# DISCLOSURE OF "BENEFICIAL OWNERSHIP" OF SYNTHETIC POSITIONS IN TAKEOVER CAMPAIGNS

Elina Khasina*



## I. INTRODUCTION

The past few years have seen a substantial rise in financial innovation of complex securities. One such ingenuity is the rise in total return equity swaps, which have the effect of decoupling the economic stake in a company from the voting rights in its stock.[1] Ownership by activist

* J.D. Candidate 2010, Columbia University School of Law; B.A. Economics 2007, New York University. The author would like to thank Professor Merritt Fox for his advice and guidance throughout the process of writing this paper.

[1] Total return equity swaps are a type of derivative contract in which the "short party" (usually a bank) agrees to pay the "long party" the cash flows associated with the underlying "reference" security position (i.e., any distributions the company pays to stockholders and any market appreciation of the stock). In exchange, the long party agrees to pay the

investors of such derivative positions[2] has critical consequences in takeover campaigns because it allows the holder of a synthetic instrument to acquire a large secret stake in a corporation. Such an undisclosed position can be transformed into ownership of the underlying stock in a matter of hours.[3] Consequently, activist investors have controlling power over how these shares are voted without having to disclose their stake under the federal rules, depriving directors as well as other shareholders in the corporation of important information.

This Note looks into new proposals for corporations to adopt advance notice bylaws that force disclosure of synthetic positions as a requirement for eligibility to nominate directors at shareholder meetings.[4] It analyzes

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bank a "financing" fee and any decrease in the market value of the underlying reference security position. Typically, short parties hedge their total return equity swap exposure by purchasing the underlying security in amounts identical to those referenced in their total return equity swap agreements. *See* CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 519–23 (S.D.N.Y. 2008) (citing the Expert Report of Marti G. Subrahmanyam).

[2] A financial instrument is referred to as a derivative because it "derives its value from the price of an underlying instrument or index." *CSX Corp.*, 562 F. Supp. 2d at 519.

[3] Since short parties hedge their total return equity swap exposure by purchasing the underlying security in amounts identical to those referenced in their total return equity swap agreements, the long party can simply "unwind the swap" causing the short party to sell the underlying security. This is because the short party has no desire to bet on the company, and therefore no longer needs the underlying security when the hedge against the swap ceases to exist. *See infra* pp. 6–8. Furthermore, when the counterparties to such swaps and the investor have an ongoing relationship and share the same economic incentives, the counterparties may act in accordance with the investor's wishes in voting the hedge shares. *See infra* pp. 11–12.

[4] Philip A. Gelston & James C. Woolery, Cravath, Swaine & Moore LLP, Beneficial Ownership – By-law Disclosure Proposal (Sept. 8, 2008), http://blogs.law.harvard.edu/corpgov/files/2008/09/beneficial-ownership-by-law-disclosure-proposal.pdf [hereinafter *Cravath Proposal*]; Posting of Charles M. Nathan, Latham & Watkins LLP, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, Developments in Takeover Defenses, http://blogs.law.harvard.edu/corpgov/2008/10/23/dev

this takeover defense under Delaware law, specifically using the *Blasius* compelling justification standard of review.[5] Most likely, when faced with this provision, the Delaware Chancery Court will find that a board of directors has a compelling justification for implementing the disclosure requirements and will therefore uphold the legality of the advance notice bylaw.

These advance notice proposals have been put forward in order to deal with issues that arose in the recent *CSX Corp. v. The Children's Investment Management Fund* ("*CSX*") decision, in which activist hedge funds attempted to control CSX Corp. through the use of synthetic positions, specifically cash-settled total return equity swaps.[6] The Williams Act does not include derivative positions in its definition of beneficial ownership. Consequently, disclosure of such a position is not currently required under the federal rules.[7] Forward-looking counsel are therefore advising boards of directors to take matters into their own hands and force disclosure through their corporate charters.

The mechanics of the advance notice bylaw mandate that a shareholder who proposes to nominate directors, or proposes some other matter to be brought to a vote at a shareholders' meeting, must disclose its derivative ownership stake. The sanction for failure to disclose the

elopments-in-takeover-defenses/ (Oct. 23, 2008, 17:20 EST) [hereinafter *Latham Proposal*].

[5] Blasius Indus. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (discussing the board's "heavy burden" of demonstrating a "compelling justification").

[6] *CSX Corp.*, 562 F. Supp. 2d at 511. There have been numerous examples of hedge funds and other outside investors using hidden (morphable) ownership to build up large undisclosed positions. For a list of eighty-two examples of equity decoupling see Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. PA. L. REV. 625, 661–81 tbl. 1 (2008) [hereinafter Hu & Black, *Decoupling II*].

[7] The Williams Act amended the Exchange Act by adding §§ 13(d) and (e) and §§ 14(d), (e), and (f). The provision applicable here is § 13(d) and the rules promulgated thereunder. These are discussed in detail *infra* Part I.

derivative interest would be to render the notice materially deficient and, therefore, the nomination or other matter may be excluded from consideration at the meeting.[8]

There are valid arguments to be made in opposition of such a proposal. One such contention is that this strategy makes the shareholder's decision to purchase synthetic positions pointless, as disclosure would eradicate the benefits of derivative ownership. Consequently, the board can preclude the activist from achieving an economic benefit with the threat of losing the vote. Since the bylaw is a defensive tactic, under Delaware law it would be analyzed using the compelling justification standard established in *Blasius*. This standard would be applicable, as opposed to the more lenient business judgment rule or even the proportionality standard set out in *Unocal* and *Unitrin*, because the sanction impedes the shareholder vote for a new slate of directors.[9] Although a large undisclosed accumulation of stock by activists may be hazardous to the board, it would still be an

[8] *Cravath Proposal, supra* note 4; *Latham Proposal, supra* note 4. As of August 1, 2009, § 112 has been added to the Delaware General Corporate Law ("DGCL"), entitled "Access to proxy solicitation materials." DEL. CODE ANN. tit. 8, § 112 (2009), *available at* http://legis.delaware.gov/LIS/lis145.nsf/vwLegislation/HB+19/$file/legis.html?open. Section 112 authorizes (but does not require) corporations to adopt bylaws that require the corporation to include shareholder-nominated candidates for board positions on the corporation's proxy statement, subject to procedures and conditions that may be set forth in the bylaws. Section 112 then includes a list of non-exhaustive potential procedures and conditions, including "defining beneficial ownership to take into account options or other rights in respect of or related to such stock." *Id.* at § 112(1). Although the provision may give corporations greater control to shape the conditions under which proxy access will be granted, this new provision does not resolve the issue presented in this Note, because Section 112 does not apply unless the activist wants to use the company proxy to make its nomination. Posting of Charles M. Nathan, Latham & Watkins LLP, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, Delaware Law Changes to Facilitate Voluntary Adoption of Proxy Access, http://blogs.law.harvard.edu/corpgov/2009/07/07/delaware-law-changes-to-facilitate-voluntary-adoption-of-proxy-access/#more-2244 (Jul. 7, 2009, 09:27 EST).

[9] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995).

attempt of the board to entrench itself in office by nullifying the shareholder vote.

However, given the current economic situation and the political climate favoring regulation and enhanced disclosure, the Delaware Chancery Court, being sensitive to the manipulative effects of derivative ownership, will likely find that the bylaw does not on its face prevent shareholders from making proposals or voting. Instead, it merely establishes procedures and requires disclosure for shareholders who wish to exercise their votes. The procedures and disclosures are intended to be reasonable and not unduly burdensome for shareholders. Their purpose is to elicit information material to other shareholders' voting decisions that federal securities laws do not otherwise require to be disclosed.[10] Transparency has a multitude of benefits and has been recognized as a fundamental basis for our current securities regulatory regime.[11] For this reason, the proposed bylaw has a good chance of success even under the stringent *Blasius* standard of review. Although shareholder voting may be somewhat burdened, the board will likely be able to show a compelling justification and keep the bylaw in place.

Accordingly, this Note proceeds in the following manner: Part II examines the federal disclosure rules and explains

[10] Derivatives can create material economic conflicts of interest between the activist shareholder and others having an economic stake in a corporation. These other shareholders should understand the implications of a proposal from a party who may have interests with the potential to conflict materially with their own.

[11] The SEC's mission statement explains that "[t]he laws and rules that govern the securities industry in the United States derive from a simple and straightforward concept: all investors, whether large institutions or private individuals, should have access to certain basic facts about an investment prior to buying it, and so long as they hold it. . . . Only through the steady flow of timely, comprehensive, and accurate information can people make sound investment decisions. The result of this information flow is a far more active, efficient, and transparent capital market that facilitates the capital formation so important to our nation's economy." SEC, The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, http://www.sec.gov/about/whatwedo.shtml (last visited Dec. 3, 2009).

the concept of derivative ownership and its implications. Part III delves into the recent *CSX* decision to show how such financial innovation plays out in practice. Part IV explores the proposals for advance notice bylaws as the solution to the problems unregulated synthetic positions have caused. Part V surveys the Delaware legal framework of judicial review, particularly the business judgment rule, as well as the enhanced scrutiny and the compelling justification standards. Part V then analyzes the advance notice bylaws under the Delaware framework, concluding that although the *Blasius* standard is applicable, the advance notice bylaw should withstand judicial scrutiny. Part VI probes the policy issues surrounding this conclusion and the stakes for corporate governance.

## II. THE FEDERAL DISCLOSURE RULES AND DERIVATIVE OWNERSHIP

The Williams Act regulates the disclosure of ownership of a significant amount of shares in a company's stock. It amended the Securities Exchange Act of 1934 ("Exchange Act") by adding key provisions regulating takeovers and tender offers, including Section 13(d).[12] Section 13(d) mandates that any person who acquires more than five percent of any class of equity securities registered under the Exchange Act must file a statement with the Securities and Exchange Commission ("SEC")[13] (with a copy to the issuer) within ten days of the acquisition.[14] The statement must set forth specified information with respect to the person's background and source of funds, the purpose of the

[12] 15 U.S.C. § 78m(d) (2006). The Williams Act was designed to address the increasing frequency with which hostile takeovers were being used to effect changes in corporate control. *See* Act of July 29, 1968, Pub. L. No. 90-439, § 2, 82 Stat. 454.

[13] Pursuant to Rule 13d-1, promulgated under § 13, the beneficial owner would have to file a Schedule 13D (17 C.F.R. § 240.13d-101) with the SEC unless it is a passive investor that qualifies for a Schedule 13G short-form filing (17 C.F.R. § 240.13d-102). *See* 17 C.F.R. § 240.13d-1 (2009).

