

Establishing, Maintaining and Exiting a Minority Equity Position: U.S. Securities Law Considerations for Hedge Funds

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A hedge fund that takes a minority equity position in a U.S. public company may encounter a variety of complex issues under the federal securities laws and other investment-related statutes. This memorandum considers the most important of these U.S. legal issues from the perspective of an equity investment's lifecycle: establishing, maintaining and exiting the position.

ESTABLISHING THE POSITION

A hedge fund interested in establishing a minority equity position in a U.S. public company faces three potential legal concerns: (i) disclosure obligations; (ii) issues regarding material nonpublic information; and (iii) limits on the permitted size of the investment. (We assume the fund purchases shares on the open market or in a manner that otherwise does not implicate the SEC's tender offer rules.²)

Disclosure Obligations

The Securities Exchange Act of 1934 (the "Exchange Act") features two ownership disclosure regimes. The first, under Section 13, applies to an issuer's five-percent beneficial owners and is designed to alert the market to stock accumulations that may

signal an incipient change of control. The second disclosure scheme, under Section 16, requires corporate "insiders," including ten-percent beneficial owners, to reveal their trades in the issuer's securities and potentially disgorge certain resultant profits.

Five-Percent Beneficial Ownership

Section 13 of the Exchange Act applies to an investor that acquires beneficial ownership of more than five percent of a class of publicly traded equity securities.³ "Beneficial ownership" is the possession of: (i) "voting power," meaning the power to vote or direct the voting of the securities in question; and/or (ii) "investment power," meaning the power to dispose or direct the disposition of the securities in question.⁴ An investor holding convertible or exchangeable instruments is generally deemed to beneficially own the underlying equity securities if the investor has the right to acquire them within 60 days (e.g., through warrants, convertible notes, subscription rights or physically settled derivative contracts).⁵

Schedule 13D

Section 13(d)(1) of the Exchange Act generally requires an investor that crosses the five-

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² The U.S. securities laws do not define "tender offer." The SEC interprets the term flexibly and has sometimes applied it to acquisitions of securities outside the classic tender offer scenario (i.e., an organized public offer made simultaneously to all shareholders at a uniform bid price). Whether a tender offer exists is a fact-intensive inquiry, but potential indicia could include active solicitation of current shareholders, pressure on current shareholders to sell through timing or pricing mechanisms, or bids that are too large to be filled in the normal trading market. Usually, however, a hedge fund should be able to engage in market accumulations of U.S. public company equity without triggering the tender offer rules.

³ More specifically, five-percent beneficial ownership of a class of equity securities that the issuer has registered pursuant to Section 12 of the Exchange Act, thus enabling the securities to be listed on a national securities exchange.

⁴ Rule 13d-3.

⁵ Rule 13d-3(d)(1). In some cases, Section 13 may require disclosure of warrants and certain derivative instruments even if they do not give rise to beneficial ownership of the related equity security.

percent beneficial ownership threshold to file a Schedule 13D with the SEC within 10 days.⁶ Schedule 13D is a public filing that discloses, among other things: (i) the identity and background of the investor; (ii) information about the investor’s control persons; (iii) the source and amount of funds used to make the acquisition; (iv) the purpose of the acquisition and any “plan” or “proposal” the investor may have with respect to the issuer (including plans or proposals to acquire additional or dispose of currently held securities, to change the board or management of the issuer, or to cause the issuer to engage in a significant corporate transaction);⁷ and (v) any “contracts, arrangements, understandings or relationships” of the investor with respect to the issuer’s securities.

Section 13 does not prohibit an investor from continuing to purchase shares during the 10-day interim period before the Schedule 13D is due. It is therefore possible that an investor’s initial Schedule 13D will indicate beneficial ownership significantly exceeding five percent.

Schedule 13G

Certain investors are eligible (although not required) to report their five-percent equity position on Schedule 13G in lieu of Schedule 13D. Schedule 13G calls for less information than Schedule 13D, and in particular does not require disclosure of an investor’s plans or proposals regarding the issuer.

