
ANTI-ACTIVIST POISON PILLS

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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 against 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 enhance the shareholder decision-making process, it should, in doing so, act as a “neutral election board.”

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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 LRR’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 eightfold between 2002 (\$23 billion) and 2016 (\$176 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

¹ ACTIVIST INSIGHT, *ACTIVIST INVESTING: AN ANNUAL REVIEW OF TRENDS IN SHAREHOLDER ACTIVISM* 8 (2017) [hereinafter *ACTIVIST INVESTING 2017*], <https://www.srz.com/images/content/1/4/v2/147747/Activist-Insight-The-Activist-Investing-Annual-Review-2017.pdf> [<https://perma.cc/975Y-NS65>] (reporting \$176 billion held by funds with focus on activist investing at end of 2016); EVESTMENT, *HEDGE FUND ASSET FLOWS: MONTHLY SUMMARY REPORT MARCH & Q1 2014*, at 1 (Apr. 17, 2014), <https://www.evestment.com/wp-content/uploads/resources/research-reports/2014/201403-vestment-HF-asset-flows-report.pdf> [<https://perma.cc/S8N6-TE3U>]; Richard Lee & Jason D. Schloetzer, *The Activism of Carl Icahn and Bill Ackman*, DIRECTOR NOTES (May 2014), <https://www.conferece-board.org/publications/publicationdetail.cfm?publicationid=2772> [<https://perma.cc/TE8V-SBBF>].

² Liz Hoffman & David Benoit, *Activist Funds Dust Off Greenmail Playbook*, WALL STREET J., June 12, 2014, at C1 (noting number of campaigns launched by activist investors).

³ *ACTIVIST INVESTING 2017*, *supra* note 1, at 7, 22 (emphasizing increasing prevalence of shareholder activism).

⁴ See *Latest Company in Activist Crosshairs: Coca-Cola*, CHIEF INV. OFFICER (July 25, 2014), <https://www.ai-cio.com/news/latest-company-in-activist-crosshairs-coca-cola/> [<https://perma.cc/5ECS-F7PF>] (describing shareholder discord at Coca-Cola); Sharon Terlep, *P&G Repels Triun in Bid over Board*, WALL STREET J., July 18, 2017, at B1 (summarizing proxy fight at Procter & Gamble); cf. J.P. MORGAN, *THE ACTIVIST REVOLUTION: UNDERSTANDING AND NAVIGATING A NEW WORLD OF HEIGHTENED INVESTOR SCRUTINY* 6 (2015), <https://>

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

These and similar data have led the press and commentators to talk of an almost “hyperbolic” increase in hedge fund activism.⁷ Shareholder activism has also become a political issue. As a presidential candidate, Hillary Clinton called for “a new generation of committed, long-term investors to provide a counter-

www.jpmorgan.com/jmpdf/1320693986586.pdf [<https://perma.cc/ZX4N-3NUT>] (reporting seventeen campaigns against companies with market capitalization above \$25 billion in 2014, compared to six, four, five, and five in the four preceding years).

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. See J.P. MORGAN, HEDGE FUND ACTIVISTS 2.0: THEY ARE BACK! 5 (2010), <https://www.jpmorgan.com/jmpdf/1320675768240.pdf> [<https://perma.cc/X7GF-32J8>].

⁶ Activists often secure board seats with only the explicit or implicit threat of a proxy fight, without even filing any proxy materials. See generally GIBSON DUNN, 2016 YEAR-END ACTIVISM UPDATE (2017), <https://www.gibsondunn.com/wp-content/uploads/documents/publications/MAReport-2016-Year-End-Activism-Update.pdf> [<https://perma.cc/KQW4-HQAF>] (providing client alert documenting successful shareholder activism campaigns throughout 2016). 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 obtained board representation in around 40% of the proxy fights, mostly through settlements. See LAZARD’S CORP. PREPAREDNESS GRP., TRENDS IN ACTIVIST BOARD REPRESENTATION: 2012-2016 (reporting that in 2015 and 2016, 97 and 124 seats, respectively, were obtained through settlements and nine and seven, respectively, through shareholder votes).

The rise in activism has produced a cottage industry of empirical studies trying to determine the average effect of activist efforts on various measures of company value and often coming to conflicting conclusions. See, e.g., Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1154 (2015) (finding that activism is associated with increase in company value); K.J. Martijn Cremers et al., *Hedge Fund Activism, Firm Valuation and Stock Returns* 41 (Dec. 19, 2018) (unpublished manuscript), <https://ssrn.com/abstract=2693231> [<https://perma.cc/3BZD-SPVM>] (finding that activism is associated with smaller increase 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; 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 learn over time which activists, and what type 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, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 1 ANNALS CORP. GOVERNANCE 1, 11-17 (2016).

weight to the hit-and-run activists.”⁸ Senators Bernie Sanders and Elizabeth Warren co-sponsored the Brokaw Act to “increase transparency and strengthen oversight of activist hedge funds.”⁹ 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 a local paper mill.¹⁰ 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.¹¹ The combination of high-profile shareholder activism combined with 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 those 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, do buy substantial blocs of shares before they acquire a company. Hence,

⁸ Everett Rosenfeld, *Clinton Lashes Out at Activists in Apple, Others*, CNBC (July 24, 2015, 7:03 PM), <https://www.cnbc.com/2015/07/24/clinton-lashes-out-at-activists-in-apple-others.html> [https://perma.cc/8PV7-25WX].

⁹ Portia Crowe, *Bernie Sanders and Elizabeth Warren Are Going After Activist Hedge Funds*, BUS. INSIDER (Mar. 18, 2016, 9:08 AM), <http://www.businessinsider.com/elizabeth-warren-sponsors-activist-hedge-fund-bill-2016-3> [https://perma.cc/T7KP-FKC4] (describing bill that would impose stricter disclosure requirements on activist hedge funds); see also Jason N. Ader & Eric Jackson, *Senate Bill Would Limit Shareholder Rights*, N.Y. TIMES: DEALBOOK (Mar. 24, 2016), <https://www.nytimes.com/2016/03/25/business/dealbook/senate-bill-would-limit-shareholder-rights.html> (criticizing bill proposed by Senators Sanders and Warren).

¹⁰ Michael R. Levin, *The Mystery of the Brokaw Act*, ACTIVIST BLOG (May 17, 2016), http://www.theactivistinvestor.com/The_Activist_Investor/Blog/Entries/2016/5/17_The_Mystery_of_The_Brokaw_Act.html [https://perma.cc/DG42-ENZR] (explaining that the Wausau Paper plant in Brokaw was obsolete and that after being targeted by Starboard Value, Wausau closed several plants and was eventually sold). *But see* Ader & Jackson, *supra* note 9 (suggesting that closing of unprofitable plant averted bankruptcy); Alon Brav, J.B. Heaton & Jonathan Zandberg, *Failed Anti-Activist Legislation: The Curious Case of the Brokaw Act*, 11 J. BUS. ENTREPRENEURSHIP & L. 329, 342 (2018) (finding that activists played no role in plant closing).

¹¹ See *infra* Section II.C (discussing “short-termism” problem).

pill features such as the trigger threshold, the types of ownership interests that count towards that threshold, and the rules on aggregation of shares held by other investors turned out to be largely irrelevant.¹²

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.¹³ 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 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.

¹² See *infra* notes 23-28 and accompanying text.

¹³ 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. See generally Sheelah Kolhatkar, *The Doomsday Investor*, NEW YORKER, Aug. 27, 2018, at 44 (discussing Elliott Management's aggressive tactics). Dan Loeb at Third Point sometimes exemplifies this style. See *infra* Section II.B (discussing Dan Loeb's style in connection with Sotheby's). 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, became involved with companies such as Hewlett Packard ("HP") because of a sense that they could be better managed, and HP ended up with Whitworth as chair of the board of directors. Mark Rogers, *Why Ralph Whitworth May Be America's Best Board Member*, FORBES (Jan. 29, 2014, 11:59 AM), <http://www.forbes.com/sites/forbesleadershipforum/2014/01/29/why-ralph-whitworth-may-be-americas-best-board-member/> [<https://perma.cc/K8J2-SL8A>] (describing Whitworth as having added value to all boards that he joined). More recently, ValueAct Capital has also generally pursued a cooperative strategy. *Values*, VALUEACT CAPITAL, <https://valueact.com/values/> [<https://perma.cc/H3SJ-ZEZ8>] (last visited Apr. 5, 2019) (quoting Bob Sulentic, CEO of CBRE Group, Inc., as saying, "Since ValueAct Capital joined our Board . . . they have developed a deep understanding of our business and we have forged an open, two-way communication with them"). Triun, 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 scrutinizes management's strategy, and, when convinced, provides credible outside validation. See David Benoit, *Activists Win a Seat at the Table*, WALL STREET J., Dec. 26, 2015, at A1. 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.

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 hypothetical, 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.

The Article closes 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*.¹⁴ *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 Corp. v. Mesa Petroleum Co.*¹⁵: the bid must constitute a threat and retention of the pill must be reasonable in relation to the threat.¹⁶ 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.¹⁷ The possibility of a proxy contest has always been critical to the legitimacy of the pill.

Following *Moran*, the structure of pills and the courts' doctrinal analysis evolved in several ways. First, flip-in features were added to pills.¹⁸ Unlike flip-

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

¹⁵ 493 A.2d 946 (Del. 1985).

¹⁶ *Moran*, 500 A.2d at 1356.

¹⁷ *Id.* at 1354 (listing examples of methods to overcome pill).

¹⁸ Flip-in pills were held valid in *Stahl v. Apple Bancorp*, 579 A.2d 1115, 1124-25 (Del. Ch. 1990), which was 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 nonbidder 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 *Reylon, Inc. v.*

over pills, flip-in pills constrain the acquisition of a large bloc of company stock even if a bidder does not pursue a subsequent freeze-out merger, effectively preventing 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.¹⁹ Moreover, courts showed substantial deference to a board determination that a bidder's offer was inadequate.²⁰ 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*.²¹ 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%.²²

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*.²³ By contrast, in modern takeover practice, bidders rarely acquire substantial pre-bid toeholds.²⁴ 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.²⁵

MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1986) (finding that note purchase rights plan that discriminated between bidder and other shareholders was reasonable in relation to threat posed).

