european corporate governance institute

Anti-Activist Poison Pills

Law Working Paper N° 364/2017
Revised August 2017

Marcel Kahan
New York University and ECGI
Edward B. Rock
New York University and ECGI

© Marcel Kahan and Edward B. Rock 2017. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

This paper can be downloaded without charge from:
https://doi.org/10.67929/ecgi-law-364-2017

european corporate governance institute

ECGI Working Paper Series in Law

Anti-Activist Poison Pills

Working Paper N° 364/2017

August 2017

Marcel Kahan
Edward B. Rock

We like to thank for helpful comments Bill Allen, GuyLaine Charles, Steve Fraidin, Sean Griffith, Jeff Gordon, Joe Grundfest, Mike Klausner, Travis Laster, Victor Lewkow, Martin Lipton, Brian Schorr, Bernard Sharfman, Leo Strine, Steve Wolosky, and participants in workshops at Boston University, Stanford, Tel Aviv University, and the NYU Roundtable.

© Marcel Kahan and Edward B. Rock 2017. All rights reserved. Short sections of text, not to exceed two paragraphs, may be quoted without explicit permission provided that full credit, including © notice, is given to the source.

Abstract

Hedge funds have become active in corporate governance. They push for changes in strategy and the adoption of specific business plans. Their tactics include buying shares, conducting public campaigns, lobbying managers and other shareholders, seeking representation on the board of directors, and sometimes running a proxy contest. In response, boards have adopted a variety of "defensive measures" including deploying "poison pill" shareholder rights plans against activists.

This article provides a comprehensive policy and doctrinal analysis of the use of poison pills again activists in corporate governance contests (as distinguished from corporate control contests). We argue that, because of the significance of the specific design features – features that have so far received little judicial attention – it is increasingly important to scrutinize pills to assure that they are targeted to address legitimate objectives. Various design features of a pill interact and features that may be harmless in pills designed to fend off a hostile takeover are unjustifiable in pills employed against an activist hedge fund. While a board, acting in good faith, should be permitted to use a pill to preserve and perfect the shareholder decision-making process, it should, in doing so, act as a "neutral election board."

Keywords: Corporate Governance, Shareholder Activism, Hedge Funds, Poison Pill

JEL Classifications: G30, G34, K22

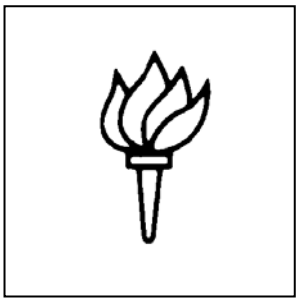
Marcel Kahan*
George T. Lowy Professor of Law
New York University, School of Law
40 Washington Square South
New York, NY 10012, United States
phone: +1 212 998 6268
e-mail: marcel.kahan@nyu.edu

Edward B. Rock
Professor of Law
New York University, School of Law
40 Washington Square South
New York, NY 10012, United States
phone: +1 212 998 6363
e-mail: edward.rock@nyu.edu

*Corresponding Author

NEW YORK UNIVERSITY SCHOOL OF LAW

LAW & ECONOMICS RESEARCH PAPER SERIES
WORKING PAPER NO. 17-08



Anti-Activist Poison Pills

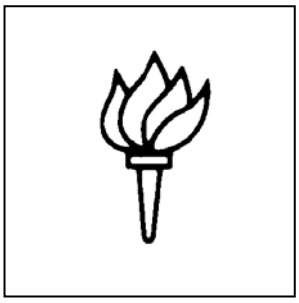
Marcel Kahan and Edward B. Rock

August 2017

Electronic copy available at: https://ssrn.com/abstract=2928883

NEW YORK UNIVERSITY
SCHOOL OF LAW

LAW & ECONOMICS RESEARCH PAPER SERIES
WORKING PAPER NO. 17-08



Anti-Activist Poison Pills

Marcel Kahan and Edward B. Rock

August 2017

Anti-Activist Poison Pills

Marcel Kahan* and Edward Rock**

Abstract

Hedge funds have become active in corporate governance. They push for changes in strategy and the adoption of specific business plans. Their tactics include buying shares, conducting public campaigns, lobbying managers and other shareholders, seeking representation on the board of directors, and sometimes running a proxy contest. In response, boards have adopted a variety of "defensive measures" including deploying "poison pill" shareholder rights plans against activists.

This article provides a comprehensive policy and doctrinal analysis of the use of poison pills again activists in corporate governance contests (as distinguished from corporate control contests). We argue that, because of the significance of the specific design features – features that have so far received little judicial attention – it is increasingly important to scrutinize pills to assure that they are targeted to address legitimate objectives. Various design features of a pill interact and features that may be harmless in pills designed to fend off a hostile takeover are unjustifiable in pills employed against an activist hedge fund. While a board, acting in good faith, should be permitted to use a pill to preserve and perfect the shareholder decision-making process, it should, in doing so, act as a "neutral election board."

* George L. Lowy Professor of Law, New York University School of Law
** Professor of Law, New York University School of Law
We like to thank for helpful comments Bill Allen, GuyLaine Charles, Steve Fraidin, Sean Griffith, Jeff Gordon, Joe Grundfest, Mike Klausner, Travis Laster, Victor Lewkow, Martin Lipton, Brian Schorr, Bernard Sharfman, Leo Strine, Steve Wolosky, and participants in workshops at Boston University, Stanford, Tel Aviv University, and the NYU Roundtable.

Introduction

Little Red Ridinghood Corp (LRR) has had mediocre performance for some time and its stock price has lagged. Lupin LLP, an activist hedge fund, has spent a good deal of time researching LRR and has accumulated 9.2% of its shares. At a regular "ideas dinner" held by a group of seven New York City based hedge funds, Lupin discussed LRR, why LRR's stock price has declined, and what could be done to reverse the trend. Shortly after the dinner, one of the other hedge funds, Remus LLP, acquired 5.1% of LRR.

LRR's board, having become aware of the stakes accumulated by Lupin and Remus, has turned to outside counsel for advice. Can LRR adopt a poison pill in defending against a proxy challenge by Lupin? Would a pill with a 10% trigger be permitted under Delaware law? LRR's board is particularly concerned that Lupin and Remus will act in a "consciously parallel" manner that will interfere with the company and its long term plans. Could LLR's board adopt a "wolf pack" provision in its pill that imposes a 15% cap on parallel acquisitions of shares by any investors?

Our opening hypo is only slightly hypothetical. Activist hedge funds are in the news -- again. According to numerous reports, activism is at an all-time high. Assets under management by activist funds have increased substantially, by some estimates eight fold between 2002 ($23 billion) and 2015 ($173 billion).[1] Surveys report 1,115 activist campaigns between 2010 and early 2014.[2] In 2016, as many as 456 U.S. companies, including 104 companies in the S&P 500 index, were publicly subjected to activist demands, an increase over 2015's total of 418 companies.[3] Well-known companies hitherto thought too large to be attacked – such as Procter & Gamble and Coca-Cola – find themselves targets of activists.[4] As the assets managed by activist funds increase further, the number of targeted companies, their size, and the stakes activists can afford to take in

[1] Schulte, Roth & Zabel, 2016 Activist Investing: An Annual Review of Trends in Shareholder Activism. 2014 Lee and Schloetzer at 2, citing "Hedge Fund Asset Flows: Monthly Summary Report March & Q1 2014"; Alistair Barr, Swashbucklers Hit the Wall, Sep. 14, 2016, available at http://www.marketwatch.com/story/activist-hedge-fund-returns-wane-as-their-niche-gets-crowded (noting increased competition for activist opportunities); Schulte, Roth & Zabel, Activist Insight 2017 Annual Review at p. 8 (reporting $176 billion held by funds with focus on activist investing at the end of 2016).

[2] Liz Hoffman & David Benoit, Activist Funds Dust Off Greenmail Playbook, The Wall Street Journal Europe, June 13, 2014 at 22.

[3] Schulte, Roth & Zabel 2017 Annual Review, supra note 1, at 7, 22.

[4] Sharon Terlep, P&G Repels Trian in Bid over Board,, Wall St. J., July 18, 2017, at B1; Latest Company in Activist Crosshairs: Coca-Cola, chief investment officer, July 25, 2015 available at https://www.ai-cio.com/news/latest-company-in-activist-crosshairs-coca-cola/; see also J.P. Morgan, The Activist Revolution at 6 (2015) (reporting 17 campaigns against companies with a market capitalization above $25 billion in 2014, compared to 6, 4, 5, and 5 in the four preceding years).

their targets are likely to increase as well.[5] Once hedge fund activists become involved, they regularly succeed in either getting the targeted company to adopt some of their proposals or in obtaining board representation.[6]

These and similar data have lead the press and commentators to talk of an almost "hyperbolic" increase in hedge fund activism.[7] Shareholder activism has also become a political issue. Hillary Clinton called for "a new generation of committed, long-term investors to provide a counter-weight to the hit-and-run activists …" Senators Sanders and Warren co-sponsored the Brokaw Act to "increase transparency and strengthen oversight of activist hedge funds."[8] The Act was named for a small town that went bankrupt after a local paper mill that had been targeted by a hedge fund was closed.[9] Prominent money managers, executives, and judges have expressed concern that activists induce managers to pursue short-term financial goals at the expense of building long-term value.[10] The combination of high profile shareholder activism combined with

[5] A rule of thumb is that activist hedge funds target firms that are approximately the same size as the fund, thereby striking a balance between focus and diversification.

[6] Activists often secure board seats with only the explicit or implicit threat of a proxy fight, without even filing any proxy materials. Gibson Dunn, 2016 Year-End Activism Update (2017) available at http://www.gibsondunn.com/publications/Documents/MAReport-2016-Year-End-Activism-Update.pdf. Activists are also very successful in achieving board representation in the cases where they proceed to a proxy fight. In 2015 and 2016, in companies with a market cap greater than $500 million, dissidents succeeded obtaining board representation in around 40% of the proxy fights, mostly through settlements. See Lazard Corporate Preparedness Group, Short Slate Proxy Contests (2012-2016) (reporting that in 2015 and 2016, 97 and 124 seats, respectively, were obtained through settlements and 9 and 7, respectively, through a shareholder vote).

The rise is activism has produced a cottage industry of empirical studies trying to determine the average effect of activist efforts on various measures of company value. See, e.g., Lucian A. Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085 (2015) (finding that activism is associated with increase in company value); Martijn Cremers et al., Hedge Fund Activism and Long-Term Firm Value (November 19, 2015). Available at https://ssrn.com/abstract=2693231 (finding that activism is associated with decrease in company value). We view these efforts as somewhat off the mark. It is not just because the empirical evidence, unsurprisingly, arrives at different conclusions. Rather it is principally because activism is a heterogeneous and evolving phenomenon. The effects of activism are likely to differ systematically depending on the style of the activist, the type of target, and the year the activism took place – and, most importantly, the skills of a particular activist and quality of the business plan it wants to pursue. Moreover, market participants will over time learn which activists, and what time of business plans, are more likely to succeed and companies will learn to what extent they should adopt certain aspects of the plans pushed by activists. Thus, from a policy perspective, the average effect of past activism is of little significance.

[7] See, e.g., John C. Coffee and Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 1 Annals of Corporate Governance 1 (2016) (surveying evidence and concluding that "[h]edge fund activism has recently spiked, almost hyperbolically").

[8] Portia Crowe, Bernie Sanders and Elizabeth Warren are going after activist hedge funds, Mar 18, 2016, available at http://www.businessinsider.com/elizabeth-warren-sponsors-activist-hedge-fund-bill-2016-3; Jason N. Ader and Eric Jackson, DealBook: Senate Bill Would Limit Shareholder Rights, N.Y. Times, Mar. 24, 2016 (criticizing bill).

[9] The Mystery of the Brokaw Act, May 17, 2016, available at http://www.valuewalk.com/2016/05/brokaw-act-hedge-funds/ (explaining that Wausau Paper had an obsolete plant in Brokaw; after being targeted by Starboard Value, Wausau closed several plants and was eventually sold); but see Alon Brav et al., Anti-Activist Legislation: The Curious Case of the Brokaw Act (2016). Available at SSRN: https://ssrn.com/abstract=2860167 (finding that activists played no role in the plant closing); Ader & Jackson, supra note 8 (suggesting that closing of unprofitable plant averted bankruptcy).

[10] See infra Section II.C.

a growing concern about "short termism" is the wind in the sails of lawyers' efforts to modify poison pills to defend against activism.

In this article, we examine the role of poison pills in today's corporate governance landscape. This issue emerges from the intersection of two related phenomena: the transformation of the poison pill from a takeover defense to a more widely-used corporate law device; and the evolving role of shareholders – activist, institutional and other – in corporate governance. If we are right in our assessment that a new balance of power is emerging in which the largest institutional investors are becoming the de facto "deciders" of corporate governance, it becomes important to understand the role of poison pills in that context.

Although pills have been in common use as anti-takeover devices since the 1980s, we argue that it is only now – in the context of anti-activist pills – that many design features of pills start to matter. The reason lies in the difference in the sources of gains derived by the raiders of yore and by today's activists. In takeovers, the bidder's primary gains are expected to come from acquiring the company and improving it. As a result, bidders neither need to nor, it turns out, in fact buy substantial blocks of shares before they acquire a company. Hence, pill features such as the trigger threshold, the types of ownership interests that count towards the threshold, and the rules on aggregation of shares held by other investors turned out to be largely irrelevant.

By contrast, today's activists generally expect to profit from an increase in the value of their stakes in the target that they hope to result from significant operational changes, increased dividends, asset sales, or the sale of the company.[11] For activists, pill features that affect the size of their stake are thus of the utmost importance.

This is the first article that provides a comprehensive policy and doctrinal analysis of the

[11] As activism has grown, a variety of styles have emerged that can be usefully arrayed along a continuum from hostile to cooperative. Some activists seek confrontation with target management. Dan Loeb at Third Point, discussed in connection with Sotheby's, infra Section II.b., sometimes exemplifies this style. New funds that are actively raising capital may often pursue a confrontational strategy in order to gain publicity.

Other activists present themselves as "supportive" of management. Relational Investors, headed by Ralph Whitworth, http://www.rillc.com/ralph-v-whitworth.htm, became involved with companies such as Hewlett Packard because of a sense that they could be better managed, and ended up with Whitworth as chair of the board of directors. http://www.forbes.com/sites/forbesleadershipforum/2014/01/29/why-ralph-whitworth-may-be-americas-best-board-member/. More recently, ValueAct Capital has also generally pursued a cooperative strategy. http://www.valueact.com/about.pl. Trian, in its engagements with Bank of New York Mellon and General Electric, has presented itself as a "highly engaged shareowner" that can provide "validation capital," that is, an engaged, minority investor that closely scrutinized management's strategy, and, when convinced, provides credible outside validation. David Benoit, Activists Win a Seat at the Table, Wall St. J., Dec. 26, 2015. Bill Ackman and Carl Icahn adopt different approaches for different targets.

The heterogeneity among fund strategies generates interesting strategic dynamics. Cooperative (and to a lesser extent, the more moderate) funds may appeal to boards arguing that, given that a firm may have to put some activist on the board, it might as well be them. At the same time, aggressive funds may succeed in inducing substantive changes (even if they do not obtain board representation) because incumbents want to avoid having their representatives in the boardroom.

use of poison pills against activists. We argue that, because of the significance of the specific design features – features that have so far received little judicial attention – it is increasingly important to assure that they are targeted to address legitimate objectives. As we show, the various design features of a pill interact and features that may be harmless in pills designed to fend off hostile takeovers are unjustifiable in pills employed against activist hedge funds.

In Part I, we review the legal validation of the shareholder rights plan as an anti-takeover device. We then contrast bidders' incentives to acquire shares in the control context with the various reasons why activists acquire stakes in target companies.

In Parts II and III, we turn to the core questions raised by anti-activist pills: What potential threats are posed by activists and what responses are justified in response to these threats? In particular, we discuss whether threats posed by activists justify expanding the pill's trigger to include synthetic equity; discriminating between new and incumbent shareholders or between activist and passive investors; and, returning to our opening hypo, adopting provisions designed to inhibit "wolf packs." The answers to these questions will help to determine the ways in which pills will be used to structure corporate decision making in the evolving landscape.

We close with a brief conclusion.