Most relevant for hedge funds is the fact that Schedule 13G is available to non-institutional passive investors

with less than 20-percent beneficial ownership. To be eligible to use Schedule 13G, the fund must be able to certify that the securities “were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer.”⁹ A non-institutional passive investor electing to report on Schedule 13G must file within 10 days of crossing the five-percent beneficial ownership threshold.

The SEC takes the position that Schedule 13G is not available to report share purchases made after the public announcement of a tender or exchange offer with the intention of later tendering the shares. In the SEC’s view, such merger arbitrage investments are made in connection with change-of-control transactions and thus must be reported on Schedule 13D.¹⁰

Exchange Act Section 16(a)—Ten-Percent Beneficial Ownership

A hedge fund that acquires beneficial ownership of more than 10 percent of a class of equity securities of a U.S. public company becomes an “insider” (along with the issuer’s directors and executive officers) subject to Section 16 of the Exchange Act and the complex system of rules thereunder.¹¹

At the acquisition stage of the investment lifecycle, the most relevant provision is Section 16(a), which requires an investor to file a Form 3 within 10 days of crossing the 10-percent beneficial ownership level. Form 3 requires disclosure of the investor’s identity and all

⁶ As discussed below, certain passive investors may be eligible to disclose their ownership on a less detailed Schedule 13G.

⁷ See Item 4 of Schedule 13D. From the reporting investor’s perspective, the requirement to describe the purpose of the investment and any plans or proposals is perhaps the most challenging element of Schedule 13D. A major question the reporting investor must address is whether it has acquired shares for investment only, or rather with the purpose of obtaining some degree of control over the issuer. Another recurrent issue is whether the reporting investor’s thoughts or intentions about the issuer rise to the level of a disclosable “plan.”

⁸ Rule 13d-1(c). Although generally of less utility to hedge funds, Rule 13d-1(b)(ii) also makes Schedule 13G available to specified types of regulated “institutional” investors, including registered investment companies and registered investment advisers, that have acquired securities in the ordinary course of business. These institutional investors are subject to different deadlines for their initial Schedule 13G filing and any subsequent amendments, and are not constrained by a 20-percent beneficial ownership cap.

⁹ See Item 10 of Schedule 13G.

¹⁰ See *Faith Colish*, SEC No-Action Letter (Mar. 24, 1980).

¹¹ Rule 3a12-3(b) under the Exchange Act exempts from Section 16 securities that have been registered under the Exchange Act by a “foreign private issuer.” Rule 3b-4 defines that term to mean any non-U.S. issuer, unless (i) more than 50 percent of the issuer’s outstanding voting securities are held directly or indirectly of record by U.S. residents and (ii) any of the following conditions exists: (a) a majority of the issuer’s directors or executive officers are U.S. citizens or residents; (b) more than half of the issuer’s assets are located in the United States; or (c) the issuer’s business is administered primarily in the United States. Most foreign issuers whose ADSs trade in the United States qualify as foreign private issuers, as a result of which the issuer’s insiders, including 10-percent beneficial owners, are not covered by Section 16.

securities of the issuer in which the investor has a “pecuniary interest,” including derivative securities.

It is important to understand that “beneficial ownership” has two definitions under Section 16. The first applies solely for the purpose of determining whether an investor is subject to Section 16 by virtue of holding 10-percent beneficial ownership. For this purpose, Section 16 borrows the standards of Section 13, under which beneficial ownership means the possession of voting power and/or investment power.¹² The second definition applies for all other purposes under Section 16, including the reporting obligations set forth in Section 16(a) and profit disgorgement liability under Section 16(b) (discussed below). This definition equates an insider’s beneficial ownership to “pecuniary interest” in the securities in question, meaning the opportunity, directly or indirectly, to profit or share in any profit derived from a transaction in the securities.¹³ These disparate definitions mean that the number of securities considered beneficially owned for purposes of determining whether an investor is subject to Section 16 may differ from the number applied for transaction reporting and disgorgement purposes.