¹⁹ *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1990) (holding that mistaken belief by shareholders could be valid threat).

²⁰ *See id.* (holding that Time board reasonably determined that inadequate price represented threat justifying poison pill).

²¹ *See Moran*, 500 A.2d at 1355.

²² ARTHUR FLEISCHER, JR., ALEXANDER R. SUSSMAN & GAIL WEINSTEIN, *TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS* § 5.05[C] (8th ed. 2017) (describing decreased threshold for poison pills).

²³ *See Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

²⁴ Sandra Betton, B. Espen Eckbo & Karin S. Thorburn, *Merger Negotiations and the Toehold Puzzle*, 91 J. FIN. ECON. 158, 166 fig.3 (2009). For a fuller discussion explaining that toeholds are no longer fixtures of hostile takeovers, see B. Espen Eckbo, *Bidding Strategies and Takeover Premiums: A Review*, 15 J. CORP. FIN. 149, 165-69 (2009).

²⁵ Air Prods. & Chems., Inc., Definitive Proxy Statement (Form DEF14A), at 40 (July 29, 2010) (describing financial relationship between Air Products and Airgas). The trigger threshold of the Airgas pill was 15%. *See Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 62 (Del. Ch. 2011).

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 twenty-four such proposals between 2010 and 2015. Of these, the bidder acquired a stake that came close to the pill threshold in only five instances. In the nineteen others, bidders either had no significant stake (seventeen instances) or a stake substantially below the pill threshold (two instances).²⁶

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 to facilitate the acquisition, even when they hold no material stake in the target at the time of the contest.²⁷ 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.²⁸ Beyond that, little matters.

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 that, 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

²⁶ This data was generated from the mergers and acquisitions database kept by Thompson One. We limited the set of all mergers and acquisitions to deals that Thompson labeled as "Hostile, Neutral, or Unsolicited but not Hostile," to U.S. public targets, and to the subset of those deals that were announced between January 1, 1985, and July 26, 2016.

²⁷ 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, 15 U.S.C. § 18a (2012); and the Williams Act, *id.* § 78m, 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. *See* Eckbo, *supra* note 24, at 165-66. 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). *Id.* 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. *Id.*

²⁸ *See* Quickturn Design Sys., Inc., v. Shapiro, 721 A.2d 1281, 1292-93 (Del. 1998) (holding that delayed redemption provision in pill impermissibly constrains power of future boards); *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356 (Del. 1985) (holding that pill was reasonable, in part because it did not inhibit proxy contest).

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 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 explained above, in control contests, 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.²⁹

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.³⁰ 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.³¹

Last, but not least, a larger bloc 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 the activist will prevail in a contested vote and thus makes the threat of waging a contest more credible.

²⁹ Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 907-08 (2013) (describing free-rider problem).

³⁰ 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 & Shira Ovide, *Hedge Fund Invests in Microsoft*, WALL STREET J., Apr. 23, 2013, at B4 (reporting on ValueAct's revelation of ownership of Microsoft stock).

³¹ For example, by acquiring stakes in both Pepsi and Mondelēz, Trian credibly signaled its belief that its proposed combination of the two companies followed by a spin-off would benefit both companies. See David Benoit & Mike Esterl, *Nelson Peltz's Trian Exits PepsiCo Stake*, WALL STREET J.: MONEYBEAT (May 13, 2016, 2:55 PM), <http://blogs.wsj.com/moneybeat/2016/05/13/nelson-peltzs-trian-exits-pepsico-stake/>.

Indeed, many proxy contests by activists involve small companies in which activists have taken a sizeable stake. Of the thirty-seven contested solicitations in 2016, thirty-two 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 fifteen of these contests, the dissident held a stake of 5-10%; and in ten contests, the dissidents held a stake in excess of 10%.³²

In sum, in the takeover context, even a pill that is far more restrictive than conventional pills—say a pill with a threshold of 1%—would not stop a hostile bid in its tracks. A bidder would acquire a small toehold,³³ announce a hostile bid, and threaten a proxy contest if the board failed to redeem 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 discussed 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. They should not presume that provisions that have become garden variety in the takeover context are 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.”³⁴ The *Unocal*

³² RAJEEV KUMAR, GEORGESON, 2016 ANNUAL CORPORATE GOVERNANCE REVIEW 58-61 (2016), <https://www.georgeson.com/us/Documents/acgr/acgr2016.pdf> [<https://perma.cc/ZC7Z-RU2X>] (documenting results of various proxy contests).

³³ A small toehold may be required for a bidder to obtain standing to challenge defensive measures. See *Omnicare, Inc. v. NCS Healthcare, Inc.*, 809 A.2d 1163, 1170-72 (Del. Ch. 2002) (holding that plaintiff must meet threshold of holding security to have standing); J. Travis Laster, *The Line Item Veto and Unocal: Can a Bidder Qua Bidder Pursue Unocal Claims Against a Target Corporation’s Board of Directors?*, 53 BUS. LAW. 767, 778 (1998) (discussing requirement of being stockholder in order to generate standing to bring a claim of breach of fiduciary duty).

³⁴ *Pell v. Kill*, 135 A.3d 764, 766 (Del. Ch. 2016); see *Stroud v. Grace*, 606 A.2d 75, 92 n.3 (Del. 1992) (noting that enhanced scrutiny applies whenever a board takes unilateral action involving shareholder franchise); *Gilbert v. El Paso Co.*, 575 A.2d 1131, 1144 (Del. 1990) (holding that court must apply enhanced scrutiny whenever board acts “in response to some threat to corporate policy and effectiveness which touch[es] upon issues of control”); *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 811 (Del. Ch. 2007) (recognizing necessity of

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.³⁵ 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 entrenchment effect³⁶ and that proxy challenges raise obvious entrenchment concerns.³⁷

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.³⁸

“vigilant” judges in this context). This enhanced scrutiny is a generalization of *Unocal/Unitrin* and may incorporate within it, depending on the context, the “compelling justification” concept from *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). See *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1129-31 (Del. 2003); *accord Stroud*, 606 A.2d at 92 n.3 (“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.’” (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985))).

³⁵ See *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 329 (Del. Ch. 2010) (applying *Unocal* in specific context of proxy challenge), *aff’d*, 15 A.3d 218 (Del. 2011). The compelling justification standard from *Blasius* does not apply because pills do not disenfranchise shareholders by preventing them from freely voting and do not prevent a shareholder from soliciting proxies. *Id.* at 335 (refusing to extend *Blasius* to specific proxy challenge); see *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029, at *15 (Del. Ch. May 2, 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*.” (footnote omitted)).

³⁶ See *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 599 (Del. 2010) (recognizing that pills can serve as entrenchment devices).

³⁷ 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, the Delaware Supreme Court has permitted boards to deploy a poison pill against controlling shareholders. See *Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022, 1087 (Del. Ch. 2004) (rationalizing resistance to controlling shareholder), *aff’d*, 872 A.2d 559 (Del. 2005). The Delaware Court of Chancery has even suggested that doing so might be required. See *In re CNX Gas Corp. S’holders Litig.*, 4 A.3d 397, 413, 415 (Del. Ch. 2010) (explaining that controlling shareholders are not entitled to veto power); *La. Mun. Police Emps.’ Ret. Sys. v. Fertitta*, No. 4339-VCL, 2009 WL 2263406, at *8 (Del. Ch. July 28, 2009) (holding board’s failure to hold controlling stockholder accountable to be irrational). Later, the Delaware courts authorized low-threshold (4.99%) poison pills to protect the value of net operating losses. See *Versata Enters.*, 5 A.3d at 586. As with innovations in other fields, with time we learn the application and the limitations and become more comfortable with additional uses.

³⁸ *Paramount Commc’ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1990).

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.³⁹

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.⁴⁰ 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*

Arguably, the most obvious threat 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 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.”⁴¹ And as a recent Chancery Court opinion echoed, “[T]here 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.”⁴²

The rationale for these holdings dates back at least to the landmark opinion by Chancellor Allen in *Blasius Industries Inc. v. Atlas Corp.*⁴³:

³⁹ These threats are equivalent because, if shareholders realized that the bid price was inadequate, there would be no need for a pill to fend off a noncoercive offer—the offer would fail on its own accord.

⁴⁰ Edward Rock & Michael Wachter, *Dangerous Liaisons: Trust Law, Corporate Law and Inter-doctrinal Legal Transplants*, 96 NW. U. L. REV. 651, 652 (2002) (discussing how “transplants can cause mischief”).

⁴¹ *Mercier v. Inter-Tel (Del.), Inc.*, 929 A.2d 786, 811 (Del. Ch. 2007).

⁴² *Pell v. Kill*, 135 A.3d 764, 788 (Del. Ch. 2016).

⁴³ 564 A.2d 651 (Del. Ch. 1987).

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.⁴⁴

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, gets things exactly backwards in addition to being patently self-serving.⁴⁵

B. *Disruption*

Another arguable threat is that an election contest, and the actions of the activists, cause disruption in the operation of the target. In *Third Point LLC v. Ruprecht*,⁴⁶ for example, Sotheby's faced an activist challenge by Third Point, a hedge fund run by Daniel Loeb.⁴⁷ In its decision, the court noted that Loeb, whose hedge fund had taken a stake in Sotheby's, acted in an "aggressive and domineering manner"⁴⁸ 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.'"⁴⁹ According to Sotheby's, potential clients expressed concern about the stability of Sotheby's going forward.⁵⁰

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

⁴⁴ *Id.* at 659.

⁴⁵ See Leo E. Strine, Jr., *The Story of Blasius Industries v. Atlas Corp.: Keeping the Electoral Path to Takeovers Clear*, 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.").

⁴⁶ No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014).

⁴⁷ *Id.* at *2.

⁴⁸ *Id.* at *22.

⁴⁹ *Id.* at *11.

⁵⁰ *Id.*

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.⁵¹

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. But 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, and others, this is the unavoidable consequence of corporate democracy. A board cannot be permitted to adopt a measure that has the principal effect of handicapping a disruptive activist without undermining corporate democracy.⁵²

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.⁵³ Such a response would not be reasonable.