I. Poison Pills and Financial Incentives

a. Poison Pills as an Anti-Takeover Device

Poison pills were developed in the 1980s as an anti-takeover device. The validity of poison pills received a big boost when the Delaware Supreme Court upheld a flip-over pill in *Moran v. Household International*.[12] *Moran* remains noteworthy for two reasons. First, it establishes the doctrinal framework for analyzing pills. When faced with an actual bid, the decision whether to redeem the rights issued under the pill is subject to enhanced scrutiny under *Unocal*: the bid must constitute a threat and retention of the pill must be reasonable in relation to the threat.[13] Second, it ties the validity of pills to a bidder's ability to succeed with a hostile tender offer even in the presence of a pill. Most importantly, *Moran* noted that a bidder could conduct a proxy contest to replace the board – and have the new board redeem the pill -- while the bid was pending.[14] From the start, the possibility of a proxy contest was thus critical to the legitimacy of the pill.

Following *Moran*, the structure of pills and the courts' doctrinal analysis evolved in several

[12] 500 A.2d 1346 (Del. 1985). For a clear summary of the development of the poison pill case law, see Chancellor Chandler's opinion in Air Products v. AirGas, 16 A.3d 48, 91-103 (2011). A "flip-over" pill discourages takeovers by granting shareholders the right to acquire shares in the acquiring company at a discount.
[13] Moran, 500 A.2d at 1356.
[14] Id. at 1354.

ways. First, flip-in features were added to pills.[15] Unlike flip-over pills, flip-in pills constrain the acquisition of a large block of company stock even if a bidder does not pursue a subsequent freeze-out merger and effectively prevent bidders from acquiring shares beyond the trigger level. Second, courts clarified that pills could be validly employed against the threat posed by a tender offer made at an inadequate price -- and the accompanying threat that shareholders would tender their shares in the mistaken belief about the long-term value of the company.[16] Moreover, courts showed substantial deference to a board determination that a bidder's offer was inadequate. As a result, courts rarely forced the redemption of a poison pill under *Unocal.*

The principal path for a bidder to remove a poison pill thus became the proxy contest route outlined in *Moran*. In effect, the poison pill moved the decision on the success of a hostile bid from shareholders voting with their feet (by tendering their shares in a tender offer) to shareholders voting by ballot (by replacing a majority of the board).

Along the way, the trigger threshold used in pills started to creep down. If a 20% trigger only has a minimal impact on conducting a proxy contest, as found by the court in *Moran*, why not adopt a pill with a lower threshold? Over time, the trigger threshold used in pills fell from 20% to 15% and then to 10%.[17]

But surprisingly, the trigger threshold turned out to be largely irrelevant. In the early 1980s, bidders acquired a substantial stake before commencing a tender offer. Mesa Petroleum, for example, owned 13% of Unocal before commencing the tender offer that gave rise to the landmark 1985 decision in *Unocal Corp. v. Mesa Petroleum*.[18] By contrast, in modern takeover practice, bidders rarely acquire substantial pre-bid toeholds.[19] For example, when Air Products made a hostile bid for Airgas in 2010 and conducted a proxy contest to replace the board, it owned just 1.8% of the Airgas shares.[20]

To get a rough sense of the current prevalence of toeholds, we collected data from Thompson Reuters on proposed takeovers that were classified as hostile. There were 24 such proposals between 2010 and 2015. Of these, the bidder acquired a stake that came close to the pill

---

[15] Flip in pills were held valid in Stahl v. Apple Bancorp, 579 A.2d 1115 (Del. Ch. 1990), later cited approvingly by the Delaware Supreme Court in Stroud v. Grace, 606 A.2d 75, 91-92 (Del. 1992). "Flip-in" pills discourage takeovers by granting the non-bidder shareholders the right to acquire shares in the target at a steep discount, thereby diluting the holdings of the bidder. For a precursor to a flip-in pill, see Revlon, Inc. v. MacAndrews & Forbes, Inc., 507 A.2d 173 (1986) (finding that notes rights plan that discriminated between bidder and other shareholders was reasonable in relation to threat posed).

[16] Paramount Commc'ns, Inc. v. Time Inc., 571 A.2d 1140, 1153 (Del. 1990).

[17] Arthur Fleischer et al., Takeover Defense: Mergers and Acquisitions, §5.5[C].

[18] 493 A.2d 946 (Del. 1985).

[19] Sandra Betton, B. Espen Eckbo and Karin S. Thorburn, Merger Negotiations and the Toehold Puzzle, 91 J. Fin. Econ. 158 (2009) (figure 3). For a fuller discussion, see B. Espen Eckbo, Bidding Strategies and Takeover Premiums: A Review, 15 J. Corp. Fin. 178 (2009).

[20] http://www.sec.gov/Archives/edgar/data/2969/000095012310069776/y85780defc14a.htm at 40. The trigger threshold of the Airgas pill was 15%. Air Products. 16 A.3d at 62.

threshold in only five instances. In the nineteen others, bidders either had no significant stake (17) or one substantially below the pill threshold (2).

In control contests, the profits from acquiring the target – rather than the profits derived from a toehold -- provide a financial incentive for the bidder. Bidders thus have incentives and the requisite credibility to conduct a proxy contest, to dismantle a pill and facilitate the acquisition, even when they hold no material stake in the target at the time of the contest.[21] Because bidders often do not come close to reaching even the lower bound of conventional pill thresholds, the fine print of a flip-in pill is largely irrelevant to them. To be sure, it remains essential that a bidder does not trigger the pill through the receipt of proxies obtained in a proxy contest and that, if the bidder succeeds in replacing a board majority, the new board can redeem the pill. But these two limitations on poison pills have long been established elements of Delaware law.[22] Beyond that, little mattered.

b. Poison Pill Thresholds and Activist Shareholders' Financial Incentives

Unlike for bidders, the particular features of pills – most importantly, the trigger threshold and what ownership interests count towards it -- are highly significant for activists. Activists acquire an economic interest in a target for at least three reasons. First and foremost, they want to profit. Activist hedge funds study the company and develop proposals which, in their assessment, would increase the company's share price. Some activists develop detailed business plans and hire financial and business advisors to assist them in their task. After devising a strategy, activists need to spend resources to persuade the board to adopt it or to convince other shareholders to exert pressure on the board. In some instances, activists decide to wage a proxy contest, which entails further expenses. Even if all these activities end up increasing the company's share price, activists will only derive profits if the increase in the value of their stake exceeds the expenses they incur. The larger the stake, the lower is the break-even point at which an increase in the price per share produces profits for an activist.

The contrast with bidders for control is critical. As we explained above, in control contests,

[21] There are several disadvantages to acquiring toeholds that, judged by bidders' actions, generally outweigh the obvious benefits. These disadvantages include disclosure requirements under the Hart-Scott-Rodino Act and the Williams Act, substantive antitrust concerns, concern that acquiring a toehold will make it more difficult to reach a friendly deal, tying up capital, creating a conflict of interest between the toehold bidder (as target shareholder) and other target shareholders, and the possibility that a toehold may lead to rational overpayment (Eckbo, supra note 19). Not acquiring a toehold also sends a credible signal that the bidder seeks to profit from an acquisition, rather than from a competing transaction (or, in the old days, greenmail). At the same time, in negotiated transactions, termination fees allow bidders that are willing to commit themselves to a merger to cover their costs if the target ultimately accepts a superior offer.

[22] See Moran, 500 A.2d at 1346; Quickturn Design Systems, Inc., v. Shapiro, 721 A.2d 1281 (Del. 1998) (holding that delayed redemption provision is pill impermissibly constrains power of future boards).

a bidder's profits mainly come from buying the target and increasing its value. In activism, profits come from improving the company *without* acquiring it. The activist's share of the gains is limited to its pro rata stake, with other shareholders taking a free ride on any increase in company value generated by the activist.[23]

Second, a larger economic stake lends credibility to activists. Activists are trying to induce the company to adopt all or part of their proposals, either by persuading the board or by inducing other shareholders to support their proposals and thereby increase pressure on the board. But neither the board nor other shareholders may pay much attention to proposals put forth by an activist who holds only a small stake in the company.[24] Even if they listen to the proposal, they may be concerned that an activist with a small stake has a second agenda: that the activist is seeking to benefit not by the increase in the value of its shares – an increase that would also benefit fellow shareholders – but in some other way that may come at the expense of other shareholders. By contrast, an activist with a large stake could persuasively claim that it is putting its money where its mouth is. And an activist who keeps buying shares signals confidence that the share price will increase further – presumably when its proposals are implemented.[25]

Last, but not least, a larger block of shares provides the activist with more votes in a proxy contest. Other things being equal, a larger number of votes controlled by an activist increases the likelihood that that the activist will prevail in a contested vote and thus make the threat of waging a contest more credible.

Indeed, many proxy contests by activists involve small companies in which activists have taken a sizeable stake. Of the 37 contested solicitations in 2016, 32 had a market cap of less than $1 billion, four had a market cap between $1 billion and $2 billion, and only one (Norfolk Southern) involved a company with a market cap of more than $2 billion, the standard threshold for "mid cap" companies. In 15 of these contests, the dissident held a stake of 5-10%; and in 10 contests, the dissidents held a stake in excess of 10%.[26]

In sum, in the takeover context, even a pill that is far more restrictive than conventional – say a pill with a threshold of 1% -- would not stop a hostile bid in its track. A bidder would acquire a small toehold,[27] announce a hostile bid, and threaten a proxy contest if the board failed to redeem

---

[23] Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 11 Colum. L. Rev. 863, 903 (2013).

[24] In a large company, even a small percentage stake can lend credibility to an activist. For example, ValueAct held only about 1% of the shares in Microsoft when it successfully engaged with the company, but these shares had a value of $2 billion. Emily Glazer and Shira Ovide, Hedge Fund Takes $2 Billion Stake in Microsoft, Wall St. J., April 22, 2013. http://www.wsj.com/articles/SB10001424127887324874204578439111840584342.

[25] For example, by acquiring stakes in both Pepsi and Modelez, Trian credibly signaled its belief that its proposed combination of the two companies followed by a spin-off of the beverage business a merger of Pepsi and Modelez would benefit both companies. http://blogs.wsj.com/moneybeat/2016/05/13/nelson-peltzs-trian-exits-pepsico-stake/

[26] Georgeson, 2016 Annual Corporate Governance Review, supplemented by additional research.

[27] A small toehold may be required for a bidder to obtain standing to challenge defensive measures. Omnicare, Inc. v.

the pill. If shareholders found the bid attractive, the proxy contest would likely succeed despite the bidder's small stake and the bidder would recoup the costs of the contests from the profits of the acquisition.

By contrast, pills that are overly restrictive could, in the extreme, eliminate the profits from activism—and thereby activism itself. As we will discuss in Part III, there are four terms that have particular salience: the trigger threshold; the treatment of "synthetic" equity that does not carry voting power; triggers that treat different shareholders differently; and the treatment of "concerted" action and wolf packs. Because of the sensitivity of activists' financial incentives to the terms of poison pills, courts must examine the specifics of the provision and the impact of the provision in a particular factual context and should not presume that provisions that have become garden variety in the takeover context should be valid as well in the activist context.

II. The Doctrinal Analysis: The Threat Posed

Delaware courts apply the "enhanced scrutiny" standard developed in *Unocal* and subsequent cases to review director conduct "affecting either an election of directors or a vote touching on matters of corporate control."[28] The *Unocal* framework applies in particular to a board decision to maintain a poison pill when faced with a potential or actual proxy challenge by a shareholder activist.[29] The application of *Unocal*, rather than the business judgement rule, to review the use of pills against activists is based on the recognition that the pill has an inherent

NCS Healthcare, Inc., 809 A.2d 1163, 1170-72 (Del. Ch. 2002); J. Travis Laster, The Line Item Veto and Unocal: Can A Bidder Qua Bidder Pursue Unocal Claims Against A Target Corporation's Board of Director's, 53 Bus. Law. 767, 768 (1998).

[28] Pell v. Kill, 135 A.3d 764, 786 (Del. Ch. 2016) (Mercier v. Inter-Tel (Delaware), Inc., 929 A.2d at 811; see also Stroud, 606 A.2d at 92 n.3 (holding that enhanced scrutiny applies whenever a board takes unilateral action "touch[ing] upon issues of control" (quotation marks omitted); Gilbert v. El Paso Corp., 575 A.2d 1131, 1144 (Del. 1990) (holding that a court must apply enhanced scrutiny whenever the board acts "in response to some threat to corporate policy and effectiveness which touches upon issues of control"). This enhanced scrutiny is a generalization of *Unocal/Unitrin* and may incorporate within it, depending on context, the "compelling justification" concept from *Blasius*. MM Cos., Inc. v. Liquid Audio, Inc., 813 A.2d 1118, 1129-31 (Del. 2003); accord Stroud v. Grace, 606 A.2d 75, 92 n.3 (Del. 1992) ("In certain circumstances, a court must recognize the special import of protecting the shareholders' franchise within Unocal's requirement that any defensive measure be proportionate and reasonable in relation to the threat posed." (quotation marks omitted)), quoted in Pell, 135 A.2d at 785 n. 8.

[29] See Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 329 (Del. Ch. 2010). The compelling justification standard from *Blasius* does not apply because pills do not disenfranchise shareholders in the sense of preventing them from freely voting and do not prevent a shareholder from soliciting proxies. *Id.* at 335; Third Point LLC. v. Ruprecht, 2014 WL 1922029 at *15 (Del. Ch. 2014) ("Since Moran, both this Court and the Supreme Court have used Unocal exclusively as the lens through which the validity of a contested rights plan is analyzed. This includes cases in which a rights plan has been used outside of the hostile takeover context. Thus, it is settled law that the Board's compliance with their fiduciary duties in adopting and refusing to amend or redeem the Rights Plan in this case must be assessed under *Unocal*.")

entrenchment effect[30] and that proxy challenges raise obvious entrenchment concerns.[31]

The starting point for any analysis under *Unocal* is the identification of a threat. A proper threat is required as a threshold matter to justify a measure subject to review under *Unocal*. Moreover, the nature and gravity of a threat determines whether a measure is reasonable in relation to that threat.[32]

In the context of a hostile takeover bid – the original context of *Unocal* – the court has identified numerous potential threats. In practice, however, the principal threat used to justify pills in hostile takeovers is that the bid price is inadequate and that shareholders will tender their shares in the mistaken belief that the bidder is making a good offer.[33]

The poison pill has become something of an inter-doctrinal legal transplant: a device developed and regulated in the context of hostile takeovers that has been transplanted into a variety of other contexts.[34] As with any transplant, one cannot assume that the issues raised in the new context will be identical to or resolved in the same way as in the original context. Here, the key transplant is from a pill deployed against a takeover bidder versus a pill deployed against an activist. This requires rethinking what counts as a threat and what it takes to establish the presence of this threat.

a. Mistaken Belief

The most obvious threat arguably posed by an activist is that even though, in the assessment of the board and its advisors, the activist's proposals are not in the best interest of shareholders, shareholders may nevertheless support the activist because they mistakenly believe otherwise. Such a threat is analogous to the threat generally claimed to be presented by an inadequate hostile bid.

The key difference, however, is context: the "threat" of an inadequate bid is that shareholders will mistakenly *tender* their shares; here, the potential "threat" is that shareholders

[30] Versata Enterprises, Inc. v. Selectica, Inc. 5 A.3d 586, 599 (Del. 2010).

[31] This approval of pills (subject to *Unocal*) outside of the classic hostile tender offer context is an important development that could not have been predicted when pills first appeared on the scene and is consistent with other areas where pills have become permitted. Thus, in a series of opinions beginning in 2002, Delaware has permitted boards to deploy a poison pill against controlling shareholders, Hollinger International v. Black, 844 A.2d 1022 (Del. Ch. 2004), aff'd 872 A.2d 559 (Del. 2005), and has even suggested that doing so might be required. In re CNX Gas Corp. Shareholder Litigation, 4 A.3d 397, 413, 415 (Del. Ch. 2010); Louisiana Municipal Police Employees' Retirement System v. Fertitta, 2009 WL 2263406 at *8. Later, the Delaware courts authorized low threshold (4.99%) poison pills to protect the value of net operating losses. See Versata, 5 A.3 at 586. As with innovations in other fields, with time we learn the application and the limitations and become more comfortable with additional uses.

[32] Paramount Communications, 571 A.2d at 1140.

[33] These threats are equivalent because, if shareholders realized that the bid price is inadequate, there would be no need for a pill to fend off an un-coercive offer: the offer would fail on its own accord.

[34] Edward Rock & Michael Wachter, Dangerous Liaisons: Trust Law, Corporate Law and Inter-doctrinal Legal Transplants, 96 Nw. U. L. Rev. 651 (2002).

will mistakenly *vote* against what the board thinks is best.