[14] 15 U.S.C. § 78m(d)(1) (2009).

acquisition, and any plans for major changes in the target company. It must further disclose any contracts or arrangements with any other person relating to the target company.[15] Furthermore, for the purposes of Section 13(d), two or more persons acting as a "group" in acquiring or holding securities are considered to be a single "person" in determining whether the requisite five-percent ownership is present.[16] "This 5% threshold establishes an early warning system that gives both the target and other potential bidders time to prepare, thus its practical effect is to promote auctions and increase the takeover premium that a bidder must offer to secure control."[17] As Judge Kaplan articulated in the *CSX* decision, the purpose of "Section 13(d) is to alert the marketplace to every large, rapid, aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control."[18]

[15] 15 U.S.C. §§ 78m(d)(1)(A)-(E) (2009).

[16] 15 U.S.C. § 78m(d)(3) (2009). A difficult question in interpreting this provision arises when a group of investors owning, in the aggregate, more than five percent of a class of securities agrees to act together for the purpose of gaining control of the issuer. The question is whether the agreement constitutes an "acquisition" by a "group" of the stock owned by its members, triggering the reporting requirement of § 13(d), even though the individual members of the group have not acquired any shares over and above their pre-existing holdings. The Supreme Court has not decided this matter. For differing views, consider the Seventh Circuit decision in Bath Indus. v. Blot, 427 F.2d 97 (7th Cir. 1970) (upholding grant of preliminary injunction since nondisclosure most likely constituted an "acquisition" and therefore a violation of the Williams Act), and the Second Circuit decision in GAF Corp. v. Milstein, 453 F.2d 709 (2d Cir. 1971) (concluding that although a "group" was formed, no violation of the Williams Act occurred because the group did not "acquire" the stock).

[17] WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES 193 (10th ed. 2007). *See* United States v. O'Hagan, 521 U.S. 642, 668 (1997) (stating that the purpose of the Williams Act is to promote informed shareholder decisionmaking when confronted with a tender offer).

[18] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 538 (S.D.N.Y. 2008) (citing GAF Corp. v. Milstein, 453 F.2d 709, 717 (2d Cir. 1971)).

While the "concept of 'beneficial ownership' is the foundation of the Williams Act and thus critical to the achievement of its goal of providing transparency to the marketplace,"[19] Congress failed to define the term. The SEC filled this gap by enacting Rule 13d-3(a), which provides that "a beneficial owner of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding, relationship, or otherwise has or shares" either (1) voting power (including the power to vote, or to direct the voting of, such security) and/or (2) investment power (including the power to dispose, or to direct the disposition of, such security).[20] Beneficial ownership can also be conferred through the anti-fraud provision established by Rule 13d-3(b),[21] which will be discussed in depth in connection with the *CSX* decision in Part III, *infra*.

The SEC disclosure rules have remained largely stagnant in the face of innovative financing. As the derivatives market continues to lack transparency, significant opportunities exist for manipulation of the disclosure requirements. For example, where securities are held by one person and the legal right to vote is held by another, only the person with the legal right to vote the shares would be considered the beneficial owner of the securities, particularly where the nominees could not vote or otherwise use the securities except as directed by the other person. However, with the growth of the use of derivatives, particularly equity swaps,[22] activist shareholders, particularly hedge funds, have learned to evade the disclosure requirements of Section 13(d).

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[19] *Id.* at 539.

[20] 17 C.F.R. § 240.13d-3(a) (2009).

[21] 17 C.F.R. § 240.13d-3(b) (2009).

[22] In an equity swap a party with the long equity side of the swap acquires economic ownership of the shares, but no voting rights, while the short side often hedges its economic risk by holding shares, thus retaining votes but no net economic ownership. Henry T.C. Hu & Bernard Black, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61 BUS. LAW. 1011, 1015 (2006) [hereinafter Hu & Black, *Decoupling I*]. This is exactly the derivative position held by TCI and 3G in the *CSX* battle.

Henry Hu and Bernard Black describe the practices they aptly coined "empty voting" and "hidden (morphable) ownership" in a series of papers that explain the phenomenon of decoupling economic ownership from legal voting rights.[23] Empty voting occurs when one has substantial voting power with limited, zero, or even negative economic ownership.[24] Other times, hedge funds (or other investors) hold greater economic ownership than votes, though often with "morphable" voting rights. Hu and Black named the phenomenon "hidden (morphable) ownership" due to investors' de facto ability to acquire the votes (quickly and easily) if needed, and because under the current disclosure rules the economic ownership and the de facto voting ownership are, in fact, hidden. This Note focuses on the recent *CSX* decision and the resulting proposals for advance notice bylaws that target holders of derivative positions of the hidden (morphable) sort.[25]

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[23] *Id.*; *see also* Hu & Black, *Decoupling II*, *supra* note 6.

[24] Hu & Black, *Decoupling I*, *supra* note 22, at 639. Such empty voting leads to perverse incentives. As Hu and Black explain, in the extreme situation of negative economic ownership (which can be obtained by short-selling), the empty voter has an incentive to vote in ways that reduce the company's share price. *Id.* For a fascinating example, refer to the battle between Perry Hedge Fund and Mylan Laboratories. Anish Monga, *Using Derivatives to Manipulate the Market for Corporate Control*, 12 STAN. J.L. BUS. & FIN. 186, 195 (2006). *See also* Posting of Steven M. Haas, Hunton & Williams LLP, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, SEC Resolves Empty Voting Action Involving King-Mylan Merger, http://blogs.law.harvard.edu/corpgov/2009/08/19/sec-resolves-empty-voting-action-involving-king-mylan-merger/#more-3262 (Aug. 19, 2009, 09:25 EST) (describing a repeat of Perry Hedge Fund's use of empty voting to vote its large stake in Mylan Laboratories in favor of a merger which was not beneficial to the rest of the Mylan shareholders because it was able to decouple its voting and economic rights).

[25] Equity decoupling is becoming a worldwide phenomenon. An example similar to *CSX* is the New Zealand case (New Zealand has an equivalent law to § 13(d)) involving a hedge fund, Perry Group's, use of equity swaps to obtain a sixteen percent undisclosed share in Rubicon Ltd. When an election came along, Perry went back to its derivative dealers, unwound the swaps, acquired "matched shares" held by the dealers to hedge the swaps, and thus obtained formal voting rights. The New

Although holding "matched shares" is a common way for a derivatives dealer to hedge the short side of an equity swap, making it very likely that the holder of the long side will be able to "morph" its equity swaps into voting shares, there is no guarantee that the long party will be able to acquire the matched shares. To illustrate this point, Hu and Black describe a 2006 buyout offer by Sears Holdings for the minority shares in its Sears Canada subsidiary:

> A hedge fund acquired equity swaps in Sears Canada from Scotiabank. A unit of Scotiabank later became the dealer-manager for Sears Holdings' buyout offer. The offer required approval by a majority of the Sears Canada minority shareholders. The bid was opposed by Sears Canada's independent directors and by many Sears Canada stockholders. The hedge fund (presumably) thought it had morphable voting rights and asked Scotiabank to unwind the swap so it could vote against the offer. Scotiabank not only refused but committed to vote its Sears Canada shares *for* the offer.[26]

As discussed in Part III *infra*, TCI, in the *CSX* battle, realizing that influence over the counterparty was not inevitable, acquired physical shares of CSX while gearing up for the proxy fight. The court found that "holding shares that [TCI] could vote directly had an advantage over swaps because the votes of shares held by swap counterparties was [sic] less certain."[27]

The financial community has realized that synthetic instruments "are a cheap way to get economic exposure to a stock movement. They are usually cash-settled and don't

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Zealand court did not find this to be a violation of that country's laws. Ithaca (Custodians) Ltd. v. Perry Corp., [2003] 2 N.Z.L.R. 216 (H.C.), *rev'd* [2004] 1 N.Z.L.R. 731 (C.A.), *conditional leave to appeal refused*, [2004] 2 N.Z.L.R. 182 (C.A.). *See also* Hu & Black, *Decoupling II*, *supra* note 6, at 1029–31.

[26] Hu & Black, *Decoupling II*, *supra* note 6, at 1031. *See* Jesse Eisinger, *In Canada, a Face-Off Over Sears*, WALL ST. J., Apr. 12, 2006, at C1.

[27] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 527 (S.D.N.Y. 2008).

afford their holders voting rights. The SEC therefore doesn't require investors to disclose their derivatives positions, unless they also own 5% or more of the actual shares."[28] This is because, according to the SEC, an owner is a person who has the right to vote, buy, or sell the securities. Stock options are the only derivatives the SEC considers to confer beneficial ownership on their holder, the reason being that within sixty days they are convertible into voting stock.[29] Obviously, this technique can, and has, become extremely important in proxy fights for corporate control. Part III explains in detail the *CSX* decision that exemplifies this point.

## III. THE *CSX* DECISION

In *CSX*, the United States District Court for the Southern District of New York considered two issues. First, it addressed whether and under which circumstances a long position under a total return equity swap may be deemed "beneficial ownership" of the underlying stock, thus requiring disclosure under the Williams Act.[30] Second, it considered whether and at what point investors' activities would cause them to be deemed a "group" for Williams Act purposes.[31] The court found that the two activist hedge funds had violated the Williams Act disclosure requirements regarding both the holding of total return swap positions and certain coordinated activities.[32] However, the district court determined that existing precedent prevented it from enjoining the hedge funds from voting their shares at the upcoming annual meeting of CSX.[33] The United States Court of Appeals for the Second Circuit subsequently denied CSX's

[28] Mara Lemos-Stein, *Poison Pills Target Derivatives*, WALL ST. J., June 18, 2008, at B5C.

[29] 17 C.F.R. § 240.13d-3(d)(1) (2009).

[30] *See* discussion *supra* Part II for an explanation of the requirements of disclosure under the Williams Act.

[31] *See* discussion *supra* note 16 for the disclosure requirements for "groups" under the Williams Act.

[32] *CSX Corp.*, 562 F. Supp. 2d at 548.

[33] *Id.*

request for an injunction pending appeal.[34] The full opinion of the Second Circuit is currently pending.

In *CSX*, two hedge funds, The Children's Investment Fund ("TCI") and 3G Capital Partners ("3G"), ran a proxy contest to capture five of the twelve board seats at CSX, a major railroad company, to facilitate their campaign to force CSX to revise its business strategies in accordance with the hedge funds' agendas.[35] Beginning in October 2006, TCI expressed interest in CSX in a number of ways, including meeting with CSX's financial advisors, exploring the possibility of a leveraged buyout, and contacting other hedge funds about CSX.[36] TCI, joined by 3G, eventually began preparing for a potential proxy fight and simultaneously began to scrutinize potential directors. At the same time, TCI increased its economic position with respect to CSX by acquiring total return swaps.[37] By using the total return equity swaps and later physical ownership, TCI ultimately amassed a total economic exposure equivalent to roughly fourteen percent of CSX's outstanding common stock.[38] However, TCI's physical securities never exceeded five percent and TCI never filed a Schedule 13D[39] based on its economic interest in CSX that exceeded five percent.[40]

Unlike TCI, 3G directly purchased shares of CSX common stock. At one point it held roughly 4.4 percent of the outstanding shares.[41] Having established their mutual interest in CSX, TCI and 3G began direct discussions

[34] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 292 Fed. Appx. 133, 2008 WL 4222848 (C.A.2 (N.Y.)).

