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A cross-border legal update from Dechert's Corporate and Securities Group

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U.S. Court Clarifies: Shareholders Acting in Concert May Not Be a "Group"; Contrast with English Law "Concert Parties" Approach

Second Circuit's July 2011 Opinion: *CSX Corp. v. The Children's Investment Fund Management*

Whether two or more shareholders have formed a group under Section 13(d) of the U.S. Securities Exchange Act of 1934 ("Exchange Act") has always been a difficult, and well-litigated, question. A shareholder or group that owns more than 5% of a public company's shares must file publicly a Schedule 13D disclosing its affiliates and its intentions with respect to the company. Making an agreement or taking concerted action may transform individual shareholders into a group, forcing them to tip their hand publicly sooner than they would like. Because poison pill agreements borrow the definition of beneficial ownership from Rule 13d-3, the formation of a group may also have economic consequences in addition to public disclosure requirements. A determination that several shareholders constitute a group, with each shareholder beneficially owning each other's shares, could cause them to cross the ownership threshold under a poison pill, catastrophically reducing the value of their shares.

Shareholder concern about unintentionally forming a group has chilled communications among large holders of shares in U.S. public companies. U.S. and English law both address this subject, but with important differences.

Recently the U. S. Second Circuit Court of Appeals provided some surprising, concrete guidance on what behavior causes shareholders to be a group. *See CSX Corp. v. The Children's Investment Fund Mgmt.*, 08-2899-cv (2d Cir. July 18, 2011). The court acknowledged that U.S. law actually protects investors as they join together to discuss and even influence corporate policy. The court held that Section 13(d) does not require shareholders to disclose their affiliation with each other unless and until they have agreed to act together with respect to the trading or voting of stock. Until they cross that threshold, investors are free to act together with regard to corporate policy and control without disclosing their affiliation in a Schedule 13D filing.

Past (Mis)Interpretation of Section 13(d)(3)

Section 13(d) and its related rules require that, with a few exceptions, any person who acquires beneficial ownership of more than 5% of a class of equity securities of a company registered under the Exchange Act must within 10 days file a Schedule 13D. Under Section 13(d)(3) and Rule 13d-5(b)(1), a "person" may include any two or more persons or entities that agree to act as a group for the purpose of acquiring, holding, voting or disposing of a company's securities. Like-minded shareholders with a mutual concern over the governance of a company must tread carefully when determining whether they must file a Schedule 13D as a group.

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Conventional wisdom holds that courts set a fairly low threshold in deciding whether investors working together, often referred to as "wolf packs," have formed a group for Section 13(d) purposes. Commentators warn that the duty to file a Schedule 13D can be triggered by "mutually supportive actions in furtherance of a common goal," actions in parallel with "an apparent common purpose and prior relationships," the formation of "a loose network of like-minded parties acting in tandem," or simply acting in concert. These characterizations of group formation go well beyond the short list of acts specified in the Exchange Act and sound strikingly similar to the obligation to disclose group affiliation under the United Kingdom's Disclosures Rules and Transparency Rules ("DTR").

Rule 5.1 of the DTR requires an investor to disclose the percentage of voting rights it holds when that percentage reaches, exceeds, or falls below certain thresholds (starting at 3%). Under DTR 5.2, the voting rights an investor includes the voting rights held by any other investors with whom it has concluded an agreement to adopt "a lasting common policy towards the management of the issuer." Unfortunately for investors, it is not always easy to determine whether a particular objective constitutes "a lasting common policy."

CSX Corp. v. The Children's Investment Fund Management

In the CSX matter, the district court did not take a clear stand on whether merely agreeing to work with a common goal or a common policy was enough to bring investors within the disclosure obligations under U.S. law. *CSX Corp. v. The Children's Investment Fund Mgmt.*, 562 F.Supp.2d 511 (S.D.N.Y. 2008). The Court correctly cited Section 13(d)(3)'s definition of a group as two or more persons acting as a group "for the purpose of acquiring, holding, or disposing of securities of an issuer," but its finding of fact merely stated that the shareholders had taken concerted action "with respect to" CSX securities. The Court never specified that the investors took any of the acts listed in Section 13(d)(3) together.[1]

The Second Circuit held that the district court's "with respect to" finding was insufficient to establish a violation of Section 13(d). The appellate court emphasized that although "the touchstone of a group within the meaning of section 13(d) is that its members combined in furtherance of a common objective[,]" the objective in question must be one of those listed within the statute or rule, i.e., acquiring, holding, voting, or disposing of the issuer's securities. *CSX Corp. v. The Children's Investment Fund Mgmt.*, 08-2899-cv (2d Cir. July 18, 2011) (internal quotation marks and citation omitted).

As Judge Winter explained in his concurring opinion, "[t]he Rule does not encompass all 'concerted action' with an aim to change a target firm's policies." Investors can "retain[] an option to wage a proxy fight or engage in some other control transaction at a later time" as long as their concerted actions do not yet involve one or more of the acts specified in the rule.

The Second Circuit's interpretation of Section 13(d) bears some similarity to a second source of English law on the subject: the Companies Act of 2006. Under the Companies Act, a public company can require investors to disclose their interest in its shares. Through Section 824 of the Companies Act, an investor is deemed to have an interest in another investor's shares when they have entered into an agreement (or arrangement) regarding the acquisition of interests in shares. However, to fall within Section 824, at least one of the parties must (1) agree to acquire interests in shares of the relevant company, (2) actually acquire interests in shares, and (3) agree to be subject to obligations or restrictions with respect to the "use, retention, or disposal of their interests in the shares". Although the contents of what the agreement needs to contain are fairly clear, it can be difficult to say whether or not the parties have an "agreement" or "arrangement" which is caught by the section. The determination can be particularly tricky when one considers that Section 824 specifies that it covers even some agreements that are not legally binding.

Conclusion

Under the Second Circuit's holding, investors have greater latitude to cooperate with one another to effect change in corporate governance than some had previously thought. Section 13(d) does not impose the same disclosure obligations as DTR 5 does under English law. DTR 5 requires investors to disclose a group affiliation

1 In its opinion, the district court consistently cited Section 13(d)(3) and its definition of a group in its analysis of whether there was group formation under Section 13(d). The Second Circuit, however, noted that under Rule 13d-5(b)(1), group formation can be predicated on a finding that investors have agreed to act together for the purpose of voting securities, in addition to the objectives specified in Section 13(d)(3).

when they have adopted a "lasting common policy" with regard to the issuer's management. This general concept of concerted action is clearly not sufficient under the Second Circuit's holding to bring investors within the disclosure obligations of Section 13(d).

The disclosure obligations of Section 13(d) are more in line with those found in the United Kingdom's Companies Act of 2006, in which there is a very specific set of circumstances under which investors must disclose their affiliation. (Note that the Companies Act group disclosure is not triggered unless the investors actually acquire interests in the issuer's shares pursuant to their agreement. This requirement is not present under Section 13(d).)

Section 13(d) allows investors to communicate, plan, and even act together to effect policy change without disclosing their affiliation. Only when their actions are taken for the purpose of acquiring, holding, voting, or disposing of the issuer's securities must they disclose their group arrangement in a Schedule 13D filing.

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