8-22-2016

Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat

William W. Bratton
University of Pennsylvania Carey Law School

Author ORCID Identifier:

William Bratton 0000-0002-1045-3535

Hedge Fund Activism, Poison Pills, and the Jurisprudence of Threat

William W. Bratton

Nicholas F. Gallicchio Professor of Law and Co-Director, Institute for Law & Economics

University of Pennsylvania Law School

Abstract

This chapter reviews the single high profile case in which twentieth century antitakeover law has come to bear on management defense against a twenty-first century activist challenge—the Delaware Court of Chancery's decision to sustain a low-threshold poison pill deployed against an activist in Third Point LLC v. Ruprecht. *The decision implicated an important policy question: whether a twentieth century doctrine keyed to hostile takeovers and control transfers appropriately can be brought to bear in a twenty-first century governance context in which the challenger eschews control transfer and instead makes aggressive use of the shareholder franchise. Resolution of the question entails evaluation of the gravity of two sets of threats, one at the doctrinal level and the other at the policy level. The doctrinal threats are exterior threats to corporate policy and effectiveness on which managers justify defensive tactics under* Unocal v. Mesa Petroleum Co. *Because some threats have greater justificatory salience under* Unocal *than do others, a question arises as to the nature and characterization of the threats allegedly held out by activist intervention. The policy threats implicate the new balance of power between managers and shareholders. The chapter appraises the threats. As regards* Unocal*, it demonstrates a serious problem of fit. The chapter goes on to conduct a thought experiment that reshapes and extends* Unocal *so that it does provide a robust basis for sustaining management defense against activist hedge funds, even shielding poison pills with 5 percent triggers. The extension amounts to radical reformulation of the conceptual framework of corporate law, thereby posing the policy threat. But the policy threat, on examination, proves uncompelling,*

today's corporate managers being disinclined to traverse shareholder preferences by promulgating standing poison pills. Given that, the chapter asks whether 5 percent poison pills could hold out policy benefits in the form of company-by-company shareholder-manager engagement on the question of suitability for activist intervention.

INTRODUCTION

Hedge fund activism is to corporate law's early twenty-first century what the hostile takeover was to its late twentieth century. Like the hostile takeover, activism threatens incumbent managers and disrupts their business plans by successfully appealing to the shareholders' interest in immediate returns. Like the hostile takeover, activism occupies center stage in corporate law policy discussions, posing a choice between short-term gain and long-term investment. But there is a glaring point of distinction. Unlike the hostile takeover, activism has precipitated no significant changes in corporate law. Where the hostile takeover triggered structural changes in state corporate codes and the federal securities laws along with a root and branch reconfiguration of fiduciary duty, hedge fund activism largely leaves corporate law where it found it. The activists manage to play hostilely without bumping up against the defensive barriers erected in the late twentieth century transformation of corporate law because they avoid attempting to take control. At the same time, law reform initiatives designed to constrain the new mode of hostile intervention have failed to pick up traction.

There is but a single high profile case in which twentieth century antitakeover law has come to bear on a management defense against a twenty-first century activist challenge—the Delaware Court of Chancery's decision in *Third Point LLC v. Ruprecht*,[1] better known as "the *Sotheby's* case." The board of directors of a target corporation, Sotheby's, lobbed a poison pill in the path of one of the more aggressive hedge funds, Third Point LLC, and its sharp-elbowed chief, Daniel Loeb. The pill had a "low threshold" feature, capping a hostile challenger's block at 10 percent of outstanding shares rather at the traditional 20 percent. It thereby disabled Third Point from enhancing its vote total in a short-slate proxy contest through additional purchases of target shares. The Chancery Court nonetheless sustained the pill under *Unocal v. Mesa*

[1] 2014 WL 1922029 (Del. Ch.)

Petroleum Co.[2] The decision implicated an important policy question: whether a twentieth century doctrine keyed to hostile takeovers and control transfers appropriately can be brought to bear in a twenty-first century governance context in which the challenger eschews control transfer and instead makes aggressive use of the shareholder franchise.

Resolution of the issue question entails evaluation of the gravity of two sets of threats, one at the doctrinal level and the other at the policy level. The doctrinal threats are exterior threats to corporate policy and effectiveness on which managers justify defensive tactics under *Unocal*. Because some threats have greater justificatory salience under *Unocal* than do others, a question arises as to the nature and characterization of the threats allegedly held out by activist intervention. The policy threats implicate the new balance of power between managers and shareholders. Hedge fund activism has operated as a catalyst that enables dispersed shareholders to surmount collective action problems so as to register preferences regarding corporate business plans in connection with voting on competing candidates for board seats. To the extent that managers wielding low-threshold poison pills disable activist challenges, the power balance could shift back in their favor with potentially negative agency cost consequences.

This chapter appraises the threats. As regards *Unocal*, it demonstrates a serious problem of fit. The most potent *Unocal* threats are those involving coercion of dispersed shareholders in connection with hostile tender offers or expropriation from dispersed shareholders by controlling blockholders. The threats, originally identified on 1980s control transfer fact patterns, show up only tangentially on the new fact patterns. To the extent that *Unocal* doctrine relies on the old threats in sustaining poison pills deployed against today's activists, it ends up as more of a formal rubber stamp than a substantive fiduciary inquiry.

