

LEGAL UPDATES

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# Activist Shareholders' Stealth Tools: Empty Voting and Total Return Swaps

Developments in the 2008 proxy season brought to light the need for corporations to review their bylaws in preparation for the upcoming proxy season. Two developments - empty voting and the use of total return swaps - can create unusual voting incentives and allow accumulation of voting power without the knowledge of management. If they have not done so, we remind our clients to consider amending the disclosure requirements of their advance notice bylaw provisions to better identify these positions.

Empty voting refers to an arrangement by which an investor retains the ability to vote, but reduces the economic exposure to a company's stock. This can be accomplished through short-selling, buying put options, or selling stock after the record date has passed. This phenomenon is problematic because it lessens a shareholder's incentive to support value-enhancing actions. In fact, when shares are borrowed and then shorted, the party holding the vote would gain from a decrease in the stock price.

The related use of total return swaps to gain indirect voting influence is equally problematic. With a total return swap, the long counterparty agrees to pay to the short counterparty, who actually owns and votes the underlying stock, any decrease in the value of the stock. The short counterparty, conversely, agrees to pay to the long counterparty any increase in the value of the stock. Though primarily used as a hedging tool, the swap also has the effect of separating the economic exposure to the stock price from the voting rights of the stock, which are retained by the short counterparty. While the long counterparty does not directly have the right to vote the stock, it can often influence the short counterparty, who is insulated from any change in the stock's price, to vote as the long counterparty wishes. Activist shareholders have exploited this effect to gain an unseen influence over large blocks of stock.

Currently, the SEC requires disclosure by any investor who beneficially owns more than 5% of the stock of a company. However, the disclosure rule does not take into account the derivative or short positions that are used in these strategies. Therefore, disclosure of either of these arrangements is not required and management will not be aware of either blocks of voting influence accumulated using total return swaps or the negative voting bias created through empty voting.

However, a company can implement bylaw changes that force disclosure of these positions. We suggest clients consider adopting bylaw amendments that:

Require any shareholder who is nominating a director or proposing other business to disclose all of its positions in the company's stock, including derivative and short positions.

Require a follow-up disclosure if any of the shareholder's positions in the company's stock change up to the date of the vote.

Require the disclosure to be made sufficiently in advance of the meeting to give management adequate time to respond to the investor's proposals.

Expand the advance notice provision to cover special meetings in addition to annual meetings (currently, many advance notice provisions cover only proposals at annual meetings).

Create an ongoing disclosure obligation that arises anytime a shareholder exceeds a certain level of beneficial interest in the company, including through derivative and short positions.

Impose penalties for non-disclosure, including disqualification from nominating directors or proposing new business at the next annual meeting.

These provisions will not prevent investors from engaging in empty voting or creating synthetic ownership positions, but they will require disclosure prior to nominating or proposing new business. Disclosure itself may act as a deterrent and make a company a less attractive target for activists.

If you have any questions about our suggestions, please contact your Husch Blackwell Sanders attorney.

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