⁵¹ 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 *Kallick v. Sandridge Energy*, 68 A.3d 242 (Del. Ch. 2013), which granted a preliminary injunction requiring the board to approve the proposed slate for purposes of the change of control provision in the credit agreement; and *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals*, 983 A.2d 304, 315 (Del. Ch. 2009), which suggested that certain change of control provisions might be unenforceable because they had an eviscerating effect on the shareholder franchise. For an empirical analysis of poison puts in loan agreements, see generally Sean J. Griffith & Natalia Reisel, *Dead Hand Proxy Puts, Hedge Fund Activism, and the Cost of Capital* (Jan. 19, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2799491 [<https://perma.cc/F7GW-8GTU>]. For a discussion of the case law and policy implications of poison puts, see generally Sean J. Griffith & Natalia Reisel, *Dead Hand Proxy Puts and Shareholder Value*, 84 U. CHI. L. REV. 1027 (2017).

⁵² Thus, the disruption created by an activist in an election contest 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. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 956 (Del. 1985) (allowing board to take extraordinary action in face of “coercive and inadequate tender offer”). Rather, hostile bids are seen as something akin to a disorderly revolution, or at least as an extraconstitutional 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. *Id.* at 954.

⁵³ From an ex ante perspective, the validity of a pill to respond to a threat of disruption would also make it less likely 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.

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.⁵⁴

Similarly, in a widely discussed public letter, Larry 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.

. . .

⁵⁴ Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013), <https://corpgov.law.harvard.edu/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/> [<https://perma.cc/ZLB7-TSKS>]; see also Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Current Thoughts About Activism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Aug. 8, 2013), <https://corpgov.law.harvard.edu/2013/08/09/current-thoughts-about-activism/> [<https://perma.cc/A4VM-LBAZ>] (“The power of the activist hedge funds is enhanced by their frequent success in proxy fights and election contests when companies resist the short-term steps the hedge fund is advocating.”); Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Dealing with Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (June 2, 2015), <https://corpgov.law.harvard.edu/2015/06/02/dealing-with-activist-hedge-funds-4/> [<https://perma.cc/2C2K-SDDV>] (describing strategies to resist activist campaigns); Martin Lipton, Wachtell, Lipton, Rosen & Katz, *The Threat to the Economy and Society from Activism and Short-Termism Updated*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 27, 2015), <https://corpgov.law.harvard.edu/2015/01/27/the-threat-to-the-economy-and-society-from-activism-and-short-termism-updated/> [<https://perma.cc/5SUC-ZDTX>] (referring to 2014 as “year of the wolf pack”).

... Successfully fulfilling [corporate leaders' duties 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*⁵⁵

The concern about short-termism has also found expression in some Delaware judges' extrajudicial 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 their managers do not themselves act or think with the long term in mind?"⁵⁶ Many others agree.⁵⁷

This high-profile concern that activist hedge funds are pursuing, and are inducing companies to pursue, short-term agendas at the expense of long-term value creation⁵⁸ 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 Larry Fink's reference to the "shrinking attention span" of market participants and is at least implicit for other commentators.⁵⁹ According to that line of reasoning, shareholders who favor

⁵⁵ Larry Fink, *Larry Fink's 2015 Letter to CEOs*, BLACKROCK, <https://www.blackrock.com/corporate/investor-relations/2015-larry-fink-ceo-letter> [<https://perma.cc/A2Q3-AVDB>] (last visited Apr. 5, 2019) (emphasis added).

⁵⁶ Leo E. Strine, Jr., *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?*, 66 BUS. LAW. 1, 1-2 (2010).

⁵⁷ See, e.g., THE ASPEN INST. BUS. & SOC'Y PROGRAM, OVERCOMING SHORT-TERMISM: A CALL FOR A MORE RESPONSIBLE APPROACH TO INVESTMENT AND BUSINESS MANAGEMENT 2 (2009) (signatories of the Aspen Institute report include Warren Buffett, Martin Lipton, Peter Peterson, Felix Rohatyn, and John Whitehead) ("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."); Jack B. Jacobs, "*Patient Capital*": *Can Delaware Corporate Law Help Revive It?*, 68 WASH. & LEE L. REV. 1645, 1657 (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.")

⁵⁸ 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, 851-58.

⁵⁹ See Fink, *supra* note 55.

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 take into account in justifying a poison pill.⁶⁰

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.⁶¹ 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 disclosure of the activist’s investment, eliminating the “pump.” It ignores the fact that disclosure requirements under sections 13(d)⁶² and 16⁶³ of the Securities Exchange Act may cause a decline in the value of the activist’s remaining stake as the activist commences the “dump.”⁶⁴ 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)⁶⁵ and the section 16(b) provisions regarding disgorgement of short-swing profits would inhibit the execution of such a scheme.⁶⁶

The “pump-and-dump” scenario is particularly implausible for “short-slate” proxy contests in which an activist seeks only minority board representation. Because Institutional Shareholder Services (“ISS”) and institutional investors

⁶⁰ See *supra* Section II.A (noting that Delaware courts have rejected this argument in context of shareholder votes).

⁶¹ Jim Cramer, *Listen to Carl Icahn, but Don't Put Him on a Pedestal*, STREET: REAL MONEY (June 8, 2016, 7:31 AM), <http://realmoney.thestreet.com/articles/06/08/2016/cramer-listen-carl-icahn-dont-put-him-pedestal> [<https://perma.cc/YR63-9Q72>] (discussing and distinguishing Icahn’s conduct from pump and dump schemes); William Lazonick, Matt Hopkins & Ken Jacobson, *Carl Icahn's \$2 Billion Apple Stake Was a Prime Example of Investment Inequality*, MARKETWATCH (June 7, 2016, 11:39 AM), <http://www.marketwatch.com/story/carl-icahns-2-billion-apple-stake-was-a-prime-example-of-investment-inequality-2016-06-07> [<https://perma.cc/UP3Y-SZE7>] (describing how activist’s investment can pump up target’s stock price).

⁶² Securities Exchange Act of 1934 § 13(d), 15 U.S.C. § 78m(d) (2012). 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 (2018).

⁶³ Securities Exchange Act of 1934 § 16, 15 U.S.C. § 78p. Rule 16a–3 requires that 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. See 17 C.F.R. § 240.16a–3.

⁶⁴ The adverse impact of disclosure may be reduced if the activist sells the whole bloc 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.

⁶⁵ See *Chiarella v. United States*, 445 U.S. 222, 225–31 (1980).

⁶⁶ Securities Exchange Act of 1934 § 16(b), 15 U.S.C. § 78p(b) (permitting suits for disgorgement of short-swing profits).

are usually reluctant to vote for activists who seek a majority of the board seats, many activists seek to replace only a minority of the directors.⁶⁷ 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.”⁶⁸ The gesture towards special interest plays into deep-seated concerns in American political history and theory that special interests will influence elected officials 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 shareholders receiving disproportionate cash flows from the company.⁶⁹ 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.⁷⁰

⁶⁷ See SULLIVAN & CROMWELL LLP, REVIEW AND ANALYSIS OF 2017 U.S. SHAREHOLDER ACTIVISM 18 (2018), https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Review_and_Analysis_of_2017_US_Shareholder_Activism.pdf [https://perma.cc/SYB3-WEA8].

⁶⁸ Coffee, Jr. & Palia, *supra* note 7, at 89-90.

⁶⁹ In general, proportionate distributions to shareholders do not raise duty of loyalty concerns. See *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 723 (Del. 1971) (holding that proportionate dividends paid to controlling shareholder were not self-dealing); *In re Synthes, Inc. S’holder Litig.*, 50 A.3d 1022, 1036 (Del. Ch. 2012) (holding in absence of special circumstances such as crisis or a fire sale, a sale of the company in which shareholders receive their proportionate share is not viewed as a conflict of interest transaction). 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.

⁷⁰ 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

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 the Delaware Supreme Court explained 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.⁷¹

For that reason, transactions resulting in a change of control are accorded special scrutiny.⁷²

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

In *Yucaipa American Alliance Fund II, L.P. v. Riggio*,⁷³ Yucaipa, a hedge fund run by Ronald Burkle, had acquired a 17.8% stake in Barnes & Noble.⁷⁴ 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%.⁷⁵ Apparently concerned with Burkle’s activism, as well as with the possibility that Burkle might decide to try to acquire the company, Barnes &

Martin Lipton’s efforts to develop a “new paradigm” for corporate governance. See Martin Lipton, Wachtell, Lipton, Rosen & Katz, *Corporate Governance: The New Paradigm*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 11, 2017), <https://corpgov.law.harvard.edu/2017/01/11/corporate-governance-the-new-paradigm/> [https://perma.cc/FYU4-GRVP] (describing “new paradigm” focusing on long-term goals). This is a concern that goes well beyond the scope of this Article. Delaware law treats the fund as a shareholder and ignores the potential agency costs between fund managers and investors.

⁷¹ *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 (Del. 1994).

⁷² *Id.* at 43-45 (describing proper additional protective measures).

⁷³ 1 A.3d 310 (Del. Ch. 2010).

⁷⁴ *Id.* at 318 (describing November 17, 2009, Schedule 13D filing).

⁷⁵ *Id.* at 324.

Noble adopted a poison pill with a 20% trigger.⁷⁶ 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.⁷⁷

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.⁷⁸ 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.⁷⁹ 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.⁸⁰

In a second case, *Third Point LLC v. Ruprecht*, two activist hedge funds (Marcato and Third Point) had acquired significant ownership positions in Sotheby's and filed disclosures using Schedule 13D.⁸¹ Unhappy with Sotheby's management, they vigorously pushed for change.⁸² In response, in October 2013, Sotheby's board adopted a poison pill with a 20% trigger for investors who did not seek a change in control (Schedule 13G filers) and a 10% trigger for all others.⁸³ When Third Point sought injunctive relief, Vice Chancellor Parsons found that "Third Point posed a threat of forming a control bloc for

⁷⁶ *Id.* at 312.

⁷⁷ *Id.* at 321 (describing grandfather provision).

⁷⁸ *Id.* at 359-60.