The *Sotheby's* opinion, although for the most part staying inside of the inherited framework of *Unocal* doctrine, does take a tentative step into the twenty-first century, suggesting that activists hold out a threat of "disproportionate influence," but without filling in any particulars about the influence's nature and negative effect. This chapter posits the missing details, conducting a thought experiment that reshapes and extends *Unocal* so that it provides a robust basis for sustaining management defense against activist hedge funds, even shielding

[2] 493 A2d 946 (Del. 1985).

poison pills with 5 percent triggers. The extension is radical. Up to now, *Unocal* has facilitated management actions that protect dispersed shareholders from being railroaded into selling the company for too little. Under the extension, *Unocal* would justify management actions that protect shareholders from the consequences of their own collective actions in casting uncoerced ballots at director elections. Many, perhaps most observers, would view the extension as a perversion of the governance system's heretofore jealous protection of the shareholder franchise to elect directors.

The chapter's refitted version of *Unocal* sharply poses the policy threat. Most observers would find the prospect of an easily-justified 5 percent poison pill threatening indeed, projecting that it would inhibit activist intervention and thereby damage the corporate governance system. But the projection of harm rings hollow in the present posture of shareholder-manager politics. Even if structural changes inhibiting activism would in fact result in economic injury, no significant inhibition is likely to follow from judicial sanction of a 5 percent pill. A low-threshold pill deters activist block formation only to the extent that it is put in in place advance of the activist's appearance. These days very few managers dare to promulgate such "standing" pills. So powerful have shareholders become that in today's managerial cost-benefit calculus, the detriments of incurring the shareholders' wrath by traversing their governance preferences regarding charters and bylaws now outweigh a poison pill's insulating benefits.

Given that, it is worth asking whether 5 percent poison pills could out policy benefits. The policy stakes are traversed in a debate in which activism is associated with value-destructive short termism. The debate's participants argue back and forth based on assumed across-the-board tendencies. But questions about short-term value sacrifices cannot be resolved on an aggregate basis. It depends on the company. Some are appropriate targets for activist intervention, while others are not. This chapter suggests that company-by-company dialogue on the point would be good thing, exploring the possibility that a 5 percent standing pill could trigger useful informational back and between managers and institutional investors without simultaneously over-deterring activist intervention.

Part I assays the *Sotheby's* case. Part II situates *Unocal* threat doctrine in the context of hedge fund activism, showing a need for reformulation. Part III reformulates *Unocal*, positing a theory supporting a poison pill with a 5 percent trigger. Part IV considers this low threshold pill's policy implications in the new world of empowered shareholders.

I. THE *SOTHEBY'S* CASE

Third Point LLC v. Ruprecht denied a motion to enjoin deployment of a poison pill carefully tailored to target an activist hedge fund. The pill featured a two-tier trigger that sorted between passive and active blockholders.[3] Blockholders whose passive intentions were verified by a disclosure statement filed under a form 13G were capped at 20 percent of the stock while an activist with aspirations to make changes at the company and so filing a form 13D under rule 13d-1 faced a lower 10 cap on its block.[4] The drafting otherwise was scrupulous. The pill's duration was limited to a year. All cash, all shares tender offers were excepted,[5] showing that the board addressed only challenges in the activist hedge fund mode and did not seek to block a hostile control transfer on procedurally fair terms. Nor, as tends to be the case these days, was it a "standing" pill, put in place well in advance of a hedge fund challenge on a one-size-fits-all basis. It was instead promulgated by the target board after the Third Point's campaign had been proceeding for months,[6] facilitating a situation specific justification keyed threats particular to Third Point.

The activist campaign was high-powered. At its commencement, a three fund "wolf pack" demanded changes in Sotheby's business plan and governance arrangements, a demand backed up by a credible threat to launch a proxy fight for board seats. Third Point, which eventually accumulated 9.6 percent of the company's outstanding shares, took the lead, with Mercato (6.6 percent) and Trian (less than 5 percent) in tow. Thus did the Sotheby's board already face a combined hostile block holding 20 percent as it promulgated its poison pill. The pill's bite lay in its containment of further stock acquisitions by Third Point, a bar that crimped the fund's freedom of action to add to its vote total by purchasing more shares in heat of a close proxy contest.

---

[3] The poison in a poison pill is two-for-one dilution of the challenger's stock block. It follows that challengers avoid traversing the triggers, instead turning to the courts to ask for invalidation.
[4] Third Point LLC v. Ruprecht, 2014 WL 1922029, at 9 (Del. Ch.)
[5] Id.
[6] Id.

The litigation laid two new situations at the door of Delaware's poison pill jurisprudence. First, the 10 percent trigger amounted to a step-up in defensive intensity, and, while not unprecedented in practice, had not been considered by a court. Poison pill drafters historically[7] had set the trigger applied to block accumulations at 20 percent, the rule-of-thumb magnitude thought to import sufficient influence to justify the attribution of "control block."[8] Second, never before had a hedge fund activist come to the Delaware Chancery Court attacking a pill deployed to inhibit a proxy contest.[9]

Even so, law sufficient to sustain the pill already was largely in place. Delaware parses review of defensive tactics into two categories. *Unocal* holds out the general rule, invalidating "preclusive" and "coercive" defenses on a *per se* basis, while subjecting all other management defenses to proportionality review, under which the measure must be reasonable in view of the threat posed.[10] A separate line of cases, grounded in *Blasius Industries, Inc. v. Atlas Corp.*,[11] applies to management actions primarily intended to interfere with or impede exercise of the shareholder franchise. These require a "compelling" justification, a standard unlikely to be met. Unsurprisingly, Third Point argued that a poison pill drafted with a discriminatory 10 percent trigger with a view to inhibit activist vote accumulation interfered with the franchise within

[7] The pill in the original case, Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985), included a 20 percent block acquisition trigger. Lower thresholds did not come into use until recent years.