Exchange Act Section 16(a)—Board Representation

Under the SEC’s “director by deputization” theory, a hedge fund also may become subject to Section 16 if it gains representation on the issuer’s board, regardless of the fund’s degree of beneficial ownership. In general, “deputization” may be found where the director-fund relationship (i) entails the sharing of confidential issuer information, (ii) enables the fund to influence the director’s decision-making on the board

or (iii) allows the director to influence the fund’s investment policy vis-à-vis the issuer.¹⁴

“Group” Issues

If a hedge fund does not have five- or 10-percent beneficial ownership of the issuer, it may nonetheless become subject to the Section 13 or Section 16 disclosure requirements through membership in a “group” that has crossed the relevant ownership threshold. A group is formed when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of an issuer’s equity securities.¹⁵

Once a group is formed, each member’s beneficial ownership position is attributed to every other member.¹⁶ If the group’s total beneficial ownership exceeds five percent, the group has a Schedule 13D or 13G filing obligation. Above the 10-percent beneficial ownership level, the group becomes subject to Section 16. A group may be deemed to exist implicitly if two or more investors are effectively acting in concert. A hedge fund must therefore be sensitive to the nature of any communications it has with the issuer’s other equity holders.¹⁷

Material Nonpublic Information

Rule 10b-5 under the Exchange Act generally makes it illegal for a person to trade in an issuer’s securities when in possession of material nonpublic information about the issuer. A hedge fund that had material nonpublic information about an issuer therefore would be precluded from acquiring shares of that issuer. This topic is discussed in more detail below under “Maintaining the Position—Trading in Issuer Securities—Insider Trading.”

¹² Rule 16a-1(a)(1).

¹³ Rule 16a-1(a)(2).

¹⁴ See, e.g., *Colan v. Cutler-Hammer, Inc.*, 812 F.2d 357 (7th Cir. 1987).

¹⁵ Rule 13d-5(b)(1).

¹⁶ For example, assume three investors, each of which owns 10 shares in the issuer. If these investors form a group, each investor will be deemed to beneficially own 30 shares. See *Rosenberg v. XM Ventures*, 274 F.3d 137, 144 (3d Cir. 2001).

¹⁷ One leading case found that the following factors demonstrated existence of a group: (i) a common plan and goal regarding the issuer; (ii) a pattern of parallel and continued purchases of issuer shares over a relatively short time period; (iii) correlation of the investors’ activities and communications through a common agent; and (iv) the investors’ claims of shareholder support at a meeting with the issuer’s management. See *Champion Parts Rebuilders, Inc. v. Cormier Corp.*, 661 F. Supp. 825, 850 (N.D. Ill. 1987).

Limits on Permitted Size of Position

Disclosure obligations aside, other provisions of federal or state law may actually limit the size of a hedge fund's permitted equity stake in a U.S. issuer, or impose conditions on acquiring ownership above a specified level. An issuer may effect similar limitations via provisions in its constituent documents.

Antitrust Considerations

Under the Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act"), acquisitions of U.S. voting securities or assets exceeding an inflation-adjusted value (currently \$63.1 million) generally must be notified to the U.S. Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice, as well as the target company, and cannot be consummated prior to the expiration or early termination of a statutory waiting period.¹⁸ The HSR Act offers a potential exemption for a passive investment involving less than 10 percent of a company's voting securities. It is particularly important to timely file any required HSR submission, as fines for non-compliance accrue over time and can become extremely expensive.

Regulated Industries

Investors in certain regulated industries (such as aviation, banking, communications, gaming, insurance, transportation and utilities) may face additional ownership restrictions and regulatory review processes, particularly if the investor is a non-U.S. entity.

State Anti-Takeover Laws

Many state legislatures have enacted laws to impede unsolicited acquisitions of significant equity positions. So-called "control share" statutes nullify the voting rights of shares held by an investor that has exceeded a

certain ownership limit (often 20 percent) unless the company's other stockholders vote to restore the investor's rights. "Business combination" statutes bar an investor that crosses a specified ownership level (frequently 15 percent) from engaging in certain change-of-control transactions unless the company's board has approved the share purchase by which the threshold was crossed.¹⁹ State anti-takeover statutes often feature deemed ownership rules that are similar to the Exchange Act's beneficial ownership standards.

