

Second Circuit: Factual Issues Remain as to Whether a Hedge Fund Is a Beneficial Owner That Must Disgorge Short-Swing Profits

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On November 23, 2020, the Second Circuit vacated a grant of summary judgment against a hedge fund and remanded, concluding that factual issues remained as to whether the hedge fund was the beneficial owner of more than 10% of a retail company's shares such that it must disgorge short-swing profits under section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78p(b). [Packer v. Raging Cap. Mgmt.](#), 981 F.3d 148 (2d Cir. 2020) (Newman, J.). Defendants claimed that the hedge fund was not the beneficial owner by virtue of an agreement in which the hedge fund delegated to its registered investment advisor investment and voting authority for the shares. In its opinion, the Second Circuit rejected each of the district court's reasons for ruling that the delegation was not effective.

Background

The hedge fund at the center of this case is the customer of a registered investment advisor, Raging Capital Management ("RCM"). Investments from the public were funneled to the hedge fund by two feeder funds. The relationship between the hedge fund, RCM and the two feeder funds was governed by an investment management agreement ("IMA"), which Defendant William Martin signed on behalf of all four parties. Martin holds positions in RCM, the hedge fund and one of the feeder funds, and has an indirect role with the other feeder fund.

Litigation Commences

In 2015, plaintiff brought a derivative lawsuit on behalf of a retail company against RCM, the hedge fund, and Martin, "to obtain disgorgement of profits resulting from a short-swing sale of [the retail company's] stock." Initially, the complaint "alleged that the three defendants were a group for purposes of determining beneficial ownership and that the group had beneficial ownership of more than ten percent of [the retail company's] Class A common stock." However, discovery showed that the hedge fund held more than 10% of the outstanding shares during the relevant trading period. The district court granted plaintiff's motion for summary judgment and ordered the hedge fund to disgorge nearly \$5 million in short-swing profits for violating section 16(b). Defendants appealed.

Beneficial Ownership Under Section 16(b)

The Second Circuit began its discussion by stating that section 16(b) of the Exchange Act “requires a ‘beneficial owner’ of more than ten percent of a company’s shares to disgorge profits obtained from a short-swing sale.” Under the relevant rules, “a beneficial owner of a security includes any person who . . . has or shares: (1) Voting power which includes the power to vote, or to direct the voting of, such security; and/or (2) Investment power which includes the power to dispose, or direct the disposition, of such security.” Additionally, “a person is deemed to be a beneficial owner of a security if that person has the right to acquire beneficial ownership of such security within sixty days.” However, as is relevant to this case, the SEC has also advised “that if a security holder has delegated all authority to vote and dispose of its stock to an investment advisor and lacks the right under the contract to rescind the authority granted . . . within 60 days, the security holder does not need to report beneficial ownership of the securities.”

Defendants sought to avoid the hedge fund’s beneficial ownership by virtue of the IMA through which the hedge fund delegated to RCM investment and voting authority for the shares. The district court ruled that the delegation was not effective. The Second Circuit vacated the grant of summary judgment, rejecting each of the district court’s three reasons for ruling that the delegation was not effective.

Rejecting Delegation on the Basis of an Intertwined Relationship Impermissibly Extends Section 16(b)

As to the district court’s first reason, the Second Circuit set forth what it termed “basic principles concerning section 16(b)[,]” explaining that section 16(b) “imposes a form of strict liability,” and is a remedy which should be “applied narrowly.” The court then stated that it would “not be consistent with these principles” to accept the district court’s reason for concluding that delegation failed because of “the intertwined relationship of these parties[.]” The Second Circuit concluded that “using generalized wording such as ‘intertwined’ or ‘not unaffiliated’ to bring a person within the coverage of Rule 13d-3(a) would extend the reach of section 16(b) beyond the text of both the statute and the rule.”

Acting as a Customer’s Agent for One Purpose Does Not Make an Investment Advisor an Agent for All Purposes

The district court based its second reason for rejecting the delegation on Second Circuit precedent that included *Analytical Surveys v. Tonga Partners*, 684 F.3d 46 (2d Cir. 2012), where as “a result of these state-law-based agency relationships, both the limited partnership and the limited partner’s agent were liable for a violation of section 16(b) by the managing member of the general partner.” However, the Second Circuit stated that in the “pending case, there is no comparable state-law-based agency relationship between [the hedge fund] and RCM. They are both distinct corporations, and the [d]istrict [c]ourt did not rule that the corporate veil could be pierced.” The Second Circuit pointed out that “making an investment advisor a customer’s agent for the specified purpose of carrying out the advisor’s traditional functions for a customer does not make the advisor an agent for all purposes.” Further, the court stated that “[n]either *Tonga* nor *Huppe*, nor anything in SEC statutes, rules, or guidance, supports such a result.”

Signing Authority Is Not Necessarily Authority to Amend or Terminate

The district court’s third reason for rejecting delegation was its view that Martin had the power to amend the IMA, allowing him to eliminate the notice requirement in the IMA’s termination provision, ending the delegation within 60 days of acquiring shares which would trigger application of section 16(b). The Second Circuit explained that the district court “based its view of Martin’s authority to *amend* the IMA on the fact that he had *signed* it on behalf of all four parties to the agreement.” The Second Circuit quickly dispatched this reasoning stating that “[a]uthority for an individual to sign a document on behalf of an entity, however, does not necessarily carry with it authority to commit those entities to making changes in, or terminating, that document.”

The Second Circuit stated that it was “not clear at this point” whether Martin could amend the IMA on behalf of the hedge fund and the feeder funds. The Second Circuit held that the district court “could not, on a motion for summary judgment, determine that Martin could alter the IMA on behalf of all four entities with strokes of a pen.” The court continued that “[i]t remains to be determined as a factual matter whether, under all the relevant circumstances, Martin is in control of [the hedge fund] and the feeder funds with authority to commit these entities to altering or terminating the IMA.” The court explained that whether such a “determination can be made on a renewed motion for summary judgment, after the record has been expanded, or will require a trial is a matter initially for the [d]istrict [c]ourt on remand.”

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