[8] A 5 percent trigger was sustained in Versata Enters., Inc. v. Selectica, Inc., 5 A.3d 586 (Del. 2010), but the case was easily distinguished. The trigger in question addressed a tax rule that removed loss carryforwards in the event of the appearance of a 5 percent block holders. Give the tax angle, the court had no trouble sustaining the low-threshold pill by reference to the welfare of the shareholders as a group.

[9] Several Delaware cases did cast doubt on the operation of a similar defensive device in the context of hedge fund activism—the "poison puts" contained in bond and loan contracts. Poison puts are drafted in the same mold as poison pills, setting out triggers keyed to a list of control changes and control challenges. When the trigger goes off, holders of the securities covered by the debt contract receive a right to put the securities back to issuer at face value. Depending on the drafting, activist challenges holding out acquisition of a majority of board seats can either trigger the pill or result in the defending board receiving discretion to trigger the pill. If the debt securities trading at a discount to face value, exercise of the put injures the corporation by transferring value to the debt holders. A cash management disability can result even in the absence of a discount. The cases in turn disable the put's operation. See Kallick v. Sandridge Energy, Inc., 68 A.3d 242 (Del. Ch.2013). The cases are easily distinguished. In a poison put case, the defensive device financially injures the company and thus its shareholders as a group for the benefit of the bondholders and the defending managers. In a poison pill case, the device injures the shareholders only by inference. It makes an activist challenge more expensive and difficult. But the deterrent effect injures the shareholders generally only to the extent that activism benefits them. Meanwhile, in a case like *Sotheby's*, the protected shareholders remain free to vote in favor of the activist slate at the annual meeting, arguably eliminating any direct threat of injury.

[10] See Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del.1995).

[11] 564 A. 2d 651 (Del. Ch. 1988).

Blasius.[12] But the cases already had restricted *Blasius* scrutiny to a small set of situations in which the defensive move has the effect of altogether precluding exercise of the franchise. [13] So long as the defense left the contestant free to put its candidates or proposition to the shareholders for an "effective" vote, the defense's effect of raising the bar to victory did not amount to "interference" within *Blasius*. [14] And nothing was preventing Third Point from conducting its proxy contest.

Meanwhile, the *Unocal* cases etched a profile of a threatening blockholder, the "creeping control" acquirer.[15] The "creeping" lies in the acquirer's gradual accumulation of a control block through open market stock purchases. By the time such a holder gets to 51 percent, the premium realizable in respect of a future control transfer appends to its block of stock rather than to the corporate entity and the shareholders as a group. The blockholder, who has not paid the selling shareholders a pro rata portion of control value in the course of its open market purchase program, effectively converts the premium potentially realized for the benefit of the shareholders as a group upon a sale of the whole. Such a block need not even amount to a majority stake, for the value of control begins to attach once the stake passes the 20 percent threshold. Thus do both the European Union and the United Kingdom require an accumulating blockholder to make an offer to buy 100 percent of the company's stock upon passing a 30 percent threshold.[16] Under the *Unocal* cases, a proxy challenger seeking less than a majority of board seats (a "short slate") and disavowing interest in control acquisition is nevertheless susceptible to a creeping control characterization to the extent the challenger can be shown to have either (1) made control acquisitions in the past implicating unequal outcomes, or (2) made statements projecting a possible control transfer at the target, including a third-party merger.[17] Creeping control is thus a capacious category of threat.

---

[12] 2014 WL 1922029, at 14-15.
[13] See Stroud v. Grace, 606 A.2d 75, 91 (Del.1992); Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310 (Del. Ch. 2010), aff'd a5 A.3d 2318 (Del. 2011).
[14] See MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1130 (Del. 2003).
[15] 2014 WL 1922029, at 16-18; Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 350-51, 359-60 (Del. Ch. 2010), aff'd 5 A.3d 2318 (Del. 2011).
[16] Directive 2004/25/EC of the European Parliament and of the Council of 21 April 2004 on Takeover Bids, art 5 sec 1-4; UK Takeover Code Rules 9.1, 9.5.
[17] Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 348-350 (Del. Ch. 2010), aff'd 5 A.3d 2318 (Del. 2011).

Third Point and its principal, Daniel Loeb, perfectly fit the profile. As regarded past activity, they had made acquisition bids for targets and negotiated defensive block repurchases by targets.[18] As regarded present statements, Loeb had both discussed the possibility of pushing Sotheby's into a private equity buyout and projected that he would take operational control of the company and re-orient its operations.[19] Potential damage to the business also was shown: Loeb's aggressive public statements were disturbing customer relationships in a heavily relational line of business.[20] It is hard to imagine an actor more ill-suited to the role of plaintiff in a test case.