[35] *CSX Corp.*, 562 F. Supp. 2d at 518.

[36] *Id.* at 524.

[37] *Id.* at 525–29. *See supra* note 1 for an explanation of the mechanics of a total return equity swap. The court found that this practice of hedging is a "fact pivotal" to the claims at issue because TCI was well aware it could later accumulate the physical shares, counting on the counterparties to hedge their positions. *Id.* at 519–23 (citing the Expert Report of Marti G. Subrahmanyam).

[38] *Id.* at 526.

[39] *See supra* note 13.

[40] *CSX Corp.*, 562 F. Supp. 2d at 531.

[41] *Id.*

regarding each other's activity relating to CSX by February, 2007. Between February and December of 2007, TCI and 3G frequently discussed CSX and coordinated their acquisitions and dispositions of CSX common stock and total return swaps, as well as their preparations for a proxy contest with CSX.[42] TCI and 3G eventually held an aggregate "physical" position of roughly eight percent of CSX's outstanding common stock, exceeding the five percent threshold for disclosure under Rule 13(d) had they been acting as a "group." However, TCI and 3G did not enter into a formal agreement to work together until December 19, 2007, and then only in the context of their contemplated proxy contest.[43] On this date, TCI and 3G filed a Schedule 13D in which they disclosed that they collectively owned 8.3 percent of CSX's outstanding common stock, that they intended to conduct a proxy fight, and that TCI held total return swaps with counterparties that gave it economic exposure to an additional eleven percent of CSX's outstanding common stock.[44]

In early 2008, TCI and 3G filed their notice of intent to nominate directors and later attempted to negotiate a resolution with CSX.[45] The parties were unable to reach a settlement, and both sides filed proxy statements.[46] TCI and 3G's proxy statement supported the election of five dissident directors and further proposed an amendment to CSX's bylaws to allow any investor holding at least fifteen percent of CSX's outstanding common stock to call special meetings of stockholders for any purpose.[47]

Following the filing of TCI and 3G's proxy statement, CSX filed suit alleging that TCI and 3G had failed to timely file a Schedule 13D and that the Schedule 13D and proxy statement were false and misleading.[48] CSX sought, among

[42] *Id.* at 532–35.

[43] *Id.* at 535–36.

[44] *Id.* at 536.

[45] *Id.*

[46] *Id.* at 537.

[47] *Id.*

[48] *Id.* at 538, 555.

other things, to enjoin the defendants from voting their shares at CSX's 2008 annual meeting.[49]

The district court, as a matter of first impression, considered whether a holder of cash-settled equity total return swaps "beneficially owns" the referenced securities held by the short party within the meaning of Rule 13(d).[50] The court observed that there were persuasive arguments for concluding that TCI exercised the requisite investment and voting power to be deemed a beneficial owner.[51] The court noted that by virtue of the customary purchases executed by the intermediary "short" party in a total return swap transaction, TCI knew its execution of total return swaps would cause the counterparty banks to purchase CSX common stock to hedge against their total return swap positions. TCI also knew that it could cause the banks to sell their hedged shares when it unwound the total return swaps.[52] With respect to voting power, the court noted that TCI had eventually shifted the majority of its total return swaps from eight banks to only Deutsche Bank and Citigroup, whom the court found would be more responsive to TCI's influence as a result of prior relationships and common interests.[53] However, the court ultimately did not determine whether TCI had beneficial ownership due to its total return swap position. Rather, it found that TCI should be deemed a beneficial owner pursuant to Rule 13d-3(b), an anti-evasion rule.[54] Considering Professor Coffee's remark

[49] *Id.* at 518.

[50] *Id.* at 517.

[51] *Id.* at 545–46.

[52] *Id.* at 541–43. The court stated that "TCI manifestly had the economic ability to cause its short counterparties to buy and sell the CSX shares." *Id.* at 546.

[53] *Id.* at 529–30. Deutsche Bank ran an in-house hedge fund, Austin Friars, which had its own position in CSX stock. Therefore, Deutsche Bank had self-interested reasons to vote with TCI. *Id.* at 530.

[54] "Any person who, directly or indirectly, creates or uses a trust, proxy, power of attorney, pooling arrangement or any other contract, arrangement, or device with the purpose of [sic] effect of divesting such person of beneficial ownership of a security or preventing the vesting of such beneficial ownership as part of a plan or scheme to evade the

that "if the decision were rested on [Rule 13d-3(a)], it could be easily avoided by predictable strategic adaptations," the court's reliance on the antifraud provision to resolve the problem seems to be a wise decision. [55]

As it was undisputed that TCI's cash-settled total return swaps were contracts, the only elements left to be determined were whether TCI entered into its total return swaps for the "purpose of preventing the vesting of beneficial ownership" of CSX shares in TCI and "as part of a plan or scheme to evade the reporting requirements of Section 13(d)."[56] The district court concluded that Section 13(d) would be violated if CSX could demonstrate that TCI entered into the total return swap transactions with the intent to create a false appearance that there was no accumulation of securities that might represent a shift in corporate control, or to "conceal[] precisely what Section 13(d) was intended to force into the open."[57]

The court further noted that Rule 13d-3(b) was promulgated to prevent circumvention of the Williams Act disclosure requirements "where there is accumulation of securities by any means with a potential shift of corporate control, but no beneficial ownership."[58] The court

reporting requirements of section 13(d) or (g) of the Act shall be deemed for purposes of such sections to be the beneficial owner of such security." 17 C.F.R. § 240.13d-3(b) (2009); *see also CSX Corp.*, 562 F. Supp. 2d at 517.

[55] John C. Coffee Jr., *The Wreck of the CSX: Transparency and Derivatives*, N.Y.L.J., Jul. 17, 2008, at 5. It is not far-fetched to say that parties holding short positions in total return swaps could hedge their positions through means other than buying the physical shares, even if it were a more expensive strategy. For example, the head of Citigroup's Prime Swap group testified that a hedge can take a multitude of forms, including option combinations or shorts or shares directly. Furthermore, it was noted that Citigroup does not always hedge total return swap positions entirely. Brief of Amici Curiae International Swaps and Derivatives Ass'n, Inc. & Securities Indus. and Financial Markets Ass'n at 10, CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (No. 08 Civ. 2764).

[56] *CSX Corp.*, 562 F. Supp. 2d at 548.

[57] *Id.* at 550–51.

[58] *Id.* at 552.

consequently found that TCI had, in fact, entered into the total return swap for the purpose of avoiding its reporting requirements under Section 13(d) of the Exchange Act, and thus concealed its accumulation of CSX securities that might represent a shift in corporate control of CSX.[59] Accordingly, the court deemed TCI to be a beneficial owner of the shares of CSX common stock held by its counterparties to hedge their short exposures created by the total return swaps.[60] Based on this finding, the court concluded that TCI had violated Section 13(d) by not filing a Schedule 13D when its total return swap position in CSX first exceeded five percent of CSX's outstanding shares of common stock.[61] The court also determined that TCI and 3G, despite acting without an express, written agreement were, in fact, a 13D group based on the circumstantial evidence of concerted action.[62]

Having found that the defendants violated the Williams Act, the court then turned to the relief sought by CSX. The court first found that there was a substantial likelihood of future violations and, therefore, permanently enjoined the defendants from committing any future violations of Section 13(d).[63] With respect to CSX's request to enjoin defendants from voting their shares at CSX's June 2008 annual meeting, the court found that CSX had not met its burden of showing irreparable injury, which was essential to the injunctive relief it sought.[64] However, in an apparent signal to the Second Circuit, the court stated that if it were free to grant injunctive relief on the grounds of deterrence or any other basis, it would have enjoined the defendants from voting the shares acquired during the period in which the defendants were in violation of their disclosure obligations.[65]

By holding that TCI amassed its total return position as part of a scheme to avoid disclosure under Section 13(d) of

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[59] *Id.* at 548–49.

[60] *Id.* at 552.

[61] *Id.* at 516.

[62] *Id.* at 517.

[63] *Id.* at 572–73.

[64] *Id.* at 572.

[65] *Id.*

the Exchange Act, the district court took an affirmative position against activist hedge funds that engage in synthetic equity trades with the purpose of influencing corporate control. It was not lost on the court that TCI used its total return position in its destabilization campaign to exert pressure on CSX, "a pressure that was enhanced by the lack of complete information."[66]

As a consequence of this decision, corporations likely will want to adopt defensive measures that enhance transparency in order to avoid an ambush of the sort utilized by TCI and 3G. In response, prominent law firms are currently developing ways to provide their clients with timelier notice of significant accumulations, as well as a more comprehensive understanding of the economic forces present in a destabilization campaign.

## IV. THE PROPOSED SOLUTION: ADVANCE NOTICE BYLAWS

In response to the *CSX* decision, corporate counsel have been forced to re-examine the effectiveness of current takeover defenses. The district court's decision (assuming it is not overturned on appeal) will provide some assistance to public companies seeking to stave off an ambush attack based on cash-settled derivatives or other forms of wolf-pack aggression. Even so, counsel at Wachtell, Lipton, Rosen & Katz ("Wachtell"),[67] Latham & Watkins LLP ("Latham"),[68]

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[66] *Id.* at 549. One can argue that there is no practical difference between the court finding that this behavior leads to beneficial ownership through the anti-evasion rule in Rule 13d-3(b) and a finding that total return swaps do in fact confer beneficial ownership through Rule 13d-3(a). The consequences of both findings are the same. Perhaps Judge Kaplan simply achieved what he deemed to be the most equitable result without having to take a controversial position that seems to flout the language of Rule 13d-3(a).

[67] Theodore N. Mirvis et al., Wachtell, Lipton, Rosen & Katz, Beneficial Ownership of Equity Derivatives and Short Positions – A Modest Proposal to Bring the 13D Reporting System into the 21st Century (Mar. 3, 2008), http://www.wlrk.com/webdocs/wlrknew/FirmMemos/WLRK/WLRK.15395.08.pdf [hereinafter *Modest Proposal Memo*]; David A. Katz & Laura A. McIntosh, Wachtell, Lipton, Rosen & Katz, Corporate

and Cravath, Swaine & Moore LLP ("Cravath")[69] believe that it is prudent for public companies to rethink some of their anti-takeover measures, which, in their view, are largely ineffective against CSX-type tactics. Because "[s]ome governance experts say the decision could help secretive hedge funds exploit unwitting companies,"[70] counsel are urging corporations not to place themselves in vulnerable situations.

