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De-Coupling of Economic and Voting Power in Public Companies – Equity Ownership Derivatives Create Unforeseen Dangers

New uses of swaps and other equity derivatives, securities loans, and stock purchases timed around record dates have moved well beyond the framework of current disclosure and regulatory regimes. Creative investors and financial intermediaries have mastered a variety of synthetic and temporary ownership techniques which – at least facially – may allow stock or debt accumulations to fly beneath the radar of existing disclosure regimes, have unexpected or counter-intuitive consequences under arrangements such as change-of-control provisions in indentures and other instruments as well as under shareholder rights plans, and create voting arrangements quite different from the traditional coupling of economic interest with voting power in public companies. Examples of situations in which such arrangements have played a very substantial role in corporate control contests, or otherwise been the subject of judicial, regulatory or media scrutiny, include King/Mylan, Sears Canada, the control battle for Endesa, and the emerging CNet situation.

As complex transactions relating to corporate ownership and control have grown beyond the framework contemplated by the drafters of our corporation, securities and other laws and regulations, and, equally important, beyond the assumptions underlying many corporate and financial instruments, these "hidden ownership" and "empty voting" phenomena have also begun to receive significant scholarly attention, including seminal work by Henry T.C. Hu and Bernard S. Black. Evolution of the existing regulatory and judicial framework to take into account these new transaction forms and instruments is likely.

In this changing environment, these non-traditional ownership and voting arrangements should be approached with caution, by companies and investors alike. Companies should review their fundamental documents, including by-laws, shareholder rights plans, employee change-in-control contracts and other compensation plans, and debt and commercial arrangements with these non-traditional ownership arrangements in mind. Companies may be surprised at how such instruments are (or are not) affected by these transactions. Amendments should be made, where possible, to ensure that the purposes served by existing arrangements are not subject to being undermined by non-traditional ownership and corporate control arrangements.

On the other hand, investors should not assume that the increased popularity of these non-traditional ownership arrangements carries with it any tacit endorsement by regulators, stock exchanges or, especially, courts. Not every financing or ownership structure, even if complicated or unconventional, is inherently an abuse or subject to legal recharacterization. But arrangements that are technically compliant with relevant statutes and regulations may not stand up to scrutiny by regulators and courts, who may take a critical view of complex arrangements where they seem designed to evade basic corporate and securities law regulatory norms and requirements. Particular emphasis will likely be placed on when and how such arrangements must be disclosed to the public markets, and whether adequate detail is being provided to allow companies and other corporate constituencies to properly assess the consequences of particular transactions.

Non-traditional corporate ownership and voting arrangements have moved from the fringes to the mainstream. With their increased prevalence will come greater scrutiny by regulators, courts, companies and various corporate constituencies. Both companies and investors need to be mindful of the pitfalls ahead in this shifting corporate ownership and voting landscape.

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