⁷⁹ *Id.* at 345 (discussing board's reasonable basis for adopting rights plan).

⁸⁰ *Id.* at 360.

⁸¹ *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029 at *3-4 (Del. Ch. 2014) (documenting 13D filings).

⁸² *Id.* at *6 (describing Loeb's critiques of management).

⁸³ *Id.* at *10 (explaining "two-tiered structure" of pill).

Sotheby's with other hedge funds without paying a control premium."⁸⁴ 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 Act 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%;⁸⁵ 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.⁸⁶ 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 therefore 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 Part III, 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."⁸⁷ 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.⁸⁸ A few weeks later, Third Point, which held a 9.6% stake, requested a waiver from the poison pill's 10% trigger to increase its ownership to 20%, which the board refused.⁸⁹

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.⁹⁰ However, the threat of "negative control" or

⁸⁴ *Id.* at *17.

⁸⁵ See *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 329 (Del. Ch. 2010) (describing Aletheia and Third Point's increased stakes).

⁸⁶ *Ruprecht*, 2014 WL 1922029, at *9 (describing collective ownership).

⁸⁷ See *id.* at *13.

⁸⁸ *Id.* at *12 (identifying candidates for director as Daniel Loeb, Olivier Reza, and Harry J. Wilson).

⁸⁹ *Id.* at *12-14.

⁹⁰ *Id.* at *21.

“disproportionate influence” did.⁹¹ 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.⁹²

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, like 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.⁹³

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 investor who wields it to elect a board to its liking or cash out minority shareholders and consequently justify special concerns about control under Delaware law⁹⁴—

⁹¹ *Id.*

⁹² *Id.* at *21-22.

⁹³ *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.”).

⁹⁴ These concerns, in addition to forming a threat under *Unocal*, are reflected in the heightened duties generated by a change or sale of control under *Revlon*, and in the fiduciary duties owed by a controlling shareholder. See *Paramount Commc’ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 47 (Del. 1994) (holding that change of control triggers *Revlon* duties).

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.⁹⁵ 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?⁹⁶

One possible answer is that Third Point, as a large shareholder, 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.⁹⁷ 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, such as 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 effective voting power is *not* proportional to the number of one’s votes. Consider the well-known example of the Electoral College. Under the voting rules of the Electoral College, under certain assumptions, California

⁹⁵ *Ruprecht*, 2014 WL 1922029, at *22 (describing area where negative control is powerful).

⁹⁶ See Donald F. Parsons, Jr. & Jason S. Tyler, *Activist Stockholders, Corporate Governance Challenges, and Delaware Law*, in RESEARCH HANDBOOK ON MERGERS AND ACQUISITIONS 377, 388 (Claire A. Hill & Steven Davidoff Solomon eds., 2016) (“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.”).

⁹⁷ *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 663 (Del. Ch. 1987).

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.⁹⁸

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, it is not generally true that a person with the largest number of votes has a disproportionately high voting power.⁹⁹ Furthermore, if voting decisions are not statistically independent, as voting decisions by shareholders almost surely are not, then no firm conclusions about voting power can be drawn just based on the distribution of votes.¹⁰⁰

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 disproportionately high voting stake is potentially problematic, may be a legitimate basis for finding a 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. “Anti-activist” is 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

⁹⁸ 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 AUTONOMOUS AGENTS & MULTI-AGENT SYSTEMS 105, 108 (2010) (describing Banzhaf and Shapley-Shubik power indices).

⁹⁹ For example, in a company with three shareholders holding 40%, 35%, and 25% respectively, the smallest shareholders would have the disproportionately largest voting power in a majority-rule system.

¹⁰⁰ *See* DAN S. FELSENTHAL & MOSHÉ MACHOVER, *THE MEASUREMENT OF VOTING POWER: THEORY AND PRACTICE, PROBLEMS AND PARADOXES* 1-5 (1998) (illustrating impossibility of assessing voting power merely based on proportionality of votes). Furthermore, a large but noncontrolling 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. For other shareholders this would counterbalance, to some extent, any disproportionate voting power of the blockholder. *See id.* at 221-78 (discussing impact of presence of large power block).

the shares concentrated in the hands of the top twenty-five institutions.¹⁰¹ In practice, hedge funds cannot win contests in these firms without the support of at least some large institutional investors, such as BlackRock, BNY Mellon, CalPERS, Fidelity, State Street, and Vanguard.¹⁰²

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 corporate elections to political elections, 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.¹⁰³

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,

¹⁰¹ Edward B. Rock, *Institutional Investors in Corporate Governance*, in THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE 363, 366-67 (Jeffrey N. Gordon & Wolf-Georg Ringe eds., 2018) (describing influence of institutional investors).

¹⁰² *Id.* at 382 (“[B]ecause activist hedge funds do not have sufficiently large positions to prevail in medium or large cap companies, they must convince the other shareholders—mainly the traditional institutional investors—to support them.”).

¹⁰³ See Gilson & Gordon, *supra* note 29, 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.”).

to support,¹⁰⁴ and maybe even (at the portfolio manager level) to help generate, ideas from activist funds.¹⁰⁵

Just as the choice of shareholder base can be thought of as a strategic decision of the firm,¹⁰⁶ so too can the choice of a decision-making process affect firm

¹⁰⁴ 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. See Emiliano Catan, *The Insignificance of Clear-Day Poison Pills*, 48 J. LEGAL STUDIES (forthcoming 2019) (manuscript at 12-13), <https://ssrn.com/abstract=2836223> [<https://perma.cc/2GAP-7QNL>] (documenting that most firms have allowed their poison pills to expire after ISS announced, in December 2004, that it would recommend that its clients withhold their votes in director elections if board adopted or renewed poison pill without shareholder approval). According to the Shark Repellent database, only five of the S&P 500 and twenty-seven of the S&P 1500 companies had a poison pill in force at the end of 2018. SHARK REPELLENT, <https://www.sharkrepellent.net/> (last visited Apr. 5, 2019). 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 acquire pre-disclosure far more than 10%. In one well-known case, Pershing Square was able to acquire, prior to its 13D disclosure, a 16.5% stake in J.C. Penney—more than it may have been permitted under some typical pill trigger thresholds. See Lauren Coleman-Lochner & Matt Townsend, *Pershing Becomes Top Investor in J.C. Penney*, *Fortune*, BLOOMBERG (Oct. 8, 2010, 4:56 PM), <http://www.bloomberg.com/news/articles/2010-10-08/ackman-s-pershing-square-discloses-16-5-stake-in-retailer-j-c-penney> (reporting that Pershing Square had become largest investor in J.C. Penney Co. and Fortune Brands Inc.). When J.C. Penney subsequently adopted a poison pill, it had to grandfather Pershing Square. See Abram Brown, *J.C. Penney Will Use a Poison Pill to Guard Against Another Bill Ackman*, *FORBES* (Aug. 22, 2013, 9:20 AM), <https://www.forbes.com/sites/abrambrown/2013/08/22/j-c-penney-adopts-poison-pill-to-guard-against-takeover/> [<https://perma.cc/RBS7-NXCZ>]. In an earlier case, JANA Partners and Sandell Asset Management together had a 21% interest in CNET at the time they filed their 13Ds. See Andrew Ross Sorkin, *A Loophole Lets a Foot in the Door*, *N.Y. TIMES*, Jan. 15, 2008, at C1 (describing how hedge funds acquired stake in CNET by exploiting loophole created by Rule 13d). These strategies, however, have become much riskier and do not seem to happen any more. In the J.C. Penney case, Pershing Square 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, 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. See Andrew Ross Sorkin, *Big Investors Appear out of Thin Air*, *N.Y. TIMES: DEALBOOK* (Nov. 1, 2010, 8:25 PM), <http://dealbook.nytimes.com/2010/11/01/sorkin-big-investors-appear-out-of-thin-air/>. If this sort of stake building revives, the difference between active and "on-the-shelf" poison pills could become more significant.

¹⁰⁵ Rock, *supra* note 101, at 381 ("[I]nstitutional investors are now willing to support hedge funds and other corporate governance activists when they are convinced that doing so will increase firm value.").

¹⁰⁶ See Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 851 (2012) (describing advantages of, and limits to, choosing sophisticated investors as part of shareholder base); Letter from Warren E. Buffett, Chairman of the Bd., Berkshire Hathaway Inc., to Shareholders, Berkshire Hathaway Inc. (Mar. 14, 1984), <http://www.berkshirehathaway.com/letters/1983.html> [<https://perma.cc/QZB6-9XNP>] (discussing

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.

For many firms, this emerging balance of power is a “new normal” that 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 at least as good a claim as anyone else to being “the deciders.” Often, traditional institutional investors will hold the bulk of shares not held by the contestants themselves; many institutions hold sufficiently large blocs so that they have incentives to obtain a fair degree of information about the “party platforms.” Furthermore, 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,¹⁰⁷ 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 noncoercive 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.¹⁰⁸ 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.

company’s decision to avoid stock splits as part of strategy for limiting ownership to “high quality shareholders”).

¹⁰⁷ See, e.g., Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 469-72 (1991) (describing agency problems faced by institutional investors, including conflicts of interest).

¹⁰⁸ Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court’s Takeover Jurisprudence*, 19 J. CORP. L. 583, 590 (1994) (noting that directors can reject tender offer and refuse to redeem pill, but that tender offer can succeed against board opposition via proxy contest).

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 intention in advance of so doing”¹⁰⁹ and, in the current versions, disclose information about the stockholder and the proposal or nominee.¹¹⁰ Advance notice bylaws are permitted because, and only to the extent that, they improve the quality of the decision-making process.¹¹¹ The content of such bylaws, and the corporation’s enforcement of them, are both subject to equitable review by the Delaware courts.¹¹²

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 standard articulated in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*¹¹³ as applied to takeover battles. *Revlon* and subsequent cases such as *Mills Acquisition Co. v. MacMillan, Inc.*¹¹⁴ and *Paramount Communications Inc. v. QVC Network Inc.*¹¹⁵ 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 standards of fairness,”¹¹⁶ may not “play[] favorites,”¹¹⁷ and is highly constrained in affording different treatment to bidders.¹¹⁸

¹⁰⁹ JANA Master Fund, Ltd. v. CNET Networks, Inc., 954 A.2d 335, 344 (Del. Ch. 2008).