The focus of this Note is on the validity of the suggested expansion of the "beneficial ownership" definition in corporate bylaws. First generation advance notice bylaws typically require shareholders to submit advance notice of their intent to introduce proposals at shareholder meetings. Additionally, such conventional bylaws require shareholders to disclose their beneficial ownership positions as a condition for nominating directors or bringing forth other matters at a shareholder meeting.[71] Since the definition of beneficial

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Governance Update: Advance Notice Bylaws: Lessons From Recent Cases (May 22, 2008), http://blogs.law.harvard.edu/corpgov/files/2008/06/corporategovernanceupdate-advancenoticebylaws-lessonsfromrecentcases.pdf [hereinafter *Lessons From Recent Cases Memo*]; Theodore N. Mirvis et al., Wachtell, Lipton, Rosen & Katz, De-Coupling of Ownership, Economic and Voting Power in Public Companies – The UK's Financial Service Authority (FSA) Moves Decisively to Close the Gap (July 3, 2008), http://blogs.law.harvard.edu/corpgov/files/2008/07/de-coupling-of-ownership-economic-and-voting-power-in-public-companies.pdf [hereinafter *FSA Memo*].

[68] *Latham Proposal*, *supra* note 4; Webcast: Developments in Takeover Defense (Latham & Watkins LLP 2008), http://event.on24.com/eventRegistration/EventLobbyServlet?target=previewLobby.jsp&eventid=117724&sessionid=1&key=7E9D9850735BEFD861664B74EBEEF7FE (last visited January 2009). Materials relating to the webcast are available at http://blogs.law.harvard.edu/corpgov/files/2008/09/latham-watkins-general-counsel-forum-23sept2008.pdf.

[69] *Cravath Proposal, supra* note 4.

[70] Nicholas Rummell, *CSX Ruling Gives Hedgies Extra Room to Play*, FIN. WK., Sept. 21, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080921/REG/309229998/1015/TOC.

[71] *See* Marc Weingarten & Erin Magnor, Schulte Roth & Zabel LLP, Second General Advanced Notification Bylaws (Mar. 17, 2009), http://blogs.law.harvard.edu/corpgov/2009/03/17/second-generation-advance-notification-bylaws/#more-921 ("First Generation ANBs were upheld by

ownership in first generation bylaws is typically linked to the Exchange Act definition, the law firms mentioned above are encouraging corporations to expand this stagnant definition.[72]

Counsel at these firms have suggested a definition of "beneficial ownership" that expressly captures derivatives, followed by enhanced documentary disclosure requirements in order for shareholders to submit director nominations or to put forward any other proposal for consideration at the next annual shareholder meeting (or any special meeting).[73] The proposals further clarify that the sanction for nondisclosure would be ineligibility to nominate directors or put any other proposal forward at the next annual shareholder meeting (or any special meeting).[74]

It is also important to note that two recent decisions highlight the Delaware Court of Chancery's interpretation of advance notice bylaws. In both *Jana Master Fund* and *Office Depot Inc.*, the court ruled against each company by refusing

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.").

[72] "For corporations that are in a position to consider innovative responses to the threat posed by the stealthy accumulation of a significant or potentially dominant position, we suggest considering an alternative approach of amending advance notice by-laws governing shareholder proposals to include new continuous disclosure obligations that incorporate and expand the existing Exchange Act and related SEC rules relating to disclosure of beneficial ownership interests, including those contained in Rule 13d and Schedule 13D." *Cravath Proposal*, *supra* note 4.

[73] Rummell, *supra* note 70.

[74] A similar proposal put forth by Latham was discussed in a webcast on developments in takeover defenses. Webcast and Supplementary Materials, *supra* note 68. See Charles M. Nathan et al., Latham & Watkins LLP, Sample Advance Notice and Related Bylaw Provisions (Sept. 2008), http://www.lw.com/upload/pubContent/_pdf/pub2322_1.pdf for Latham's model advance notice bylaw provision, specifically drafted for a Delaware corporation. See Wachtell, Lipton, Rosen & Katz, Model Notice and Director Qualification By-law (Jun. 4, 2008), http://www.wlrk.com/webdocs/wlrknew/FirmMemos/WLRK/ModelNoticeDirectorQualificationByLaw.PDF for Wachtell's model advance notice bylaw provision.

to apply their advance notice bylaw provisions to block proxy contests.[75] Therefore, it is necessary for the bylaws to be unambiguous and set the standards in a clear and concise matter. Otherwise, even if the court does not invalidate the advance notice bylaw under *Blasius* or *Unocal*, it is possible that the court will simply sidestep its provisions by finding the bylaw inapplicable.

Although the focus of this Note is to consider the legality of an advance notice bylaw that expands the notion of beneficial ownership, it is important to consider another strategy that firms have utilized in response to the *CSX* decision. An equally effective tactic has been to change a company's poison pill provisions to include derivatives as part of the beneficial ownership calculation.[76] CSX itself did not have a poison pill in place, but, if it had, the decision would likely have triggered it. Many companies have recently adopted poison pills that include total return swaps

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[75] In *Jana Master Fund v. CNET Networks Inc.*, 954 A.2d 335 (Del. Ch. 2008), the court narrowly interpreted CNET's bylaws to apply only to stockholder proposals under Rule 14a-8 and not to a stockholder-finances proxy contest. Further, in *Levitt Corp. v. Office Depot Inc.*, 2008 WL 1724244 (Del. Ch. 2008), the court ruled that Office Depot's advance notice provision, which required advance notice of shareholder-proposed *business,* included shareholder proposed *nominations* in the definition of business and concluded that since director elections were properly included in the Notice of Meeting, the shareholder-proposed nomination could be made at any time. These two rulings demonstrate the importance of drafting advance notice bylaw provisions in a very clear and specific way. Phillip R. Mills & Mutya F. Harsch, *Mergers & Acquisitions 2008: What You Need to Know Now: The State of Post-Signing Deal Jumps and Hostile Bids*, 1695 PLI/CORP 585, Sept. 25–26, 2008, at 596.

[76] The poison pill is a shareholder rights plan that prevents any shareholder from owning more than a certain percentage of a company (typically 10–15%) by allowing all other shareholders to purchase shares at a lower price in the event one "triggers the pill" by crossing the threshold without the approval of the board of directors. This effectively kills the value of the triggering shareholder's investment through dilution. The legality of the poison pill was upheld as a legitimate exercise of the board's business judgment in *Moran v. Household Int'l, Inc.*, 500 A.2d 1346 (Del. 1985). For further reading and an example of a typical shareholder rights plan see RONALD J. GILSON & BERNARD S. BLACK 58–95, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS (2d ed. Supp. 2004).

and other derivative securities when calculating beneficial ownership.[77] A suit is now pending against Atmel Corporation in the Delaware Court of Chancery seeking invalidation of an amendment to Atmel's poison pill that would add synthetic equity to the definition of beneficial ownership.[78] The Atmel shareholders sued following a failed buyout bid by Microchip Technology Inc. The plaintiffs' main contention is that the revision to the "beneficial ownership" definition is impermissibly vague in that neither affected investors nor the company would be readily able to determine the number of notional shares covered by the equity derivative position.[79] The Cravath proposal did in fact warn that such a poison pill is likely to be "problematic in many respects, including the difficulty a corporation will face monitoring its rights plan and dealing with inadvertent triggers that may come to light weeks or month after the fact."[80] Atmel asserts that the determination is not very complicated, and that the long party to the derivatives knows perfectly well how many notional shares are covered by each of its derivative contracts.[81] The Delaware Court of Chancery did in fact reject the challenge to Atmel's poison pill, although a formal opinion is not available as of this writing.[82] However, the continued focus of this Note will

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[77] *See* Lemos-Stein, *supra* note 28 ("[C]ompany executives are charging up their poison pills to prevent activists intent on doing a stealth takeover.").

[78] La. Mun. Police Employees' Ret. Sys. v. Laub, C.A. No. 4161-CC (Del. Ch. filed Nov. 14, 2008). The complaint is available at http://www.delawarelitigation.com/uploads/file/intA7.PDF.

[79] Posting of Charles M. Nathan & Stephen Amdur, Latham & Watkins LLP, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, Second Generation Advance Notice Bylaws and Poison Pills, http://blogs.law.harvard.edu/corpgov/2009/04/22/second-generation-advance-notice-bylaws-and-poison-pills/#back-six (Apr. 22, 2009, 09:31 EST).

[80] *Cravath Proposal*, *supra* note 4.

[81] Nathan and Amdur, *supra* note 79.

[82] Delaware Corporate and Commercial Litigation Blog, http://www.delawarelitigation.com/2009/05/articles/chancery-court-updates/delaware-chancery-court-rejects-challenge-to-atmels-poison-pill/

leave aside the validity of the poison pill and will instead examine the validity of the proposed advance notice bylaws.[83]

The firms defend the advance notice bylaw proposal on the grounds that "[w]hen deployed, these strategies permit investors to manipulate their economic interests and voting rights, as well as the nature and timing of disclosure, in a manner that may deprive the corporation, and, more importantly, the shareholders of the ability to make informed voting and other decisions."[84] Charles M. Nathan, a senior partner and global co-chair of the Mergers & Acquisitions division at Latham, voiced that "[t]he new disclosure provision and related additions to traditional advance notice bylaws, we believe, are not unreasonable or unduly burdensome nor do they otherwise restrict, in an inequitable manner, the ability of shareholders to make proposals, nominate directors, call special meetings or act by written consent."[85] Part V of this Note agrees with this position and concludes that that the primary purpose of the bylaw is, in fact, to achieve the necessary transparency required for good corporate governance.

## V. EVALUATION

### A. The Delaware Legal Framework

Although Delaware law permits amendments to the corporate bylaws,[86] the courts have limited the power of the board where it seeks to exercise this power for purposes of

(May 21, 2009). *See also* Jef Feeley & Phil Milford, *Atmel Defeats Court Challenge to 'Poison-Pill' Takeover Defense*, BLOOMBERG, May 20, 2009, http://www.bloomberg.com/apps/news?pid=20601103&sid=ahGoAep3XKt8&refer=u.

[83] For a detailed discussion of the current state of poison pills with expanded definitions of beneficial ownership, *see* MARK D. GERSTEIN ET AL., LATHAM & WATKINS LLP, THE RESURGENT RIGHTS PLAN: RECENT POISON PILL DEVELOPMENTS AND TRENDS (2009), http://www.lw.com/upload/pubContent/_pdf/pub2628_1.pdf.