The difference in context makes a huge difference in outcome. Delaware courts have been steadfast in holding that a decision by shareholders to vote against what the board believes is best does *not* pose any cognizable threat. As now Chief Justice Strine held while on the Chancery Court, "The notion that directors know better than the stockholders about who should be on the board is no justification at all."[35] And as a recent Chancery Court opinion echoed: "there is one justification that the directors cannot use to justify their actions: they cannot argue that without their intervention, the stockholders would vote erroneously out of ignorance or mistaken belief about what course of action is in their own interests."[36]

The rationale for these holdings dates back at least to the landmark opinion by Chancellor Allen in *Blasius Ind. v. Atlas Corp.*

> The shareholder franchise is the ideological underpinning upon which the legitimacy of directorial power rests. … [I]t is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own. Thus, when viewed from a broad, institutional perspective, it can be seen that matters involving the integrity of the shareholder voting process involve considerations not present in any other context in which directors exercise delegated power.[37]

The logical consequence of the reasoning in *Blasius* is that – as long as shareholders are provided with full information and the vote is free from structural flaws such as coercion – a board's determination that shareholders are likely to vote "the wrong way" is not a legitimate basis for taking defensive measures. If shareholders can be trusted to vote intelligently, then there is no reason for the board to interfere. But if shareholders cannot be trusted to vote intelligently, then the incumbent board – which was the product of a prior (and likely uncontested) shareholder vote in which shareholders likely did not pay close attention -- lacks legitimacy as well. And the contention that shareholders could be trusted to vote intelligently in electing the incumbent board, but now cannot be trusted and require protection against their own foolish choices, in addition to being patently self-serving, gets things exactly backwards.[38]

b. Disruption

Another arguable threat is that an election contest, and the actions of the activists, cause

[35] Mercier, 929 A.2d at 811.
[36] Pell, 135 A.2 at 788.
[37] 564 A.2d 651, 659 (Del. Ch. 1987).
[38] See also Leo E. Strine, Jr., The Story of Blasius Industries v. Atlas Corp., in Corporate Law Stories 243, 290-91 (J. Mark Ramseyer ed., 2009) ("[W]hat was core to Blasius was that the judiciary not accept the doctrine of substantive coercion as a justification for director conduct affecting the election process.").

disruption in the operation of the target. In *Third Point LLC v. Ruprecht*, for example, Sotheby's faced an activist challenge by Third Point, a hedge fund run by Daniel Loeb. In the case, the court noted that Daniel Loeb – whose hedge fund Third Point had taken a stake in Sotheby's – acted in an "aggressive and domineering manner"[39] and represented himself "to some of Sotheby's employees at a December 2013 art show . . . as the person who 'was going to be appointing management in the future.'" [40] According to Sotheby's, potential clients expressed concern about the stability of Sotheby's going forward.

To the extent that an activist advocates changes in the company's business practices, other parties – such as Sotheby's employees and clients – could well feel insecure. To reassure stakeholders who feel insecure, it may be justifiable to adopt reasonable measures to protect them *in case the activist succeeds* – such as "tin" parachutes for lower level employees or long-term contracts for key suppliers.[41]

But, although the disruption created by an election contest can harm the company, this harm cannot justify poison pills. Contested board elections *inherently* create uncertainty about the future management. But it is the very purpose of a contested election is to resolve disagreements about business strategy. To achieve this purpose, activists must be permitted – in fact, they should be encouraged -- to state their business plans. If these plans scare the company's employees, customers, suppliers, etc., this is the unavoidable consequence of corporate democracy. Without undermining corporate democracy, a board cannot be permitted to adopt a measure that has the principal effect of handicapping a disruptive activist. [42]

But that is exactly what a pill does. The only conceivable way in which a poison pill "responds" to the threat of disruption and stakeholder feelings of insecurity is that the pill – in the anticipation of third parties and in reality – makes it less likely for an activist to succeed.[43] Such a

[39] 2014 Del. Ch. LEXIS 64 at *76.
[40] Id. at *36.
[41] See generally Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. Pa. L. Rev. 577 (2003) (discussing embedded defenses). With regard to "poison put" change of control provisions in third party contracts, see San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, 983 A.2d 304, 315 (Del. Ch. 2009) (suggesting that certain change of control provisions might be unenforceable because they eviscerating effect on shareholder franchise) and Kallick v. Sandridge Energy, 68 A.3d 242 (Del. Ch. 2013) (granting preliminary injunction requiring board to approve proposed slate for purposes of change of control provision in credit agreement). For an empirical analysis of poison puts in loan agreements, see Sean J. Griffith & Natalia Reisel, Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital (Working paper 2017); see also Sean J. Griffith & Natalia Reisel, Dead Hand Proxy Puts and Shareholder Value, forthcoming U. Chi. L. Rev __ (describing case law and discussing policy implications).
[42] The disruption created by an activist in an election contest is thus differs from the disruption created by a bidder in a hostile bid. Delaware corporate law does not view hostile bids as a normal part of orderly corporate democracy. Rather, hostile bids are seen as something akin to a disorderly revolution, or at least as an extra-constitutional mechanism to transfer corporate control. In other words, while the threat of disruption arguably could be a cognizable threat in the takeover context under the heading of "a danger to corporate policy and effectiveness," it does not play an equivalent role in an election context.
[43] From an ex ante perspective, the validity of a pill to respond to a threat of disruption would also make it less likely

response would not be reasonable.

c. The "Short-Termism Problem"

In the policy debate, a principal charge levelled against shareholder activism is that it contributes to "short termism." When hedge funds criticized Apple's large retained earnings in 2013, Martin Lipton remarked:

> The activist-hedge-fund attack on Apple—in which one of the most successful, long-term-visionary companies of all time is being told by a money manager that Apple is doing things all wrong and should focus on short-term return of cash—is a clarion call for effective action to deal with the misuse of shareholder power. … [A] gaggle of activist hedge funds … troll through SEC filings looking for opportunities to demand a change in a company's strategy or portfolio that will create a short-term profit without regard to the impact on the company's long-term prospects..[44]

Similarly, in a widely discussed public letter, Laurence Fink, chair and CEO of BlackRock, joined Lipton's call:

> Over the past several years at BlackRock, we have engaged extensively with companies, clients, regulators and others on the importance of taking a long-term approach to creating value. *We have done so in response to the acute pressure, growing with every quarter, for companies to meet short-term financial goals at the expense of building long-term value*. …. In the face of these pressures, more and more corporate leaders have responded with actions that can deliver immediate returns to shareholders, such as buybacks or dividend increases, while underinvesting in innovation, skilled workforces or essential capital expenditures necessary to sustain long-term growth. . . Successfully fulfilling [corporate leaders' duty of care and loyalty] requires that corporate leaders engage with a company's long- term providers of capital; that they resist the pressure of *short-term shareholders* to extract value from the company *if it would compromise value creation for long-term owners*.[45]

The concern about short-termism has also found expression in some Delaware judges' extra-judicial writing. Chief Justice Strine wondered "Why should we expect corporations to chart a sound long-term course of economic growth, if the so-called investors who determine the fate of

---

for an activist to emerge or to make disruptive proposals. These effects are equally illegitimate. Likewise, a measure designed to get an activist to modify its plans to make them less disruptive should not be permitted.

[44] Martin Lipton, Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy, February 22, 2013, WLRK.22303.13.pdf. See also Martin Lipton, Current Thoughts About Activism, August 8, 2013 WLRK.22722.13.pdf; Martin Lipton, The Threat to the Economy and Society from Activism and Short-Termism Updated, January 27, 2015 (WLRK.23815.15.pdf); Martin Lipton, Dealing with Activist hedge Funds, June 2, 2015, available at WLRK.23975.15.pdf

[45] Laurence Fink, March 31, 2015 open letter, (available at http://www.wlrk.com/docs/S31Duplica15040911540.pdf)

their managers do not themselves act or think with the long term in mind?"[46] Many others agree.[47]

This high-profile concern that activist hedge funds are pursuing, and are inducing companies to pursue, a short term agenda at the expense of long term value creation[48] is the wind in the sails of efforts to implement and expand anti-activist measures. To put it in doctrinal terms, then, does the possibility that a particular activist seeks "short-term profit" without regard to the impact on the company's "long-term prospects" constitute a threat?

When we unpack these concerns, however, they seem to be an amalgam of various arguments, none of which makes a persuasive case for a board's ability to deploy a pill in an activist proxy contest. On one level, the "short-termism" argument just particularizes the concern that shareholders will cast votes in a mistaken assessment of their own best interest: that is, shareholders undervalue long-term benefits. This is explicit in Laurence Fink's reference to the "shrinking attention span" of market participants and is at least implicit for other commentators. According to that line of reasoning, shareholders who favor short-termism – both the activist hedge funds and others who support them -- are hurting themselves as much as they are hurting their fellow shareholders. While this is a valid argument in the court of public opinion, it is not a proper factor to be taken into account in justifying a poison pill.

On another level, there is the intimation that, although shareholders as a whole lose from short-termism, activist hedge funds do not. How could this be? One possibility is that activists are engaged in a kind of "pump and dump" scheme.[49] They accumulate stock, obtain control, change the corporate strategy, exit at a profit, and leave the other shareholders with losses that will accrue in the future.

But that such a scheme can be regularly employed is implausible. It assumes that market participants are fooled over and over again – otherwise, the stock price would not rise with the

---

[46] One Fundamental Corporate Governance Question We Face: Can Corporations be managed for the long term unless their powerful electorates also act and think long term?; see also Jack Jacobs, Patient Capital, 68 Wash. & Lee L. Rev. 1645 (2011) ("In today's world, the shareholders of public companies are highly motivated to influence the company's board and executives to govern for the short-term. … The boards and executives that wish to manage their businesses for the long-term have little power to resist.")

[47] See, e.g., Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management, The Aspen Institute (2009) ("We believe a healthy society requires healthy and responsible companies that effectively pursue long-term goals. Yet in recent years, boards, managers, shareholders with varying agendas, and regulators, all, to one degree or another, have allowed short-term considerations to overwhelm the desirable long-term growth and sustainable profit objectives of the corporation.") (signatories include Warren Buffett, Martin Lipton, Peter Peterson, Felix Rohatyn, and John Whitehead).

[48] For an insightful discussion of why many proposals by hedge funds focus on short-term payoffs, see Bernard S. Sharfman, Activist Hedge Funds in a World of Board Independence: Creators or Destroyers of Long-Term Value?, 2015 Colum. Bus. L. Rev. 813, 851-858.

[49] William Lazonick, Matt Hopkins and Ken Jacobson, Carl Icahn's $2 billion Apple stake was a prime example of investment inequality, http://www.marketwatch.com/story/carl-icahns-2-billion-apple-stake-was-a-prime-example-of-investment-inequality-2016-06-07; Jim Cramer, Listen to Carl Icahn, but Don't Put Him on a Pedestal, http://realmoney.thestreet.com/articles/06/08/2016/cramer-listen-carl-icahn-dont-put-him-pedestal.

disclosure of the activist's investment (eliminating the "pump"). It ignores the fact that disclosure requirements under Sections 13(d)[50] and 16[51] of the Securities Exchange Act may cause a decline in the value of the activist's remaining stake as the activist commences the "dump."[52] And it overlooks the fact that, for an activist who places some of its top managers on the target board, the insider trading prohibitions under Section 10(b)[53] and the Section 16(b) disgorgement of short-swing profits provisions would inhibit the execution of such a scheme.[54]

The "pump and dump" scenario is particularly implausible for "short slate" proxy contests in which an activist seeks only minority board representation. Because ISS and institutional investors are usually reluctant to vote for activists who seek a majority of the board seats, few activists seek to replace, and even fewer succeed in replacing, a majority of the directors.[55] But an activist who runs a short-slate contest, even if it wins the contest, would have to persuade some of the other directors and management in order to implement any of its ideas. To convince other board members to change the corporate strategy to enable a pump and dump scheme, while the activist liquidates its holdings at the same time, would be a tall order.

A final suggestion in the short-termism argument– never far below the surface – is that activist funds represent some form of "special interest." For example, our colleagues Jack Coffee and Darius Palia note that "a majority of short-term shareholders [may] gain de facto control, only to exit on average within a year after their appearance. At least sometimes, this temporary majority will view issues differently than a majority of indexed (or at least largely diversified) shareholders."[56] The gesture towards special interest plays into deep seated concerns in American political history and theory that special interests will influence elected officials, by means of campaign contributions or whatever, to enact legislation that benefits that special interest at the expense of the general public.

The corporate analogue to "special interest" in the political context consists of companies bestowing unequal benefits on some shareholders. But to the extent that activists pursue a short-term oriented policy – whether or not misguided -- this policy affects all shareholders equally. Commentators worried about short-termism do not argue that short-termism results in some

[50] Under Rule 13d-2(a), an activist who has more than 5% of the target stock would have to "promptly" make a filing whenever it sells 1%. See 17 C.F.R. § 240.13d–2,

[51] If an activist has a director on the board, the director must disclose any sales by the activist by the end of the second business day on Form 4. Rule 16a-3, 17 C.F.R. § 240.16a-3 . .

[52] The adverse disclosure impact may be reduced if the activist sells the whole block on the same day. But in a block sale, the buyer will be on notice that a blockholder – possibly the activist – is selling. If the block is liquidated through market sales over a short period, the increased supply of stock will likely depress the price.

[53] Chiarella v. U.S., 445 U.S. 222 (1980).

[54] Securities Exchange Act of 1934, Section 16(b), 15 U.S.C.A. § 78p(b) (permitting suits for disgorgement of short-swing profits).

[56] Coffee and Palia, supra note 7,

shareholders receiving disproportionate cash flows from the company.[57] Rather, the choice between a short-term and long-term policy reflects a choice in investment horizons. To the extent that different shareholders disagree about the investment horizons they want their board to pursue, a robust debate among shareholders and a fair voting process are the proper way to resolve this disagreement.[58]

d. Acquiring Creeping Control

A more plausible justification for a pill is that an "activist" may be trying to acquire control incrementally and without paying a control premium ("creeping control"). The move from a corporation with dispersed shareholding to one with a controlling shareholder has a special significance in corporate law. As explained by the Delaware Supreme Court in a different context:

> When a majority of a corporation's voting shares are acquired by a single person or entity, or by a cohesive group acting together, there is a significant diminution in the voting power of those who thereby become minority stockholders. … [S]tockholder votes are likely to become mere formalities where there is a majority stockholder.[59]

For that reason, transactions resulting in a change of control are accorded special scrutiny.[60]

From this perspective, the fact that an activist may have started to wage, or may contemplate waging, a proxy contest, is incidental. A proxy contest is not *per se* relevant to the threat of acquiring creeping control; it merely calls for increased care as the board may use a purported threat of acquiring creeping control to fend off a bothersome proxy challenge. And although tender offers are a conventional mechanism for acquiring control, it is obviously possible to acquire control through open market purchases as well. Thus, the mere fact that an activist has not made a tender offer does not take the control issue off the table.

Indeed, the threat of creeping control has been recognized in two Delaware cases as a valid basis for employing a poison pill in a proxy contest. Although both cases involved complicating

---

[57] Shareholders receiving proportionate cash flows, by contrast, is generally not regarded as a concern from the duty of loyalty perspective. See Sinclair Oil Corp. v. Levien, (Del. 1971) 280 A.2d 717 (holding that proportionate dividends paid to controlling shareholder were not self-dealing); In re Synthes, Inc. Shareholder Litigation,, 50 A.3d 1022, 1036 (Del. Ch. 2012) (outside the context of a crisis, fire sale, sale of company where shareholders receive proportionate amount of cash generates no cognizable conflict of interest). Although there are situations (e.g., greenmail) in which it is plausible to think of activist hedge funds as receiving disproportionate cash flows, these situations are uncommon and raise concerns distinct from the short-termism arguments.

[58] There is another version of the concern that is beyond the scope of the "special interest" concern: it could be that both activist hedge funds and actively managed mutual funds have financial incentives skewed towards short term results, even if that is not in the interests of the median shareholder. It is a concern with this notion of "short termism" that lies behind Martin Lipton's efforts to develop a "new paradigm" for corporate governance. This is a concern that goes well beyond the scope of this paper. Delaware law treats the fund as a shareholder and ignores the potentially agency costs between the fund managers and investors.

[59] Paramount Communications Inc. v. QVC Network Inc,. 637 A.2d 34, 42 (Del. 1994).

[60] Id.

facts that we address below, their analysis of the threat of creeping control is relatively straightforward.