The Chancery Court, per Vice-Chancellor Parsons, nonetheless characterized the case as close. The Court inspected the pill as of two different dates, first upon promulgation prior to the commencement of the proxy contest, and second, at a later date in the midst of the solicitation process. The second look had been triggered by Third Point, which made a formal request to the Sotheby's board to waive the 10 percent threshold so as to permit it to buy up to 20 percent.[21] The Court sustained creeping control as a validating threat only as of the earlier date. In the Court's characterization, the promulgating board had faced a 20 percent wolf pack the intentions of which could have included either of control acquisition or a third party control transfer.[22] As of the later date, however, the Court held that a creeping control threat no longer was plausible. By then it was clear that the hostile attack devolved on a proxy contest for a few board seats with no control transfer in the offing.[23] Moreover, one of the Sotheby's directors, when asked on deposition what had motivated the board to refuse to waive the pill, said that minimizing the challenger's vote total was the prevailing concern.[24] Under *Unocal*, a primary motivation to retain one's position leads to prompt invalidation,[25] and it is one of the defending counsel's primary jobs to make sure that the board justifies its actions exclusively in terms of shareholder injury prevention. Such slips can be fatal.

[18] 2014 WL 1922029, at 5.
[19] Id. at 4.
[20] Id. at 7, 11.
[21] Id. at 20.
[22] Id. at 17-19.
[23] It bears noting that one of the wolf pack members, Trian, had sold down its block a month after the board adopted the pill. See Carmen X.W. Lua, Unpacking Wolf Packs, 125 Yale L.J. 773, 780 (2016).
[24] 2014 WL 1922029, at 13.
[25] 493 A.2d at 19 (plaintiffs must show a reasonable probability of demonstrating that the Board acted with "animus" or an "entrenchment motive").

But the Sotheby's board squeaked through and Third Point's motion to enjoin the pill was denied for failure to make the requisite showing of a likelihood of success on the merits.[26] The Chancery Court devised two additional, albeit weaker, threat characterizations applicable on the later date. The first, "negative control," was relied upon in as a basis for refusing the injunction: even though Third Point could not be said to aspire to hold a control block, further acquisitions could import negative voting salience—a number of shares sufficient to veto a proposition subject to a super-majority vote.[27] The Court added that even if Third Point did not have enough shares to wield a unilateral negative block, moving up toward 20 percent could give it "disproportionate control and influence over major corporate decisions." [28] There was no further explication as to what that meant.

Third Point lost the battle but not the war. Soon after the Court refused the injunction, preliminary vote counts showed that Third Point was poised to win the proxy contest. The Sotheby's board cut its losses and settled, admitting Loeb and two of his nominees into the boardroom.[29]

Third Point also might have won the battle against the poison pill had the Court analyzed the situation slightly differently as of the second look. Previous cases had focused on creeping control. Once creeping control was off the table, alternative decisional possibilities opened up, most importantly the option of giving decisive weight to the evidence concerning the motivation of the defending board. To the extent the Sotheby's directors were focused on the impending vote count, they arguably no longer lay in the zone of *Unocal* threat protection at all. It would have been a suitably narrow ground of decision. Alternatively, the Court might have travelled the harder road and dismissed the secondary threats, negative control and disproportionate influence, as lacking in gravity.

But it didn't, leaving us with two questions. The first goes to the accuracy of the creeping control characterization in the activist context. The second question, which follows in

[26] 2014 WL 1922029. at 21.
[27] Id.
[28] Id. at 22.
[29] S. Michael J. de la Merced & Alexandra Stevenson, Sotheby's Yields to Hedge Fund Mogul and Allies, N.Y. Times, May 5, 2014 available at http://dealbook.nytimes.com/2014/05/05/sothebys-and-loeb-end-fight-over-board/?_r=0.

the wake of a negative answer to the first, is whether activism otherwise holds out threats, however characterized, cognizable in *Unocal* contexts.

II. HEDGE FUND ACTIVISM AND CORPORATE CONTROL

This Part reconsiders *Unocal* and the creeping control threat in activist contexts. Stewart Gillen and Laura Starks have accurately defined shareholder activists as "investors, who dissatisfied with some aspect of the company's management or operations, try to bring about change within the company without a change in control."[30] One accordingly must massage the facts a little in order to support a creeping control characterization. Two factors have come to the fore, the wolf pack engagement pattern and the activists' interest in pushing their targets into third-party mergers. But the creeping control characterization remains problematic even given selective underscoring. There are three reasons: (1) individual hedge funds almost never accumulate 20 percent; (2) wolf packs are not ubiquitous and tend to accumulate less than 20 percent, and (3) the mergers that do result in a minority of cases and hold out no cognizable harm to shareholders. Control transfer by merger is a salient, but ancillary possibility in the wake of activist intervention. When intervention does prompt a control transfer, the hedge fund is very, very unlikely to be acquiring party and the proceeds of sale are shared pro rata with the shareholders as a group. It follows that the articulated basis for applying *Unocal* in activist contexts is lacks substantial support in the practice.