[84] *Latham Proposal*, *supra* note 4.

[85] *Latham Proposal*, *supra* note 4.

[86] DEL. CODE ANN. tit. 8, § 109 (1999).

entrenchment or impeding the shareholder vote. The following is an examination of the current Delaware case law evaluating defensive measures by the board of directors.

### 1. The Business Judgment Rule

The business judgment rule operates as a "presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[87] The practical consequence of invoking the business judgment rule is that it "bestows on the decision of disinterested directors virtual immunity from judicial review."[88] However, as the takeover wave of the 1980s emerged, courts realized that directors at times take actions based on motivations to perpetuate themselves in office and so intermediate standards of judicial review were established.

### 2. The Enhanced Scrutiny Standard of Review

In *Unocal Corp. v. Mesa Petroleum Co.*, Mesa Petroleum accumulated thirteen percent of Unocal's stock, at which point it made a two-tier offer to buy approximately thirty-seven percent of Unocal's outstanding stock at $54 per share.[89] The remaining shares would be eliminated under an exchange of stock for junk bonds worth much less than $54.[90] The board considered the proposal inadequate and initiated a defensive strategy to thwart the takeover by making a self-tender offer under which Unocal would purchase its own shares.[91] The court upheld the discriminatory self-tender by the target corporation as a response to the two-tiered coercive tender offer.[92] The proportionality standard set in

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[87] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1373 (Del. 1995) (quoting Arnson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[88] KLEIN & COFFEE, *supra* note 17, at 202–03.

[89] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 949 (Del. 1985).

[90] *Id.* at 949–50, 956.

[91] *Id.* at 950–51.

[92] *Id.* at 958.

*Unocal* requires an evaluation of whether the defensive measure was adopted in good faith, after reasonable investigation and deliberation, and was reasonable in relation to the threat posed by the bidder.[93]

The proportionality standard was subsequently clarified in *Unitrin, Inc. v. American Gen. Corp.* There, the target corporation, Unitrin, responded to a hostile cash tender offer for all of its shares by announcing a repurchase program for ten-million shares (nearly twenty percent of its outstanding stock).[94] The effect of the repurchase program would have been to inflate the voting power of the Unitrin board of directors, which already held twenty-three percent of the outstanding stock.[95] This had special significance because, under Unitrin's certificate of incorporation, a bidder needed to obtain seventy-five percent in a shareholder vote to effect a follow-up merger with a greater than fifteen percent shareholder.[96] Finding this repurchase program to be a defensive reaction governed by *Unocal,* the Delaware Supreme Court remanded to the Court of Chancery to determine whether the response was preclusive or coercive and therefore not "within the range of reasonableness."[97] Under the new standard, in order to invalidate a defensive tactic, the Delaware Court must find that the "defensive response was draconian because it was either coercive or preclusive in character."[98]

The standard for analyzing director defensive measures in responding to a takeover threat asks whether the directors can demonstrate, through a reasonable investigation, that they "had reasonable grounds for believing that a danger to corporate policy and effectiveness existed and the defensive measure was reasonable in relation to the threat posed."[99] If the directors are able to

[93] *Id.* at 955. *See* KLEIN & COFFEE, *supra* note 17, at 203.

[94] Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1370–71 (Del. 1995).

[95] *Id.* at 1370.

[96] *Id.* at 1377.

[97] *Id.* at 1390–91.

[98] *Id.* at 1387.

[99] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985).

pass this enhanced scrutiny standard, judicial review reverts back to the business judgment rule.[100]

### 3. The Compelling Justification Standard

The Delaware Court of Chancery, in *Blasius Indus. v. Atlas Corp.*, held that the compelling justification standard is applicable when a director acts with the primary purpose of interfering with the exercise of shareholder voting rights.[101] In *Blasius*, shareholders brought an action challenging the validity of the directors' decision to add two new members to the board of directors, the counting of votes on a consent solicitation to increase the board from seven to fifteen members, and the directors' ability to name a majority of the board.[102] Under *Blasius*, a plaintiff must show that the board acted for the primary purpose of thwarting the exercise of the shareholder vote, otherwise, the business judgment rule applies.[103] According to the court, the board then has the burden of demonstrating a compelling justification for its actions.[104] As the Delaware courts went on to note in subsequent cases, "[t]his test potentially presents the defendants with the 'quite onerous' burden of demonstrating a compelling justification for their actions."[105]

Courts have used the *Blasius* standard of review on numerous occasions to invalidate inappropriate entrenchment strategies taken by directors. For example, in *Wisconsin Investment Board v. Peerless Systems Corp.*, the board adjourned a shareholder meeting to avoid a vote that would have had an unfavorable outcome and then continued to solicit support for its position.[106] After convincing enough

[100] *Id.* at 958.

[101] Blasius Indus. v. Atlas Corp., 564 A.2d 651, 661 (Del. Ch. 1988).

[102] *Id.* at 652.

[103] *Id.* at 659–60.

[104] *Id.* at 661.

[105] Wis. Inv. Bd. v. Peerless Sys. Corp., No. Civ.A. 17637, 2000 WL 1805376, at *8 (Del. Ch. Dec. 4, 2000) (quoting Williams v. Geier, 671 A.2d 1368, 1376 (Del. 1996)).

[106] *Id.* at *4–5.

shareholders to vote in favor of its position, the board held another meeting a month later at which its proposal passed.[107] The court denied summary judgment and ordered a trial to determine whether "the defendants exercised this high degree of caution embodied in the 'compelling justification' standard."[108] However, the court signaled that although it was not ready to make a determination as a matter of law, the directors will likely not meet the compelling justification standard because "any efforts by those controlling the vote to alter the results of that vote, even where there is no clear conflict of interest between the directors and the shareholders, must be undertaken with extreme caution so as not to undermine the legitimacy of the corporate structure itself."[109] Similarly, in *Carmody v. Toll Bros.*, the court invalidated the "dead hand pill"[110] because it effectively disenfranchised shareholders who wished to elect a board committed to redeeming the pill by deterring proxy contests by prospective acquirers.[111] Courts have wrestled with the application of the *Blasius* doctrine because it puts the court in the difficult position of determining the purpose behind a director's action. The board will surely deny any wrongdoing and, with the aid of skilled counsel, can craft a seemingly legitimate reason for thwarting the shareholder vote.[112]

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[107] *Id.* at *5.

[108] *Id.* at *15.

[109] *Id.*

[110] A "dead hand" poison pill can only be redeemed by the incumbent directors who adopted it or their designated successors. Carmody v. Toll Bros., 723 A.2d 1180, 1184 (Del. Ch. 1998).

[111] The dead hand pill disenfranchises shareholders because it makes an "unsolicited offer for the company more unlikely by eliminating a proxy contest as a useful way for a hostile acquiror to gain control, because even if the acquiror wins the contest, its newly-elected director representatives could not redeem the Rights." Carmody v. Toll Bros., 723 A.2d 1180, 1184–5 (Del. Ch. 1998).

[112] David C. McBride & Danielle Gibbs, *Interference with Voting Rights: The Metaphysics of Blasius Industries v. Atlas Corp.*, 26 DEL. J. CORP. L. 927, 929 (2001).

### 4. Application of the Standards

The Delaware courts have struggled to apply these standards consistently. In the recent decision of *MM Cos. v. Liquid Audio, Inc.*, the Delaware Supreme Court clarified the *Blasius-Unocal* framework to some extent and set the standards for corporate directors whose response to a takeover threat effectively disenfranchises shareholders.[113] In *Liquid Audio*, shareholders sought injunctive relief after Liquid Audio's incumbent board of directors took defensive action to expand its staggered board from five to seven members in response to MM's attempt to gain control by nominating its own slate of directors.[114] The Liquid Audio board thereafter rejected MM's attempt to nominate its own candidates to the two newly created vacancies and instead the board itself appointed two new directors.[115]

The Delaware Supreme Court held that the *Blasius* standard applied, and therefore, the incumbent board of directors had the burden of demonstrating a compelling justification for expanding the size of its membership as a prerequisite to obtaining the less strict *Unocal* standard.[116] The court then applied the *Unocal* standard and found that the defensive measure was not proportionate and reasonable in relation to the threat posed.[117] The court retained the *Blasius* standard within its evaluation of the board's response to a takeover that thwarts shareholder voting, thereby choosing not to integrate the question into the *Unocal* standard.[118] The two standards remain separate, although both may be used in certain situations.[119]

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[113] MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118 (Del. 2003).

[114] *Id.* at 1121, 1123.

[115] *Id.* at 1124.

[116] *Id.* at 1129–31.

[117] *Id.* at 1131.

[118] Vice Chancellor Leo Strine disagrees with this result and thinks that, in fact, the *Blasius* standard should be integrated into *Unocal*, unless the specific instance of director elections is in question. *See* Mercier v. Inter-Tel, Inc., 929 A.2d 786 (Del. Ch. 2007).

[119] Arguments have been advanced by various scholars for abandoning the *Blasius* framework and applying the *Unocal* standard in all situations.

The Delaware Supreme Court in *Liquid Audio* and in *Stroud v. Grace* emphasized that the *Blasius* and *Unocal* standards of enhanced judicial review are not mutually exclusive.[120] Both *Unocal* and *Blasius* may be invoked in certain circumstances, as the Delaware Supreme Court held applicable in *Liquid Audio*.[121] Whether the *Blasius* standard applies independently or within *Unocal* depends on whether the board's action is in response to a threat to the corporation. The advance notice bylaw that is the focus of this Note can be implemented at different times. If the board adopts the bylaw provision in question in response to a specific threat, the action will be interpreted under both *Blasius* and *Unocal*, as occurred in *Liquid Audio*. If the board simply adopts such a bylaw as a precautionary provision, anticipating future contests for control, *Unocal* will be inapplicable, and a strict *Blasius* analysis will be conducted.

The court in *Liquid Audio* also observed that the board's action "need not actually prevent the shareholders from attaining any success in seating one or more nominees in a

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*See* William T. Allen et al., *Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 26 DEL. J. CORP. L. 859, 886–90 (2001). Clearly the Supreme Court of Delaware rejected the view that the *Unocal* standard is sufficient to protect the shareholder vote.

[120] Stroud v. Grace, 606 A.2d 75, 92 n. 3 (Del. 1992); *Liquid Audio*, 813 A.2d at 1130.