In *Yucaipa Am. Alliance Fund II v. Riggio,*[61] Yucaipa, a hedge fund run by Ronald Burkle, had acquired a 17.8% stake in Barnes & Noble. At about the same time, Aletheia Research and Management, a hedge fund with a history of following Yucaipa's lead, had increased its stake from 6.37% to 17.44%. Apparently concerned with Burkle's activism as well as with the possibility that Burkle might decide to try to acquire the company, Barnes & Noble adopted a poison pill with a 20% trigger. The 30% stake held by Leonard Riggio, Barnes & Noble's founder, was grandfathered under the plan but Riggio was precluded from acquiring any additional shares.[62]

In rejecting Burkle's challenge that the pill interfered with his ability to mount a proxy contest, then-Chancellor Strine's opinion highlighted the concern that Yucaipa may acquire creeping control. The court noted that Yucaipa's claim that it posed no control threat was undermined by the fact that its 13D disclosures indicated that it may acquire as much as 50% of Barnes & Noble.[63] The court proceeded to address the threat of "creeping control" posed by Yucaipa (thereby transforming the pill into a takeover pill):

> No doubt our law provides substantial protections for other investors in the event that a large stockholder with board representation proposes a going private transaction or engages in other forms of unfair value extraction, but that does not mean that the Barnes & Noble board was not entitled to take reasonable, non-preclusive action to ensure that an activist investor like Yucaipa did not amass, either singularly or in concert with another large stockholder, an effective control bloc that would allow it to make proposals under conditions in which it wielded great leverage to seek advantage for itself at the expense of other investors. Precisely by cabining Yucaipa at a substantial, but not overwhelming, level of voting influence, the board preserved for itself greater authority to protect the company's public stockholders. … All the Rights Plan denies to Yucaipa is the chance, in the first instance, to form a bloc with Aletheia or through its own purchases, use that bloc to seat three new directors and oust the company's founder from the board, and thereafter freely use its new influence to explore ideas like having Yucaipa be the lead equity investor in a going private transaction.[64]

In a second case, *Third Point LLC v. Ruprecht*,[65] two activist hedge funds (Marcato and Third Point) had acquired significant ownership positions in Sotheby's and filed disclosures using

[61] 1 A.3d 310 (Del. Ch. 2010).
[62] Id. at 321.
[63] Id. at 345.
[64] Id. at 360.
[65] 2014 Del. Ch. LEXIS 64

Form 13D. Unhappy with Sotheby's management, they vigorously pushed for change. In response, in October 2013, Sotheby's board adopted a poison pill with a 20% trigger for investors who do not seek a change in control (Form 13G filers), and a 10% trigger for all others. When Third Point sought injunctive relief, Vice Chancellor Parsons found that "Third Point posed a threat of forming a control block for Sotheby's with other hedge funds without paying a control premium."[66] This threat of creeping control justified the adoption of the pill.

Acknowledging that "creeping control" constitutes a legitimate threat, however, is only the beginning of the inquiry. The next steps are determining when an activist poses such a threat and what responses are reasonable. In both *Yucaipa* and *Ruprecht*, the activists had left open the possibility of participating in a control transaction in their 13D filings, acquired a large number of shares in a short period, and made Hart-Scott-Rodino filings that would permit them to acquire a controlling ownership stake in the company. In addition, in *Yucaipa*, Aletheia – a fund that had worked with Yucaipa in the past -- had substantially increased its ownership stake (with the funds' combined stake amounting to 36%);[67] and in *Ruprecht*, funds had accumulated an aggregate 19% of the company's shares by the time the company adopted a pill (though they had no history of cooperating and each seemed to pursue its own agenda).[68] Even without considering the possibility of cooperation between multiple funds and whether the possibility of such cooperation should be regarded as the acquisition of joint control, the presence of a second fund with substantial stakes creates the possibility that one fund could rapidly increase its stake by buying out the other fund. We thus agree with the courts' assessments that threats of creeping control were present in these cases and, more generally, will ordinarily be present absent a specific and credible disavowal by an activist who filed a 13D. In the next part, we take up the more difficult question: what kind of pill is justified by a threat of creeping control?

e. Negative Control and Disproportionate Influence

A further threat (accepted in *Ruprecht* as a justification for an anti-activist pill) is that an activist may obtain "negative control" or "disproportionate influence."[69] In February 2014, after Sotheby's initial pill adoption, Third Point filed an amended 13D indicating that it intended to nominate three candidates for director at the upcoming annual meeting. A few weeks later, Third

[66] Id. at *9. In Ruprecht, the court held that there was no threat of creeping control when Third Point asked to raise its ownership stake to up to 20%. However, the court's analysis in this regard suggest that the court's focus was on whether a threat of creeping control could justify a 10% trigger, rather than on whether at the time when Third Point made this request the threat of creeping control had completely disappeared.
[67] 1 A.3d at 324.
[68] 2014 Del. Ch. LEXIS 64, *30
[69] Id. at *21.

Point, which held a 9.6% stake, requested a waiver from the poison pill's 10% trigger to increase its ownership to 20%. The board refused.[70]

In reviewing Third Point's challenge to the board's decision, Vice Chancellor Parsons noted that, by March 2014, creeping control no longer posed a threat that justified the 10% trigger. However, the threat of "negative control" or "disproportionate influence" did. Because these concepts are somewhat amorphous, we quote the relevant passage of the opinion:

> The evidence currently available indicates that Sotheby's may have had legitimate real-world concerns that enabling individuals or entities, such as Loeb and Third Point, to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions, even if they do not have an explicit veto power.
>
> The notion of effective, rather than explicit, negative control obviously raises some significant concerns, chief among them being where does one draw the line to ensure that "effective negative control" does not become a license for corporations to deploy defensive measures unreasonably. In this case, however, on the preliminary record developed to date there appears to be an objectively reasonable basis to believe that Third Point could exercise effective negative control over the Company. If Third Point was given the waiver it requested and achieved 20% ownership it would, by far, be Sotheby's largest single stockholder. That fact, combined with the aggressive and domineering manner in which the evidence suggests Loeb has conducted himself in relation to Sotheby's, provides an adequate basis for legitimate concern that Third Point would be able to exercise influence sufficient to control certain important corporate actions, such as executive recruitment, despite a lack of actual control or an explicit veto power.[71]

Ruprecht raises several questions. Negative control generally refers to an entity having legal or de facto veto power over certain corporate actions. Because some corporate actions – mergers and charter amendments -- require either a supermajority of votes or a majority of shares entitled to vote, effective negative control can arise at lower ownership levels than actual control.[72]

But even under the (rather questionable) assumption that a pill with only a 20% threshold would enable Third Point to obtain effective veto power in some votes, how is this a threat? Unlike positive control – which enables the person who wields it to elect a board to its liking or cash out minority shareholders, powers that justify special concerns about control in Delaware law[73] –

---

[70] Id. at *14.

[71] Id. at *22 (citations omitted).

[72] Id. at *21 ("Plaintiffs are correct that the Delaware case law relating to the concept of negative control addresses situations in which a person or entity obtains an explicit veto right through contract or through a level of share ownership or board representation at a level that does not amount to majority control, but nevertheless is sufficient to block certain actions that may require, for example, a super-majority vote.")

[73] These concerns are reflected, in addition to forming a threat under *Unocal*, in the heightened duties generated by a change or sale of control under *Revlon* and in the fiduciary duties owed by a controlling shareholder. QVC, 637 A.2d at 34.

negative control merely enables the wielder to block a limited set of transactions that the board proposes. In *Ruprecht*, no such transaction was contemplated. And the possibility that, at some future point, the board would propose, say, a merger; that Third Point would oppose it; and that all of this actually harms Sotheby's seems exceedingly remote.

So perhaps negative *voting* control is not what the court in *Ruprecht* had in mind. Indeed, the one specific issue the court mentions – executive recruitment – falls within the domain of the board and is not subject to a shareholder vote. But then, why would it matter that Third Point would become, "by far," Sotheby's "largest single shareholder?" And how does Loeb's "aggressive and domineering manner," a factor that the judge highlighted in a subsequent article as a basis for his holding, matter.[74]

One possible answer is that Third Point, as a large holder, obtains "disproportionate" influence over *board* decisions because it can credibly threaten to wage a successful proxy contest. Given Loeb's aggressive style, Third Point may be more likely to disagree with the board, and to do so more forcefully, than a more passive investor: that is, it would be more likely to exercise its influence in a manner that, in the board's assessment, harms the company.

But the implication of *Blasius* is that it is not a threat if shareholders exercise their governance rights even if the board sincerely believes that they are misguided. If it is not a cognizable threat for Third Point to actually wage a proxy contest because, say, it is unhappy about an executive recruitment action taken by the company (e.g. hiring Ms. Miller as CFO) – regardless of Ms. Miller's qualifications – then a credible option that Third Point may wage a contest if the board hires Ms. Miller should not amount to a threat either.

It is also worth noting that it is a fundamental property of weighted voting systems – such as "one-share, one-vote" (as opposed to "one-person, one-vote") -- that one's voting power is *not* proportional to the number of one's votes. Consider a well-known example: the Electoral College. Under the voting rules of the Electoral College, under certain assumptions, California wields voting power that is disproportionately large in relation to its electoral votes in as much as California's vote is disproportionately likely to be pivotal.[75]

But the mathematical properties of weighted voting systems provide only limited support for a sweeping pronouncement that the largest shareholder has disproportionate power. For one,

[74] Donald F. Parsons and Jason S. Tyler, Activist Stockholders, Corporate Governance Challenges, and Delaware Law (June 6, 2016). Research Handbook on Mergers and Acquisitions, Claire A. Hill and Steven Davidoff Solomon (eds), Edward Elgar Publishing, Forthcoming. Available at SSRN: https://ssrn.com/abstract=2791791 ("At the same time, the decision expressly recognizes for the first time that stockholder activism, or a proxy contestant's conduct in respect of the company, can threaten a business. Without holding that directors may silence dissent as a matter of business judgment, it accepts the possibility that an activist can impose sufficiently threatening costs on the corporation and its stockholders that the board may consider adopting an appropriate defensive measure.")

[75] The most common measures of voting power are the Banzhaf power index and the Shapley-Shubik power index. See, e.g., Yoram Bachrach et al., Approximating power indices: theoretical and empirical analysis, 20 Auton Agent Multi-Agent Syst 105 (2010).

it is not generally true that a person with the largest number of votes has a disproportionately high voting power.[76] Furthermore, if voting decisions are not statistically independent – as voting decisions by shareholders almost surely are not – no firm conclusions about voting power can be drawn just based on the distribution of votes.[77]

On the whole, therefore, we do not see how "negative control" or "disproportionate influence" is a threat that would justify an anti-activist poison pill, either generically or specifically in the factual context presented in *Ruprecht.* As we discuss in the next section, however, the court's underlying intuition – that permitting an activist to accumulate a disproportionally high voting stake is potentially problematic – may be the basis for a related threat to the electoral system.

f. Preserving a Fair Election Process

A final potential justification for an "anti-activist" poison pill is that it results in a more fair process in the upcoming board election, where a "fair election process" is one in which the side with the better argument prevails. We put "anti-activist" in quotations marks because, according to this rationale, the pill is a neutral device, rather than a device specifically intended to impede activists. We are not aware of this justification being explicitly offered but we believe that it better captures the underlying concerns than most of the "threats" identified above and is more defensible doctrinally and normatively.

After decades of increasing holdings by institutional investors, the balance of power in public corporations has changed. In many corporations, institutional investors collectively hold more than 70% of the shares, with more than 30% of the shares concentrated in the hands of the top twenty-five institutions.[78] In practice, hedge funds cannot win contests in these firms without the support of at least some large institutional investors, such as BlackRock, Vanguard, BNY Mellon, State Street, Fidelity, and CalPERS.[79]

Corporate governance battles in such firms can thus be understood as a contest between incumbents (the board and managers) and activist hedge funds for the hearts and minds of the institutional investors that constitute the stable core of the shareholder base. If one analogizes

[76] For example, in a company with 3 shareholders holding, respectively, 40%, 35% and 25%, the smallest shareholders would have disproportionately largest voting power in a majority rule system.

[77] Dan S. Felsenthal & Moshe Machover, The measurement of voting power: theory and practice, problems and paradoxes (Cheltenham, U.K.: Edward Elgar 1998). Furthermore, a large (but non-controlling) shareholder has incentives to acquire information and to distribute it to other shareholders. Thus, the presence of a large shareholder not aligned with the board increases the effective power of shareholders as a group at the expense of the de facto control of the incumbent board. This would counterbalance to some extent, for other shareholders, any disproportionate voting power of the blockholder.

[78] Edward Rock, Institutional Investors, Chapter 17 in The Oxford Handbook of Corporate Law and Governance (Forthcoming 2017) (Jeffrey Gordon and Wolf-Georg Ringe, eds.).

[79] Id.

corporate elections to political ones, one can think of the incumbent board and the activist as representing two political parties that offer competing slates of candidates and competing plans for how to maximize value. The electorate – the mainly institutional, largely unaligned, and generally open-minded shareholders – is asked to choose the plan they deem more likely to succeed.[80]

Indeed, over the last two decades, as the trend towards increasing institutionalization of shareholding has continued, the largest institutions have awakened to their power. They have shown substantial willingness to listen to, to support,[81] and maybe even (at the portfolio manager level) to help generate, ideas from activist funds.[82]

Just as the choice of shareholder base can be thought of as a strategic decision of the firm,[83] so too can the choice of a decision-making process affect firm value. From this perspective, a board of directors, as part of its duty to oversee the business and affairs of the corporation, can plausibly view the emerging decision-making process as an important strategic variable that should be designed so that the side with the better argument prevails. A board should be able to do so, as long as it acts in good faith and in an unbiased manner.

---

[80] See Gilson & Gordon, supra note 23, at 897 ("Activist investors specialize in monitoring portfolio company strategy and formulating alternatives when appropriate for presentation to the institutional investors; in turn, institutional investors specialize in portfolio management and in evaluating proposals presented by activist investors.")

[81] Similarly, ISS, the most influential proxy advisor, often recommends votes in favor of activists. ISS's policies are also responsible for the demise of clear-day poison pills. Emiliano Catan, The Insignificance of Clear-Day Poison Pills (September 7, 2016). NYU Law and Economics Research Paper No. 16-33. Available at SSRN: https://ssrn.com/abstract=2836223 (documenting that most firms have allowed their poison pills to expire after ISS, in December 2004, announced that it would recommend withhold in director elections if a board adopted or renewed a poison pill without shareholder approval). According to the Shark Repellent data base, only 24 of the S&P 500 and 135 of Russell 3000 companies currently have a poison pill in force. Shark Repellent (checked on 10/6/2015).

The difference between an actual and a virtual or "on the shelf" pill is minimal with regard to contests for control, where the delays necessitated by the Williams Act and Hart Scott Rodino (HSR) review mean that a target will have ample time to adopt a pill against a bid for control. By contrast, there have been a few instances in which activists show up with far in excess of 10%. Two well known cases are when Pershing Square was able, prior to its 13D disclosure, to acquire a 16.5% stake in J.C.Penney, more than it may have been permitted under some typical pill trigger thresholds. Lauren Coleman-Lochner and Matt Townsend, Pershing Becomes Top Investor in J.C. Penney, Fortune, Bloomberg Business October 8, 2010, available at: http://www.bloomberg.com/news/articles/2010-10-08/ackman-s-pershing-square-discloses-16-5-stake-in-retailer-j-c-penney. When JC Penney subsequently adopted a poison pill, it had to grandfather Pershing Square. In an earlier case, JANA Partner had a 21% interest in CNET at the time in filed its 13d. Andrew Ross Sorkin, A Loophole Lets a Foot in the Door, N.Y. Times, Jan. 15, 2008, at C1.

These strategies, however, have become much riskier and do not seem to happen any more. In the J.C.Penney case, Pershing was able to rely on pre-merger advice by the FTC that its stake raised no antitrust concern. After Pershing Square's acquisition became controversial – see Andrew Ross Sorkin, Big Investors Appear Out of Thin Air (Nov. 1, 2010) available at http://dealbook.nytimes.com/2010/11/01/sorkin-big-investors-appear-out-of-thin-air/ – the FTC's pre-merger notification office apparently stopped providing advanced guidance on stake-building, although it did not issue any public notice to this effect. If this sort of stake-building revives, the difference between and active and an "on the shelf" poison pill could become more significant.

[82] Rock, supra note 78.

[83] Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders (Mar. 14, 1984), available at http://www.berkshirehathaway.com/letters/ 1983.html; Edward B. Rock, Shareholder Eugenics in the Public Corporation, 97 Cornell L. Rev. 849 (2012).

