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ENTIRE FAIRNESS LITIGATION

The Standing Demand Committee

By Robert B. Greco and Matthew D. Perri

Recently, corporations and fiduciaries have faced enhanced litigation risk arising from entire fairness claims challenging related-party transactions and other transactions implicating unique interests of corporate fiduciaries. This risk is most pertinent for controlled public corporations, although it has also affected public and private corporations with significant non-majority holders.

The prospect of costly entire fairness litigation has also proven to be ripe for exploitation by "entrepreneurial plaintiffs' lawyers,"[1] as this risk can alone supply plaintiffs with considerable settlement leverage. And this risk is not limited to the M&A sale transactions that have historically been the focus of stockholder litigation. Numerous other circumstances, such as financings and compensation awards, could implicate entire fairness review.

But importantly, Delaware Supreme Court decisions over the past several years have confirmed that challenges to these types of

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The Passive/Aggressive Investor: Significant New SEC Staff Interpretive Guidance on Schedule 13G Eligibility

By Ron Mueller, Jim Moloney, Aaron Briggs, Beth Ising, Tom Kim, Brian Lane, Lori Zyskowski, Mickal Haile, and Matt Staugaard

On February 11, 2025, the Staff in the Division of Corporation Finance (Staff) of the U.S. Securities and Exchange Commission (SEC or the Commission) issued updated and new Compliance and Disclosure Interpretations (C&DIs)[1] that are likely to significantly impact how investors engage with public companies. These interpretations address beneficial ownership reporting on Schedule 13G vs. Schedule 13D (13G and 13D, respectively), expand the nature and scope of activities the Staff views as "influencing control of the issuer" (which could deter otherwise passive investors who own more than 5% of a company's voting securities from certain forms of engagement to avoid becoming ineligible to rely on 13G reporting), and could require groups of smaller social activist shareholders to become subject to 13D reporting.

The Staff's recent guidance underscores the agency's increasing scrutiny of institutional investors' corporate governance stewardship activities, particularly in the context of environmental, social, and governance (ESG) matters.

Key Changes to 13G Filing Eligibility Standards

Shareholders, including those acting as a group, that beneficially own more than 5% of a class of registered voting securities must report their ownership on either a 13G or a 13D. To maintain eligibility to report on 13G instead of 13D,[2] a shareholder must certify that the subject securities "were not acquired and are not held for the purpose of or with the effect of changing or influencing the control of the issuer." A 13D requires more detailed information on a shareholder's beneficial ownership of and transactions in a subject company's shares, as well as its plans and proposals with respect to the company and requires prompt amendments for any material changes in the reported information.

1. 13G Filing Eligibility and Shareholder Engagement.

In revised C&DI 103.11, the Staff reaffirmed that a shareholder's inability to rely on the Hart-Scott-Rodino Act's exemption from notification and waiting period requirements for an acquisition made "solely for the purpose of investment" would not affect a shareholder's ability

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to report on 13G. The Staff emphasized that a shareholder's ability to report on 13G instead depends on whether its activities suggest an intent to influence control of the company. The guidance reminds investors that such determination necessarily entails a factual analysis of the shareholder's actions and intentions in relation to "control" as defined under Exchange Act Rule 12b-2.[3] Notably, as shown by the redline that the Staff now provides when it revises its C&DIs, the Staff withdrew its prior guidance that engagement with a company on executive compensation, environmental, social, or other public interest issues, or on corporate governance topics unrelated to a specific change of control, without more, would generally not cause a loss of 13G eligibility.

2. Actions Constituting a "Purpose or Effect of Influencing Control".

In new C&DI 103.12, the Staff addresses circumstances that in its view would preclude an investor from reporting on 13G because it held securities with a disqualifying "purpose or effect of changing or influencing control of the issuer." The interpretation makes clear that a shareholder exerting "pressure" to adopt governance measures, particularly tied to ESG or political policy matters, may be viewed as an attempt to influence control over the company.

When Does Engagement with Management Cross the Line?

The new and revised C&DIs state that engaging with a company's management on corporate governance or other policy matters could, depending on all the relevant facts and circumstances, result in a disqualification from reporting on 13G. This is particularly relevant for investors whose activities, though intended to push for governance changes or ESG-driven policies, may be interpreted as attempts to influence control. The Staff's recent interpretation aligns with comments made by SEC Acting Chairman Mark Uyeda, who previously stated that asset managers' voting policies on ESG matters may qualify as attempts to exert control over management.[4] According to the Staff, investors exerting pressure on management to implement specific measures or changes to a policy would be influencing control over the company. Such examples of exerting pressure over the company include the following:

1. *Subject Matter Engagement*: Shareholders engaging with management to specifically call for control-related actions – such as a sale of the company or a significant amount of assets, restructuring, or the election of director nominees other than the company's nominees – would be disqualified from 13G eligibility solely due to the subject matter of the discussion or communications.