Corporate Takeover Defenses

Corporations may erect their own barriers to investments above a certain level. The classic mechanism is a shareholder rights plan, or "poison pill." Under this type of plan, the company issues to its existing shareholders rights to purchase additional shares. The rights become exercisable if a third party purchases more than a specified amount of the company's outstanding shares (often 10, 15 or 20 percent) without board approval. Once exercisable, the rights entitle every shareholder but the unsolicited acquiror to purchase additional shares at a very significant discount, thus heavily diluting the acquiror's stake. The board of directors typically has the power to waive application of the poison pill with respect to any given investor, presumably following negotiations.

Federal Tax Considerations

Companies conducting business as real estate investment trusts (or "REITs") are subject to special ownership restrictions under the U.S. Internal Revenue Code. In addition, REITs often include ownership restrictions in their charters or other organizational documents. These restrictions vary, but usually prevent a single investor from owning 10 percent or more of the REIT's equity. An investor's deemed level of ownership is normally determined pursuant to

¹⁸ In determining whether the HSR threshold is crossed, the investor aggregates the value of securities already held and the securities proposed to be acquired, in each case pursuant to statutorily prescribed valuation methods.

¹⁹ An example of a business combination statute is Section 203 of the Delaware General Corporation Law, which categories as an "interested stockholder" any holder of 15 percent or more of Delaware issuer's voting stock. An interested stockholder is barred for a period of time from engaging in a "business combination" with the issuer absent certain types of board or shareholder consent.

complex ownership attribution rules under the Internal Revenue Code.

Issuers that seek to avoid potential restrictions on their use of net operating loss carryovers for U.S. federal income tax purposes sometimes adopt charter provisions that restrict purchases and sales of issuer stock by five-percent equity owners.

MAINTAINING THE POSITION

The issues described above may well remain relevant once a hedge fund has established an initial equity investment; for example, if the initial investment represents four-percent beneficial ownership, a subsequent increase to six-percent ownership would trigger a Schedule 13D or 13G filing. That said, a separate set of concerns is unique to a hedge fund's maintenance of an equity position. These relate primarily to: (i) ongoing Section 13 disclosure obligations; (ii) trading in the issuer's securities; (iii) communicating with the issuer's other investors; (iv) in certain circumstances, the possibility of "controlling person" liability; and (v) in the bankruptcy context, evolving standards of ownership disclosure applicable to members of *ad hoc* committees of equity holders.

Disclosure of Changes in Ownership Level or Investment Intent

Schedule 13D Implications

A hedge fund that has reported its ownership on Schedule 13D must amend the filing "promptly" upon the occurrence of a material change to the information disclosed in the prior filing.²⁰ The acquisition or disposition of beneficial ownership of one percent or more of the class of securities owned is material by definition.²¹ In addition, an amendment to Schedule 13D is often triggered by a fund's adoption or modification of a "plan" or "proposal" relating to the issuer's securities.

Schedule 13G Implications

A non-institutional passive investor that has filed a Schedule 13G²² must file an annual amendment to report any changes to its previously disclosed information. This annual amendment is due within 45 days of the calendar year-end. In addition, a non-institutional passive investor must file a "prompt" amendment to its Schedule 13G upon exceeding 10-percent beneficial ownership of the class of securities and, thereafter, to reflect any subsequent ownership increase or decrease of more than five percent of the class.²³

A non-institutional passive investor disclosing its ownership via Schedule 13G must switch to Schedule 13D if it (i) acquires 20-percent or greater beneficial ownership or (ii) ceases to have a passive investment purpose. A fund in this situation must file the Schedule 13D within 10 days, and may not purchase or otherwise acquire beneficial ownership of additional shares in the issuer, or vote its currently owned shares, until 10 days after the filing.²⁴ In this sense, the price of electing to report under the short-form Schedule 13G regime is that the fund will be frozen out of the market for at least 10 days if it subsequently reaches 20-percent beneficial ownership or adopts a non-passive investment posture. An initially passive investor that has filed on Schedule 13D is subject to no such consequence. This fact sometimes prompts funds that could report their holdings on Schedule 13G to opt instead for Schedule 13D, notwithstanding the latter's more onerous disclosure requirements.