For many firms, this emerging balance of power, a "new normal," leaves the board in charge at most times, but places institutional investors at the center of corporate governance when a conflict – such as an activist attack -- arises. Among the participants in corporate governance, the large institutions have as good or better a claim to being "the deciders" than anyone else. Often, traditional institutional investors will hold the bulk of shares not held by the contestants themselves; many institutions hold sufficiently large blocks so that they have incentives to obtain a fair degree of information about the "party platforms"; and most institutions are managed by financially sophisticated professionals who can evaluate this information. Even though traditional institutions add an additional layer of agency costs and some may have conflicts of interest,[84] they will often remain, among all realistically available options, the best candidates for resolving disagreements about strategic direction.

While an ideal election process is impossible to achieve, a disinterested board committed (or resigned) to this vision of corporate decision-making could reasonably view as problematic a result in which one of the contestants was permitted to buy a number of votes that is, in absolute and relative terms, much higher than the number of votes held by partisans on the other side. In such a case, the contestant could win even if a large majority of the unaligned electorate voted for the other side.

This goal of channeling critical corporate decisions through a fair election process has deep roots in Delaware law. It underlies the regulation of hostile takeover bids. The validity of a poison pill means that, in the hostile takeover context, a decision by a majority of shareholders to tender into a non-coercive bid is not sufficient to permit the bid to go forward, but requires that the bidder win a proxy contest for control, a potentially more deliberative process than a tender offer.[85] If a board can opt to channel the control contest through an election process, it is a short step to conclude that the election process itself should retain substance by enabling a board to prevent gross imbalance in the electoral stakes of the contestants.

This approach is also consistent with the treatment of advance notice bylaws which require "stockholders wishing to make nominations or proposals at a corporation's annual meeting to give notice of their attention in advance of so doing" and, in the current versions, disclose information about the stockholder, and the proposal or nominee.[86] Advance notice bylaws are permitted because – and to the extent that – they improve the quality of the decision making process.[87] The

[84] See, e.g., Rock, The Logic and (Uncertain) Significance of Institutional Shareholder Activism, 79 Geo. L. Rev. 445 (1991).
[85] Marcel Kahan, Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence, 19 J. Corp. L. 583 (1994).
[86] Jana Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 344 (Del. Ch. 2008).
[87] Parsons & Tyler, supra note 74 (citing Openwave Sys. Inc. v. Harbinger Capital P'rs Master Fund I, Ltd., 924 A.2d 228, 239 (Del. Ch. 2007)); accord Hubbard v. Hollywood Park Realty Enters., Inc., 1991 WL 3151, at *13 (Del. Ch. Jan. 14, 1991) (Advance notice bylaws serve the "proper purpose of assuring that stockholders and directors will have

content of such bylaws, and the corporation's enforcement of them, are both subject to equitable review by the Delaware courts.[88]

The notion that a board must run a fair process, but may take measures to make sure that the process is in fact fair, is also fundamental to the *Revlon* standard as applied to takeover battles. *Revlon* and subsequent cases such as *Macmillan* and *QVC* have held that when a company is in *Revlon* mode and faced with competing bids, the board must be "most scrupulous" in "adher[ing] to ordinary principles of fairness,"[89] may not "play[] favorites" and is highly constrained in affording different treatment to bidders.[90]

Being in *Revlon* mode has some notable similarities to facing a proxy contest. To get into *Revlon* mode, the board must initiate an end-game -- a sale, change of control, or break up.[91] Because of the nature of the end game, the board's ordinary governance powers over the corporation are constrained and the board's role is to provide shareholders with information, present alternatives to shareholders, and assure a fair process for *shareholder* decision making. In an election contest, as well, it is *shareholders* who are called upon to make a decision – and the board's role, likewise, should be to provide shareholders with information, present alternatives to shareholders, and assure a fair process for shareholder decision making.

It is perhaps this notion of a fair election process that Vice-Chancellor Parsons had in mind when he cited "disproportionate influence" as a potential threat in *Ruprecht*: permitting Third Point – a presumed partisan in an election contest -- to raise its stake would enable it to obtain voting rights much larger than those of the incumbent board (the other partisan).[92] The appeal of using a pill to force an activist to win by the force of its arguments, rather than by the size of its purse, shines through in *Yucaipa* when Chancellor Strine noted approvingly that:

> Yucaipa is left the chance to gain influence by electing three directors at the next meeting, and three more at the following meeting. It just must do so by convincing other stockholders on the merits to vote for its slate, and without entering into mutual agreements about joint governance that raise the spectre of a de facto control bloc.[93]

What is distinctive about this notion of electoral fairness is that it is primarily procedural: decisions are best left to the "neutrals." It need not be tied to any substantive assessment of the

---

reasonable opportunity to thoughtfully consider nominations and to allow for full information to be distributed to stockholders, along with the arguments on both sides.").

[88] Parsons & Tyler, supra note 74.

[89] Mills Acquisition Co., v. MacMillan Inc., 559 A.2d 1261, 1264 (Del. 1989).

[90] QVC Network Inc. 637 A.2d at 46; see also Barkan v. Amsted Industries Inc., 567 A.2d 1279, 1286-87 (Del 1989).

[91] 637 A.2d at 42 - 48.

[92] Ruprecht, 2014 WL 1922029, *20. Our notion that preserving a fair election process may be a legitimate objective of a poison pill is consistent with the well-established rule that shareholders are entitled to vote their shares in their own best interest and that even controlling shareholders owe no fiduciary duties in this regard to others. Bershad v. Curtiss-Wright Corp., 535 A.2d 840 (Del. 1987). It is exactly because shareholders are free to vote their shares as they please that shareholders may care about the identity of their fellow shareholders.

[93] 1 A.3d at 360.

merits in a particular contest – whether, in absolute terms, the proposal of the activist is good or, in relative terms, the activist is better or worse than the incumbents. The substance of the proposal will be part of the arguments made to the neutral deciders who, in this context, make the ultimate determination. Moreover, it is premised on permitting an activist to acquire a stake that would provide incentives to mount an effective contest; otherwise, there would be no decisions that the "neutrals" are called to make.

This vision of shareholder decision making may be controversial. One could well argue that small dispersed shareholders, a material component of the "neutrals," lack adequate incentives to become informed and that the managers of larger institutional shareholders – who have incentives to become informed -- suffer from agency problems that may bias their decision.[94] Perhaps a system in which partisans would not be constrained in the number of shares they can buy – and in which they can put as much money where their mouth is as they want – would be preferable to a system in which significant power is held by such uninformed or biased neutrals. Nevertheless, it is a sufficiently plausible vision that a disinterested board decision to preserve, protect or improve such a decision-making process is hardly out of bounds.

At the same time, as in the *Revlon* context, when the board's goal is to improve the decision-making process, the court must make sure that it acts neutrally, as a "neutral election board." As the court put it in *Aprahamian v. HBO & Co.*:

> The corporate election process, if it is to have any validity, must be conducted with scrupulous fairness and without any advantage being conferred or denied to any candidate or slate of candidates. In the interests of corporate democracy, those in charge of the election machinery of a corporation must be held to the highest standards of providing for and conducting corporate elections. The business judgment rule therefore does not confer any presumption of propriety on the acts of directors in postponing the annual meeting. Quite to the contrary. When the election machinery appears, at least facially, to have been manipulated those in charge of the election have the burden of persuasion to justify their actions.[95]

Can one reasonably expect a board, embroiled in a high-pitched battle with an aggressive activist, to act as a "neutral election board"? Left to its own devices, probably not; but with proper oversight by the Delaware courts, perhaps yes.

---

[94] Agency problems may, for example, induce them to prefer short-term gains over long-term gains even if the long-term gains are ultimately more valuable or may lead them to pursue political goals of one sort or another., or may induce them to favor management to preserve the benefit of side dealings between affiliates of the institutional investors and the company (e.g. from managing the company's pension fund or providing investment banking services). See generally Rock, supra note 84, at 464-478.

[95] Aprahamian v. HBO & Company, 531 A.2d 1204, 1206-07 (Del. Ch. 1987), quoted in Blasius, 564 A.2d at 661.

III. Proportional Responses

The "threat" analysis is only the first step. Having identified a cognizable threat, the board's response – in adopting or maintaining a pill – must be reasonable in relation to the threat posed.[96]

In the preceding Part, we have identified several arguable "threats". Of these, only two threats can, in our view, justify a pill in principle: the possibility that an activist may obtain control through a creeping acquisition of stock; and the threatened undermining of a fair electoral process by a large stake held by an activist. In contrast, the possibility that shareholders will vote the wrong way, that the election contests or the specific behavior of an activists creates disruption, that the activist will pursue a short-term agenda, that an activist will obtain negative control/disproportionate influence are either not cognizable threats at all or are threats in relation to which a pill would generally not be a reasonable response. But even with respect to the two threats that may, in principle, justify a pill, the terms of any specific pill must be properly crafted to constitute a reasonable response. In the context of director elections, the fit between means and ends is particularly important.[97] The analysis of whether a pill is reasonable requires greater scrutiny in the context of an anti-activist pill than in the context of an anti-takeover pill.

An anti-takeover pill is generally reasonable as long as the board reasonably believed that the price of an acquisition offer was unreasonable and the pill permits the bidder to replace the board, in the ordinary course, through a proxy contest and have the new board redeem the pill. That is, in the takeover context, the very ability to run a proxy contest is what renders a pill reasonable. Because a bidder has significant incentives to wage a contest even if it does not hold a significant stake in the target, other design elements – the trigger threshold, the specific definition of beneficial ownership, whether and when different thresholds may be applied to different owners, and the specific rules on aggregating shares by different owners – have given rise to few, if any, legal disputes in the takeover context.

For an anti-activist pill, the calculus must be different. Because an activist depends on an economic stake in the target to provide it with economic incentives and credibility to wage a proxy contest, many more design features of the pill bear on the practical ability to run a proxy contest than in the takeover context. Because an anti-activist pill that is too strong is not rendered more reasonable by the ability to replace the board and have the new board redeem the pill, it is necessary for courts to scrutinize these design features to assure that they constitute reasonable responses to a threat. Even design features that have long been elements of anti-takeover pills, and have raised

[96] Unitrin v. American General Corp., 651 A.2d 1361, 1367, 1387-88 (Del. 1995).
[97] Liquid Audio, 813 A.2d at 1126-27; Mercier, 929 A.2d at 819; Pell, 135 A.2d at 787.

no controversy in this setting, may be unreasonable in pills directed against activists.

In this Part, we examine the implications of this approach for several features of a pill: the treatment of instruments that do not confer voting power; the trigger threshold; the setting of different trigger thresholds for different holders; and, finally, the treatment of wolf packs.

a. Synthetic Equity

Starting around 2008, provisions in poison pills increasingly included "synthetic equity" in the definition of ownership for determining whether a pill has been triggered.[98] According to a study by Latham and Watkins, 76% of all pills adopted or amended in 2013 included such provisions.[99] Whether such inclusion is permissible has, to our knowledge, never been addressed by the Delaware courts.

"Synthetic equity" refers to swaps, options or other instruments that confer an economic interest to the holder. For example, a holder may enter into a "total return swap" with a counterparty (typically a bank). In the swap, the purchaser receives the total economic return – dividends and share appreciation – on some notional number of shares over the life of the swap, but must pay the counterparty if the value of the shares declines.[100]

Unlike actual shares, synthetic equity does not confer any voting rights on the holder. Moreover, while some forms of synthetic equity, such as certain options, include a right to purchase actual shares with voting rights, other forms – such as cash-settled total return swaps or cash-settled options – do not even do that. This raises the questions whether synthetic equity positions generate, or contribute to, a threat posed by a shareholder activist.

In our view, they do not. Because synthetic equity entails no voting rights, it does not create a threat of the activist acquiring creeping control or of the activist's stake undermining a

---

[98] The Genesco pill provides a typical example of a derivatives provision. Beneficial ownership includes:

> any securities that are the subject of one or more derivative transactions entered into by such Person … , or derivative security acquired by such Person … which gives such Person … , the economic equivalent of ownership of an amount of such securities due to the fact that the value of the derivative is determined by reference to the price or value of such securities, or which provides such Person … an opportunity, directly or indirectly, to profit, or to share in any profit, derived from any change in the value of such securities, in any case without regard to whether (a) such derivative conveys any voting rights in such securities to such Person … , (b) the derivative is required to be, or capable of being, settled through delivery of such securities, or (c) such Person may have entered into other transactions that hedge the economic effect of such derivative ….

Genesco Second Amended and Restated Rights Agreement at Section 1 (Certain Definitions) (hereinafter Genesco Pill), GENESCO INC, Form 8-K, File Number 001-03083, Filed Apr 09, 2010. Period date: Apr 08, 2010. Corporate Filing. EX-4.1:
EX-4.1

[99] Latham & Watkins, The Resilient Rights Plan: Recent Poison Pill Developments and Trends (July 2014) available at https://www.lw.com/thoughtLeadership/2014-poison-pill-developments-and-trends

[100] http://www.investopedia.com/terms/t/totalreturnswap.asp.

fair electoral process (or, for that matter any of the other threats).[101] Counting synthetic equity towards a pill trigger is therefore unwarranted.

Even synthetic equity instruments that confer a right to acquire actual shares should not be counted towards a pill trigger. [102] To be sure, such instruments create the potential that the right to acquire actual shares may be exercised -- and such exercise may amount to a cognizable threat. But this possibility can, and should, be addressed by a pill that counts these shares *if and only if* this right is exercised. If an activist would exceed the trigger threshold by exercising the right to acquire shares, the activist will be deterred from doing so and any threat that would result from the acquisition of actual shares will not materialize.

An important corollary of our position is that a pill *can* constrain the ability of an activist to exercise an option to acquire shares even if the option was acquired *before* the pill was adopted.[103] When options are not included in reaching the triggering threshold, the *exercise* of the option should and will constitute an increase in the number of shares that count towards the trigger threshold. Thus, while we oppose limits on an activist's ability to acquire synthetic equity, the pill design we favor imposes stricter limits on an activist's ability to convert synthetic equity into actual equity than most pills currently impose.[104]

---

[101] Some forms of synthetic equity – in particular, options exercisable for actual stock – are included in the ownership definition of Section 203 of the Delaware General Corporation Law. See 8 Del.C. § 203(a)(9).. Others forms, such as cash settled options and swaps, are not. In any case, for two reasons, Section 203 does not significantly inhibit activist challenges. First, the 15% ownership threshold coupled with the unlimited ability to acquire synthetic equity not covered by the ownership definition under Section 203 generally leaves an activist with sufficient room to acquire a stake in the target. Second, Section 203 only inhibits certain types of conflict and self-dealing transactions by an interest shareholder. While it is conceivable that such transactions are part of the activists' business plan or that an activist may want to retain flexibility to engage in such transactions, the limitations imposed by Section 203 will often not be relevant.

[102] Certain types of synthetic equity, notably securities that a holder has the option to acquire within 60 days, are included in the definition of beneficial ownership for purposes of Section 13(d). See Rule 13d-3(d)(1), 17 C.F.R. § 240.13d–3. Rule 13d, however, was designed for different purposes than pills – to provide information to the market about share accumulations, rather than to counter a cognizable threat – and has a different structure. It is a disclosure provision, not a de facto prohibition of acquiring stock beyond a threshold. For these reasons, different types of ownership are relevant for Rule 13d than for pills and over-inclusiveness in the definition of ownership is much less problematic for Rule 13d than it is for anti-activist pills.

This being said, there are certain advantages of tying the beneficial ownership definition under a pill to the beneficial ownership position under Section 13(d). As long as the pill definition does not go beyond the 13(d) definition, and as long as the 13(d) definition does not encompass synthetic equity that is cash-settled, the advantages – in terms of simplicity and standardization – of using the same definition in our view outweigh the disadvantages of having a somewhat broader definition than is warranted.

[103] See, e.g., David Benoit, Avis Uses 'Poison Pill' to Block Longtime Investor from Gaining Too Much Control, WSJ January 23, 2017, available at https://www.wsj.com/articles/avis-uses-poison-pill-to-block-longtime-investor-from-gaining-too-much-control-1485210927?emailToken=JRrzcvF8ZX6WgNM2a8w1ylwzK7QTBvTMXlTWN3fMf1DNsHiQveXkzaEyjNjypWSpSlp74t1B7mghSCbNh3AvUtWWnvtwmFaien9S643D1kiOJ0/b2UWNe/YGsa2Qp3U5s/MCQlkKPQ== (Avis used a poison pill aimed at blocking SRS Investment Management from acquiring more than 10% in voting power; SRS owned 9.7% of the common stock and had another 18.8% in economic interest that did not have voting power).