[121] The Delaware Supreme Court explained "[t]his case presents a paragon of when the compelling justification standard of *Blasius* must be applied within *Unocal*'s requirement that any defensive measure be proportionate and reasonable in relation to the threat posed. The *Unocal* standard of review applies because the Liquid Audio board's action was a 'defensive measure taken in response to some threat to corporate policy and effectiveness with touched upon issues of control.'" *Liquid Audio*, 813 A.2d at 1131 (quoting Gilbert v. El Paso Co., 575 A.2d 1131, 1144 (Del. 1990)). "The compelling justification standard of *Blasius* also had to be applied within an application of the *Unocal* standard to that specific defensive measure because the primary purpose of the Board's action was to interfere with or impede the effective exercise of the shareholder franchise in a contested election for directors." *Id.* at 1131 (quoting *Stroud*, 606 A.2d at 92) (emphasis removed). In 2007 the Chancery Court took the same approach in *Mercier*, 929 A.2d at 786.

contested election for directors and the election contest need not involve a challenge for outright control of the board of directors."[122] Therefore, it is the directors' intent that is important to the analysis.

The rest of this discussion examines the bylaw under a strict *Blasius* analysis because a combined *Blasius-Unocal* analysis is appropriate only in the limited situation when the board undertakes defensive measures in response to a hostile takeover. It is meaningless to undertake a theoretical *Unocal* analysis without knowing what the precise threat is, and therefore whether this response would be "within the range of reasonableness." The assumption is that a board wishes to implement an advance notice bylaw provision as a protective measure without any threat on the horizon (other than perhaps the general economic environment). Although there is no impending threat, the board is undertaking defensive action in order to avoid becoming the target of a hostile takeover. Further, the board could be instituting this defensive policy to prevent a dissident shareholder from exercising control over the corporation and the board, as was the situation in *CSX*. In view of the current market for corporate control and the constant warnings from scholars and counsel, it is inevitable that a board will consider taking some action to protect itself from attack by secret accumulation of synthetic positions. A failure to consider and take preventive measures may itself be a violation of the business judgment rule.

## B. Application

"The most fundamental principles of corporate governance are a function of the allocation of power within a corporation between its stockholders and its board of directors. The stockholders' power is the right to vote on specific matters, in particular, in an election of directors."[123] On the other hand, the power of managing the corporation

[122] *Liquid Audio*, 813 A.2d at 1132.

[123] *Id.* at 1126.

rests with the board of directors.[124] Countless courts and academics have articulated the fundamental tenant of Delaware corporate law as the separation of ownership and control.[125] The "shareholder franchise" has been characterized as the "'ideological underpinning' upon which the legitimacy of directorial power rests."[126]

The *Liquid Audio* court stressed the fundamental importance of the stockholders' ability to vote management out of office and to elect new management if they are unsatisfied with how the corporation is being run. Consequently, the Delaware Supreme Court noted that

> [t]he courts of this state will not allow the wrongful subversion of corporate democracy by manipulation of the corporate machinery or by machinations under the cloak of Delaware law. Accordingly, careful judicial scrutiny will be given a situation in which the right to vote for the election of successor directors has been effectively frustrated and denied . . . .[127]

Consequently, judicial review under the deferential traditional business judgment rule standard is inappropriate when a board of directors acts for the primary purpose of impeding or interfering with the effectiveness of a shareholder vote. Chancellor Allen set forth a cogent explanation for this tenant of Delaware law in the context presented in *Blasius*, that of a contested election for directors:

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[124] *Id.*

[125] Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, J.L. & ECON., Vol. XXVI, June 1983, *available at* http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID924170_code9.pdf?abstractid=94034&mirid=1 ("Our goal is to explain the survival of organizations characterized by separation of "ownership" and "control"—a problem that has bothered students of corporations from Adam Smith to Berle and Means and Jensen and Meckling."); *see* Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675 (2007).

[126] Bebchuk, *supra* note 125, at 676 (quoting Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659 (Del. Ch. 1988)).

[127] Giuricich v. Emtrol Corp., 449 A.2d 232, 239 (Del. 1982) (internal citations omitted).

> [T]he ordinary considerations to which the business judgment rule originally responded are simply not present in the shareholder voting context. That is, a decision by the board to act for the primary purpose of preventing the effectiveness of a shareholder vote inevitably involves the question who, as between the principal and the agent, has authority with respect to a matter of internal corporate governance. That, of course, is true in a very specific way in this case which deals with the question who should constitute the board of directors of the corporation, but it will be true in every instance in which an incumbent board seeks to thwart a shareholder majority. A board's decision to act to prevent the shareholders from creating a majority of new board positions and filling them does not involve the exercise of *the corporation's power* over its property, or with respect to *its* rights or obligations; rather, it involves allocation, between shareholders as a class and the board, of effective power with respect to governance of the corporation . . . . Action designed principally to interfere with the effectiveness of a vote inevitably involves a conflict between the board and a shareholder majority. Judicial review of such action involves a determination of the legal and equitable obligations of an agent towards his principal. This is not, in my opinion, a question that a court may leave to the agent finally to decide so long as he does so honestly and competently; that is, it may not be left to the agent's business judgment.[128]

In the present case, if the *Blasius* standard is found to apply, a board adopting this provision will have to show a compelling justification. "In reality, invocation of the *Blasius* standard usually signals that the court will invalidate the board action under examination."[129] This is a difficult

[128] *Blasius,* 564 A.2d at 659–60 (emphasis original).

[129] Mercier v. Inter-Tel, Inc., 929 A.2d 786, 806 n.44 (Del. Ch. 2007) (citing Chesapeake v. Shore, 771 A.2d 293, 323 (Del. Ch. 2000)).

standard to meet, and in fact, until very recently, no director has ever established a compelling justification.[130]

However, the Delaware Court of Chancery recently upheld a decision by the Inter-Tel, Inc. board to postpone a stockholder vote that would have rejected a third-party merger that the independent directors believed to be in the stockholders' best interests.[131] The court applied both the *Unocal* and the *Blasius* standards, finding that the board's actions were both "reasonable in relation to their legitimate objective and did not preclude the stockholders from exercising their right to vote."[132] In applying *Blasius*, the court held that compelling circumstances were present when the independent directors believed that the stockholders would have almost certainly rejected the merger as against their best interests.[133] The Vice Chancellor spent a significant amount of time in the opinion characterizing and criticizing the *Blasius* standard. He read the supreme court opinion in *Liquid Audio* as signaling "that the stringency of the *Blasius* approach should be reserved largely for director election contests or election contests having consequences for corporate control."[134] Therefore, the holding was inevitable, since the directors were in fact trying to get the merger passed despite the fact that it would leave them without their positions. The court found that the primary purpose of the Inter-Tel board was not to disenfranchise its stockholders, but rather to give them more time to deliberate before exercising their right to vote.[135]

The bylaw provision involves exactly the situation that the *Liquid Audio* and *Mercier* courts envisioned necessary of the *Blasius* approach, because it encompasses the replacement of incumbent directors when they stand for re-election. The consequence of noncompliance with the disclosure requirements of the bylaw is a prohibition on

[130] McBride & Gibbs, *supra* note 112, at 929.

[131] *Mercier,* 929 A.2d at 787.

[132] *Id.* at 810.

[133] *Id.* at 819.

[134] *Id.* at 809.

[135] *Id.* at 818–19.

director nominations. This is exactly the type of situation that requires careful judicial scrutiny, as it is the "right to vote for the election of successor directors that [will be] effectively frustrated and denied."[136]

However, although the electoral process is at issue, the board's primary purpose in implementing this defensive bylaw is not to entrench itself in office, but rather to protect the corporation from secret ambush attacks by hedge funds and other activist investors. The issue is not one strictly involving the electoral process. It also involves a legitimate business decision, specifically, a reaction to the current troubling financial environment. The significant decline in stock market value for equity securities in U.S. companies has caused a considerable number of them to become undervalued. This in turn has increased management concerns regarding unsolicited takeover attempts, which makes effective takeover defenses more critical than ever.[137]

From the perspective of the acquiring company, maintaining secrecy in its acquisition plans is critically important because it limits the target company's opportunity to seek a competitive bid. Empirical studies suggest that the stock of a target company experiences an average abnormal return of 7.74% when an acquiring company files a Schedule 13D, even if it is only disclosing that it is merely considering making an acquisition.[138] "Here the concern is the acquiring company's ability to purchase the target company's stock at the [initial] market price, before disclosure of the acquiring company's plans causes the price of the target company stock

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[136] *Id.* at 808 n.63 (quoting MM Cos. v. Liquid Audio, 813 A.2d 1118, 1127 (Del. 2003)) (emphasis removed).

[137] *See* MARK D. GERSTEIN, *supra* note 83 ("[C]orporations today face continued threats of abusive takeover transactions, as well as threats from activist and other 'event-driven' investors. The credit crunch and the resulting recession, accompanied by substantial deterioration in U.S. equity markets, has exacerbated these vulnerabilities.").

[138] RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 899 (2d ed. 1995) (1986) (citing Wayne Mikkelson & Richard Ruback, *Corporate Investments in Common Stock* 16 tbl. 4 (Mass. Inst. of Tech., Sloan Sch. of Mgmt.,Working Paper No. 1633-85, 1985)).

to increase significantly."[139] It follows that the board needs to prevent the acquirer from secretly purchasing the target company stock at the lower, pre-announcement price.

Another reason that the acquirer prefers not to disclose its position is the obvious out-of-pocket costs of disclosure, such as hiring attorneys and accountants. Furthermore, by filing a disclosure document, the acquirer is exposing itself to possible litigation. This occurred in the *CSX* case itself, where CSX sued TCI and 3G claiming that the Schedule 13D that was eventually filed was materially misleading because they failed to reveal that they were acting as a "group."[140] It is apparent that a potential acquirer will do everything in its power to avoid disclosure, and holding derivative positions is one very successful strategy.

Consequently, a well-organized antitakeover plan that accounts for derivative positions enables a board of directors to take a commanding role in negotiating with hostile shareholders who certainly have the upper hand in the current financial crisis. Directors would be wise not to turn a blind eye to the precedent of cases such as *CSX* and the warnings from prominent law firms not to leave the corporation open to attack. It is difficult to say, then, that the "primary" purpose of the director action is to thwart the shareholder vote. The issue in *Blasius* itself "did not involve a business transaction, but was simply an act relating to the process by which directors would be selected."[141] Additionally, unlike the situation at hand, many other cases applying the *Blasius* framework similarly lacked a true business decision.[142]

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[139] *Id.* at 898–99.

[140] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 555 (S.D.N.Y. 2008). This concern is intensified when one considers the overly litigious U.S. litigation system. *See infra* Part VI comparing this concern in the U.S. to the U.K. system.

[141] McBride & Gibbs, *supra* note 112, at 936.