A. Share Accumulation

1. Standalone funds.

Hedge funds, even lead hedge funds, do not build control blocks. Only a handful of activist positions ever approach 20 percent. Boyson and Mooradian found a mean activist block holding of 8.8 percent upon initial 13d-1 filing and a maximum accumulation mean holding of 12.4 percent.[31] Other studies offer a more granular picture. Brav, Jiang, Partnoy, and Thomas

[30] Stewart L. Gillan & Laura T. Starks, The Evolution of Shareholder Activism in the United States, 19 J. Applied Corp. Fin. 55 (2007).
[31] Nicole M. Boyson & Robert M. Mooradian, Experienced Hedge Fund Activists, working paper, April 3, 2012 available at http://ssrn.com/abstract=1787649.

show, at the 75th percentile, an initial holding of 8.8 percent and a maximum holding of 13 percent. At the 95th percentile, they report an initial holding of 19.8 percent and a maximum holding of 25 percent.[32] More recently, Gantchev reports an initial filing maximum of 16 percent at the 95th percentile and a maximum holding of 18 percent[33]—that is, even the biggest accumulations by standalone funds fall short of 20 percent.

2. Wolf packs

Of course, even if standalone hedge funds almost never approach 20 percent, any threat still is magnified due to their tendency to attack in groups of two and three. Hedge fund wolf packs operate in the absence of formal agreements among their members because formal agreement means a securities law "group" and enhances filing requirements.[34] Informal group activity nonetheless suffices for *Unocal* purposes—appropriately so, for consciously parallel courses of action are there for all to see.

There remains a question regarding the size and prevalence of group activity. The first sustained study, from Becht, Franks, Grant, and Wagner, appeared only recently.[35] Looking at 1362 engagements, they find that 78.3 percent involve a standalone fund and 21.7 percent involve a wolf pack. Considering each target separately, they find that 88.2 percent faced a standalone fund while 11.8 percent faced a wolf pack.[36] The mean wolf pack stockholding is 13.4 percent compared with 8.3 percent for a standalone fund. [37] Group action does enhance influence. Given a wolf pack, the target's stock price rises 14 percent during the during the window period surrounding the activist's disclosure of its position compared with 6 percent for a

[32] Alon Brav, Wei Jiang, Frank Partnoy & Randall Thomas., Hedge Fund Activism, Corporate Governance, and Firm Performance, 63 J. Fin. 1729, 1747 (2008).
[33] Nikolay Gantchev, The Costs of Shareholder Activism: Evidence from a Sequential Decision Model 47 working paper August 2012, available at www.ssrn.comabs=16464712012.
[34] Section 13(d)(3) of the Securities Exchange Act of 1934 provides that "[w]hen two or more persons act as a . . . group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection." 15 U.S.C. § 78m(d)(3) (2012). The leading case finding a group is CSX Corp. v. Children's Inv. Fund Mgmt., (UK), LLP, 562 F. Supp. 2d 511, 525 (S.D.N.Y. 2008).
[35] Marco Becht, Julian Franks, Jeremey Grant, & Hannes Wagner, The Returns to Hedge Fund Activism: An International Study March 2015, working paper available at www.ssrn.com/abs=2376271.
[36] Id. at 51.
[37] Id. at 32.

standalone fund.[38] The probability of success is 78 percent with a wolf pack and 46 percent for an activist alone.[39]

The foregoing figures presuppose disclosure by each wolf pack member. But there also are silent fellow travelers who pile in when the lead fund discloses its holding but stay below the 5 percent reporting threshold. A recent study looks at share turnover at the time of lead fund disclosure and finds that trading volume is 325 percent above normal levels and then then infers that 250 percent of the activity can be attributed to buyers other than the lead.[40] The study characterizes engagements in the top turnover quartile as wolf pack engagements and finds a 6 percent higher rate of success and a 9 percent higher rate of board seat acquisition for the subset.[41]

Wolf pack presence has been taken as the fact that validates a creeping control characterization of activism.[42] But what we see in fact is enhanced influence without control. Wolf packs matter because votes matter, and the objective continues to be minority board representation. While wolf pack formation makes victory more likely, it does not on average virtually assure the activist of success by trivializing the number of additional supporting shares needing to be solicited.[43] Given a mean holding of 13.4 percent, success still requires the support of a substantial number of passive shareholders, even assuming the presence of undisclosed fellow travelers.

B. Mergers

Technically, a creeping control acquisition entails the accumulation and use of a control block with little or no sharing of the benefits of control with the non-controlling shareholders.[44] There are a number of scenarios. A creeping controller can use its accumulated votes to take control of the board and then run the company, taking for itself the offices, compensation, and other spoils. To complete the game of exclusion, it can use its control power to cash out the

---

[38] Id. at 5.
[39] Id. at 5.
[40] Yu Ting Forester Wong, Wolves at the Door: A Closer Look at Hedge Fund Activism 3, working paper January 2016 available at http://ssrn.com/abstract=2721413.
[41] Id. at 7.
[42] John C. Coffee, Jr. & Darius Palia, The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance, 41 J. Corp. L. 545, 593 (2016).
[43] Id. at 562-68.
[44] Id. at 593.

minority in a later merger.[45] Alternatively, once in power, it can sell its control block to a third party, pocketing a premium price.[46]

None of these scenarios figures into the working picture of activism. The closest one gets is a case where an activist (or wolf pack) with a relatively large block successfully pushes a sale of the target to a third party. Any abuse lies in the activist's acquisition of shares prior to disclosing its own presence in a public filing. It thereby accumulates the block at a market price unreflective of the coming control transfer, in effect converting the later premium from the market sellers. Two questions follow. First, whether the scenario occurs frequently, and, second, whether it is accurate to characterize it as wrongful conversion.