[104] When a pill is adopted after an activist emerges, the activist's existing stake is typically grandfathered. To the extent that a pill does not differentiate between voting shares and synthetic equity, an activist who acquired a large

Even though synthetic equity confers no voting rights -- and hence poses none of the threats we identified -- holding a large amount of synthetic equity may well be important for an activist shareholder. As we discussed, activists may acquire a stake in the target for three reasons: to make profits; to gain credibility with other shareholders; and to obtain voting rights. While synthetic equity has no voting rights, it enables an activist shareholder to increase its economic stake and confers some credibility upon the activist with other shareholders (albeit presumably less than actual share ownership). The principal effect of the inclusion of synthetic equity in the pill trigger is thus to impede an activist challenge unconnected to any threat.

Importantly, two arguments sometimes made for treating synthetic equity like actual shares do not provide persuasive reasons for counting synthetic equity toward a pill threshold.[105] First, some commentators have suggested that swap counterparties hedge their short exposure by buying shares in the market and sell their shares when the swap is closed out. These sales, in turn, make it easy for the swap purchaser to acquire the shares and thereby create "morphable ownership."[106]

But the concern over morphable ownership, even if factually valid, is inapposite to the pill context. Any shares the swap purchaser acquires when the swap is closed -- when the synthetic equity actually morphs -- would obviously count towards the trigger. Thus, to the extent that morphing is the problem, a pill does not need to include synthetic equity. Whenever a pill that includes synthetic equity in the trigger would be triggered by a swap, an equivalent pill that excludes synthetic equity from the trigger will be triggered when the swap morphs.

Second, it has been argued that the swap counterparty will vote the shares bought as a hedge as requested by the swap purchaser to keep an important client happy. This, it was claimed, creates "hidden ownership."[107] This argument found some support in Judge Lewis Kaplan's 2008

---

synthetic stake before the pill is adopted could convert its "grandfathered" synthetic equity into voting shares even after a pill is adopted in response to the filing of the 13D. To the extent that, in our proposal, synthetic equity would be excluded, such an activist would be disadvantaged with respect to the acquisition of its initial stake.

Given this effect, the inclusion of synthetic equity might be defended on the grounds that it provides greater economic incentives for the firms that identify a target, and thus encourages valuable investments in search. In our view, however, it is adequate and, indeed, preferable to provide economic incentives for activism by not including synthetic equity into the pill trigger threshold – and permitting the acquisition of an even greater economic stake through synthetic equity – even if this comes at the expense of constraining an activist's ability to convert synthetic equity that was acquired before pill adoption into actual shares.

[105] Wachtell Lipton has pushed for expanding 13(d) to include derivative positions and other sorts of synthetic equity on the grounds that such positions can lead to empty voting. David Katz and Laura McIntosh, Corporate Governance Update: 13(d) Reporting Inadequacies in an Era of Speed and Innovation, The New York Law Journal (September 24, 2015). By contrast, Ron Gilson and Jeff Gordon have argued that synthetic equity should likewise not count towards beneficial ownership under Section 13(d). See Gilson & Gordon, supra note 23, at 912-915. While we agree with much of Gilson and Gordon's argument, we believe that Section 13(d), which is a mere disclosure statute, may call for a more expansive definition of instruments creating "beneficial ownership" than poison pills.

[106] Henry Hu & Bernard Black, The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership, 79 Southern Cal. L. Rev. 811 (2006).

[107] Id.

opinion in *CSX v. TCI*.[108] In that case, The Children's Investment Fund (TCI), an activist hedge fund, had accumulated a position in CSX, a major railroad, through a combination of stock and derivatives that gave it an economic exposure equivalent to 14%. The legal issue was whether, under Rule 13d-3, cash-settled total return swaps that did not grant any rights over the voting or disposition of the shares that the swap counterparty may purchase to hedge its position counted towards the 5% beneficial ownership threshold that triggered a Schedule 13D disclosure obligation. In holding that TCI had violated Section 13(d), Judge Kaplan noted, without ultimately holding, that TCI may have influence over the voting of the shares held by counterparties.[109]

We note at the outset that, even as a theoretical matter, the concern that a swap counterparty may vote shares as requested by the swap purchaser only applies to privately negotiated derivatives. With respect to publicly traded derivatives – such as publicly traded call options – an option seller would neither know the identity of the option buyer nor have any incentives to vote shares as requested by that buyer.

But even for privately negotiated derivatives, Judge Kaplan's concern is misplaced, at least given current market practice. First, swap dealers may hedge through means other than acquiring actual shares.[110] Indeed, it generally takes less capital for swap dealers to hedge their exposure under the swap through derivatives than through buying actual shares. For example, a swap dealer who arranged a total return swap on 1,000 shares of XYZ Corp. based on a current market price of $100 per share can fully hedge its exposure by buying call options on 1,000 shares and selling put options on 1,000 shares, each with an exercise price of $100. The net costs (if any) of these trades to the swap dealer would typically be substantially less than the costs of hedging its exposure by buying 1,000 actual shares.

Second, swap dealers hedge on a "portfolio basis" – that is, they look to be market neutral for their whole trading book – and not on an individual transactional basis.[111] To the extent that, over the duration of the swap, other parts of the trading book serve as a hedge, a dealer may not need to acquire, or can liquidate, any further hedge. Moreover, hedging on a portfolio basis means that swap dealers are not set up to attribute a particular hedging purchase to a specific swap transaction. In that respect, Judge Kaplan's concern that swap purchasers can influence the voting of the shares bought to hedge their swap does not comport with reality.

Third, when swap dealers hedge by buying shares, they seek to reduce their costs by "lending" out the shares (e.g., to short-sellers who need to secure shares in order to settle). Many other institutional investors that lend shares– such as mutual funds and public pension funds –

[108] CSX Corp. v. Children's Investment Fund Management (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), affirmed in part, vacated in 654 F.3d 276 (2d Cir. 2011) (expressing concern about hidden and morphable ownership).
[109] Id. at 522.
[110] E-mail from Joseph White, Managing Director, Equities & Derivatives, Societe Generale, July 13, 2017.
[111] Telephone Conversation with Partner at major New York law firm specializing in derivatives, June 16, 2017.

restrict their supply or recall shares they lent out prior to a shareholder vote, especially if the vote is contested, in order to exercise their voting rights.[112] Because swap dealers are one of the last sources of borrowable shares around voting record dates, fees for lending shares over such dates tend to be especially high.[113] When shares are lent out, the borrower – rather than the swap dealer – is entitled to exercise voting rights with respect to the borrowed shares.

Finally, and most importantly, even if a swap dealer hedges its exposure through actual shares and is entitled to vote these shares, it is unwarranted to assume that these share will be voted in the interest of the swap purchaser. Swap dealers have policies, which they treat as confidential, on the voting of shares they acquire for hedging purposes and in which they thus have no economic stake. These policies generally call for not voting the shares at all, voting them in a sterilized manner (so that they do not influence the voting outcome),[114] or voting them in accordance with the recommendations by the board or by a voting advisor. By contrast, to our knowledge, no swap dealer has a policy of voting shares as requested by (or as assumed to be in the interest of) the swap purchaser.[115] Indeed, the personnel at the swap dealer in charge of voting will often not even know the identity of the purchaser for any particular swap and the swap purchaser will not know the policies the dealer follows.[116]

Since synthetic equity confers neither direct nor, as a general matter, indirect voting power, its inclusion in a poison pill's definition of beneficial ownership is not warranted. Indeed, from an incentive and systemic perspective, the single most important limit the Delaware courts can place on anti-activist poison pills is to reject the inclusion of derivative positions in the definition of beneficial ownership when those positions confer no voting rights.

b. The Trigger Thresholds

Outside the special context of "Net Operating Loss" or NOL pills,[117] current market practice is to employ pills with trigger thresholds between 10% and 20%.[118] Because it provides

[112] Reena Aggarwal, Pedro Saffi, and Jason Sturgess, The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market." 70 J. Fin. 2309 (2015).
[113] Id. (using 2007-09 data); E-mail, supra note 110; but see Susan Christoffersen, Christopher Géczy, David K. Musto & Adam V. Reed, Vote trading and information aggregation, 62 J. Fin. 2897 (2007) (finding no material increase in lending fees around record date in 1998 and 1999 period).
[114] Telephone Conversation, supra note 111.
[115] As a result, proxy solicitors do not bother soliciting derivative brokers in the ordinary course as such efforts do not have a history of influencing if or how the broker votes.
[116] E-mail from Joseph White, Managing Director, Equities & Derivatives, Societe Generale, July 13, 2017.
[117] NOL pills typically have 4.9% or 4.99% triggers. In Versata, 5 A.3d at 586, the court accepted this low threshold because of the tax treatment of NOLs, but cautioned that "[t]he fact that the NOL Poison Pill was reasonable under the specific facts and circumstances of this case, should not be construed as generally approving the reasonableness of a 4.99% trigger in the Rights Plan of a corporation with or without NOLs."
[118] Fleischer, supra note 17, §5.5[C].

a useful reference, we take this range as the basis of our discussion.[119]

It is hard to see how the most potent of the threats that we have identified – the acquisition of creeping control – can justify a pill with a trigger threshold of less than 20%. There are very few cases in Delaware in any contexts finding control at levels below 40% and none at levels below 30%.[120] Thus, for example, in *PNB*, then Vice-Chancellor Strine faced with a 33.5% block noted that "[a]t that level, a single stockholder would not be deemed a controller without additional facts supplementing his clout."[121] And in *Cysive*, an owner of 35% was deemed a controller only because he was also Chairman and CEO, was deemed to wield influence over another director who owned 1%, and had the option to acquire 3-4% of the company's shares.[122]

In *Yucaipa*, the court upheld a pill with a 20% threshold under the creeping control rationale. In that case, the activist Yucaipa held 17.8% of the stock and Aletheia, another hedge fund that had a history of cooperating with Yucaipa, held 17.4%.[123] Given the substantial holdings by both funds and their prior relationship, the court's conclusion that a 20% threshold was needed to guard against creeping control was plausible.

On the other hand, in *Ruprecht*, the threat of creeping control was used to justify a pill with a 10% threshold. Although several hedge funds had positions at various times in Sotheby's, their aggregate ownership was only 19%.[124] Thus, even taking into account that multiple activists – apparently independently – pursued Sotheby's, we are skeptical whether the threat of creeping control justified a 10% trigger.

In particular, the mere fact that several hedge funds, without evidence or a past pattern of coordination, have taken a position in the activist target and are agitating for change, does not justify a 10% trigger to combat the threat of creeping control. As Vice Chancellor Strine vividly explained in *PNB*, separate persons who have temporarily aligned interests – as such funds may have in inducing the company to change its strategy – do not for that reason become a unified controlling shareholder: "Glomming share-owning directors together into one undifferentiated mass with a single hypothetical brain would result in an unprincipled Frankensteinian version" of

---

[119] Market practice may also affect the assessment of reasonableness by Delaware courts. Thus, for example, after early cases approved breakup fees of 1-2% and then 1-3%, breakup fees creeped up to 2-3% then 2-4% and it is now generally accepted that breakup fees of 3-5% of transaction value are within the range of reasonableness even though there has never been any real evidence on the level of breakup fee that is be "coercive" or "preclusive," as would seem to be required under Unocal/Unitrin. Not surprisingly, breakup fees now cluster in the 3-5% range, depending on deal size. See generally Steven M. Davidoff and Christina M. Sautter, Lock-Up Creep, 38 J. Corp. L. 681 (2013); John C. Coates, IV & Guhan Subramanian, A Buy-Side Model of M&A Lockups: Theory and Evidence, 53 Stan. L. Rev. 307 (2000) (figure 2).

[120] Marcel Kahan & Edward Rock, How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity, 58 Emory L. J. 713, 742-43 (2009).

[121] In re PNB Holding Company Shrs Litigation, 2006 WL 2403999 (Del. Ch. 2006) at *42-45.

[122] In re Cysive, 836 A.2d 531, 535 (Del. Ch. 2003).

[123] See supra Section II.d.

[124] Id.

a controlling shareholder.[125] What is true for the PNB directors is also true for hedge funds.[126]

The threat of undermining a fair election process, however, may present a more serious argument for Sotheby's low threshold pill. According to the company's 2014 proxy statement, Sotheby's directors and executive officers as a group owned just 1.95% of the shares, a portion of which consisted of derivatives without voting rights. In these circumstances, permitting an activist to accumulate 19.9% of the votes could strongly tilt the outcome of a board election. With a turnout of, say, 85%, an activist would need just a little more than a third of the votes of the "neutrals" in order to prevail.

That, however, does not imply that the threat of undermining a fair election process generally justifies low threshold pills. One factor that is relevant is *the board's* equity stake. When, say, the CEO owns 12% of the stock, we do not see that permitting an activist to acquire up to 20% poses a material threat. For one, incumbents have numerous built in advantages in an election contest – in particular, the fact that the company bears their campaign expenses -- that may legitimately be outbalanced by letting an activist acquire a somewhat greater voting stake. Moreover, a pill can at most try to limit gross imbalances and neither can nor should try to achieve complete equality. [127]

Last, and most importantly, it is of course legitimate for an activist to put its money where its mouth is and to vote the shares it owns, even if it owns more shares than the incumbents. The goal of maintaining a fair election process, as we have articulated it, is to assure that the activist – like the incumbents -- cannot prevail without at least carrying a significant fraction of the "neutral" vote, not that the activist must obtain a *majority* of the neutral vote. (The latter rule would require, in essence, depriving *both* sides of their voting rights – a goal we do not endorse and, we are confident, any board would strongly oppose whenever the incumbents have more votes than the

[125] PNB, 2006 WL 2403999, *10.

[126] Moreover, a 10% trigger pill was not needed to address the possibility that two or more of the funds would buy additional shares of Sotheby's and *then* form a group. A pill with a higher threshold would effectively prevent the formation of a group that, in the aggregate, has shares in excess of this threshold. And the draconian financial consequences of triggering a pill should deter the funds from any borderline group formation. Furthermore, when, as in Sotheby's, only a minority of board seats are up for election, or are not contested, a majority of the incumbent board can retain a pill and thereby inhibit any post-election group formation.

[127] As we discussed, we are skeptical in principle whether "negative control/disproportionate influence" constitutes a material threat. To the extent that it does, it is not evident why it would justify a 10% trigger threshold. Even a 19.9% voting stake would have hardly conferred negative control upon Third Point. And, without knowing more about the share ownership structure, it is hard to evaluate how much disproportionate influence Third Point would have obtained and how much of a threat this would have constituted. Pills with a threshold of less than 20% (low threshold pills) are of particular concern if synthetic equity is counted towards the threshold. Synthetic equity, which carries no voting rights, confers no negative control/disproportionate influence of its holder. To the contrary, relative to the economic stake, an activist has synthetic equity will have disproportionately *low* influence. Viewed from that perspective, a decision by the board to include ownership of synthetic equity towards the threshold creates a strong inference that the board's true concern was not the threat of negative control/disproportionate influence, but rather the desire to fend off a pesky challenger – and should lead to further skepticism about a claim that a low threshold pill is justified by such a threat.

activist.)[128] With 12% and 20% stakes for the two sides and an 85% turnout, the activist would still need over 42% of the neutrals to win.[129]

Any benefit in maintaining a fair election process would have to be balanced with the extent to which a pill adversely affects an activist's ability to mount an effective proxy challenge. Permitting a low threshold pill that discourages any activist from mounting a challenge would amount to throwing out the baby with the water. Without a challenge, neutrals have no de facto power to make a decision. To ameliorate the incentive problem, it is – again – key that low threshold pills do not count synthetic equity towards the threshold.

However, it may not always be enough not to count synthetic equity. For small-cap companies, it generally takes a higher *percentage* equity stake than for larger companies to make waging a proxy contest worthwhile. The reason is that the costs of a challenge – which include the costs of developing an alternative strategy, legal expenses, the costs of writing a proxy statement, and campaign expenditures – as a proportion of the value of the company tend to be higher for smaller companies than for large ones. To compensate for these higher proportionate costs, an activist must have higher proportionate gains. And in order to obtain such gains from the appreciation of the value of the company, and to persuade other shareholders that appreciation of company value (rather than private control benefits) are the source of such gains, an activist must have a higher economic stake in the company.

But if a company lacks a developed market for derivatives and other types of synthetic equity, the only practicable way to obtain such a stake may be to buy stock. Moreover, synthetic equity creates less of a commitment by an activist to become a longer-term shareholder. Most types of synthetic equity – such as call options or total return swaps – represents a play on relatively short-term price movements. Unless the activist takes affirmative steps, its economic stake will end the option expire of the swap terminates. Hence, an activist who has only, or predominantly, synthetic equity may not be seen as a long-term shareholder -- be taken less seriously -- by the other shareholders. For these reasons, pills with a trigger threshold of 10% may be inappropriate even if the activist is free to acquire synthetic equity and, as in Sotheby's, incumbents own only a trivial stake.