2. *Context of Engagement*: Under C&DI 103.12, a "shareholder who discusses with management its views on a particular topic and how its views may inform its voting decisions, without more, would not be disqualified from reporting on a Schedule 13G." However, "pressuring" management to adopt specific measures or tying support for directors to the adoption of certain proposals (*g.*, removal of staggered boards, changes to executive compensation practices, eliminating poison pill rights plans, undertaking specific actions relating to an environmental, social, or political policy, and stating or implying during any such discussions that it will not support one or more of the company's director nominees at the next annual meeting as a means of "pressuring" a company to adopt a particular recommendation) may also risk the loss of 13G eligibility. "Pressure" can be direct or indirect, express or implied.

SEC Guidance on 13D Group Formation

The Staff's guidance should be read in conjunction with the SEC's October 2023 Release,[5] which described examples of activities and/or communications that would not give rise to

formation of a Section 13(d) group. According to the Commission, the following scenarios would **not** give rise to group formation:

1. *Discussions in private or public forums*: Meetings between two parties or an independent, free exchange of ideas among shareholders at a conference, without the intent to engage in concerted actions or agreements related to securities acquisition, holding, or disposition, are not considered group activity.

2. *Discussions with company management*: Engaging with company management and other shareholders to jointly recommend board structure and composition, without discussing individual directors, expanding the board, or pressuring the board to take specific actions, does not form a group.

3. *Non-binding shareholder proposals*: Having conversations about or submitting a non-binding shareholder proposal jointly with others does not constitute group activity.

4. *Conversations with activist investors*: Conversations, emails, phone calls, or meetings between a shareholder and an activist investor seeking support for proposals, without further coordinated actions, are not considered group activity.

5. *Announcement of voting intentions*: Announcing an intention to vote in favor of an unaffiliated activist investor's director nominees, without further coordinated activity, does not form a group.

In contrast, a substantial shareholder sharing information with the intent of inducing others to purchase the same stock, where those purchases directly result from the information shared, could raise the possibility of group formation.

These scenarios provided by the Commission offer useful guidance for investors who may communicate with a public company and its shareholders, but do not want to inadvertently become a member of a group.

Implications and Possible Impact of the Staff's Interpretations

The Staff's views expressed in the C&DIs foreshadow stricter scrutiny on passive investors' 13G status and create new risks for investors (or groups of investors) when communicating with management and boards at public companies. The new C&DI introduces the concept of "pressure," which will be difficult to administer in practice and is, ultimately, a subjective standard. Investors should be mindful of the risk that, if a company believes the investor has crossed the line to "pressure" the company, it may contact the Staff to question whether the investor should be filing on a 13D and provide more details on its beneficial ownership and related transactions, as well as its intentions, including any plans or proposals, with respect to the company. The only example of "pressure" that is provided in the C&DIs is conditioning support for the company's director nominees at the next election of directors.

While these interpretations should rein in the minority of 13G filers who campaign on various ESG issues subject to a threat of voting against directors, they will likely influence the actions of large institutional investors who in recent years have sought to address ESG matters through their own "board accountability" voting policy standards (which those institutions have in recent years increasingly relied on in lieu of supporting shareholder proposals on such issues). The interpretations also raise the possibility that groups of investors that collectively own more than 5% of a company's stock, including smaller social activist investors that individually hold less than 5% of a company's stock, could be viewed as forming a 13D group if they coordinate to urge companies to adopt specific climate-change, diversity, equity and inclusion, or other ESG policies, particularly if backed by pressure through a "vote no" campaign.

The updated C&DIs should prompt investors who are reporting on 13G, as well as smaller activist investors who are not 13D or 13G filers but have signed on to various ESG letter-writing and other campaigns, to reassess their strategies.

Passive investors who have traditionally filed on 13G despite pushing for governance or ESG-related changes should now assess whether their actions could be seen as attempts to exert "pressure" and may need to change their approach to protect their 13G eligibility.

While it is theoretically possible for investors reporting on 13G to temporarily opt to report on 13D, many mutual funds and other investors face institutional or practical restrictions that make 13D reporting unrealistic. As a result, those investors may seek to avoid or minimize any communications that could be viewed as exerting "pressure" or attempts to exert control. Passive investors who chose to migrate from 13G to 13D in situations where communications relate to control-related issues or rise to the level of "pressure" may be able to revert back to 13G reporting once the shareholder engagement is completed and a vote taken on the matter at hand.

