

Loopholes Provide Activist Securityholders Unfair Advantages in Takeover Contests; How Targets Can Fight Back

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In *CSX v. Children's Fund Mgmt. (UK) LLP*, a court struck down a target company's attempt to prevent activist hedge funds from voting their shares at the annual stockholders' meeting. With this decision, activist hedge funds obtained a favorable ruling, allowing greater shareholder leeway when making proposals and director nominations. This commentary, written by F. Mark Reuter of Keating Muething & Klekamp PLL, analyzes the CSX case in depth, and posits that it demonstrates the modern trend of hedge funds employing sophisticated legal practices to bring controversial proposals and to replace boards of directors.

Mr. Reuter writes: *This case highlights the increased use of two practices by activist securityholders. First, it is now common for multiple hedge funds to invest in the same target; activist funds believe that their collective activities will yield desired results. Although federal securities laws do not prohibit securityholders from communicating with one another regarding their investments in a target, securityholders are required to report to the SEC if and when they beneficially own in the aggregate more than 5% of the target's securities when they have entered into a relationship, understanding, arrangement or contract regarding their investments.*

The goal of these rules is to alert the marketplace to any incipient control contest. At least until it filed its amicus curiae brief to the CSX court earlier this month, the SEC had generally defined beneficial ownership broadly. Unfortunately, as a result of evidentiary issues, the SEC and courts rarely find that coordinated action of activist shareholders violates this "group" reporting requirement under Section 13(d) of the Securities Exchange Act of 1934.

Second, activist securityholders are more frequently purchasing derivative instruments, such as hedges and swaps connected to the target's voting stock. The SEC suggested in its amicus brief that total return equity swaps are not subject to beneficial ownership reporting requirements. Combined with the feature that such swaps allow activist securityholders to leverage and increase potential returns in targets, these instruments now allow activist alliances to exist virtually undetected. [footnotes omitted]

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