[142] *See* Wis. Inv. Bd. v. Peerless Sys. Corp., No. Civ.A. 17637, 2000 WL 1805376, at *1 (Del. Ch. Dec. 4, 2000) (disputing the operation and conduct of the electoral process, which is not a business decision); Chesapeake Corp. v. Shore, 771 A.2d 293, 342–43 (Del. Ch. 2000) (requiring a supermajority vote to amend bylaws, an act precluding shareholders from

Admittedly, the fact that the conduct involves a business decision is not conclusive. For example, in *Carmody v. Toll Brothers* the board decided to institute a "dead hand" poison pill, the goal of which is to deter takeovers and to protect the corporation from outside control by reinstating the board's power and forcing the acquirer to negotiate.[143] This is precisely the same business goal as the currently proposed bylaw provisions. Furthermore, the court applied the *Blasius* standard in *Carmody* because the board's actions interfered with the electoral process since the directors that would have been elected by the stockholders would have been deprived of the power to redeem the pill, and, therefore, deprived of doing exactly the job they were elected in to do.[144] However, one can argue that the *Carmody* case "had little to do with the business of the corporation and much more to do with the election process and the power of directors."[145] The purpose of the dead hand poison pill was to prevent newly nominated directors from redeeming the pill. If the directors cannot redeem the pill there is no purpose in their nominations. Directors can then be successful in simply nullifying, or even preventing, the shareholders from nominating a competing slate of directors. The dead hand pill would make it mathematically impossible for a new slate of directors to redeem the pill, which would effectively deter a potential acquirer from making an offer for the firm altogether. No such coercion will occur with the advance notice bylaw. The bylaw simply requests compliance with certain procedures which will enable directors and other shareholders to make informed decisions. If it is not prohibitively expensive to make disclosure under the federal rules and a Schedule 13D filing does not prevent the

amending bylaws without the vote of shares controlled by management); McBride & Gibbs, *supra* note 112, at 936–38 (reviewing cases that apply the *Blasius* framework although no business decision is involved).

[143] Carmody v. Toll Bros., 723 A.2d 1180 (Del. Ch. 1998). *See supra* note 111–12 explaining the mechanics of the dead hand poison pill.

[144] *Id.* at 1193–94.

[145] McBride & Gibbs, *supra* note 112, at 938.

acquisition of shares, this argument should not be given substantial weight with regard to synthetic positions.

The analysis consequently leads to the question of whether the board is properly motivated, or, alternatively, whether the directors are attempting to entrench themselves in office. The board will argue that it has a good faith concern that the rise in shareholder activism in the recent years combined with the decline in stock prices have made companies vulnerable to attack. The board's position is that it is attempting to protect the company by preventing surprise threats similar to those made in the *CSX* battle. There is merit to this argument. Proposals by dissident stockholders to eliminate poison pills and de-stagger boards have increased dramatically in recent years.[146] The law firm proposals discussed in Part III are legitimate responses to this takeover-prone environment.[147] Companies are urged to be attuned to early warning signs of activism and to "[o]rganize a strategic, defensive process to handle activism . . . ."[148] It is notable that even Schulte Roth & Zabel LLP, the advocate for hedge fund and activist rights, admitted that

[146] *See* Mills & Harsch, *supra* note 75, at 591–93. As of December 2007, thirty-six percent of S&P 1500 companies had a poison pill in place, down from fifty-six percent in 2004. *Id.* at 593. In 2008, there were forty-five shareholder proposals to destagger boards, up from forty-two such proposals in 2007. *Id.* Fifty-two percent of S&P 1500 companies had a classified board as of December 2007 and the percentage has consistently declined since 2004, when almost sixty percent of companies in the S&P 1500 had a staggered board. *Id.* "Other takeover defenses have also been targeted, including proposals to eliminate supermajority voting, proposals related to shareholder ability to call special meetings and proposals to allow for cumulative voting in the election of directors." *Id.* at 594.

[147] Other prominent firms share this view. Davis Polk & Wardwell has recommended that public companies be increasingly alert to shareholder activism as well. Mills & Harsch, *supra* note 75, at 594–603. In explaining the *CSX* holding, Davis Polk & Wardwell warns that until the case is resolved on appeal "and/or the SEC enacts rule-making to address the treatment of derivatives under the current disclosure regime or otherwise, vigilance continues to be essential in order to monitor any exposure a company may have." *Id.* at 595.

[148] Mills & Harsch, *supra* note 75, at 595.

> [s]uch increased disclosure requirements should not be problematical 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 consequences 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.[149]

Activist shareholders could potentially argue that these disclosure requirements are unduly burdensome since they would defeat the advantages of purchasing total return swaps over physical shares in the first place. It is clear, however, that the advantages obtained by the long party in a total return swap transaction result in the manipulation of the disclosure requirements under Section 13(d) and are therefore a violation of Rule 13d-3(b).[150] As the court in *CSX* articulated:

> The avoidance of public disclosure can confer significant advantages on the long party. By concealing its activities, it may avoid other investors bidding up the referenced stock in anticipation of a tender offer or other corporate control contest and thus maximize the long party's profit potential. Second, it permits a long party who is interested in persuading an issuer to alter its policies, but desirous of avoiding an all-out battle for control, to select the time of its emergence to the issuer as a powerful player to a moment of its choosing, which may be when its exposure is substantially greater than 5 percent. In other words, it permits a long party to ambush an issuer with a holding far greater than 5

[149] Posting of Marc Weingarten & Erin Magnor, Schulte Roth & Zabel LLP, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, Second General Advanced Notification Bylaws, http://blogs.law.harvard.edu/corpgov/2009/03/17/second-generation-advance-notification-bylaws/#more-921(Mar. 17, 2009, 11:05 EST).

[150] 17 C.F.R. § 240.13d-3(b) (2009). This is precisely what occurred in the *CSX* decision, where 3G and TCI were held to beneficially own the shares pursuant to the anti-evasion rule. *See supra* Part III.

> percent. One other point bears mention here. TRSs, like all or most derivatives, are privately negotiated contracts traded over the counter. Their terms may be varied during their lives as long as the counterparties agree. In consequence, a TRS that in its inception contemplates cash settlement may be settled in kind—i.e., by delivery of the referenced shares to the long party—as long as the parties consent. This confers another potential advantage on a long party that contemplates a tender offer, proxy fight, or other corporate control contest. By entering into cash-settled TRSs, such an investor may concentrate large quantities of an issuer's stock in the hands of its short counterparties and, when it judges the time to be right, unwind those swaps by acquiring the referenced shares from those counterparties in swiftly consummated private transactions. Moreover, even if such TRSs were settled in cash, the disposition by the short counterparties of the referenced shares held to hedge their swap exposures would afford a ready supply of shares to the market at times and in circumstances effectively chosen and known principally by the long party. The long party therefore likely would have a real advantage in converting its exposure from swaps to physical shares even if it does not unwind the swaps in kind.[151]

Subsequently, although some advantages of holding total return swaps and other equity derivatives may be eradicated by disclosure, this argument is not sufficient to conclude that the board is liable under the *Blasius* standard of review. Although the shareholder vote is in question, and therefore the *Blasius* standard is applicable over the business judgment rule, the directors can demonstrate a compelling justification for their action. The directors are exercising their business judgment by relying on advice from counsel based on recent litigation and preventing an attack on their corporations. There is no justification for allowing activists to

[151] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 523 (S.D.N.Y. 2008).

gain an undue advantage by concealing their derivative positions and exerting pressure on corporate boards. Therefore, a Delaware court is likely to uphold the implementation of the advance notice bylaw.

## VI. POLICY

The *CSX* decision did not fill the gap in the federal rules and left much uncertainty for future conduct. According to the district court in *CSX*, "[s]ome people deliberately go close to the line dividing legal from illegal . . . . A few cross that line and, if caught, seek to justify their actions on the basis of formalistic arguments even when it is apparent that they have defeated the purpose of the law."[152] The SEC should fill the loopholes that allow for such behavior through either rulemaking or through more comprehensive and timely enforcement actions.[153] The SEC seems to be, in the words of Professor John Coffee, "in a state of regulatory paralysis . . . in ignoring swaps, the SEC is wearing blinders."[154] There is no doubt that creative and complicated swaps and other equity derivatives exert influence over corporate decision

[152] *Id.* at 516.

[153] It is unclear whether the SEC has the authority to regulate derivative positions. On the one hand, Professor Coffee notes that there is hardly any doubt that the SEC has this authority, as "the SEC has gone much further in relying on § 14(e) of the Exchange Act to enable it to broadly extend its substantive tender offer rules so that they go well beyond the statutory text of § 14(d)." John C. Coffee Jr., *The Wreck of the CSX*, *supra* note 55, at 5. Furthermore, according to Professor Coffee, "Section 23(a) of the Exchange Act gives the SEC broad power to make such rules and regulations as may be necessary or appropriate to implement the provisions of this chapter." *Id.* Lastly, Rule 14e-3, addressing a related context, "goes well beyond the normal scope of insider trading liability and was upheld in *United States v. O'Hagan,* 521 U.S. 642, 669 (1997)." *Id.* On the other hand, such authority may be contrary to the Gramm-Leach-Bliley Act of 2000, which added Section 3A of the Exchange Act and excludes equity-based swaps from the Exchange Act's definition of a security. It also prohibits the SEC from imposing reporting requirements on these instruments. 15 U.S.C. § 78c-1 (2006). However, whether the SEC has authority to regulate derivative positions is beyond the scope of this Note.

[154] Coffee, *The Wreck of the CSX*, *supra* note 55, at 5.

making with little or no apparent duty to disclose the existence or nature of these positions or their plans with respect to the relevant issuers.[155] Therefore, it is vital that the SEC undertake reforms for Rule 13d-3.[156]

There is hardly a counterargument to the assertion that "the purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control . . . ."[157] As professor and former SEC Commissioner Joseph Grundfest, together with other academics, advised the court in the *CSX* case, "[in] the context of this case, the . . . integrity of the stock market was undermined and an uneven playing field was created."[158] Since the SEC has not changed its position regarding transparency in the market, it should realize that "[the] disclosure rules should be internally consistent. They should treat substantively identical positions similarly, which current rules do not."[159] Further support for this argument is that the "reporting of derivative instruments on Schedule 13D is already the norm for options, warrants and other

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[155] *See* Coffee, *The Wreck of the CSX*, *supra* note 55, at 5.

[156] However, "[e]ven as amended, Section 13(d) may ultimately prove a hollow weapon for companies. Shareholders cannot sue under Section 13(d), and companies cannot sue for monetary damages. Instead, companies can only seek injunctive relief such as an order to correct or file the 13(d)." Posting of Professor Steven M. Davidoff to The New York Times DealBook, The Rules of Engagement, http://dealbook.blogs.nytimes.com/2008/05/23/the-rules-of-engagement/?scp=1&sq=davidoff%20rules%20of%20engagement&st=cse (May 23, 2008, 12:41 EST). Therefore, companies may still have to use advance notice bylaw provisions to get the information they require from hedge funds and other activist investors.