---

[128] Section 203 of the Delaware General Corporation law adopts a version of dual neutralization: Section 203(a)(2) excludes shares held by the board in calculating whether an interested stockholder achieves an 85% majority; Section 203(a)(3) exempts business combinations approved by 2/3 of the outstanding stock not counting stock owned by the interested stockholder. 8 Del.C. § 203(a)(3).

[129] Cf. Unitrin, 651 A.2d at 1361 (holding that repurchase program that raised board stake from 23% to 28% even though shark repellant provision I charter effectively capped a raider's share to 15% was still reasonable because a raider who acquired 15% of the shares would have realistic chances of winning of proxy contest). Given Unitrin's assumption of a 90% turnout, the board of Unitrin would have had to win only 36% of the shares to prevail against the raider in such a contest.

c. Discriminatory Triggers

Another issue that is of particular significance for activist pills is whether a pill may have different trigger thresholds for different shareholders. In traditional pills designed to ward off a hostile takeover, such discrimination among shareholders poses no special problem. Hostile takeover pills are mostly designed to guard against the threat of a takeover at an inadequate price. As *Moran* made clear, this threat has to be evaluated by the board in the context of a specific bid. Thus, while the pill may be maintained, say, for a bidder, because that bidder is planning to make a bid at an inadequate price, the board could – in fact, may be required to – exempt another shareholder from the pill because that other shareholder is making a bid at an adequate price.[130]

In the context of a pill directed against an activist, however, discriminating among shareholders raises different issues. In practice, the issue of discrimination often arises in one of two settings: the grandfathering of an existing large shareholder (as in *Yucaipa*) or the imposition of different thresholds for 13D and 13G filers (as in *Ruprecht*). We address each setting separately.

1. Grandfathering

Consider a company faced with an activist challenge that has an existing large shareholder, perhaps its founder, who holds 31% of the company's stock. Any new poison pill adopted by that company with a trigger threshold of, say, 20% would prevent any other shareholder from acquiring more than 20% of the company's stock, but would generally permit the founder to retain her 31% stake (though the pill could prevent her from acquiring additional shares).[131] Could the company adopt such a discriminatory pill against a shareholder activist?

If the justification for the pill lies in the preservation of a fair election process, a discriminatory pill that grandfathers a shareholder who is part of, or affiliated with, the incumbent board cannot be justified.[132] To the contrary: such discrimination would result in an uneven playing

[130] Moran, 500 A.2d at 1356. If two bidders make non-coercive cash offers, the company under *Revlon* may not use the pill to discriminate among the bidders. Revlon, 506 A.2d at 184. However, if one bidder makes a stock offer and the transaction would not subject the target to *Revlon* duties, the company may be permitted to exempt the stock transaction from the pill while maintaining the pill to block a different transaction, even if that transaction offered a higher current value.

[131] In a recent Delaware Chancery court opinion in *Dole*, the court makes clear that the 30% shareholder Murdock had credibly threatened to launch a hostile tender offer if an independent committee did not accept the proposed buyout terms. In re Dole Food Co., Inc. Shareholder Litigation, 2105 WL 5052214 *17. An emerging issue, beyond the scope of this article, is whether Delaware is inching towards the view that in a controlling shareholder freezeout context, the special committee – either to get the benefit under MFW or to rebut a duty of loyalty claim – must adopt a pill that blocks the controlling shareholder from increasing its position. See supra note 31 (discussion of controlling shareholder pill cases).

[132] The same applies to the threat of negative control/disproportionate influence. Whatever its general plausibility, grandfathering a large shareholder who is part of or affiliated with the incumbent board – and presumably wields disproportionate influence – undermines this rationale. A board should not be permitted to cherry-pick which shareholders may acquire such negative control and disproportionate influence and which may not. Moreover, given

field inconsistent with the goal of making the election process more fair.

Likewise, it is difficult to justify grandfathering when a pill is intended to respond to the threat of creeping control. But if the grandfathered holder with its stake already has control, then there is no further control for the new holder to be obtained; and if the grandfathered holder with its stake does not have control, then why not let the new holder obtain the same percentage of stock (and with the same lack of control)?

Even if control is a matter of degree, then the fact that the company already has a shareholder who owns sufficient shares to exert a material degree of control militates in favor of letting another shareholder acquire a large stake. The degree of control a stake conveys is clearly related not just to the absolute size of the stake, but also to the overall ownership distribution. A 49% stake entails no control in a company where a single shareholder holds the other 51% but a lot of control in a company where a large number of dispersed shareholders hold the other 51%. In the presence of a large shareholder, therefore, permitting another shareholder to accumulate a substantial stake would often reduce the degree of control that the first shareholder exercises. The argument that the threat of creeping control justifies discrimination, thus, should at a minimum be closely scrutinized.

By contrast, grandfathering should be permitted when the to-be-grandfathered shareholder is antagonistic to the board (and, say, acquired its stake before it filed a Schedule 13D which alerted the board to the potential need to adopt a pill). Such cases do not raise the concern that the purpose or effect of the pill is to preserve the power of the to-be-grandfathered shareholder. Rather, in such cases, a discriminatory pill may be the lesser of two evils. As to the existing large shareholder, the train has left the station: any damage generated by permitting him to hold such a large stake has occurred, and the board cannot change that. The question facing the board is thus whether, *given the presence of an existing large shareholder*, it would be desirable to constrain other investors to a lower ownership threshold – and not whether, in an ideal scenario, a lower ownership threshold applicable to all shareholders would have been even more preferable. If the lower threshold pill would be valid absent grandfathering, then the fact that an existing shareholder is grandfathered should not damn the pill.

This analysis stands in apparent tension with *Yucaipa*. In that case, the court upheld a pill that constrained the activist Yucaipa to a maximum of 20%, but grandfathered Riggio's existing 31% stake.[133] However, in *Yucaipa*, there was also a second activist, Aletheia, that together with

---

that the company has a large shareholder supportive of management, it is not at all clear that the emergence of *another* large shareholder critical of management would result in disproportionate influence. Rather, it is more plausible that the second large shareholder would reduce the existing disproportionate influence of the first one and empower the remaining shareholders.

[133] Yucaipa, 1. A.3d at 321.

Yucaipa held over 36% of the stock.[134] We think that *Yucaipa* is better understood as a case addressing how of the presence of multiple activists affects the proper pill threshold, rather than as a general case about grandfathering. And as we discuss below,[135] understood in that matter, the tension largely disappears.

2. Different Thresholds for 13D and 13G Filers

While we generally would not permit discrimination through grandfathering, discrimination between 13D and 13G filers may be justified. The difference is two-fold. First, grandfathering (of the problematic sort) involves a specific large shareholder who is supportive of management. In distinguishing between 13D and 13G filers, the board discriminates in favor of *a category of* shareholder (13G filers) without knowing who these shareholders will be and without having grounds for believing that they will support the board.

Second, a 13G filer will generally present less of a "threat" than a 13D filer. A shareholder that holds more than 5% may file the (less burdensome) Form 13G if it has not acquired the securities with any purpose or with the effect of changing or influencing the control of the company.[136] 13G filers thus credibly disavow any interest in obtaining control or becoming an

---

[134] Id. at 324.

[135] See infra Section III.d.2.

[136] Certain categories of shareholders that hold more than 5% can file a 13G "short form" beneficial ownership disclosure rather than the full 13d disclosure. For our purposes, two categories are important. First, 13G is available to "qualified institutional investors" including registered broker dealers, registered investment companies and registered investment advisors, who acquired the securities in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer. Such investors must file with 10 days of the end of the month of the triggering event requiring the filing, and must amend the Schedule 13G each year within 45 days of the end of the calendar year to report changes. If, however, a 13G filer acquires in excess of 10% of the stock, an amended 13G must be filed within 10 days of the acquisition. Second, 13G filing is also available to "passive investors" defined as an investor that "(i) has not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the issuer, or in connection with or as a participant in any transaction having that purpose or effect, other than a qualified institutional investor; and (ii) is not directly or indirectly the beneficial owner of 20% or more of the class." Rule 13d-1(c), 17 C.F.R. § 240.13d-l. Passive investors must file the 13G within ten days of the acquisition of 5% (but less than 20%).

Mutual funds typically file 13Gs as QII while hedge funds that have a genuine intent to remain passive take advantage of the passive investor exemption. By contrast, hedge funds with a history of activism, and who have even an inkling that a passive engagement may eventually turn active, are well advised to file a 13D from the outset.

At least for QIIs, filing a 13G is consistent with engaging in substantial shareholder activism that falls short of a control contest. Amendments to Beneficial Ownership Reporting Requirements, File No. S7-16-96, SECURITIES AND EXCHANGE COMMISSION, INTERNATIONAL SERIES Release Nos. 1111, 34-39538; 17 CFR Part 240; RIN 3235-AG81Adopting Release at p. 10, 1998 SEC LEXIS 63, *33. Such activism could, e.g., include urging management to sell assets or pay a large dividend or change executive compensation, pushing for the elimination of poison pills and staggered boards, and possibly using proxy access to nominate a couple of directors (along with a stated commitment not to seek control) in a company that has adopted proxy access. In the wake of the Department of Justice's HSR enforcement action against ValueAct, the SEC modified its Compliance and Disclosure Interpretations to clarify that not qualifying for the HSR "solely for the purpose of investment" exception due to a shareholder's efforts to influence management on a particular topic does not, by itself, disqualify the shareholder from reporting on 13G. https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm (July 14, 2016), Question

active contestant in a proxy contest. Because 13G filing status is not available to any person who acquires stock with the purpose or with the effect of changing or even influencing the control of the company, concluding that 13G filers pose no or a substantially reduced threat of obtaining creeping control is reasonable. Accordingly, if a pill is meant to protect against a threat of creeping control, a higher threshold for 13G filers is appropriate and perhaps required.

Similarly, as 13G filing status is not available for active contestants in a proxy contest, a 13G filer presumptively remains one of the "neutrals." The fact that a 13G filer is a neutral who owns a lot of shares means, on one side, that the filer, within the group of neutrals, carries a lot of weight. But it also means that the filer has strong incentives to determine how best to cast its vote. Because the existence of such a shareholder does not detract from the goal of furthering a fair election process, it may thus also be reasonable to differentiate between 13D and 13G filers if the pill is justified on that basis.[137]

d. Groups and Packs

A final poison pill design element that arises in the activist context is the impact of *other* holders who may be likely to support the activist. In particular, how may pills deal with "wolf packs," where several hedge funds take sizeable positions in a target and act in what critics claim is a parallel manner, as in our opening hypo?

We divide our discussion into two parts. First, under what circumstances can pills aggregate ownership for purposes of determining whether a holder has exceeded the pill threshold? Second, under what circumstances can boards take the presence of other holders supportive of an activist into account in setting the threshold, e.g., can a wolf-pack justify a *lower* threshold pill

---

103.11.

For hedge funds, such activism would be more risky especially if they later decided to push for a sale of the company. At the very least, starting as a 13G filer and later switching to 13D, even if at the time there were no thoughts of control, is legally risky.

[137] With regard to the threats of negative control/disproportionate influence, it is far less clear why the difference between 13D and 13G filers should matter. Mere "negative control" – the ability to exercise voting power that makes it difficult for the board to pursue a certain course of action –- is probably not control for purposes of Section 13 and is thus compatible with 13G filing status. CITE. A 13G filer may thus now, or in the future, veto a board proposal – e.g. by opposing a merger – without endangering its filing status. And even though 13D and 13G filers differ in their ability to threaten a proxy contest, as conducting a contest is not compatible with 13G filing status, this, as discussed above, is not a basis for finding a threat of disproportionate influence.

In *Ruprecht*, the court upheld a pill with a 10% threshold on 13D filers and a 20% threshold on 13G based on the threat of negative control or disproportionate influence. To the extent that *Ruprecht* could be read to endorse differential thresholds for 13D and 13G filers, we agree with the outcome, though not with the reasoning: the differential threshold in *Ruprecht* could be justified based on the threat to a fair election process, but not on any threat of negative control/disproportionate influence.

than would be permissible in the absence of a wolf-pack?[138]

1. Aggregation

To the extent that two or more holders act together for the purpose of acquiring, holding, voting or disposing of securities, they form a group and their ownership interests are aggregated under Rule 13D. Such an agreement can be formal or informal. Standard poison pills already incorporate the 13d concept of a "group" in aggregating ownership by different entities for purposes of determining whether a pill is triggered. But as long as they do not make any explicit or implicit agreements with respect to the target company securities, the members of a wolf pack can communicate without triggering 13d or causing aggregation under a standard pill.[139]

Some practitioners have therefore suggested to expand the circumstances where ownership is aggregated for pill purposes to include shareholders who "act in concert" or, borrowing a concept from the antitrust laws, engage in "conscious parallelism." Genesco's pill provides a useful example of such a "wolf pack" trigger:

> A Person shall be deemed to be "Acting in Concert" with another Person if such Person knowingly acts (whether or not pursuant to an express agreement, arrangement or understanding) in concert with such other Person in, or towards a common goal relating to, changing or influencing the control of the Company or in connection with or as a participant in any transaction having that purpose or effect, in parallel with such other Person where at least one additional factor supports a determination by the Board of Directors that such Person intended to act in concert in or in parallel with other

[138] We ignore the use of advance notice bylaws to address wolf packs as beyond the scope of this article. See, e.g., Charles Nathan and Stephen Amdur, Second Generation Advance Notice Bylaws and Poison Pills, April 22, 2009 at https://corpgov.law.harvard.edu/2009/04/22/second-generation-advance-notice-bylaws-and-poison-pills/ ; Marc Weingarten and Erin Magnor, Second Generation Advance Notice Bylaws, https://corpgov.law.harvard.edu/2009/03/17/second-generation-advance-notification-bylaws/.

[139] Section 13(d), part of the 1967 Williams Act, is intended to provide early warning of potential change in control transactions. The case law interpreting the scope of 13d views the limitations on the reporting obligation as intentional. The analysis starts with the proposition that "there must be an agreement to act in concert" for one of the stated purposes. Texasgulf, Inc. v. Canada Development Corp., 366 F. Supp. at 403. (D. Tex 1973). Thus, agreements for other purposes are not regulated, such as sponsoring litigation against management (even if the litigation could lead to a change in control), Portsmouth Square, Inc. v. Shareholders Protective Committee, 770 F.2d 866, 873 (9th Cir. 1985), or discussions and agreements about management's performance, Bath Indus., Inc. v. Blot, 427 F.2d 97, 110 (7th Cir. 1970). As Briggs explains in a comprehensive discussion of 13d doctrine, "Mere preliminary discussions do not count: 'Section 13(d) allows individuals broad freedom to discuss the possibilities of future agreements without filing under securities laws.' Meetings, conferences and telephone calls among concerned shareholders who discuss various options about what to do, without coming to any definitive agreements, arrangements or understandings also do not count. The language used by courts has been fairly sweeping and reads like a charter of shareholders' rights." Thomas W. Briggs, Shareholder Activism and Insurgency Under the New Proxy Rules, 50 Bus. Law. 99, 113-114 (1994), footnotes and copious citations eliminated. More recent cases confirm the relatively narrow focus of 13d, including Hallwood Realty Partners L.P. v. Gotham Partners, L.P. 286 F.2d 613 (2d Cir. 2002) (no group even though one was a well-known activist and all three discussed how to improve value of the target); meVC Draper Fisher Juvetson Fund I, Inc. v. Millenium Partners, L.P., 260 F. Supp. 2d 616, 631-633 (S.D.N.Y. 2003) (no group despite joint slate of directors); but see Coffee & Palia, supra note 7 (criticizing what they see as a narrowing of the definition).

> Person, which such additional factors may include, without limitation, exchanging information, attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel.[140]

Echoing the antitrust doctrine,[141] these "acting in concert" provisions require something more than pure parallel conduct.[142] The "plus" factors are intended to capture conduct among shareholders that falls short of an "agreement, arrangement or understanding" but that nonetheless facilitates parallel action, such as "exchanging information, attending meetings, conducting discussions, or making or soliciting invitations to act in concert or in parallel." Delaware has not ruled on the validity of these provisions.[143]

In our view, wolf pack provisions suffer from two fatal flaws, each of which would on its own be sufficient to render them invalid. First, and more obviously, wolf-pack provisions like Genesco's do not clearly specify what activities would result in aggregation. It includes nebulous terms like "acting in concert" or "in parallel"; broad plus factors like "exchanging information" and "attending meetings" which are arguably satisfied by mundane conversations; and some vague requirement of either a common goal "related to" control or "purpose or effect" of "influencing" control. Because triggering a pill would have severe adverse consequences, such vague, and potentially overbroad, provisions would have a chilling effect on an activist's ability to communicate with other shareholders. Averse to running the risk of being caught by a wolf-pack provision, and unable to provide specific guidance, legal counsel to institutional investors may well advise their clients to avoid any direct contact with an activist, lest a portfolio managers say or do something (like buy more shares) that could be construed as "Acting in Concert."