There is no question that activism prompts mergers. But different studies yield different figures. At the low end, Brav, Jiang, and Kim report in 12.2 percent of the cases in their database.[47] At the high end, Greenwood and Schor come in at 23 percent.[48] Becht, Franks, Grant, and Wagner fall between at 18.76 percent.[49] The largest and most recent study, from Boyson, Gantchev, and Shivdasani,[50] tends toward the high end. It shows a takeover bid occurring in 24 percent of the engagements—from third parties in 19.9 percent and from the activist itself in 3.4 percent.[51] A third party bid is 5 times more likely to occur at an activist target than at a nontarget firm.[52] If the particular activist is categorized as aggressive, the probability of a bid is 29.0 percent; if the activist is categorized as experienced in causing mergers, the probability rises to 36.4 percent.[53] A bid also means significantly higher stock price

[45] Here fiduciary scrutiny minimizes the opportunity for unilaterally imposing a low price. See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).
[46] This was at one time the central problem of corporate fiduciary law. The leading case was Perlman v. Feldmann, 219 F.2d 173, cert. denied 349 U.S. 952 (1955). For the leading critique, see William D. Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 Harv. L. Rev. 505, 515-22 (1965). The flow of case law has trailed off.
[47] Alon Brav, Wei Jiang & Hyunseob Kim, Hedge Fund Activism: A Review 16, working paper February 2010, available at http://ssrn.com/abstract=1551953**.** Also at the low end are Bebchuk, Brav, and Jiang who report that the rate of attrition due to merger for all public companies across a five year period is 42 percent compared to 49 percent for their sample of activist targets. **See** Lucian A, Bebchuk, Alon Brav & Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085, 1104 (2015).
[48] Robin Greenwood & Michael Schor, Investor Activism and Takeovers, 92 J. Fin. Econ. 92, 364, 368 (2009).
[49] Becht, Franks, Grant & Wagner, supra note 35, at 54.
[50] Nicole M. Boyson, Nickolay Gantchev & Anil Shivdasani, Activism Mergers, working paper February 2016, available at
[51] Id. at 34.
[52] Id.
[53] Id. at 16.

returns from the engagement, with third party bids offering larger premiums than those from activists.[54] Significantly, the stock price gain is shared pro rata.

The "victims" are those who sell to activist and wolf pack followers before and at the time the lead activist crosses the 5 percent reporting threshold. It appears that these sellers are noise-trading institutions making liquidity trades.[55] The sales are uncoerced and result from independent business decisions, often portfolio related. There is no loss, only an opportunity cost. Given widespread shareholder diversification, this opportunity cost is in the long run matched by a gain on a held investment in a different hedge fund target. There is no cognizable injury.

C. Summary

There is a serious problem of fit between classic creeping control picture of shareholder victimization and the ordinary incidents of activist intervention. Hedge funds almost never take control. Although intervention frequently results in a sale of control, the sale holds out a considerable upside for the target's other shareholders. The gains from sale are shared with the group as whole. And, of course, there is no sale in 76 percent (or more) of the cases. Any concerns respecting the premium paid when the activist itself bids can be dealt with under the separate line of fiduciary cases that begins with *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*[56] *Unocal*, in short, is being applied to sustain management defense against activist campaigns on a questionable basis that awkwardly cabins twenty-first century hostile intervention in a twentieth century mold.

III. *UNOCAL* AND ACTIVISM RECONSIDERED

This Part conducts a ground up reconsideration of *Unocal* threats in the context of activist intervention. It suggests that the *Sotheby's* Court's "disproportionate influence" notion can be amplified so as to fit the circumstances. The analysis takes corporate law into new territory. As

[54] The 24 month cumulative average returns work out as follows: targets in general 9.8 percent; third party bid 38.9 percent; activist bid 18.4 percent; failed bid 17.7 percent. Id. at 19-24.
[55] Nickolay Gantchev & Chotibhak Jotikasthira, Institutional Trading and Hedge Fund Activism 3 working paper November 2015 available at ssrn.com/abstract=2139482.
[56] 506 A.2d 173 (Del. 1986).

restated, *Unocal* protects shareholder minorities from the business judgments of apparently unconflicted shareholder majorities, a reversal of the inherited conceptual framework.

A. The State of Play

The *Sotheby's* case stretches existing *Unocal* caselaw close to the breaking point. The court, once creeping control was off the table, was forced to improvise, formulating two new threats—negative control and disproportionate influence—in order to sustain the board's refusal to waive the pill.[57] The new threats hold out considerably less in the way of shareholder injury than would a genuine creeping control acquisition. The Court made no attempt to warrant them otherwise, implying that low-threshold pills could be vulnerable under *Unocal* depending on a future case's particular facts. Meanwhile, there are companies are implementing 10 and 15 percent standing pills that tend to include language calculated to pick up wolf pack formation—the pills apply to persons "acting in concert" or in "conscious parallelism" with a lead hedge fund.[58] Absent a lead activist with a clear creeping control profile like that of Third Point, these pills easily could fail inspection under a narrow reading of the *Sotheby's* opinion.