¹¹⁰ See DANIEL E. WOLF & SHAUN J. MATHEW, KIRKLAND & ELLIS LLP, KIRKLAND M&A UPDATE: ADVANCE NOTICE BYLAWS – ADVANTAGE CONFIRMED 1 (2018), https://www.kirkland.com/siteFiles/Publications/Advance_Notice_Bylaws_Advantage_Confirmed.pdf [<https://perma.cc/5B9C-MGFJ>] (“In recent years, many companies have implemented enhanced advance notice bylaws adding additional requirements such as requiring that nominating stockholders and director nominees provide information about themselves and their holdings.”).

¹¹¹ Parsons & Tyler, *supra* note 96, at 380 (“Delaware law sanctions advance notice bylaws as maintaining orderly meetings by ensuring ‘fair warning to the corporation so that it may have sufficient time to respond to [both] shareholder nominations [and business proposals].’ In other words, Delaware law permits advance notice bylaws precisely ‘because’ their (modest) restrictions promote a larger goal of a free, fair, and fully informed stockholder franchise” (alterations in original) (footnotes omitted)); accord *Hubbard v. Hollywood Park Realty Enters., Inc.*, No. 11779, 1991 WL 3151, at *13 (Del. Ch. Jan. 14, 1991) (noting that advance notice bylaws serve the “proper purpose of assuring that stockholders and directors will have a reasonable opportunity to thoughtfully consider nominations and to allow for full information to be distributed to stockholders, along with the arguments on both sides”).

¹¹² Parsons & Tyler, *supra* note 96, at 381 (“[A]ny corporation’s enforcement of its advance notice bylaw is subject to equitable limitations policed by the Delaware courts”).

¹¹³ 506 A.2d 173 (Del. 1986).

¹¹⁴ 559 A.2d 1261 (Del. 1989).

¹¹⁵ 637 A.2d 34 (Del. 1994).

¹¹⁶ *MacMillan*, 559 A.2d at 1264.

¹¹⁷ *QVC Network*, 637 A.2d at 46.

¹¹⁸ *Barkan v. Amsted Indus. Inc.*, 567 A.2d 1279, 1286-87 (Del. 1989) (“When multiple bidders are competing for control, [*Revlon*’s] concern for fairness forbids directors from using defensive mechanisms to thwart an auction or to favor one bidder over another.”).

Being in *Revlon* mode has some notable similarities to facing a proxy contest. To get into *Revlon* mode, the board must initiate an endgame—a sale, change of control, or break up.¹¹⁹ Because of the nature of the endgame, 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.¹²⁰ 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).¹²¹ Similarly, 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.¹²²

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 merits in a particular contest—whether, in

¹¹⁹ *QVC Network*, 637 A.2d at 42-48 (concluding, after reviewing precedent, that “when a corporation undertakes an action which will cause: (a) a change in control; or (b) a break-up of the corporate entity, the directors’ obligation is to seek the best value reasonably available to the stockholders,” per *Revlon*).

¹²⁰ See Laura Anthony, *Mergers and Acquisitions: Board of Director Responsibilities*, LAWCAST (Oct. 6, 2015), <http://lawcast.com/2015/10/06/mergers-and-acquisitions-board-of-director-responsibilities/> [<https://perma.cc/LSP2-R4D4>].

¹²¹ *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029, at *21 (Del. Ch. May 2, 2014) (“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 . . .”). 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 interests and that even controlling shareholders owe no fiduciary duties in this regard to others. *Bershad v. Curtiss-Wright Corp.*, 535 A.2d 840, 845 (Del. 1987) (“Stockholders in Delaware corporations have a right to control and vote their shares in their own interest.”). 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.

¹²² *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 360 (Del. Ch. 2010).

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.¹²³ Perhaps a system in which partisans would not be constrained in the number of shares they can buy, allowing them to 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 as a “neutral election board.” As the court put it in *Aprahamian v. HBO & Co.*¹²⁴:

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 in 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.¹²⁵

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

¹²³ 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; 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 107, at 464-78 (describing agency problems arising in context of institutional shareholder activism).

¹²⁴ 531 A.2d 1204 (Del. Ch. 1987).

¹²⁵ *Id.* at 1206-07.

devices, probably not; but with proper oversight by the Delaware courts, perhaps yes.

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.¹²⁶

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 activist creates disruption, that the activist will pursue a short-term agenda, or 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.¹²⁷ 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 inadequate 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

¹²⁶ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1387-88 (Del. 1995) (“If a defensive measure is not draconian . . . because it is not either coercive or preclusive, the *Unocal* proportionality test requires the focus of enhanced judicial scrutiny to shift to the ‘range of reasonableness.’ Proper and proportionate defensive responses are intended and permitted to thwart perceived threats.” (citation omitted)).

¹²⁷ *See* *MM Cos. v. Liquid Audio, Inc.*, 813 A.2d 1118, 1126-27 (Del. 2003) (“Maintaining a proper balance in the allocation of power between the stockholders’ right to elect directors and the board of directors’ right to manage the corporation is dependent upon the stockholders’ unimpeded right to vote effectively in an election of directors.”); *Pell v. Kill*, 135 A.3d 764, 787 (Del. Ch. 2016) (finding directors’ conduct in reducing number of board seats on which stockholders could vote, and thus their ability to control the corporation, was “sufficiently suspect to warrant review under the enhanced scrutiny test,” which requires defendant fiduciaries to prove “(i) that ‘their motivations were proper and not selfish,’ (ii) that they ‘did not preclude stockholders from exercising their right to vote or coerce them into voting a particular way,’ and (iii) that the directors’ actions ‘were reasonable in relation to their legitimate objective’” (quoting *Mercier v. Inter-Tel (Del.)*, Inc., 929 A.2d 786, 810-11 (Del. Ch. 2007))); *Mercier*, 929 A.2d at 810 (“[O]ur cases have universally recognized the need for close scrutiny of director action that could have the effect of influencing the outcome of corporate director elections or other stockholder votes having consequences for corporate control.”).

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 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 have included “synthetic equity” in the definition of ownership for determining whether a pill has been triggered.¹²⁸ According to a study by Latham & Watkins, 76% of all pills adopted or amended in 2013 included such provisions.¹²⁹ Whether such

¹²⁸ The Genesco Inc.’s pill provides a typical example of a derivatives provision. Beneficial ownership includes:

[A]ny 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 Inc., Second Amended and Restated Rights Agreement (Form 8-K), at 6-7 (Apr. 9, 2010) [hereinafter Genesco Pill].

¹²⁹ MARK D. GERSTEIN ET AL., LATHAM & WATKINS LLP, THE RESILIENT RIGHTS PLAN: RECENT POISON PILL DEVELOPMENTS AND TRENDS 7 (2014), <https://www.lw.com/thought-leadership/2014-poison-pill-developments-and-trends> [<https://perma.cc/NQY4-NDVJ>]

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.¹³⁰ 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.¹³¹

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 question whether synthetic equity positions generate, or contribute to, a threat posed by a shareholder activist.

In our view, they do neither. Because synthetic equity entails no voting rights, it does not create threats that justify a pill in principle; it does not create a threat of the activist acquiring creeping control or of the activist’s stake undermining a fair electoral process (or, for that matter, any of the other threats).¹³² 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.¹³³ To be sure, such instruments

(“Seventy-six percent of all traditional rights plans adopted or amended in 2013 contained provisions including synthetic equity positions . . .”).

¹³⁰ See Sam Ro, *Synthetic Equity: A Way to Buy Stocks Without Buying Stocks*, BUS. INSIDER (Sept. 18, 2011, 3:13 PM), <https://www.businessinsider.com/synthetic-equity-ubs-2011-9> [<https://perma.cc/A3SJ-YH6W>].

¹³¹ James Chen, *Total Return Swap*, INVESTOPEDIA, <http://www.investopedia.com/terms/t/totalreturnswap.asp> [<https://perma.cc/J247-Q8E2>] (last updated Feb. 23, 2019) (defining “total return swap” as “a swap agreement in which one party makes payments based on a set rate, either fixed or variable, while the other party makes payments based on the return of an underlying asset, which includes both the income it generates and any capital gains”).

¹³² Some forms of synthetic equity—options exercisable for actual stock, in particular—are included in the ownership definition of section 203 of the Delaware General Corporation Law. DEL. CODE ANN. tit. 8, § 203(c)(9) (2019) (defining “owner” as one who beneficially owns stock and has “the right to acquire such stock . . . pursuant to any agreement, arrangement or understanding, or upon the exercise of conversion rights, exchange rights, warrants or options”). Other 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 interested shareholder. While it is conceivable that such transactions are part of the activist’s business plan, or that the activist may want to retain flexibility to engage in such transactions, the limitations imposed by section 203 will often not be relevant.

¹³³ Certain types of synthetic equity, notably securities that a holder has the option to acquire within sixty days, are included in the definition of beneficial ownership for purposes

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.¹³⁴ 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 than most pills currently impose on an activist's ability to convert synthetic equity into actual equity.¹³⁵

of section 13(d). See 15 U.S.C. § 78m(d) (2012) (requiring beneficial owners “of more than 5 per centum” of class of stock to file statement with Securities and Exchange Commission (“SEC”)); 17 C.F.R. § 240.13d-3(d)(1) (2018) (“A person shall be deemed to be the beneficial owner of a security . . . if that person has the right to acquire beneficial ownership of such security, as defined in Rule 13d-3(a) (§ 240.13d-3(a)), within sixty days . . .”). The definition of beneficial ownership in Rule 13d-3, however, was designed for different purposes than pills. It relates to providing information to the market about share accumulations; that is, Rule 13d-3 is a disclosure provision rather than a de facto prohibition of acquiring stock beyond a threshold. For these reasons, different types of ownership are relevant for section 13(d) purposes than for pills, and overinclusiveness in the definition of ownership is much less problematic for section 13(d) purposes than it is for anti-activist pills. That 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 of using the same definition—simplicity and standardization—in our view outweigh the disadvantage of having a somewhat broader definition than is warranted.

