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GROUP THERAPY

SEC RULES CAN CONFOUND PARTNERSHIPS BETWEEN PRIVATE EQUITY FIRMS AND HEDGE FUNDS

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A recent case provided some narrow guidance on an increasingly important issue for private equity and hedge funds: what constitutes a group for Securities and Exchange Commission purposes.

A person beneficially owning 5% of a public company must make disclosures on SEC Form 13D within 10 days of reaching the numerical threshold. Recognizing the trigger, however, is increasingly difficult as private equity funds invest with hedge funds in situations traditionally dominated by hedge funds, and vice versa. Interactions and communications with other funds may be construed as acting "in concert," the talisman for group existence under 13D and treatment as a single "person" for SEC purposes.

Ten percent owners (including groups) are subject to Section 16(b)'s short-swing profit limitations. If a group sells and purchases securities of a public company within six months, all profits must be disgorged to the company. Six months is not a long investment hold for a private equity fund, but it is a lifetime for hedge funds. Historically, private equity funds primarily made long-term investments in private securities of private companies, and sometimes private securities of public companies, like private investments in public equity, or PIPEs. Hedge funds invested in liquid markets featuring rapid trading patterns.

There are differences, so radical as to be almost genetic, between their respective thought processes, investment time-horizons and branding aspirations. As private equity and hedge funds increasingly invest with each other outside their traditional investment boundaries and partners, the likelihood increases that misunderstandings may arise based on deeply ingrained, but different institutional assumptions.

Broadly stated, the decision in Litzler v. CC Investments held that no group was formed when three independent hedge funds purchased an entire Series C convertible preferred round. At the company's request, they used a single lawyer as principal drafter for final negotiation. Plaintiff suggested that group behavior occurred because the funds collectively bought the entire private placement, each converted to common, and none purchased a subsequent tranche of securities. "Careless drafting" (including referring to the lead lawyer as "investors' counsel") was insufficient, however, to establish a group. The court highlighted that no individual fund intended to "exercis[e] control" of the company, and the company "did not consider the three [hedge funds] as a group."

Frustratingly, there is no bright-line test. Groups may be created intentionally (by written action) or inadvertently (by conduct or speech). Common street practices (ranging from funds sharing information and analyses to collectively purchasing a private placement) could theoretically create a group. Meeting the same investment banker, and individually and collectively expressing dissatisfaction with management, have been judicially cited as potential evidence of a group. Prior cases have even counter-intuitively suggested that funds with different investment intentions about the same company could still be considered a group. The Litzler court observed that factors as external and subjec-

tive as how a third-party perceives the relationship (in this case the company's views) may be relevant in finding group existence. Prior cases also were influenced by how potential groups were perceived by others, usually shareholders.

Private equity funds commonly accumulate open-market stock (deliberately staying below 5% ownership) while simultaneously negotiating a private placement with the same public company. If at (or about) the same time a private equity fund and hedge fund "communicate" about the company, a group may be formed, depending on the nature and intention of the communications. Given the fluidity of dealmaking, their respective intentions may not be clear at the outset to either themselves or others. They may never "agree" to work together with respect to a particular company, nor fully share with each other their intentions or beneficial ownerships. Without that knowledge, the funds may literally not even know if they are a "group," and if they are, whether 5% ownership has in fact been reached, requiring that a 13D should be filed.

Technical SEC analysis aside, many private equity funds want to be known as constructive, value-added investors. In the long term, they need management's trust. Hostility is not the marketplace perception they seek. Visible alignment with hedge funds may be inconsistent with their overall strategies since perceptions are strongly affected by which entity the public identifies as a fund's partner. If a private equity fund files a 13D with a hedge fund whose goals with respect to a company are different, and potentially more hostile, the public association may adversely affect the private equity fund's "brand." Since groups can be formed without having identical investment "intentions," 13Ds may be filed by members of the same "group" but accurately state and reflect different investment intentions, and levels of aggressiveness.

Some hedge funds, however, may welcome a hostile reputation. Aggregating beneficial holdings may increase their apparent strength, negotiating leverage, or market impact. Filing a 13D with aggressive "control" intentions may be desirable. Under this hypothesis, a private equity fund may want to avoid group characterization and a 13D filing while a hedge fund may seek it.

The major countervailing tension for a hedge fund is avoiding 10% ownership, and being subject to short-swing profit disgorgement. This limitation is normally inconsistent with a hedge fund's short-term trading strategies.

Today's markets are highly politically charged. Previously acceptable behavior may now be more rigorously scrutinized and interpreted. If group formation is not a fund's goal, then conduct creating even the appearance of a group should be avoided. Every fund should examine and formalize its processes regarding sharing information, strategy or trading intentions with third parties. Heightened caution is the new mantra. ■

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