Thus does the poison pill drafter's holy grail, a 5 percent standing pill drafted for general application, seem unreachable. Coffee and Palia sensibly opine such a pill carries a cognizable risk of peremptory invalidation as "preclusive" within *Unocal*.[59] They nonetheless experiment with a justificatory strategy, positing a jump shift to a justification grounded in a public reporting benefit rather than in a threat to the target's business. They offer a 5.1 percent standing pill that would be triggered only if the purchaser failed to file a form 13D before purchasing stock in excess of the threshold.[60] That is, the activist could exceed a 5 percent holding only by making an immediate SEC filing upon reaching 5 percent and surrendering the option to continue to take advantage of rule 13d-1's 10-day filing window to make further unreported stock purchases.[61] As a further modification designed to diminish the chance of invalidation, they suggest that this "window-closing pill" allow further acquisitions up to a 15 percent or 20 percent threshold in the

[57] It is noted that influence can be found as a factor in Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 348 (Del. Ch. 2010), aff'd 5 A.3d 2318 (Del. 2011).
[58] Coffee & Palia, supra note 42, at 602.
[59] Id.
[60] Id.
[61] The window is set under rule 13d-1 under section 13(d) of the Securities and Exchange Act of 1934. Sections 929R of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) explicitly authorize the SEC to shorten the filing window. See 15 U.S.C. § 78m(d)(1) (2012).

event of timely filing.[62] The redirection of the justificatory theory away from traditional threats towards the supplementation of the SEC's block reporting regime and its 10-day filing window addresses a perceived policy need. Many think the SEC itself should shorten the filing period to a day or two even as the SEC has remained unresponsive to their suggestions.[63] Coffee and Palia's window-closing pill would effect the change by private ordering. Significantly, Coffee and Palia do not appear to think that hedge fund activism otherwise holds out a threat adequate to the task of justifying a 5 percent pill, presumably because the holding level is too low to implicate control transfer, creeping or otherwise.

B. Disproportionate Influence as a *Unocal* Threat

Suppose we extended the law of *Unocal* threats so as to acknowledge a cognizable activist threat without regard to prospects for control transfer. What would such a regime look like? We here project its possible parameters. So doing facilitates consideration of the policy question attending management actions that impede activist campaigns. If the projected justificatory threat rings hollow, management defensive responses should be deemed to be presumptively unreasonable under *Unocal*.

We begin with the two backstop threats invoked in the *Sotheby's* case—negative control and disproportionate influence. In the litigated case, the former did the work of justifying the board's refusal to waive the 10 percent cap, while the latter was mentioned only in passing. Now the roles are reversed. Negative control, while working better than creeping control in justifying defensive moves against activists, still holds out a problem of fit. Disproportionate influence, in contrast, provides a robust basis for reconfiguring *Unocal*, at least at a descriptive level.

Negative control amounts to a lightweight version of creeping control. It similarly looks to control-acquisition, positing that hedge fund blocks potentially injure the general shareholder population by acquiring holdup power in respect of supermajority votes. But the theory also moves closer to the activist fact pattern, dropping the concern with the value consequences of a

[62] Coffee & Palia, supra note 42 at 602.

[63] *See* Letter from Wachtell Lipton Rosen & Katz to SEC Sec'y Elizabeth M. Murray (May 7, 2011), http://www.sec.gov/rules/petition/201 1/petn4-624.pdf (petitioning the SEC to shorten the ten-day window of the Williams Act); see also Adam 0. Emmerich, Theodore N. Mirvis, Edward S. Robinson & William Savitt, Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure and the Use and Abuse of Shareholder Power, 3 Harv. Bus. L. Rev. 135 (2013).

full control transfer and looking only toward distortionary effects on exercises of the shareholder franchise. Certainly, holdups by blockholders with selective incentives and private agendas conceivably could be a problem at some companies some of the time.[64] But, ultimately, there is little resonance with activist practice. Activist impact is not solely a function of the number of shares held. It follows from the support from similarly-minded shareholders, whether or not they are activist hedge funds. Unilateral power to effect voting results, whether positively or negatively, does not figure into the model. Furthermore, the model looks to affirmative results. Hold ups and side payments respecting matters submitted by management for shareholder approval (other than low-price mergers on the sell side and high-price mergers on the buy side) simply don't figure into the program.

The second threat, disproportionate influence, poses a more open-ended characterization of activism. Here there is no problem of fit. Disproportionate influence is what hedge fund activism is all about. Activists travel light, avoiding the large investments required for outright control purchase, instead buying smaller, more easily disposable blocks. They then leverage their small stakes into revisions of target business plans by soliciting the voting support of other shareholders. If activism poses a threat, this is where it lies—in change effected at the level of business policy, whether focused on an asset sale, additional borrowing, a stepped-up dividend, share repurchase activity, operating cost reductions, or a sell-side merger—change effected with the consent of a majority of the shares outstanding.

Of course, there is no threat if these activist-induced changes unequivocally add value. Empirical studies weigh in favor of the activists at this point, showing on an aggregate basis that their appearance causes enduring stock price increases[65] without simultaneously negatively

[64] For discussion, see Zohar Goshen, Controlling Strategic Voting: Property Rule or Liability Rule?, 70 So. Cal. L. Rev. 741, 769-71 (1997).