¹³⁴ See, e.g., David Benoit, *Avis Uses ‘Poison Pill’ to Block Longtime Investor from Gaining Too Much Control*, WALL STREET J. (Jan. 23, 2017, 5:35 PM), <https://www.wsj.com/articles/avis-uses-poison-pill-to-block-longtime-investor-from-gaining-too-much-control-1485210927?> (describing how Avis, after giving board seat to investor, “put in place a ‘poison pill’ aimed at blocking [the investor] from acquiring more than 10% voting power”).

¹³⁵ 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 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 Form 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 in the pill trigger threshold, and by permitting the acquisition of an even

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 entails 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.¹³⁶ First, some commentators have suggested that swap counterparties hedge their short exposure by buying shares in the market and selling 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.”¹³⁷

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.

greater economic stake through synthetic equity, even if this comes with the expense of constraining an activist’s ability to convert pre-pill adoption synthetic equity into actual shares.

¹³⁶ Wachtell Lipton has pushed for expanding section 13(d) to include derivative positions and other sorts of synthetic equity on the grounds that such positions can lead to empty voting. See David A. Katz & Laura A. McIntosh, *13(d) Reporting Inadequacies in an Era of Speed and Innovation*, N.Y. L.J., Sept. 24, 2015, at 2 (“Decoupling arrangements can lead to ‘empty voting,’ in which an investor holds voting rights in excess of their economic interest, and ‘morphable ownership,’ in which an investor holds economic interest in excess of formal voting rights but has the ability to transform the economic position into a traditional ownership position.”). By contrast, Professors Ron Gilson and Jeff Gordon have argued that synthetic equity should not count towards beneficial ownership under section 13(d). See Gilson & Gordon, *supra* note 29, at 915 (suggesting the SEC define “beneficial ownership” more narrowly “to exclude a total return swap that has been ‘sterilized’ through a mirrored voting commitment with respect to any proposal or proxy contest mounted by the activist counterparty”). 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.

¹³⁷ See, e.g., Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 836-40 (2006) (presenting “hidden (morphable) ownership” argument).

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.”¹³⁸ This argument found some support in Judge Lewis Kaplan’s 2008 opinion in *CSX Corp. v. Children’s Investment Fund Management (UK) LLP*.¹³⁹ 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%.¹⁴⁰ The legal issue was whether, under Rule 13d-3(a),¹⁴¹ cash-settled total return swaps that did not grant any rights over the voting or disposition of the shares that the swap counterparties may purchase to hedge their positions counted towards the 5% beneficial ownership threshold that triggered a Schedule 13D disclosure obligation.¹⁴² In holding that TCI had violated section 13(d), Judge Kaplan noted, without ultimately holding, that TCI may have had influence over the voting of the shares held by counterparties.¹⁴³

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.¹⁴⁴ 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

¹³⁸ *Id.* at 837-38 (“When the derivatives dealer hedges an equity swap with matched shares, a market practice may well be emerging in which both sides expect that the dealer, if asked, will either unwind the swap and sell the shares to its client . . . or vote the matched shares as its client wants.”).

¹³⁹ 562 F. Supp. 2d 511, 522 (S.D.N.Y. 2008) (expressing concern about hidden and morphable ownership), *aff’d in part, vacated in part*, 654 F.3d 276 (2d Cir. 2011).

¹⁴⁰ *Id.* at 525.

¹⁴¹ 17 C.F.R. § 240.13d-3(a) (2018).

¹⁴² *CSX Corp.*, 562 F. Supp. 2d at 540 (“[The Court] first considers whether TCI had beneficial ownership, within the meaning of Rule 13d-3(a), of the shares of CSX stock referenced by its swap agreements and held by its counterparties . . .”).

¹⁴³ *Id.* at 522 (noting that “[s]ome may be influenced, at least in some cases, to vote as a counterparty desires”).

¹⁴⁴ See E-mail from Joseph White, Managing Dir., Equities & Derivatives, Société Générale, to authors (July 13, 2017, 13:50 EST) (on file with authors) (noting that swap dealers are not required to own shares to hedge swap transaction).

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,” and not on an individual transactional basis. That is, they look to be market neutral for their whole trading book.¹⁴⁵ 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, 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.¹⁴⁶ 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.¹⁴⁷ 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 shares 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),¹⁴⁸ or voting them in accordance with the recommendations of the board or a voting advisor. By contrast, to our knowledge, no swap dealer has a policy of voting

¹⁴⁵ Telephone Interview with Partner at major N.Y.C. law firm specializing in derivatives (June 16, 2017) (notes on file with author) (confirming that hedges are done on portfolio basis). Note that the interviewee has asked to remain anonymous for this Article.

¹⁴⁶ Reena Aggarwal, Pedro A.C. Saffi & Jason Sturgess, *The Role of Institutional Investors in Voting: Evidence from the Securities Lending Market*, 70 J. FIN. 2309, 2309 (2015) (“Investors restrict lendable supply and/or recall loaned shares prior to the proxy record date to exercise voting rights.”).

¹⁴⁷ *See id.* (using 2007-2009 data); E-mail from Joseph White, *supra* note 144 (“As a record date for a proxy vote approaches these typical lenders usually recall their lent shares because they want to be the owner of record on the record date, they care about the outcome of the vote and they intend to vote the shares.”). *But see* Susan E.K. Christoffersen et al., *Vote Trading and Information Aggregation*, 62 J. FIN. 2897, 2913 fig.3 (2007) (finding no material increase in lending fees around record date 1998-1999).

¹⁴⁸ Telephone Interview, *supra* note 145.

shares as requested by (or as assumed to be in the interest of) the swap purchaser.¹⁴⁹ 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.¹⁵⁰

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 ("NOL") pills,¹⁵¹ current market practice is to employ pills with trigger thresholds between 10% and 20%.¹⁵² Because it provides a useful reference, we take this range as the basis of our discussion.¹⁵³

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

¹⁴⁹ 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.

¹⁵⁰ E-mail from Joseph White, *supra* note 144 ("It is unlikely any swap counterparty could anticipate if or how a Swap Dealer might vote any shares it holds as its hedge to a swap transaction. Swap Transaction Confirmations are typically silent on share voting considerations and do not require a Dealer to own any shares at all as the Dealer's hedge to a swap transaction.").

¹⁵¹ NOL pills typically have 4.9% or 4.99% triggers. FLEISCHER, SUSSMAN & WEINSTEIN, *supra* note 22, § 5.05[C] ("Pills with trigger levels at 4.99% or 5% have proliferated recently, not so much as a takeover defense, but as a means to protect net operating losses (NOLs), which can be used to offset future profits for tax purposes."). In *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010), 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." *Id.* at 607.

¹⁵² FLEISCHER, SUSSMAN & WEINSTEIN, *supra* note 22, § 5.05[C] (noting that "[t]he 15% trigger became the level most frequently chosen for newly adopted pills in the mid-1990's").

¹⁵³ 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 crept up to 2-3%, then 2-4%. 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 a breakup fee that is "coercive" or "preclusive," as would seem to be required under *Unocal/Unitrin*. See John C. Coates IV & Guhan Subramanian, *A Buy-Side Model of M&A Lockups: Theory and Evidence*, 53 STAN. L. REV. 307, 355 fig.2 (2000) (showing changes in breakup fee magnitude between 1988 and 1999); Steven M. Davidoff & Christina M. Sautter, *Lock-Up Creep*, 38 J. CORP. L. 681, 705 (2013) (describing rise of breakup or "termination" fees that has attended increase in merger agreement lock-ups in recent years).

less than 20%. There are few cases in Delaware in any contexts finding control at levels below 40%.¹⁵⁴ Thus, for example, in *In re PNB Holding Co. Shareholders Litigation*,¹⁵⁵ then-Vice Chancellor Strine, faced with a 33.5% block, noted that “[a]t that level of ownership, a single stockholder would not be deemed a controller without additional facts supplementing his clout.”¹⁵⁶ And in *In re Cysive, Inc. Shareholders Litigation*,¹⁵⁷ an owner of 35% was deemed a controller only because he was also Chairman and CEO, and was deemed to wield influence over another director who owned 1%, and had the option to acquire 3-4%, of the company’s shares.¹⁵⁸

In *Yucaipa*, the court upheld a pill with a 20% threshold under the creeping control rationale.¹⁵⁹ 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%.¹⁶⁰ 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.¹⁶¹ Although several hedge funds had positions at various times in Sotheby’s, their aggregate ownership was only 19%.¹⁶² Thus, even taking into account that multiple activists, apparently

¹⁵⁴ 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) (“[W]hile there are a variety of cases in a variety of contexts finding control between 40% and 50% of the shares, there are no cases finding control below 40%.”). Since 2009, Delaware courts have, in select circumstances, held that a lower ownership level in conjunction with other factors may confer control. See *In re Tesla Motors, Inc. S’holder Litig.*, No. 12711-VCS, 2018 WL 1560293, at *15, *19-20 (Del. Ch. Mar. 28, 2018) (denying motion to dismiss because Plaintiffs had pled sufficient facts to establish founder Elon Musk’s control over Tesla, despite Musk owning just 22% of company); *In re Oracle Corp. Derivative Litig.*, No. 2017-0337-SG, 2018 WL 1381331, at *2-4 (Del. Ch. Mar. 19, 2018) (discussing without deciding alleged facts pointing to founder Lawrence Ellison’s control of Oracle, when Ellison owned 28% of Oracle’s common stock); *In re Zhongpin Inc. Stockholders Litig.*, No. 7393-VCN, 2014 WL 6735457, at *1, *12 (Del. Ch. Nov. 26, 2014) (denying motion to dismiss and holding that Plaintiffs had pled sufficient facts to raise inference that CEO Xianfu Zhu, who owned 17.3% of shares, had control), *rev’d on other grounds sub nom. In re Cornerstone Therapeutics Inc. Stockholder Litig.*, 115 A.3d 1173 (Del. 2015).

¹⁵⁵ No. Civ.A. 25-N, 2006 WL 2403999, at *1 (Del. Ch. Aug. 18, 2006).

¹⁵⁶ *Id.* at *10.

¹⁵⁷ 836 A.2d 531 (Del. Ch. 2003).