Second, the very purpose of wolf-pack provisions – to make illicit parallel actions that are not the product of an agreement – is based on a fundamental misconception of how shareholders *ought* to interact. These sorts of provisions threaten to chill the sort of shareholder interaction that sound corporate governance depends upon and that decades of reform have sought to encourage. To illustrate why, let us return to our opening hypo and assume that two hedge funds – Lupin and

---

[140] Genesco Pill, supra note 98.

[141] ABA, Antitrust Law Developments: 1-1 Antitrust Law Developments 1B; 1-3 Antitrust Law Developments 3B (available on Lexis).

[142] Frank Aquila and Melissa Sawyer, Perfect Pill, Imperfect Defense; Latham 2014 Poison Pill Developments and Trends 29-33; Jack Bodner and Leonard Chazen, Conscious Parallelism May Justify a Wolf Pack Pill, Law 360 (May 27, 2014); William Tevlin, The Conscious Parallelism of Wolf Packs: Applying the Antitrust Conspiracy Framework to Section 13(D) Group Formation, forthcoming Fordham L. Rev. __.

[143] In *Yucaipa*, the Barnes & Noble pill had a wolf pack trigger that was removed before court ruling, and there is language in the opinion that suggests that the court had doubts about that the validity of that provision. The Resilient Rights Plan, supra note 99, at 31; Yucaipa, 1 A3d. at 339-40. In *Stahl*, the Chancery Court upheld a pill that aggregated shares on the basis of an agreement to share expenses in a proxy contest, even if the agreement did not relate to voting. Stahl v. Apple Bancorp, 1990 WL 114222 (Del. Ch. 1990). In that case, the proxy challenger already owned over 30% of the company's stock and sought to acquire control – factors that may well justify a broad definition of beneficial ownership for pill purposes. But in any case, *Stahl* concerned an express agreement that raised neither of the concerns that we regard as fatal for wolf-pack provisions.

Remus -- accumulate shares in Little Red Ridinghood Corp ("LRR"). Each fund is aware, from rumors or public disclosures, of the other's activities. Lupin then sends a letter to the board of LRR asking for various changes in the company's business strategy and threatening a short-slate proxy contest if the company does not adopt its proposal.

May Lupin, without having to worry about a wolf-pack provision, meet with officials of Remus to try to persuade them of the merits of its proposals? May Remus advise Lupin on how its proposals should be changed to gain its support and may Lupin make such changes? May Remus, in its filings or in a press release, indicate its support for Lupin's proposals?

Under the Genesco pill, the answer would seem to be no. But these activities would be innocuous if undertaken by LRR's management or if one substituted a long-term institutional shareholder for Remus. Indeed, the actions are not just innocuous, but are laudable and exactly what one would expect from a highly engaged shareowner: surely it is desirable, from a corporate governance perspective, that Lupin exchange information with, and solicit the input from, other shareholders and adapt its proposals in response to that input. In fact, such "coordination" is indistinguishable from normal campaigning.

Applying the wolf pack provision to traditional institutional investors would restrict normal and appropriate shareholder interaction and would fail *Unocal*. Applying it to hedge funds should not change the analysis. The fact that activist hedge funds sometimes act like shareholders on steroids when compared to the traditional institutional or individual shareholders does not constitute a cognizable threat, but merely reflects the confluence of economic incentives and the legal rights granted by Delaware corporate law.

In the end, a wolf pack trigger lacks normative coherence. Thirty years of corporate law reform has been aimed at encouraging shareholders to become more active and to consult with other shareholders.[144] Some level of shareholders acting in concert, engaging in conscious parallelism, and coordinating is desirable given their common interest in increasing the value of the stock and given the need to communicate on how best to further this common interest. Communications among shareholders are regulated by the proxy rules, which are designed to assure that shareholders have reasonably complete and accurate information in casting their votes.[145] The proxy rules have been criticized as imposing an undue compliance burden.[146] Perhaps they do, but the goal of the proxy rules – increasing the information available to shareholders so that they can make better choices – is at least unimpeachable. In addition to the proxy rules, disclosure obligations under Section 13(d) further chill communication among

[144] For a summary of the obstacles to shareholder activism, see Bernard Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520-608 (1990).
[145] Regulation 14A [17 CFR 240.14a-1 - 240.14b-2]
[146] See, e.g., Bernard Black, The Legal and Historical Contingency of Shareholder Passivity, 88 Mich. L. Rev. 520 (1990).

shareholders on matters of common interest such as the quality of candidates for director. Wolf pack triggers are designed to make communication even more dangerous and to limit actions that are indistinguishable from shareholders talking to each other and exchanging information so that they can make better choices.

The parallel between wolf pack triggers and conscious parallelism in the antitrust context demonstrates exactly this problematic feature of wolf pack triggers. In the antitrust context, cooperation among competitors is presumptively disfavored and the chilling effect of overbreadth can be justified as protecting consumers. As Adam Smith famously remarked:

> People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.[147]

But in an effective corporate democracy, shareholders meeting together is a necessity, not a danger.

2. The Proper Threshold

A more difficult question is whether the presence of wolf-packs can be taken into account in setting the pill threshold. In particular, a wolf pack may raise two concerns that relate to the two threats we have identified. First, even if there is no formal or informal agreement between members of the wolf pack at the time, could such an agreement, which would then confer control upon the pack, be formed at a later point in time? And second, may a wolf pack undermine the fairness of the electoral process?

Take first the concern that the wolf pack may form a control group later on. The initial answer to this concern is that, as long as a poison pill remains in place, such a formation would trigger the pill and be prohibitively expensive for the members of the pack.[148] But, of course, there is no assurance that a pill will remain in place. Under Delaware law, an incumbent board cannot constrain a future board from redeeming a pill.[149] So it is possible that a pill will be removed and that the wolf pack will form a control group.

In most proxy contests, where challengers compete for only a minority of seats, the incumbents would retain board control. But in any case, the possibility that a future board, consistent with its fiduciary duties, may redeem a pill in order to enable a shareholder to acquire control always exists, whether a single activist, a wolf pack, or no activist at all lurks in the background. The only factor that differentiates a wolf pack from a single activist is the possibility that, without any agreement or understanding, all members of a wolf-pack may share a self-

[147] Adam Smith, The Wealth of Nations 128 (1937).
[148] Indeed, one reason to declare a 13d group in an initial 13d filing is to take advantage of grandfathering.
[149] Quickturn, 721 A.2d at 1281.

interested goal – forming a group to obtain control in the future – and will act to further it.

This possibility illustrates the second potential issue, namely that a wolf pack may undermine a fair election process. This issue is more complex and relates to the broader one raised above: if it is legitimate to structure corporate elections so that contestants need to persuade a significant fraction of the "neutrals" about the merits of their business plans, who exactly should count as "neutral"? If we are right about the emerging balance of power in corporate decision-making, and if one accepts our view that preserving a fair election process is a legitimate board goal, the detail of what this means will have to be worked out in the factual context of actual contests. Our thoughts here are thus preliminary.

Which shareholders are part of the "neutral" bloc that will be the decision-makers, which are partisans? By definition, the contestants themselves – the board and activist challenger – are partisans. But how about shareholders who have a general disposition to favor activist challengers, or incumbents, in proxy contests? A mere disposition, based on past voting record or a shared business philosophy, to favor one side in a contest should not render an investor non-neutral. For one, each shareholder has *some* prior disposition. And, of course, a disposition does not control the vote cast in an actual contest. A contestant still has to persuade shareholders disposed towards it that its proposals actually merit a vote in its favor.

Second, incumbents will be inclined to regard shareholders disposed towards activists as non-neutral, while counting shareholders disposed towards themselves as neutral. With a vague and amorphous definition of who is non-neutral, courts will have difficulty policing board decisions and maintaining a fair process—and effective policing by courts is integral in assuring that board does not favor itself under the guise of enhancing the fairness of the election process.

Third, and most importantly, dispositions are legitimate. A disposition to favor activists (based on a general notion that management in many companies needs some shaking up) or a disposition towards incumbents (based on some general notion that activists are self-interested and short-term oriented) should not be neutralized via a poison pill. These dispositions *ought* to make it easier or harder for one side to prevail.

Thus, it is not clear to us that the mere fact that other hedge funds have taken a position in the target, or even that other funds have filed a Schedule 13D or have (independently or after listening to a contestant) concluded that the activist challenger's business strategy is promising, is a permissible consideration in setting the pill threshold.

A workable system for determining which shareholders, other than the contestants, are not "neutrals," harkens back to another area of corporate law: the duty of loyalty. With regard to self-dealing and material conflict transactions, the law requires that directors be disinterested and

independent for the approval to have a cleansing effect.[150] The concept of disinterestedness and independence are reasonably well developed and, moved to the context of shareholder voting, can be employed to justify lower threshold pills in some context.

In the duty of loyalty context, a person is interested if she obtains a material benefit from a transaction (other than a benefit proportionally bestowed on all shareholders).[151] In the context of shareholder voting, it may be appropriate to expand the relevant transaction to include both the shareholder vote itself and the business strategy a contestant plans to pursue. Thus, for example, employees may be considered interested when one of the contestants campaigns on raising wages (or firing half the workforce); or a shareholder who also has a material investment in a hedge fund contestant may be interested. Such instances of interestedness are likely to be uncommon, but may arise occasionally.

In the duty of loyalty context, a person lacks independence if she has a relationship with another person who is interested that impairs her ability to cast a vote on the merits of a transaction.[152] Common relationships giving rise to lack of independence include being employed by the interested person or being a material supplier of goods or services. In the context of shareholder voting, a corporate shareholder may be considered interested if, for example, the CEO of that company is one of the director nominees or if the company has material business dealings with one of the contestants.

As in the duty of loyalty context, an assessment of interestedness or lack of independence would have to be based on tangible evidence: the identification of a transaction that generates a material interest or a specific relationship giving rise to a lack of independence. And of course, shareholders are permitted to cast their votes in their own interest, even if their interest differs from the interests of other shareholders. Thus, while an assessment of interestedness or lack of independence could be a reason for a company to deploy a pill with a threshold lower than the one that would otherwise be permitted, it would not be a basis for a breach of fiduciary duty claim.

From this perspective, we may again consider *Yucaipa*. Recall that in *Yucaipa*, Barnes & Noble adopted a pill grandfathering Riggio (who held over 30% of the stock), but imposing a 20% threshold on new shareholders. Yucaipa was agitating for change and another hedge fund, Aletheia, was also in the picture. Yucaipa and Aletheia together held stock in a similar magnitude as Riggio and some small shareholders close to him.[153] We earlier argued that the creeping control rationale, without more, does not present a valid basis for discriminating between Riggio and a challenger. Moreover, even a non-discriminatory pill (set at the level of Riggio's holdings) would

[150] Marciano v. Nakash, 535 A.2d 400, 404-405 (Del. 1987).
[151] Orman v. Cullman, 794 A.2d 5, 25 n. 50 (Del Ch. 2002)
[152] Id.
[153] 1 A.3d at 324.

have prevented Yucaipa and Aletheia from forming a control group.[154]

But was Aletheia disinterested and independent? Yucaipa and Aletheia were not strangers. Burkle, the head of Yucaipa, and Peter Eichler, Aletheia's founder, had met to discuss Barnes & Noble; Eichler had followed Burkle's lead in at least three other investments and was following it again in this one; and Eichler, the court found, was quite taken by Burkle:

> At his deposition, Eichler gushed over Burkle, and made clear that for him, the chance to talk investments with Burkle was equivalent to an aspiring songwriter getting to trade licks and lyrics with Dylan. In the same deposition, Eichler expressed his view that Barnes & Noble would be fortunate to have Burkle on its board.[155]

Filtering out the judge's colorful language, this degree of admiration, in the context of a shareholder vote, goes significantly beyond a mere disposition to support someone but approaches – and arguably reaches -- a level of deference that amounts to lack of independence. To that extent, the board of Barnes & Noble may have been justified in imposing a 20% pill threshold on other shareholders while grandfathering Riggio's 32% stake.

Conclusion: Policy Implications

In the new world of corporate governance, in which activist hedge funds and other "highly engaged shareowners" seek to change corporate policy through methods that range from public and private pressure to proxy contests, and in which large institutional investors have become the ultimate decision makers in corporate controversies, poison pills are being deployed by boards of directors. In reviewing these moves, courts will be faced with a variety of issues that did not arise in the takeover context. In this article, we worked through a variety of these issues.

There are several very clear implications of our analysis. The two most plausible threats posed by an activist are that the activist is seeking control and that a disproportionally high stake held by the activist would enable it to win an election contest without carrying a significant percentage of the unaffiliated shareholder base. By contrast, the possibility that shareholders will make the wrong choices in deciding how to vote, that the activist is pursuing a short-term agenda, that the activist may obtain negative control or disproportionate influence, or that the activist and the election campaign creates disruption do not represent threats that could justify a poison pill.

In this context, we are skeptical of including synthetic equity – which confers no voting rights – in the calculation of the poison pill trigger. Synthetic equity does not affect the outcome of a control contest, contribute to or facilitate creeping control or relate to any other cognizable

[154] See supra note 126.
[155] 1 A.3d at 325.

threat. On the other hand, the economic stake generated by synthetic equity -- the ability to profit from the increase in stock price -- is the life-blood of activism. The main effect – and perhaps the goal – of including mere economic exposure in the pill threshold is thus to make activism financially less attractive.

With the caveat that purely economic exposure should generally not count towards the threshold, we would regard non-discriminatory pills with a 20% threshold as presumptively valid. Such pills seem overall reasonably designed to prevent creeping control, and often serve to maintain a balanced election process, without significantly impeding an activist. On the other hand, even if economic exposure does not count, we would regard anti-activist pills with a threshold of less than 10% and pills with a "wolf-pack" trigger to be presumptively invalid. Such pills are not a reasonable response to any cognizable threat and impose excessive restrictions on the ability of an activist to conduct a credible contest and communicate with other shareholders.

Whether pills with a threshold of 10% or 15% (low threshold pills) should be permitted against activists depends on the context. In particular, low threshold pills may be justified in principle either when the incumbent board and management hold a substantially lower equity stake than the maximum an activist could acquire under a low threshold pill or when other significant holders either have a material interest in the outcome of the election contest that is not shared by shareholders at large or are dependent on the activist so that it is doubtful whether they would cast their votes "on the merits" to further the best interests of shareholders at large. These factors may make low threshold pills reasonable in preserving a balanced election process, at least when the activist can acquire a significant synthetic stake in the company without running afoul of the pill.

A final factor in evaluating pills is whether the same threshold applies to all shareholders. While we would permit pills to differentiate between 13D and 13G filers, pills that impose a low threshold on activists but grandfather a large, existing shareholder are suspect. Absent special circumstances, such discrimination – especially in low threshold pills -- is warranted neither by a threat of creeping control or by a desire to maintain a balanced election process.

european corporate governance institute

about ECGI

The European Corporate Governance Institute has been established to improve *corporate governance through fostering independent scientific research and related activities.*

The ECGI will produce and disseminate high quality research while remaining close to the concerns and interests of corporate, financial and public policy makers. It will draw on the expertise of scholars from numerous countries and bring together a critical mass of expertise and interest to bear on this important subject.

The views expressed in this working paper are those of the authors, not those of the ECGI or its members.

www.ecgi.org

european corporate governance institute

ECGI Working Paper Series in Law

Editorial Board

Editor	Luca Enriques, Allen & Overy Professor of Corporate Law, Faculty of Law, University of Oxford
Consulting Editors	John Coates, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School
	Paul Davies, Senior Research Fellow, Centre for Commercial Law, Harris Manchester College, University of Oxford
	Horst Eidenmüller, Freshfields Professor of Commercial Law, University of Oxford
	Amir Licht, Professor of Law, Radzyner Law School, Interdisciplinary Center Herzliya
	Roberta Romano, Sterling Professor of Law and Director, Yale Law School Center for the Study of Corporate Law, Yale Law School
Editorial Assistants :	Tamas Barko , University of Mannheim

www.ecgi.org\wp