There are other notable collateral, and possibly unintended, consequences of the Staff's revised interpretations. For example, companies engaged in a proxy contest may find it more difficult to engage with their largest institutional investors, as those investors may be concerned that expressing views on issues arising in the contest could be viewed as pressuring company management and, therefore, triggering 13D reporting.

Ironically, if faced with less transparency from their large institutional shareholders, companies may become more reliant on engaging with and attempting to sway the major proxy advisory firms. Even outside of the context of an actual proxy contest, another unintended consequence may be a stifling of dialogue between large institutional investors and companies, a decrease in transparency on how these investors intend to vote, and possibly an increase in abstentions.

Practical Considerations for Investors and Companies

The Staff's updated guidance on 13G eligibility risks chilling the type of routine engagement that many companies have sought to foster and believe better positions them with their investors to help ward off proxy contests and other forms of traditional activism. With respect to the upcoming proxy season, we understand that some investors have already begun canceling or delaying long-scheduled engagements with companies as they assess the implications of the Staff's guidance. As a result, companies may need to consider enhancing their disclosures and considering alternative additional solicitation strategies to ensure they are effectively communicating their key messages to investors.

Nevertheless, while the determination of whether an investor is acting with a control purpose or intent will depend on all the relevant facts and circumstances, there are some guideposts that investors and companies should bear in mind:

1. The C&DI expressly states that a shareholder who discusses with management its views on a particular topic and how its views may inform its voting decisions, without more, generally would not be disqualified from reporting on a 13G.

2. Discussions around non-binding proposals, such as votes on management's say-on-pay proposals and discussions with non-proponents regarding shareholder proposals, should present less risk of being viewed as applying pressure on management or attempting to influence control of the company.

3. Investor responses to company-initiated inquiries regarding the investor's views on a particular issue, and investor references to other companies' practices or disclosures that the investor views as favorable, without more, should present less risk of being viewed as applying pressure on management or attempting to influence control of the company. As a result, companies will need to be more proactive in requesting engagement with investors and asking questions about key topics during those engagements.

4. Companies and investors may explore additional steps to foster productive discussions

that avoid creating a mis-impression that an investor is seeking to apply pressure when that is not the investor's intent. For example, when applicable, some investors might seek to clarify with a company that voting decisions are made on a case-by-case basis, by a committee, or by individual portfolio managers, and therefore that the investor's engagement team should not be viewed as representing how the investor will vote on a particular matter.

5. The C&DI notes the context in which an engagement occurs is highly relevant in determining whether a shareholder is holding securities with a disqualifying purpose or effect of "influencing" control of the company and, as such, off-season engagements may present less risk of losing 13G eligibility.

Ultimately, the latest C&DIs are likely to chill institutional investors' willingness to engage with companies as candidly as in recent years and could lead to unexpected negative votes on director elections, say on pay, or other matters. As a result, companies and boards will need to stay highly attuned to investor sentiment as expressed through other means, such as voting policies and public statements, and seek to maintain open channels of communication year-round to avoid these risks and ensure alignment on key governance and ESG matters. Companies and boards are encouraged to review their shareholder engagement activities, and consult with outside counsel as needed, on specific situations considering the Staff's new guidance.

Conclusion

The Staff's latest guidance signals a more stringent approach to shareholder activism, with a new emphasis on engagement as a factor that may cause a shareholder to lose its 13G eligibility. Shareholders who have traditionally been viewed as passive should be more mindful of how their actions (overt or implicit) and communications with management and boards may be seen as constituting "pressure," particularly with respect to governance, environmental, social, and political policy matters. In many instances, views as to what amounts to "pressure" may be in the eye of the beholder. As a result, we recommend training, clarifying ground rules between parties, and avoiding one-on-one communications between companies and shareholders.

Notes

1. Specifically, the Staff revised Question 103.11 and issued a new Question 103.12 under "Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting."

2. Rule 13d-1(b) and Rule 13d-1(c) require the shareholder to certify that the securities were not acquired and are not held with a disqualifying purpose or effect. Any person who acquired beneficial ownership before a company's voting securities were registered under the Exchange Act can report on 13G pursuant to Rule 13d-1(d) regardless of control over the company.

3. Exchange Act Rule 12b-2 defines "control" (including the terms "controlling," "controlled by" and "under common control with") as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

4. U.S. Securities & Exchange Comm., Nov. 17, 2022, *https://www.sec.gov/news/speech/uyeda-remarks-cato-summit-financial-regulation-111722* (remarks of Comm. Uyeda at Cato Summit on Financial Regulation).

5. *See* SEC Release Nos. 33-11253; 34-98704 (Oct. 10, 2023) at *https://www.sec.gov/files/rules/final/2023/33-11253.pdf*.

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