¹⁵⁸ *Id.* at 552-53 (finding “controlling stockholder” status for reasons mentioned).

¹⁵⁹ *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 359 (Del. Ch. 2010) (finding pill with 20% trigger reasonable because “setting the threshold any higher would have only made Yucaipa’s creeping acquisition of control more likely”).

¹⁶⁰ *Id.* at 318, 324.

¹⁶¹ *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029, at *20 (Del. Ch. May 2, 2014) (finding it “reasonably probable” that the 10% pill was “a proportionate response to the control threat posed”).

¹⁶² *Id.* at *9.

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 of 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 a controlling shareholder.¹⁶³ What is true for the *PNB* directors is also true for hedge funds.¹⁶⁴

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.¹⁶⁵ 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 over one-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.¹⁶⁶

¹⁶³ *In re PNB Holding Co. S'holders Litig.*, No. Civ.A. 28-N, 2006 WL 2403999, at *10 (Del. Ch. Aug. 18, 2006).

¹⁶⁴ 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 postelection group formation.

¹⁶⁵ Sotheby's, Definitive Proxy Statement (Form DEF14A), at 40 (Mar. 24, 2014).

¹⁶⁶ As we discussed, we are skeptical in principle whether "negative control/disproportionate influence" constitutes a material threat. *Cf. Ruprecht*, 2014 WL 1922029, at *21 (describing "negative control" as an "objectively reasonable and legally cognizable 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

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. The goal is not to force the activist to obtain a *majority* of the neutral vote.¹⁶⁷ 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.¹⁶⁸

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 bath 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 to not 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, as a proportion of the value of the company, 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—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,

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 on its holder. To the contrary, an activist who has synthetic equity will have disproportionately *low* influence relative to its economic stake. 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 is not the threat of negative control/disproportionate influence, but rather the desire to fend off a pesky challenger. That should lead to further skepticism about a claim that a low-threshold pill is justified by such a threat.

¹⁶⁷ The latter rule would require, in essence, depriving *both* sides of their voting rights, a goal we do not endorse. We are confident that any board would strongly oppose such a rule whenever the incumbents have more votes than the activist. 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; and section 203(a)(3) exempts business combinations approved by two-thirds of the outstanding stock, not counting stock owned by the interested stockholder. DEL. CODE ANN. tit. 8, § 203(a)(2)-(3) (2019).

¹⁶⁸ *Cf.* *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1383, 1385, 1389 (Del. 1995) (holding that repurchase program that raised board stake from 23% to 28%, even though shark repellent provision in charter effectively capped raider’s share to 15%, was still reasonable because a raider who acquires 14.9% of the shares would have a realistic chance of winning proxy contest).

and to persuade other shareholders that appreciation of company value (rather than private control benefits) is 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 and total return swaps, represent a play on relatively short-term price movements. Unless the activist takes affirmative steps, its economic stake will end when the options expire or the swaps terminate. Hence, other shareholders may not see an activist who has only, or predominantly, synthetic equity as a long-term shareholder, and therefore may take such an activist less seriously. 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.

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.¹⁶⁹ 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.¹⁷⁰

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 Schedule 13D and 13G filers, as in *Ruprecht*. We address each setting separately.

¹⁶⁹ *Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1356-57 (Del. 1985) (“[T]he Directors must show that the defensive mechanism was ‘reasonable in relation to the threat posed.’”).

¹⁷⁰ *See id.* at 1356 (holding that pill may not be deployed unless board reasonably believes that there is a threat). If two bidders make noncoercive cash offers, under *Revlon* the company may not use the pill to discriminate among the bidders. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 184 (Del. 1986) (“[W]hen bidders make relatively similar offers, or dissolution of the company becomes inevitable, the directors cannot fulfill their enhanced *Unocal* duties by playing favorites with the contending factions.”). 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.

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.¹⁷¹ 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.¹⁷² To the contrary—such discrimination would result in an uneven playing field inconsistent with the goal of making the election process fairer.

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 already has control with its stake, then there is no further control for the new holder to obtain; and if the grandfathered holder does not have control with its stake, then why not let the new holder obtain the same percentage of stock, 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%,

¹⁷¹ In a recent Delaware Court of Chancery opinion, the court made clear that Murdock, a 30% shareholder, had credibly threatened to launch a hostile tender offer if an independent committee did not accept the proposed buyout terms. See *In re Dole Food Co., Inc. S'holder Litig.*, No. 8703-VCL, 2015 WL 5052214, at *17 (Del. Ch. Aug. 27, 2015) ("Murdock was preparing to launch a hostile tender offer if the Committee did not respond favorably . . ."). 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 rebut a duty-of-loyalty claim, or to get the benefit under *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014), must adopt a pill that blocks the controlling shareholder from increasing its position. See *supra* note 37 (discussing controlling-shareholder-pill cases).

¹⁷² 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/disproportionate influence and which may not. Moreover, given 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.

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. Thus, the argument that the threat of creeping control justifies discrimination should, at a minimum, be closely scrutinized.

By contrast, grandfathering should be permitted when a shareholder is antagonistic to the board, and, say, acquired its stake before it filed a Schedule 13D, alerting 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 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.¹⁷³ However, in *Yucaipa*, there was also a second activist, Aletheia, that together with Yucaipa held over 36% of the stock.¹⁷⁴ We think that *Yucaipa* is better understood as a case addressing how the presence of multiple activists affects the proper pill threshold rather than as a general case about grandfathering. And, as discussed below,¹⁷⁵ understood in that manner, the tension largely disappears.

2. Different Thresholds for Schedule 13D and 13G Filers

While we generally would not permit discrimination through grandfathering, discrimination between Schedule 13D and 13G filers may be justified. The difference is twofold. 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 shareholders (13G filers), without knowing who these shareholders will be and without having grounds for believing that they will support the board.

¹⁷³ *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 359 (Del. Ch. 2010) (upholding 20% pill and stating that “[w]ith the Riggios’ ownership, that threshold was reasonable because setting the threshold any higher would have only made Yucaipa’s creeping acquisition of control more likely”).

¹⁷⁴ *See id.* at 324.

¹⁷⁵ *See infra* Section III.D.2 (discussing thresholds).

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 Schedule 13G if it has not acquired the securities with any purpose or effect of changing or influencing the control of the company.¹⁷⁶ Schedule 13G filers thus credibly

¹⁷⁶ 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. 17 C.F.R. § 240.13d-1(c)(1)-(3) (2018). Such investors must file within ten days of the end of the month of the triggering event requiring the filing, and must amend the Schedule 13G each year within forty-five 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 ten days of the acquisition. Second, 13G filing is also available to a “passive investor,” defined as an investor that “[h]as 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 “[i]s not directly or indirectly the beneficial owner of twenty percent or more of the class.” *Id.* Passive investors must file the 13G within ten days of the acquisition of 5% (but less than 20%) of a corporation’s stock. Mutual funds typically file 13Gs as Qualified Interest Income (“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. *See* Amendments to Beneficial Ownership Reporting Requirements, Exchange Act Release No. 34-39,538, 63 Fed. Reg. 2854, 2854 (Jan. 16, 1998) (codified at 17 C.F.R. pt. 240) (noting in summary that amendments “make the short-form Schedule 13G available, in lieu of Schedule 13D, to all investors beneficially owning less than 20 percent of the outstanding class that have not acquired and do not hold the securities for the purpose of or with the effect of changing or influencing the control of the issuer of the securities”). Such activism could, for example, include urging management to sell assets, 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” exemption due to a shareholder’s efforts to influence management on a particular topic does not, by itself, disqualify the shareholder from reporting on 13G. *See Exchange Act Sections 13(d) and 13(g) and Regulation 13D-G Beneficial Ownership Reporting*, U.S. SEC. & EXCH. COMM’N Q.103.11, <https://www.sec.gov/divisions/corpfin/guidance/reg13d-interp.htm> [<https://perma.cc/7GE9-AFCT>] (last updated July 14, 2016) (“The inability to rely on the HSR Act exemption alone would not preclude a shareholder from filing on Schedule 13G. Instead, eligibility to use Schedule 13G under Exchange Act Rule 13d-1(b) or 13d-1(c) will depend, among other things, on whether the shareholder acquired or is holding equity securities with the purpose or effect of changing or influencing control of the issuer.”). 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.

disavow any interest in obtaining control or becoming an active contestant in a proxy contest. Because 13G filing status is not available to any person who acquires stock with the purpose or 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.¹⁷⁷

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 into account the presence of other holders supportive of an activist in setting the threshold? In other words, can a wolf-pack justify a *lower* threshold pill than would be permissible in the absence of a wolf pack?¹⁷⁸

¹⁷⁷ 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. A 13G filer may thus now, or in the future, veto a board proposal, say, 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 filers based on the threat of negative control or disproportionate influence. See *Third Point LLC v. Ruprecht*, No. 9469-VCP, 2014 WL 1922029, at *21 (Del. Ch. May 2, 2014). 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.

¹⁷⁸ We ignore as beyond the scope of this Article the use of advance notice bylaws to address wolf packs. See, e.g., Charles M. Nathan & Stephen Amdur, *Latham & Watkins LLP, Second Generation Advance Notice Bylaws and Poison Pills*, HARV. L. SCH. F. ON CORP.

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 section 13(d).¹⁷⁹ Such an agreement can be formal or informal. Standard poison pills already incorporate the section 13(d) 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 section 13(d) or causing aggregation under a standard pill.¹⁸⁰

GOVERNANCE & FIN. REG. (Apr. 22, 2009), <https://corpgov.law.harvard.edu/2009/04/22/second-generation-advance-notice-bylaws-and-poison-pills/> [<https://perma.cc/NP7T-HAAD>] (discussing use of second generation advance notice bylaws to increase transparency and accountability for wolf packs); Marc Weingarten & Erin Magnor, Schulte Roth & Zabel LLP, *Second Generation Advance Notice Bylaws*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Mar. 17, 2009), <https://corpgov.law.harvard.edu/2009/03/17/second-generation-advance-notification-bylaws/> [<https://perma.cc/77QJ-6EML>] (describing development of “second generation” advance notice bylaws, which require more extensive disclosure from proponent shareholders).