[157] GAF Corp. v. Milstein, 453 F.2d. 709, 717 (2d Cir. 1971).

[158] CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511, 547 n.191 (S.D.N.Y. 2008) (citing Letter from Joseph Grundfest, Henry Hu, and Marti Sabrahmanyam to Brian Cartwright, General Counsel of the SEC (June 2, 2008), at 13).

[159] Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 819 (2006).

derivative products. The addition of cash-settled swaps should not be any more burdensome."[160]

On the other side of the debate, activist investors argue that making disclosure more difficult can make it harder to "influence the strategy and management of underperforming companies."[161] In support of this view, Professor Merritt Fox points out that "[s]ubstantial evidence indicates . . . that activist hedge funds have been able to target individual firms and accomplish changes in management, managerial policy, and corporate governance in ways that appear to be share value enhancing."[162] However, "[h]edge funds are set up to make money for their investors without regard to whether the strategies they follow benefit shareholders generally."[163] Since "hedge funds frequently engage in hedges and other sophisticated trading and arbitrage strategies . . . conflicts of interest are likely to arise" that may cause a hedge fund not to act in the best interest of the shareholders of a specific company in order to turn a higher profit for the fund itself.[164] Not only are these "hedging-related conflicts" a problem with hedge fund activism, but "stress fractures"

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[160] Motion for Leave to File CSX's Response to the Letter of Professor Bernard Black Submitted to the SEC at 25, CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. June 2, 2008) (No. 08 Civ. 2764).

[161] Alistair Barr, *Activist Investor Tool Threatened*, WALL ST. J., Jun. 2, 2008, http://www.marketwatch.com/news/story/activist-tool-threatened-judge-weighs/story.aspx?guid=%7B53D0024F-5A4A-493D-9EF9-2A788FF9135F%7D.

[162] Merritt Fox, *Civil Liability and Mandatory Disclosure*, 109 COLUM. L. REV. 237, 246 (2009).

[163] Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1071 (2007).

[164] *Id.* *See, e.g., id.* at 1073 (In a merger transaction (or other combination) where "a hedge fund owns other securities, the value of which depends on whether the transaction is consummated," the fund will have perverse incentives to vote either for or against the transaction regardless of its value to general shareholders.). *See also In re* MONY Group, Inc. S'holder Litig., 853 A.2d 661 (Del. Ch. 2004) (fund attempted to prevent consummation of a value enhancing merger because of its long position in a specific type of convertible debt security).

imposed by the funds on corporations also trigger concern.[165] Another frequently cited problem with hedge fund activism is that "due to their short-term trading horizons, [hedge funds] aggravate an already serious problem of 'short-termism' in the executive suite" and, therefore, may hurt corporations and their shareholders in the long term while in search of quick profits.[166]

Moreover, this debate assumes that hedge funds act solely to influence corporate strategy and ignores that they are also in the business of acquiring companies. When a hedge fund does take over a corporation, concerns regarding "Saturday Night Specials"[167] arise, because the fund wants to purchase the company at the lowest price possible while the shareholders want to sell at the highest.[168] Furthermore, the practice of acquiring large synthetic positions expands beyond the hedge fund world and will continue to pervade the financial markets. Although the practice of acquiring large synthetic positions started with hedge funds (as is frequently the case), there is nothing stopping potential acquirers of all forms to engage in this elusive conduct.

Those arguing against enhanced disclosure also believe that imposing more stringent disclosure requirements may "restrain the growth of the $10 trillion equity derivatives market."[169] In their amicus brief, the International Swaps

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[165] Kahan & Rock, *supra* note 163, at 1071. For example, activist hedge funds tend to form coalitions with other hedge funds and attack in "wolf-packs" such as TCI and 3G's concerted action in the *CSX* litigation.

[166] *Id.* at 1071, 1083–87 ("Short-termism thus presents the potentially most important, most controversial, most ambiguous, and most complex problem associated with hedge fund activism.").

[167] The term alludes to the fact that many takeover bids, specifically in the 1980s, were announced over the weekend in order to avoid too much publicity to keep the price of the stock from increasing and making the target more expensive to the raider, as well as to surprise management without giving it time to put together a defensive strategy.

[168] See Kahan & Rock, *supra* note 163, at 1072 ("A hedge fund's activities may not be so much directed at making sure that the target is sold at the highest price, but rather at increasing the likelihood that the hedge fund succeeds in its acquisition attempt.").

[169] Barr, *supra* note 161.

and Derivative Association and the Securities Industry and Financial Markets Association argued that if swaps were included in beneficial ownership rules, it "would create substantial uncertainties in the securities and derivatives markets and could chill legitimate and desirable commercial activity."[170]

It is puzzling that in a letter submitted to the General Counsel of the SEC, Professor Bernard Black expressed the view that the Southern District should not find that TCI and 3G had beneficial ownership. In *Decoupling II,* Professor Black wrote that "[f]rom an economic standpoint, share pricing will be more efficient if investors know what major investors are doing and have advance notice of possible changes in control. The integrity of, and confidence in, the stock market will be enhanced."[171] However Professor Black takes an inconsistent stance when he says that

> [a]n effort by the courts or the SEC to stretch the concept of beneficial ownership under the current 13D rules, to cover equity swaps would be a mistake. Equity swaps alone clearly do not convey beneficial ownership over shares. The case for thinking that equity swaps might convey beneficial ownership relies instead on a complex set of market practices which surround the equity swaps business. However, these market practices are evolving, and will surely shift in response to whatever the courts or the SEC do. They offer an unstable basis for finding beneficial ownership. Moreover, while the distinction between economic and voting ownership is increasingly unsatisfactory as a basis for regulation, it is an intelligible basis, reflected in a number of SEC rules. Twisting 13(d) to capture equity swaps

[170] Brief for International Swaps and Derivatives Ass'n, Inc. et al. as Amici Curiae Supporting Petitioner, CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008) (No. 08 Civ. 2764), *available at* http://www.sifma.org/regulatory/briefs/2008/TCIFAmicusbrief-CSXCorp.pdf.

[171] Hu & Black, *Decoupling II*, *supra* note 6, at 684.

> will produce an unintelligible, inconsistent line, which will soon be evaded.[172]

In response to Professor Black, the SEC should consider that in 2007, the United Kingdom's Financial Service Authority ("FSA") updated its disclosure rules to require a stockholder controlling three percent or more of a listed company's total voting rights to make substantial disclosures of all direct and indirect investments in that company.[173] "The FSA's action demonstrates again that existing disclosure and regulatory regimes – including most importantly those in the U.S. – are inadequate to effectively police the proliferation and variety of synthetic and temporary ownership techniques now in use by creative investors and financial intermediaries."[174] As Professor Coffee articulated, the SEC "has waffled and sadly demonstrated that it is woefully behind other major securities regulators."[175]

Unfortunately, the staff of the SEC's Division of Corporation Finance, in a letter to the district court, commenting on the *CSX* case, weighed in on the side of hedge funds.[176] The letter stated that

> 'standard cash-settled equity swap agreement[s]' do not confer either voting or investment power to the

[172] Bernard S. Black, *Equity Swaps and Schedule 13D* (U. Texas Law, Working Paper No. 133, 2008), *available at* http://ssrn.com/abstract=1138299.

[173] Financial Services Authority (U.K.), Disclosure Rules and Transparency Rules 5 & 22 (Rules 5.1.2 & 5.8.3) (2009), http://fsahandbook.info/FSA//handbook/DTR/5.pdf. *See also* Leo Strine, *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Way Forward*, 63 BUS. LAW. 1079, 1101 n.74 (2008).

[174] *FSA Memo*, *supra* note 67.

[175] Coffee, *The Wreck of the CSX*, *supra* note 55.

[176] Rummell, *supra* note 70. *See also* Posting of Theodore Mirvis, Partner, Wachtell, Lipton, Rosen & Katz, to the Harvard Law School Forum on Corporate Governance and Financial Regulation, SEC Advises on Disclosure of Hedge Fund Positions, http://blogs.law.harvard.edu/corpgov/2008/06/12/sec-advises-on-dislcosure-of-hedge-fund-positions/ (June 12, 2008, 13:27 EST).

> swap party over shares acquired by its counterparty to hedge the relevant swaps, a 'conclusion [that] is not changed by the presence of economic or business incentives that the counterparty may have to vote the shares as the other party wishes or to dispose of the shares to the other party.'[177]

One can only hope that counsel at Wachtell is correct that the staff's views do not represent the formal position of the SEC and were tailored to the narrow questions posed by the *CSX* litigation.[178]

If the SEC refuses to act, boards of directors should take matters into their own hands and protect their companies from secret attacks that threaten corporate policy and effectiveness. While it is true that "delegating rule-writing power to companies is problematic, because company managers may well write rules that block vote-buying forms used by outside investors, while allowing forms used by insiders,"[179] this is not the goal or the effect of the proposed bylaw. Although it is unlikely that the political system, especially in the face of the 2008-09 financial crisis, will tolerate secret control and manipulation in the stock market much longer, corporations need to start taking preventive measures now.

## VII. CONCLUSION

This Note has delved into the economic and legal consequences of current financial innovation, particularly total return equity swaps that decouple voting rights from

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[177] Theodore N. Mirvis et al., Wachtell, Lipton, Rosen & Katz, SEC Staff Advises that 13D Disclosure Requirements Do Not Extend to Total Return Equity Swaps (June 9, 2008), http://blogs.law.harvard.edu/corpgov/files/2008/06/sec-staff-advises-that-13d-disclosure-requirements-do-not-extend-to-total-return-equity-swaps.pdf (quoting SEC Division of Corporate Finance Letter to the United States District Court, Southern District of New York, CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. June 11, 2008) (No. 08 Civ. 02764)) (alterations in original).

[178] *Id.*

[179] Hu & Black, *Decoupling I*, *supra* note 22, at 1019.

the economic position of a stock. The result of this practice is that holders of long positions in total return swaps are able to avoid federal disclosure rules and amass large secret stakes in corporations that can be turned into physical shares in a matter of minutes. Since the SEC has refused to fill the loopholes in the current disclosure regime, corporations are being urged to protect themselves by updating their bylaws to incorporate an advance notice provision requiring disclosure of synthetic positions to make nominations to the board or to bring other matters before shareholder's meetings.

Consequently, Delaware courts looking into the legality of the proposed advance notice bylaws will likely apply the stringent compelling justification standard of review because the defensive tactic interferes with shareholder rights. The decision to amend the bylaws is based on the rise in shareholder activism. That, coupled with the current financial crisis that left many companies undervalued and thus vulnerable to attack, means that a board of directors can likely meet the compelling justification standard. This leads to the conclusion that such provisions will likely be declared valid by the Delaware Chancery Court if and when their legitimacy is challenged.