within a period of less than six months.

Expiration and Settlement Dates

Investors should also keep in mind that the expiration date of a TRS must be at least six months after the date that the TRS is entered into to avoid potential Section 16(b) issues. A shorter term would result in a Section 16(b) purchase upon entry into of the TRS and a Section 16(b) sale upon settlement of the TRS at its expiration, both occurring within the short-swing period. Of course, even where the expiration date of the TRS is six months or more from the time the TRS is entered into, there may be unforeseen events that cause the long party to desire to settle the TRS prior to the expiration date. If this happens within less than six months of the date the TRS was entered into and at a time when the TRS reference price is less than the settlement price (as any long party would hope), then the profit the insider would have made on the TRS transaction could be disgorgable under Section 16(b). Thus, while the ability to settle a TRS prior to the expiration date is a term frequently seen in TRS contracts, a Section 16 insider must be prepared to commit to six months of exposure from the time the TRS is entered into, or possibly longer if the insider has effected any other matchable transactions, in order to avoid profit disgorgement liability.

The relevant "settlement date" for Section 16 purposes is the date that the term of the swap ends and the settlement price becomes fixed. Generally, it is on this date that the insider will be deemed to have a sale for Section 16 purposes. Although swap contracts typically provide for a standard T+3 settlement (on which date the owing party will deliver the amount due under the swap contract to its counterparty), this is not the relevant date for Section 16 purposes. This distinction must be kept in mind in order to ensure timely reporting¹² and to properly structure transitions to be outside of the Section 16 six-month window.

Cancellations and Amendments

The cancellation of a TRS and the entry into of a new TRS can also result in a sale and purchase for purposes of Section 16(b). This is true regardless of whether the terms of the new TRS are identical to the terms of the original TRS. This can occur, for example, when canceling a swap and entering into

a new swap with identical terms but for an adjustment to the reference price of the swap. It can also occur when canceling an existing swap and entering into a new swap with another counterparty.¹³

Insiders should also be mindful about amending any material terms of a TRS during the life of the swap because this may be treated as a settlement of the existing swap and the entry into of a new swap, a potential non-exempt purchase and sale under Section 16(b). Amendments that have been deemed to be significant include a change in the conversion price or term of a derivative security.¹⁴ Although it may be in the interest of both parties to agree to an amendment, such as a change in the method of determining the settlement price, from a business perspective, Section 16 considerations may restrict an insider's ability to do so without consequence. In the case of a simultaneous acquisition and disposition, there should be no difference in the market price of the underlying securities and, therefore, no recoverable profit. The acquisition and disposition could, however, be matched against any other transactions in the issuer's securities within the prior or subsequent six-month period.

Conclusion

The issues that need to be contemplated when engaging in transactions in TRSs as a Section 16 insider are numerous. It is always prudent to fully analyze the surrounding facts and potential consequences before an insider enters into a new TRS or engages in any transactions with respect to an existing TRS. Insiders also need to determine how the entry into, and subsequent settlement of, a TRS may affect their ability to engage in future transactions in an issuer's securities free from Section 16(b) profit liability. ■

11 Rule 16b-6(c)(1) provides that, when matching identical derivative securities, profits are calculated by matching the prices at which the derivatives were bought and sold. When matching non-identical derivative securities relating to the same class of underlying securities or a derivative security and the underlying security to which it relates (i.e., the common stock), the SEC's rules do not dictate a formula for calculating recoverable profits. Instead, Rule 16b-6(c)(2) establishes a "cap" on recoverable profits by providing that the recoverable profit may not exceed the difference between the market price of the security underlying the derivative(s) on the date of purchase and sale. Subject to that maximum, the determination of recoverable profits is left to the courts. Rule 16b-6(c)(2) provides, however, that a court "may" measure recoverable profits as if the short-swing transaction involved identical derivative securities—that is, if the insider purchased a derivative security, by matching the purchase against a hypothetical sale of an identical derivative security valued as of the actual date of the matching sale, or, if the insider sold a derivative security, by matching the sale against a hypothetical purchase of an identical derivative security valued as of the actual date of the matching purchase.

12 Transactions by insiders must be reported on a Form 4 within two business days of the applicable transaction.

13 This is distinguishable from a direct assignment of an existing swap to a new counterparty where the existing swap is never cancelled. Where the derivative security is never cancelled, there is no change in the insider's derivative security position and, accordingly, it should not be deemed to be an event for purposes of Section 16.

14 See SEC Release No. 34-29131, fn 35; Knight-Ridder, Inc., SEC No Action Letter, Jan. 27, 1992; *Lerner v. Millenco*, L.P. 23 F. Supp. 337, (S.D.N.Y. 1998); and *Analytical Surveys, Inc. v. Tonga Partners, L.P.*, 2008 WL 4443828 (S.D.N.Y. September 29, 2008).

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