Trading in Issuer Securities

Securities Act Concerns Regarding Sales

Under Section 5 of the Securities Act of 1933 (the "Securities Act"), any sale of a security—including a resale by an investor—must either be registered under

²⁰ Rule 13d-2(a).

²¹ This does not mean, however, that a change of less than one percent is necessarily immaterial.

²² That is, an investor that has elected to file a Schedule 13G pursuant to Rule 13d-1(c). See note 8 and accompanying text, *supra*.

²³ Rules 13d-2(b) and (d).

²⁴ Rules 13d-1(e) and (f).

the Securities Act or effected in reliance on an exemption from registration. These issues are discussed below under “Exiting the Position—Resales by Affiliates” and “—Resales by Non-Affiliates.”

Exchange Act Section 16(a)—Transaction Reporting

Section 16(a) of the Exchange Act obligates 10-percent beneficial owners and other insiders to disclose to the SEC on Form 4 any transaction or change of pecuniary interest in the issuer’s securities. Form 4 is a public filing and is due within two business days of the reportable event. The Form 4 reports only the securities that are the subject of the transaction and need not repeat information that remains unchanged from prior Section 16 filings.

Exchange Act Section 16(b)—Disgorgement of “Short-Swing” Trading Profits

In addition to reporting its trades on Form 4, a 10-percent beneficial owner may be liable under Section 16(b) to disgorge any profits from “short-swing” trading transactions (i.e., any purchase and sale, or sale and purchase, of the company’s securities, derivatives based on the company’s securities or security-based swap agreements involving the company’s securities, within any six-month period). This is the case regardless of the insider’s intention when entering into the trades.²⁵ The Section 16(b) disgorgement system can impose significant practical limits on a 10-percent investor’s ability to manage its position through hedging, sales or further purchases.²⁶

The “group” concept discussed above can also affect a fund for purposes of Section 16(b). That is, if several investors each beneficially owning less than 10 percent of an issuer are deemed to be a group, each member investor will be exposed to disgorgement liability for its short-swing trading profits. An investor will not have Section 16(b) disgorgement liability for another group member’s trades, however, if the investor does not have a “pecuniary interest” in the transacting member’s securities.

Short Selling

A hedge fund that engages in short sales of an issuer’s equity securities may be subject to disclosure requirements and other restrictions.²⁷

Temporary Rule 10a-3T, adopted by the SEC in October 2008, requires certain institutional investors to file with the SEC a weekly Form SH disclosing short sales of and short positions in so-called “section 13(f) securities.”²⁸ A hedge fund that (i) was required to file a Form 13F for the most recent quarter and (ii) during a Sunday-to-Saturday calendar week has effected a non-*de minimis* short sale in a section 13(f) security (other than options) must file a Form SH with respect to that calendar week. The Form SH is due at the SEC on the last business day of the week following any week in which a reportable short sale occurred. Form SH is a non-public filing.

Rule 10b-21 under the Exchange Act, also adopted by the SEC in October 2008, provides that a short seller has committed fraud if it (i) deceives a broker-dealer about the seller’s intention or ability to deliver the

²⁵ A share purchase that occurs before the investor becomes a 10-percent holder (including the purchase taking the investor over 10 percent) is not “matched” against subsequent sales for disgorgement purposes.

²⁶ Although not typically relevant to hedge funds, Rule 16a-1 identifies several categories of persons, consisting essentially of institutional investors and their control persons, that are permitted to exclude from their 10-percent ownership calculation securities that are held (i) for the benefit of third parties or in customer or fiduciary accounts in the ordinary course of business and (ii) without the purpose or effect of changing or influencing control of the issuer. The persons allowed to invoke this exclusion are the same “institutional” investors permitted by Rule 13d-1(b)(ii) to report their holdings on Schedule 13G rather than Schedule 13D. See note 8, *supra*.

²⁷ Rule 200(a) of the SEC’s Regulation SHO defines a short sale as “any sale of a security which the seller does not own or any sale which is consummated by the delivery of a security borrowed by, or for the account of, the seller.” For purposes of Regulation SHO, an investor is deemed to “own” securities only to the extent it has a net long position in the securities.

