Toehold Accumulations: Further Convergence Between Private Equity and Hedge Fund Strategies

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Over the past few years, private equity funds and hedge funds have increasingly employed tactics traditionally employed by the other as part of their value maximization strategies. Underscoring this convergence has been a willingness by private equity funds to incorporate a "toehold" accumulation strategy into their investment model. As highlighted in an October 2016 *Wall Street Journal* article, accumulation strategies have been used by traditional private equity funds such as KKR, Vista Equity Partners, Golden Gate and Sycamore Partners in a number of situations.

One reason for this shift is a reduced incentive on the part of private equity funds to be viewed as the most "management-friendly" sponsor. Traditionally, private equity funds relied on strong relationships with a target's management team and a pro-management reputation to source and close acquisitions. The accumulation on the open market of a stake in a target company is often viewed as an "anti-management", hostile tactic. Private equity firms have therefore historically been hesitant to employ this approach as an alternative, or incremental, step to a whole company acquisition. However, the ability of management to influence a sales process has largely been neutralized by the Delaware Chancery Court's focus in recent years on conflicts of interest in going private transactions. Cases such as *In re J.Crew Shareholder Litigation*, 6043-CS (Del. Ch.), where the Court found that management had steered transactions to preferred bidders, have led to the increased prevalence of pre-signing market checks and post-signing "go-shop" periods, which open transactions to a range of bidders beyond any preferred private equity sponsor. In turn, private equity funds have become less focused on being viewed as management-friendly and more willing to consider strategies utilized by their hedge fund counterparts, such as acquiring a toehold position in a target company, to create leverage and hedge costs as they pursue investment targets.

Advantages

A private equity fund that pursues a toehold accumulation strategy could recognize a number of benefits, such as:

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- Market Pricing. The fund is able to accumulate a stake in the target company at market prices, which do not include a control premium.
- Head Start to Deal Certainty. The fund's stake in the target company may be attractive to a target in search of entering into a transaction with optimal deal certainty. In this scenario, the fund can enter into a voting agreement with respect to its shares in connection with a proposed acquisition of the target, thus offering a "head start" in obtaining stockholder approval and increasing deal certainty.
- Market Reaction. The accumulation may put the company "in play" by signaling interest to the market and attracting additional like-minded investors and potential acquirors to the company, thus increasing the chances that the fund acquires the company or otherwise benefits from a sale to another acquiror at a premium.
- Seat at the Table. The accumulation may enable the fund to seek a confidentiality agreement with the company in its capacity as a stockholder and/or provide greater access to management and a "seat at the table" with respect to the strategic direction of the company.
- Acquire Stockholder Rights. The fund will have access to the director nomination and shareholder proposal processes to which stockholders are entitled.
- Lawsuit Standing. The fund will have standing to bring lawsuits in respect of alternative strategies or transactions the company seeks to undertake.

Disadvantages

A private equity fund's use of a toehold accumulation strategy may also present certain disadvantages, such as:

- Reputational Risk. Use of an accumulation strategy may result in the fund earning an anti-management reputation and harm its relationships with public companies and investment bankers, thus making it less likely that it will be presented with potential transactions in the future.
- Lack of Due Diligence. Accumulation of a toehold position generally will need to be executed based solely on publicly available information, which represents a contrast from the extensive due diligence traditional private equity buyers often undertake prior to the deployment of capital.
- Downside Market Risk. An accumulation strategy will expose the fund to downside market risk in the event the stock price of the company decreases following purchase of the shares.

- Inflated Market Price. The fund's accumulation may result in an artificial increase in the stock price, thus making the acquisition of the full company more costly for the fund.

Legal Considerations

Private equity funds that engage in a toehold accumulation strategy should be mindful of certain considerations that will be applicable to their investments:

- Schedule 13D. A fund that acquires beneficial ownership of more than 5% of a target's stock will be required to file a Schedule 13D with the SEC within 10 days of exceeding the 5% ownership threshold. The Schedule 13D will disclose to the public the identity of the fund and those controlling the fund (but not the identity of their respective limited partners) and the amount of shares beneficially owned by such persons, as well as detailed information regarding the source of funds used to make the investment, the fund's purpose, plans and proposals with respect to the investment and any agreements or arrangements entered into by the fund with respect to the shares. Amendments to the Schedule 13D will be required to disclose any material changes to the previously filed Schedule 13D.
    - Derivatives Strategies. Complex derivatives strategies are often utilized to gain exposure to, or hedge against, the share performance of a company. Whether such derivative securities will count toward the 5% threshold is a fact-specific analysis for which legal advice should be sought.
    - Formation of a "Group". The securities laws provide that stockholders that "act together for the purpose of acquiring, holding, voting or disposing of equity securities" will form a "group" for purposes of filing a Schedule 13D and Section 16 (discussed below). The result of forming such a group is that each member will be deemed to beneficially own the shares of each other member. Investors should therefore take caution that their communications with other stockholders do not result in the unintended formation of a group. While the rule is not intended to pick up all discussions among stockholders regarding a company's management and direction, the determination as to whether communication among stockholders results in the formation of a group is highly fact-specific and we encourage investors to seek legal advice prior to entering into these discussions.
- Section 16 Filings. A fund that acquires beneficial ownership of more than 10% of a target's stock will be required to file a Form 3 with the SEC within 10 days of exceeding the 10% threshold, and a Form 4 with the SEC to disclose any future changes to the fund's beneficial ownership. An investor that becomes subject to Section 16 as a result of passing this threshold will also become subject to "short