¹⁷⁹ See 15 U.S.C. § 78m(d)(3) (2012).

¹⁸⁰ Section 13(d), part of the 1968 Williams Act, Pub. L. 90-489, 82 Stat. 455, is intended to provide early warning of potential change-in-control transactions. 15 U.S.C. § 78m(d). The case law interpreting the scope of section 13(d) 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. Can. Dev. Corp.*, 366 F. Supp. 374, 403 (S.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), see *Portsmouth Square, Inc. v. S’holders Protective Comm.*, 770 F.2d 866, 872-73 (9th Cir. 1985) (holding that corporation did not have right to relief under section 13(d) with regard to shareholders who attempted to raise funds for lawsuit challenging validity of existing corporate stock because shareholders were attempting to vindicate existing right, not plotting takeover), or discussions and agreements about management’s performance, see *Bath Indus., Inc. v. Blot*, 427 F.2d 97, 110 (7th Cir. 1970) (“[Section 13(d)] does not proscribe informal discussion among existing shareholders concerning the performance of current management. Nor does it proscribe legitimate cooperation among existing shareholders to assert their determination to take over control of management, *absent* an intention to acquire additional shares for the furtherance of such purpose.”). As Thomas Briggs explains in a comprehensive discussion of section 13(d) 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, 113-14 (1994) (citations omitted). More recent cases confirm the relatively narrow focus of section 13(d). See, e.g., *Hallwood Realty Partners, L.P. v. Gotham Partners, L.P.*, 286 F.3d 613, 617-18 (2d Cir. 2002) (finding no group even though one person was well-known activist and all three people had discussed how to improve value of target); *meVC*

Some practitioners have therefore suggested expanding 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.”¹⁸¹ 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 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.¹⁸²

Echoing the antitrust doctrine,¹⁸³ these “acting-in-concert” provisions require something more than pure parallel conduct.¹⁸⁴ The “plus” factors are intended to capture conduct among shareholders that falls short of an “agreement,

Draper Fisher Jurvetson Fund I, Inc. v. Millenium Partners, L.P., 260 F. Supp. 2d 616, 631-33 (S.D.N.Y. 2003) (finding no group despite joint slate of directors). *But see* Coffee, Jr. & Palia, *supra* note 7, at 79 (criticizing what authors see as narrowing of definition).

¹⁸¹ See, e.g., Leonard Chazen & Jack S. Bodner, *Conscious Parallelism May Justify a Wolf Pack Pill*, LAW360 (May 27, 2014, 9:45 PM), <https://www.law360.com/articles/540818/conscious-parallelism-may-justify-a-wolf-pack-pill> (discussing risks posed by “conscious parallelism”: wolf-pack tactic whereby activist shareholders who do not have an agreement to act in concert pattern their behavior off each other to effectively act on target as a group while avoiding triggering traditional poison pills).

¹⁸² Genesco Pill, *supra* note 128, at 3-4.

¹⁸³ See AM. BAR ASS’N, 1 ANTITRUST LAW DEVELOPMENTS 1B (8th ed. 2017) (describing proof of existence of “a contract, combination, or conspiracy” as one element of violation of § 1 of Sherman Act); *id.* at 3B (describing horizontal mergers).

¹⁸⁴ See GERSTEIN ET AL., *supra* note 129, at 29-33 (discussing threats from wolf packs); Frank Aquila & Melissa Sawyer, *Perfect Pill, Imperfect Defense*, 47 REV. SEC. & COMMODITIES REG. 231, 234-35 (2014) (“‘[S]tockholders acting in concert’ provision does not unduly interfere with the valid exercise of shareholder rights, such as the right to meet and to communicate with other shareholders.”); William R. Tevlin, Note, *The Conscious Parallelism of Wolf Packs: Applying the Antitrust Conspiracy Framework to Section 13(D) Group Formation*, 84 FORDHAM L. REV. 2335, 2335 (2016) (arguing that, in making group determinations for section 13(d) purposes with regard to wolf packs, “courts should apply the antitrust conspiracy framework from section 1 of the Sherman Antitrust Act,” which “identifies conscious parallelism and plus factors as evidence of price-fixing conspiracies”); Chazen & Bodner, *supra* note 181 (suggesting that such provisions would require evidence of conscious parallelism, or one investor patterning its behavior after another with which it has no agreement to act in concert).

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.”¹⁸⁵ Delaware has not ruled on the validity of these provisions.¹⁸⁶

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. Such a pill 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 having the “purpose or effect” of “influencing” control.¹⁸⁷ Because triggering a pill would have severe adverse consequences, such vague 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 manager 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

¹⁸⁵ See, e.g., Genesco Pill, *supra* note 128, at 3-4 (employing this language).

¹⁸⁶ In *Yucaipa*, the Barnes & Noble pill had a wolf-pack trigger that was removed before the court ruled, and there is language in the opinion that suggests that the court had doubts about the validity of that provision. See *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 338 (Del. Ch. 2010) (noting, after removal of the provision, that “as it now stands, the Rights Plan’s trigger is based on a well-recognized standard, which sophisticated investors like Yucaipa must address as a regular course of doing business due to provisions like § 13(d) of the Securities Exchange Act of 1934 . . . and which has been the subject of many judicial rulings” (citation omitted)); GERSTEIN ET AL., *supra* note 129, at 32-33 (noting that although “the validity of wolf-pack language is still an open question, this discussion [from *Yucaipa*] reveals some concern with a definition that extends beyond the ‘well-recognized standard’ of Section 13D, particularly if phrased with ambiguity or unnecessary breadth”). In *Stahl v. Apple Bancorp, Inc.*, No. 11510, 1990 WL 114222 (Del. Ch. Aug. 9, 1990), the Delaware Court of Chancery 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. *Id.* at *8 (“Thus, I conclude in these circumstances, that the position of the board to leave in place and enforce the beneficial ownership term of the stock rights plan is reasonable in relation to the threat posed by the Stahl offer at this time.”). In that case, the proxy challenger already owned over 30% of the company’s stock and sought to acquire control. *Id.* at *1 (“Stanley Stahl, a 30.6% shareholder of defendant Apple Bancorp, Inc. (‘Bancorp’), is presently extending a tender offer for any and all shares of that company’s stock at \$38 cash per share.”). These factors 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.

¹⁸⁷ Genesco Pill, *supra* note 128, at 3.

threaten to chill the sort of shareholder interaction upon which sound corporate governance depends and that decades of reform have sought to encourage. To illustrate why, let us return to our opening hypothetical and assume that two hedge funds, Lupin and 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.¹⁸⁸ 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 when casting their votes.¹⁸⁹ The proxy rules have been criticized as imposing an undue compliance burden.¹⁹⁰ Perhaps they do, but the

¹⁸⁸ See generally Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990) (summarizing obstacles to shareholder activism).

¹⁸⁹ See, e.g., 17 C.F.R. § 240.14a-1, b-2 (2018) (containing rules governing proxy process).

¹⁹⁰ See, e.g., Black, *supra* note 188, at 529 (“Some have observed the impediments to shareholder voice created by various legal rules.”).

goal of the proxy rules—increasing the information available to shareholders so 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 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.”¹⁹¹ 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?

First, take 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.¹⁹² 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.¹⁹³ 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

¹⁹¹ ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS* 128 (Edwin Cannan ed., Modern Library 1937).

¹⁹² Indeed, one reason to declare a 13D group in an initial 13D filing is to take advantage of grandfathering.

¹⁹³ *Quickturn Design Sys., Inc., v. Shapiro*, 721 A.2d 1281, 1291 (Del. 1998) (holding provision of pill invalid because it would allow “dead hand” of past to “impermissibly deprive any newly elected board of both its statutory authority to manage the corporation . . . and its concomitant fiduciary duty pursuant to that statutory mandate”).

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-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 details 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” block that will be the decision makers, and which are partisans? By definition, the contestants themselves—the board and the activist challenger—are partisans. But what 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 to assuring that the board does not favor itself under the guise of enhancing the fairness of the electoral 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.¹⁹⁴ The concepts 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 contexts.

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.¹⁹⁵ 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 alternatively, firing half the workforce. 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.¹⁹⁶ 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

¹⁹⁴ *Marciano v. Nakash*, 535 A.2d 400, 404-05 (Del. 1987) (describing common law and statutory tests for ensuring directors are disinterested in such transactions).

¹⁹⁵ *Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002) (“[A] disabling ‘interest,’ as defined by Delaware common law, exists in two instances. The first is when (1) a director personally receives a benefit (or suffers a detriment), (2) as a result of, or from, the challenged transaction, (3) which is not generally shared with (or suffered by) the other shareholders of his corporation, and (4) that benefit (or detriment) is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders. The second instance is when a director stands on both sides of the challenged transaction.”).

¹⁹⁶ *Id.* (“‘Independence’ does not involve a question of whether the challenged director derives a benefit from the transaction that is not generally shared with the other shareholders. Rather, it involves an inquiry into whether the director’s decision resulted from that director being *controlled* by another.”).

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.¹⁹⁷ *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.¹⁹⁸ Earlier, we 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 have prevented *Yucaipa* and Aletheia from forming a control group.¹⁹⁹

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.²⁰⁰

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 approximately 30% stake.

CONCLUSION

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, boards of directors are deploying poison pills. In reviewing these moves, courts will face a variety of issues that did not arise in the takeover context. In this Article, we worked through a variety of these issues.

¹⁹⁷ *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 324 (Del. Ch. 2010).

¹⁹⁸ *Id.* (noting that *Yucaipa* held 20% of stock and Aletheia held 17.44%, for a combined 37.44%, as compared to Riggio's 30%).

¹⁹⁹ *See supra* note 164 (using Sotheby's as example to illustrate this possibility).

²⁰⁰ *Yucaipa*, 1 A.3d at 325 (citation omitted).

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 disproportionately 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 threat. On the other hand, the economic stake generated by synthetic equity, the ability to profit from the increase in stock price, is the lifeblood of activism. The main effect, and perhaps the goal, of including mere economic exposure in the pill threshold is thus to make activism less financially 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 nor by a desire to maintain a balanced election process.