²⁸ Rule 10a-3T is effective until August 1, 2009, unless extended by the SEC. Rule 10a-3T essentially formalizes the weekly short-sale reporting requirements established by the SEC’s emergency orders of September and October 2008. For a discussion of the ongoing Form SH requirements, please see our memorandum dated October 17, 2008, “SEC Extends and Modifies Short-Sale Disclosure Regime,” available at www.rkollp.com/2008/10/sec_extends_and_modifies_short.php.

security being sold in time for settlement and (ii) in fact fails to deliver the security by the settlement date. In order to be liable under Rule 10b-21, the short seller must have knowingly or recklessly misled the broker-dealer.

Section 16(c) of the Exchange Act provides that a 10-percent beneficial owner or other insider may not sell an equity security of the issuer that it does not own. If the insider does own the security being sold, the insider must deliver the security for settlement within 20 days of the sale or deposit the security in the mail or other normal channel for delivery within five days of the sale. In effect, Section 16(c) prohibits an insider from engaging in any short sale other than against a boxed position, and in that case only if the specified delivery or deposit deadline is met.

Insider Trading

Rule 10b-5 under the Exchange Act generally makes it illegal for a person to trade in an issuer's securities when in possession of material nonpublic information about the issuer. Accordingly, if a hedge fund has obtained such information (for instance, through discussions with the issuer's management), the fund will be unable to buy or sell issuer securities until the information has been made public or gone stale. Note that this rule applies without regard to the fund's percentage ownership of the issuer.

Most U.S. public companies maintain internal securities trading policies. These policies typically permit officers and directors to purchase or sell the issuer's securities only during specified "window" periods, and often require the officer or director to obtain pre-approval from the issuer's legal or compliance department before trading. A director affiliated with a hedge fund would be personally subject to any such issuer policy. Less obviously, a hedge fund with a representative on the issuer's board should take care to understand whether its own ability to buy or sell issuer securities is constrained by the

issuer's trading policy; some policies apply to directors' affiliates as well as to directors individually.

Regulation M

Rule 102 under the SEC's Regulation M provides that when an issuer is engaged in a public offering or other "distribution" of securities, an investor that is an "affiliated purchaser" may not purchase or induce others to purchase securities during a restricted period surrounding the offering. A hedge fund that is an "affiliate" of the issuer (see note 36 below) is likely to be an affiliated purchaser covered by the Rule 102 prohibition.

Communicating with Fellow Investors

In addition to the risk of deemed "group" membership discussed above in connection with Sections 13 and 16 of the Exchange Act, a hedge fund that communicates with its fellow investors may become subject to the SEC's proxy rules.²⁹

The proxy rules regulate in great detail the process and content of communications with an issuer's shareholders. An investor becomes subject to the proxy rules when it engages in a "solicitation" of shareholders. Whether a solicitation exists is a fact-intensive inquiry, but hedge funds may be surprised by the extent to which intra-shareholder communications or public statements may implicate the proxy rules.

A hedge fund that decides to mount a proxy solicitation must, in addition to complying with the SEC's rules, explore whether the issuer's by-laws contain advance notice deadlines or other procedural requirements designed to regulate shareholder initiatives.

Controlling Person Liability

In the case of a sufficiently large investment, or where a hedge fund has board representation, the possibility of "controlling person" liability arises. This theory of liability is set forth in Section 20(a) of the Exchange Act, which provides that any person or entity that

²⁹ The proxy rules are embodied in Regulation 14A under the Exchange Act.

“controls” an issuer may have derivative liability for the issuer’s violations of the Exchange Act. Thus, for example, a controlling person could be liable under Rule 10b-5 for an issuer’s material misstatements or omissions in a Form 10-Q, 10-K or 8-K.³⁰

The Exchange Act does not define “control.” The SEC defines the term as “the possession, direct or indirect, of the power to direct, or cause the direction of, the management and policies of the issuer, whether through ownership of voting securities, by contract or otherwise.”³¹ Although it is clear that control may be attributed to an investor that has significantly less than majority voting power, the SEC’s definition is often inadequate to determine definitively whether control exists in any particular case. Accordingly, courts addressing Section 20(a) claims have developed varying fact-dependent tests, generally focusing on an investor’s “power to control” and/or “actual control” of the issuer.³²

Even if a Section 20(a) defendant is deemed to possess control, it may avoid liability by establishing the statutory defense that it “acted in good faith” and “did not directly or indirectly induce” the issuer’s violation of the Exchange Act.³³ Hedge funds with significant equity ownership or other potential indicia of control (such as a board seat) should pay particular attention to controlling person risk, and may wish to consult with counsel as to the details of their situation.