swing liability" under Section 16(b) of the Exchange Act. This means that the company will be permitted to recover any profits derived from any purchase and sale, or sale and purchase, of the shares of the company by such investor within any six-month period, subject to certain exceptions.

- Antitrust Approval.
    - HSR Threshold. A fund seeking to acquire more than $80.8 million (as valued under applicable law) of a target's *voting* shares, including shares already held, is required to obtain approval under the Hart-Scott-Rodino Act (HSR) prior to such purchase. A fund will also be required to obtain additional HSR approval if it exceeds certain incremental thresholds in excess of $80.8 million.
    - Public Disclosure. The target, but not the public, will be notified of an HSR filing and the identity of the "ultimate parent entity" of the fund making the filing in respect of a proposed acquisition. Further, the receipt of HSR clearance will be made public if early termination of the 30-day HSR waiting period is requested and obtained. Investors are urged to consult with counsel at the early stages of structuring their fund to ensure that the HSR process will not result in the unintended disclosure of the fund's investors as the so-called ultimate parent (*i.e.*, the 50% owner).
    - Derivatives Strategy. It is important to note that HSR clearance need only be obtained for the accumulation of *voting* securities in excess of certain thresholds, and investors therefore often enter into derivative transactions to increase economic exposure without obtaining an interest in *voting* securities exceeding the applicable threshold. Whether a derivative arrangement will count towards the HSR threshold requires a highly technical analysis, and investors are urged to consult with counsel to ensure that the thresholds are not inadvertently exceeded through use of derivatives transactions.
    - Parallel Funds. Purchases of shares by parallel funds within the same fund family are not always aggregated for purposes of calculating the applicable HSR threshold; aggregation is required only if the parallel funds share the same ultimate parent, which is often not the case.
- Fund Documentation. A fund seeking to implement a toehold strategy should review its fund documents to ensure that it is not contractually restricted from acquiring a minority position in a public company or exercising its rights as a minority stockholder to, among other things, run a proxy contest or make an unsolicited bid to acquire the company.

- Insider Trading. An investor may not trade in shares of a company while in possession of material, nonpublic information about the company if the investor obtained or received the information in violation of a fiduciary duty or other relationship of trust and confidence owed to the company, its shareholders, or the source of the information. As a general matter, an investor's own ideas or plans with respect to a particular company are not considered to be material nonpublic information; nor is information that an investor has received directly from a fellow investor if such investor does not have a duty to keep such information confidential. However, the securities laws do expressly provide that an investor may not acquire shares of a company if it is aware, on a nonpublic basis, that a third party has taken substantial steps toward commencing a tender offer for the shares of that company. Again, the determination as to whether information held by an investor will run afoul of these requirements is highly fact-specific and legal advice should be sought in making this determination.

- Business Combination Statutes. Investors should take note of the jurisdiction of organization of the applicable target and any "business combination" or similar statutes to which the target is subject. These laws generally provide that an investor exceeding a certain percentage of ownership in a company (in the case of Delaware, 15%) may not, absent target board support, enter into a business combination with the target for a certain amount of time following accumulation of a stake in excess of the relevant threshold (in the case of Delaware, 3 years). Certain states, including Delaware, allow companies to expressly opt out of the "business combination statute" in the company's organizational documents.

- Stockholder Rights/Company Defenses. The target's organizational documents, along with applicable state statutes, should be reviewed in order to determine the rights available to stockholders of the company, and the defenses available to the company in resisting stockholder influence. The organizational documents and the relevant statutes will set forth a framework for the availability of stockholder rights, such as the ability of stockholders to nominate directors and make other shareholder proposals, remove directors, call special stockholder meetings, act by written consent and fill vacancies on the board, and any impediments to a stockholder's use of these rights. A firm understanding of these rights is critical to an investor, particularly if the investor intends to seek board representation, commence a proxy contest or make a hostile bid to acquire the company. Furthermore, investors should take note of whether the company has a poison pill in place that will limit the amount of shares the investor may acquire without target board approval.

- Industry-Specific Ownership Restrictions. Investors should understand the regulatory framework applicable to the target companies in which they seek to invest and that which is applicable to the investor itself. For instance, the organizational documents

for companies that qualify as REIT's and certain types of media companies often contain ownership limitation provisions to ensure compliance with tax and regulatory requirements. In addition, investors that are affiliated with bank holding companies are subject to limitations on their ability to invest in certain other types of companies.

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