

Is the Fix In? — Are Hedge Funds Secretly Disenfranchising Shareholders?

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One guiding principle governing shareholders' rights is that shareholders – those who have an economic interest in the success of a corporation – must have a voice in certain important corporate decisions, and that voice is expressed and exercised through voting. What becomes of the principles underlying shareholder democracy when an investor is permitted to purchase voting rights in a corporation where that investor has no economic stake in the corporation's success or failure? Theoretically, assuming an investor had the voting power to control corporate events, yet had no economic stake in the corporation, the investor could force corporate action that benefited only that investor to the detriment of the corporation itself and its other shareholders.

Under the law, investors cannot simply purchase naked voting rights in a corporation. However, if an investor sufficiently hedges the investment in the corporation so that the net effect of the investment is a neutral position – meaning the investor has no economic stake in the corporation – the investor would in effect simply be purchasing voting rights. This novel issue was recently raised in a lawsuit pending in the Middle District of Pennsylvania titled *High River Limited Partnership v. Mylan Laboratories, Inc., Robert Coury, Perry Corp., Richard C. Perry et.al.*, Civ. Action No. 04-CV-2677. Billionaire investor Carl Icahn filed suit against Perry Corp. and others accusing Perry of, among other things, manipulation supposedly in aid of Mylan Labs' proposed bid for King Pharmaceuticals. It is alleged that Perry purchased a block of voting rights without "at the same time acquiring economic interests in the shares." (Complaint at §2). This was accomplished by supposedly purchasing "reciprocal market positions in which the exposure to the underlying security is fully hedged." *Id.*

The Wall Street Journal reported on this litigation on December 15, 2004:

Here's how it works: Perry owns 9.9% of Mylan, or 26.6 million shares. But the firm has no economic interest in the stock, having entered into hedging transactions for its entire position. While Perry was buying all that stock, it had a cooperative brokerage firm (or firms) short an equal amount of Mylan stock -- selling shares borrowed from shareholders. At the same time, Perry got the right to sell its shares back to the brokerage, while the brokerage received the right to call the stock back from Perry -- all at the same price. The result is a wash. That means Perry is indifferent to the price of Mylan, having no economic interest in it. Nevertheless, it retains nearly 10% of Mylan's voting rights, becoming one of its most powerful shareholders.

Why would Perry go through all this trouble? Because the hedge fund owns seven million shares of King and wants Mylan's takeover bid to go through, boosting the value of Perry's stake in King -- as the *New York Times* and the *Daily Deal* noted in stories about the matter.

In reporting on this lawsuit, the *Wall Street Journal* poses a most poignant question – "[I]awyers say it all appears perfectly legal, but should it be?"

The idea of vote-buying is not new. In Delaware, the seminal case is *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982), in which the Delaware Court of Chancery examined the history of vote-buying jurisprudence in Delaware. *Schreiber* involved a corporate restructuring of Texas International Airlines, Inc. ("Texas International") via a share-for-share merger between Texas International and Texas Air Corporation ("Texas Air"). Jet Capital Corporation ("Jet Capital") was a large shareholder which, by virtue of its ownership of a certain amount of preferred stock, was in a position to block the proposed merger. A problem for Jet Capital was that it held warrants to purchase Texas International common stock. Jet

Capital lacked the necessary funds to exercise the warrants, and if the merger were consummated prior to the warrants being exercised the tax consequences to Jet Capital would have been "intolerable." An independent committee of Texas International directors, acting with the advice of independent financial and legal consultants, determined that the best solution was for Texas International to make a loan to Jet Capital, in exchange for Jet Capital's vote in favor of the merger. Although the Texas International shareholders voted overwhelmingly in favor of the loan proposal, and there was never any allegation that facts were not fully disclosed, the plaintiff in *Schreiber* alleged, among other things, that the loan amounted to vote-buying and was therefore void and a waste of corporate assets.

The court explained that "[the] vote-buying [in this instance], despite its negative connotation, is simply a voting agreement supported by consideration personal to the stockholder, whereby the stockholder divorces his discretionary voting power and votes as directed by the offeror." The court then examined the history of Delaware jurisprudence in this area and discerned two distinct principles: First, that vote-buying is illegal *per se* "if its object or purpose is to defraud or disenfranchise other stockholders" - and a fraudulent purpose is defined at common law as "a deceit which operates prejudicially upon the property rights of another"; and second, that vote-buying is illegal *per se* as a matter of public policy because "each stockholder should be entitled to rely upon the independent judgment of his fellow stockholders." Significantly, the court clarified the second principle by explaining that "while self-interest motivates a stockholder's vote, theoretically, it is also advancing the interests of the other stockholders. Thus, any agreement entered into for personal gain, whereby a stockholder separates his voting right from his property right was considered a fraud upon this community of interest."

The court then stated that the policy reasons that traditionally made vote-buying illegal *per se* were no longer applicable in that Delaware has discarded the presumption against voting agreements. The court quoted Fletcher's *Cyclopedia Corporation* for the idea that courts have generally abandoned the above principles because "it is both impracticable and impossible of application to modern corporations with many widely scattered stockholders." The court also cited to *Ringling Bros., Etc., Shows, Inc. v. Ringling*, 53 A.2d 441 (Del. 1947), in which the Delaware Supreme Court stated that "generally speaking, a shareholder may exercise wide liberality of judgment in the matter of voting, and it is not objectionable that his motives may be for personal profit, or determined by whims or caprice, so long as he violates no duty owed to his fellow stockholders." The court also cited to *Oceanic Exploration Co. v. Grynberg*, 428 A.2d 1 (Del. 1981), which upheld a voting trust in which a stockholder gave up his right to vote on all corporate matters in exchange for valuable consideration.

Ultimately, the court in *Schreiber* held that an agreement involving the transfer of voting rights without the transfer of ownership in the company should be considered illegal *per se* only if the object or purpose is to defraud or disenfranchise other stockholders. Given the facts of *Schreiber*, the court specifically ruled that the purpose of the loan was to create a benefit for all shareholders, and that ratification of the loan by fully informed shareholders precluded further judicial inquiry.

The *Schreiber* decision, therefore, can be interpreted to permit the separation of voting rights from property interests so long as the two interests are not separated for the improper purposes of defrauding or disenfranchising other shareholders. The actions of Perry Corp. are arguably illegal *per se* even given the modern view where courts have permitted much wider latitude regarding voting rights.

If plaintiff's allegations in the *Mylan* case are correct, then Perry Corp. was essentially buying votes so that it could cause Mylan to enter into a deal with King which would benefit Perry Corp arguably to the detriment of the other Mylan shareholders. Contrary to the alleged vote-buying in *Schreiber* which was transparent, disclosed and subject to shareholder approval, the alleged vote buying scheme at issue in *Mylan* was undisclosed. It seems that the law simply did not envision what appears to be the purchase of naked voting rights such that the holder can affect corporate policy without any duty or any stake in the corporation's future. Plaintiff in *Mylan* alleges that "[u]nless checked, this unlawful technique of vote-buying will compromise the integrity of the securities markets. If shareholder voting rights are divorced

from shareholder ownership, legitimate expectations of corporate democracy will be undermined.” (Complaint, §3). This intriguing issue certainly merits deliberation.

Milberg Weiss is involved in litigation involving the Mylan transaction. The views expressed in this article are those of the authors and do not necessarily express the views of the law firm Milberg Weiss Bershad & Schulman LLP.

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