Unofficial Equity Committees in Bankruptcy Proceedings

A hedge fund that is a member of an *ad hoc* (i.e., unofficial) equity holders’ committee in a Chapter 11 bankruptcy proceeding may face evolving disclosure

obligations concerning the fund’s transactions in the debtor’s stock.

Bankruptcy Rule 2019 provides that an entity or committee representing more than one creditor or equity security holder must file with the court a statement disclosing, among other things, “the amounts of [shares] owned by . . . the members of the committee . . . , the times when acquired, the amounts paid therefor, and any sales or other disposition thereof.” Traditionally, *ad hoc* committee members have understood Rule 2019 to require disclosure of share ownership on an aggregate, rather than member-by-member, basis.

This understanding was upset, however, in a pair of 2007 rulings by the U.S. Bankruptcy Court for the Southern District of New York in the Northwest Airlines bankruptcy proceedings.³⁴ The court required an *ad hoc* committee of equity security holders to supplement a Rule 2019 statement of holdings to disclose each member’s holdings, acquisition dates and prices, and sales or other dispositions. The court also denied the committee’s request to file the supplemented Rule 2019 statement under seal.

While subsequent rulings in other jurisdictions have called into question the Southern District’s reading of Rule 2019,³⁵ the interpretive issue remains unsettled. To the extent the *Northwest Airlines* rulings retain vitality, hedge funds concerned about the confidentiality of their trading strategies may wish to consider whether the benefits of participating in an *ad hoc* committee outweigh the potential for public disclosure of their transactions in the debtor’s securities.

³⁰ Section 15 of the Securities Act articulates a similar theory of controlling person liability, which applies to an issuer’s violations of Sections 11 and 12 of the Securities Act.

³¹ Rule 12b-2 under the Exchange Act and Rule 405 under the Securities Act.

³² See, e.g., *Laperriere v. Vesta Insurance Group Inc.*, 2008 WL 1883482 (11th Cir. 2008). A full discussion of the circumstances in which an investor might be deemed to control an issuer, for purposes of Section 20(a) or otherwise, is beyond the scope of this memorandum.

³³ Courts are split as to whether the plaintiff has the burden of proving the defendant’s culpable participation in the issuer’s Exchange Act violation, or whether the defendant has the burden of proving its good faith. Compare *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450, 1473 (2d. Cir. 1996) with *Howard v. Everex Systems, Inc.*, 228 F.3d 1057, 1065 (9th Cir. 2000).

³⁴ *In re Northwest Airlines Corp.*, Case No. 05-17930, Docket No. 5220 (Bankr. S.D.N.Y. 2007).

³⁵ See, e.g., *In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Texas 2008), and *In re Sea Containers Ltd.*, Case No. 06-11156 (Bankr. D. Del. 2008).

EXITING THE POSITION

The legal issues relating to exiting an equity investment primarily concern the means by which the shares may be sold. That question hinges on whether (i) the investor is an “affiliate” of the issuer and/or (ii) the shares to be sold are “restricted securities.” In addition, the exit transaction may trigger disclosure or disgorgement under Section 16 of the Exchange Act, as well as an amendment to Schedule 13D or 13G. The insider trading and Regulation M concerns described above also will apply to the exit sale.

Resales by Affiliates

A hedge fund that holds or has voting control over 10 percent or more of an issuer’s equity securities, or that has appointed a director to the issuer’s board, may be deemed an “affiliate” of the issuer.³⁶ Shares held by an affiliate are known as “control securities.”

