Hunton & Williams
Corporate Law Update

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Recent SEC Settlement Illustrates Potential Threat of Derivatives that Separate the Voting and Economic Interests of Common Stock

On July 21, 2009, the Securities and Exchange Commission ("SEC") announced a settlement agreement with Perry Corp. ("Perry") stemming from the hedge fund's alleged failure to disclose its accumulation of nearly 10 percent of an issuer's voting shares with the intent of influencing a merger vote. Those shares were also hedged through swap transactions in order to eliminate Perry's economic exposure if the share price declined. The SEC argued that Perry should have promptly disclosed its 10 percent position on a Schedule 13D, which must be filed within 10 days after initially obtaining 5 percent ownership, rather than on a Schedule 13G, which may be filed 45 days after the end of the calendar year. Read the order approving the settlement.

The Perry settlement arose from the failed attempt by Mylan Laboratories, Inc. to acquire King Pharmaceuticals, Inc. in 2004. Perry had a significant ownership stake in King and stood to benefit from the merger, which offered King stockholders a 61 percent premium. Once the merger was announced, Perry also shorted Mylan shares, betting that Mylan's stock price would decline as the merger became more likely.

The King-Mylan merger was conditioned on Mylan's stockholders' approval. When Carl Icahn emerged as a large Mylan stockholder vocally opposed to the merger, Perry began accumulating up to 10 percent of Mylan's outstanding voting stock with the intent to vote it in favor of the merger. The purchases were done after US markets closed in a manner that avoided public volume-reporting. Perry then entered into swap transactions that hedged risk from any potential drop in Mylan's share price. As a result, Perry could vote the Mylan shares without any potential economic downside facing other Mylan stockholders in order to realize value from the merger as a King stockholder.

While the King-Mylan merger was never consummated, the SEC brought an enforcement action alleging that Perry should have disclosed its ownership on a Schedule 13D once it acquired 5 percent of Mylan's stock. Perry argued that the purchases were made in the "ordinary course of business" and therefore could be disclosed after the end of the calendar year on a Schedule 13G. The SEC took the position that:

> When institutional investors, such as Perry, acquire ownership of securities for the purpose of influencing … the outcome of a transaction—such as acquiring shares for the primary purpose of voting those shares in a contemplated merger—the acquisition is not made … in the "ordinary course" of business….

Pursuant to the settlement, Perry paid a $150,000 fine without admitting any wrongdoing.

The SEC did not challenge Perry on the larger point detailed in the settlement order: that Perry was "essentially buying votes" "without having any economic risk and no real economic stake in [Mylan]." Perry's swap transactions are an example of "empty voting," by which a stockholder votes shares without any underlying economic interest in them. By "decoupling" the voting and economic rights of the Mylan stock, Perry had no economic downside if the merger was not in Mylan's best interests. Thus, Perry had different, and possibly inconsistent, interests from those of Mylan's other stockholders.

The issue of "empty voting" is part of a larger phenomenon identified by Professors Henry Hu and Bernard Black in an article titled "The New

Vote Buying: Empty Voting and Hidden (Morphable) Ownership," 79 S. Cal. L. Rev. 811 (2006), that details various methods by which hedge funds have separated the voting and economic attributes of stock through swap transactions and other equity derivatives. For example, in addition to "empty voting," hedge funds have used derivatives and "synthetic" transactions to mirror the economic rights of stock while trying to avoid having "beneficial ownership," which triggers disclosure obligations. Last year, JANA Partners and Sandell Asset Management reportedly used cash-settled swaps along with direct share ownership to secretly accumulate 21 percent of CNet Networks, Inc.'s outstanding voting shares before announcing a proxy contest.

The SEC has been slow to respond to the use of derivatives by parties seeking to influence corporate actions, although it reportedly is studying potential amendments to Rule 13d-3. In 2008, a federal district court ruled in *CSX Corp. v. The Children's Investment Fund Management* that two hedge funds had used numerous cash-settled equity total return swaps as part of an unlawful scheme to evade federal disclosure requirements. Yet the SEC publicly disagreed with the court's interpretation of its rules. The district court's rulings were appealed to the United States Court of Appeals for the Second Circuit last year, which has yet to issue its opinion.

The Perry settlement is a reminder to public companies of the broad use of derivatives and swap transactions potentially to affect corporate governance and control, from influencing the outcome of a stockholder vote to accumulating stock positions secretly. Although there are few defensive tools available to issuers, one step they can take is to ensure their bylaws governing advance notice of stockholder proposals and director nominations require the proponent to disclose derivative positions in addition to direct share ownership. Advance notice bylaws should also require the proponent to provide an updated disclosure of its holdings on the record date so that other stockholders are fully informed of the proponent's underlying interests. Some corporations have similarly amended their stockholder rights plans, or "poison pills," to capture derivative interests of a potential hostile acquiror.

Delaware corporations can also take advantage of new amendments to the Delaware General Corporation Law, which will be effective on August 1, 2009. The amendments will permit boards to declare separate record dates to determine which stockholders are entitled to notice and which stockholders are entitled to vote at a stockholders' meeting. The amendments limit, but do not foreclose, the ability of parties without an economic interest in a company's stock to influence the outcome of a stockholder vote. We expect Delaware corporations to work closely with legal counsel and proxy solicitors in determining how best to utilize the new law during next year's proxy season.

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