An affiliate may resell control securities in the U.S. public market in either of two ways. The first is pursuant to an effective resale shelf registration statement maintained by the issuer under the Securities Act. The second method is a resale in compliance with Rule 144 under the Securities Act. Any resale of control securities under Rule 144 must satisfy the current public information, volume, manner -of-sale and notice requirements set forth in Rules 144 (c), (e), (f) and (h), respectively.³⁷ (As discussed below, if the control securities are also restricted securities, a six-month holding period under Rule 144(d) will apply as well.)

Securities lose “control” status once the investor ceases to be an affiliate of the issuer.

Resales by Non-Affiliates

A hedge fund that is not an affiliate of the issuer typically is free to sell issuer shares in the public market.

One departs from this general rule, however, when the shares held by the fund are “restricted securities,” i.e., shares acquired directly or indirectly from the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving any public offering.³⁸ To be resold publicly, restricted securities must either (i) have the benefit of a resale registration statement maintained by the issuer under the Securities Act or (ii) be resold by the investor in conformity with Rule 144.

In order to resell restricted securities in reliance on Rule 144, the investor must have held the securities for at least six months. Following the expiry of the six-month holding period, the non-affiliate investor may sell restricted securities freely, as long as the issuer is current in its Exchange Act periodic reporting obligations under Rule 144(c); after 12 months, that condition drops away and the non-affiliate may sell without limitation.³⁹

Form 4 Disclosing Exit Sale; Potential Disgorgement of Trading Profits

If the hedge fund is a 10-percent beneficial owner (or a director by deputization) and thus subject to the Section 16(a) transaction reporting regime, it will need

³⁶ An “affiliate” of an issuer is a person that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with the issuer. As noted above, “control” means the possession, direct or indirect, of the power to direct, or cause the direction of, the management and policies of the issuer, whether through ownership of voting securities, by contract or otherwise. Market participants often view 10-percent beneficial ownership of an issuer’s voting securities as conferring presumptive affiliate status for purposes of Rule 144. Percentage ownership alone is not always dispositive, however; for example, a 10-percent beneficial owner might plausibly deny control, and hence affiliate status, if another single investor had majority voting power or controlled the board of directors.

³⁷ The Rule 144(c) current public information requirement is generally satisfied if the issuer has timely fulfilled its Exchange Act reporting obligations during the 12 months preceding the resale. Rule 144(e) provides that the amount of securities resold, together with all sales of securities of the same class for the account of the seller within the preceding three-month period, may not exceed the greater of (i) one percent of the class of securities outstanding and (ii) the average weekly volume of trading in such securities. Rule 144(f) generally requires the resale to be made in a broker’s transaction, through a market-maker or in a riskless principal transaction. Subject to a *de minimis* threshold, Rule 144(h) requires the selling shareholder to file with the SEC a notice of resale on Form 144.

³⁸ Rule 144(a)(3).

³⁹ Rule 144(d). If the issuer has not been an Exchange Act reporting company for at least 90 days, the resale may be made in reliance on Rule 144 only if a 12-month holding period has been satisfied.

to file a Form 4 disclosing the exit sale. For Section 16 (b) purposes, an exit sale may be subject to “matching” and potential disgorgement if the fund has purchased issuer securities within the preceding six months.⁴⁰

Amendment to Schedule 13D or 13G

An exit sale by a hedge fund reporting on Schedule 13D or 13G will trigger an amendment disclosing the transaction.

CONCLUSION

A hedge fund faces numerous potential legal issues when it establishes, maintains or exits a minority equity position in a U.S. public company. Any fund investing in U.S. public equity securities, or securities exchangeable for or convertible into public equity, should ensure that its counsel is well-versed in the federal securities laws and other legal considerations that apply throughout the investment lifecycle.

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If you have any questions regarding the matters discussed in this memorandum, please call your usual contact at Richards Kibbe & Orbe LLP or one of the persons listed below.

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⁴⁰ A disgorgement tail period presumably applies to an investor that was subject to Section 16 by reason of the SEC's “director by deputization” theory. A purchase/sale occurring after the investor's representative leaves the issuer's board remains subject to matching against any sale/purchase that occurred during the previous six months at a time when the representative was still a board member.