[65] Activist intervention causes an immediate stock price increase that lasts for at least a year. The magnitude of the bump varies with the study. See Brav et al., supra note 32, at 1729 (7 percent to 8 percent), April Klein & Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187, 188 (2009)(10.2 percent); Chris Clifford, Value Creation or Destruction? Hedge Funds as Shareholder Activists 4-5, working paper, April 2008, available at http://ssrn.com/abstract=971018 (3.39 percent), Robin Greenwood & Michael Schor, Investor Activism and Takeovers, 92 J. Fin. Econ. 362, 366-68 (2009)(3.5 percent); Lucian A, Bebchuk, et. al., supra note 47 at 1122 (6 percent). Some of the studies show that positive cumulative abnormal returns continue to rise during the period following the activists' first appearance. See Greenwood & Schor, supra at 366-68 (an additional 6.5% over 18 months); Klein & Zur, supra, at 188 (an additional 11.4% over one year).

impacting operating metrics in the long run.[66] But a threat characterization still can lie if we disaggregate target shareholders into two interest groups. Following the financial economics,[67] we distinguish those with short-term time horizons who take the full benefit of the stock price bump from those with long-term time horizons. The long-termers' interests are impaired to the extent that activist-induced change chokes off investment activity that would eventually enhance returns on the target's stock. Such value impairment is a distinct possibility at some companies some of the time, being more likely at twenty-first century businesses that invest heavily in ideas and relationships and less likely at twentieth-century brick and mortar producers.[68] But long-term value sacrifice will not invariably result from activist victory, and, as noted, the present body of empirical studies shows no harm on an aggregate basis.

The company-specific threat amounts to a twenty-first century recreation of the substantive coercion line of *Unocal* doctrine. Substantive coercion is the threat held out by a procedurally uncoercive tender offer that holds out a substantial premium over the market price but nevertheless arguably sacrifices greater long-term value held out by the incumbents' business plan.[69] Like the threat being posed here, it divides the shareholders into short- and long-term constituencies and allows management to intervene defensively in the name of the latter group.

There is a significant point of distinction, despite the parallel. Although *Unocal* allows management to deploy a poison pill so as to block a premium tender offer, it ultimately only delays a persistent challenger. The challenger can leave the offer on the table while conducting a proxy contest to gain control of the board with a view to withdrawing the pill and completing the acquisition. *Unocal* evolved on the theory that the shareholders still got a choice on control

---

[66] The study of operations that takes the longest view comes from Bechuk, Brav, and Jiang, who purport to confirm that activist intervention adds long-term value. They run five-year post-engagement ROA and Tobin's Q figures for a set of engagements from 1994 to 2007. Bebchuk, Brav & Jiang, supra note 47, at 1105.

[67] See, e.g., Francois Brochet, et al., Short-Termism, Investor Clientele, and Corporate Performance 2, working paper Nov. 2013 available at http://ssrn.com/abstract=1999484.

[68] See, e.g., See Alex Edmans, Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices, 101 J. Fin. Econ. 621, 622 (2011)(using appearance on the annual list of 100 Best Companies to Work for in America has a proxy for employee satisfaction); Francois Brochet, Maria Loumioti & George Serafeim, Short-termism, Investor Clientele, and Corporate Performance, working paper Nov. 2013 available at http://ssrn.com/abstract=1999484 (sorting companies between short and long term oriented by coding language used by senior managers and investors during quarterly conference calls); Jillian Popadak, A Corporate Culture Channel: How Increased Shareholder Governance Reduces Firm Value, working paper Mar. 2014 available at http://ssrn.com/abstract=2345384 (quantifying corporate culture through textual analysis of a data set of over 1.8 million employee reviews).

[69] See Unitrin, Inc. v. American General Corp., 651 A.2d 1361 (Del. 1995).

transfer through the exercise of their franchise. The implicit shareholder-protective justification was that the shift from the market for shares to the franchise and the resulting delay gave the competing parties time to lay out their cases and the shareholders a low-coercion context in which to evaluate the merits of the transaction. Any chilling effect on hostile takeover activity was disregarded, and, arguably, the shareholder interest has not been injured thereby in the long run.

The new application of substantive coercion doctrine suggested here shifts the venue to that self-same shareholders' meeting. It thereby steps outside of the received justificatory framework, which assumes that exercises of the shareholder franchise respecting board composition absolutely determine matters of business policy, even at the sacrifice of long-term value. The step is radical, for it disavows systemic reliance on indirect expression of shareholder business preferences in connection with director elections.

Here is a possible justification for the move. The situation can be described as a majority-minority shareholder conflict of interest: a long-term oriented shareholder minority is being disadvantaged at the hands of a short-termist shareholder majority, which majority, due the parochial, skewed interests of agents of shareholder intermediaries, prefers a low-value short-term revision of the business plan to a superior long-term value strategy. The majority-minority phrasing is conceptually comforting. But it still camouflages an implicit judgment that shareholder majorities cannot be trusted to determine business planning, even indirectly through the exercise of the board franchise. So let us color the picture of abuse a bit more intensely, re-characterizing the situation as one in which a short-termist minority exploits a long-termist majority. We get from here to there by disregarding the activists' shareholdings on the ground of interest in the outcome of the vote, analogizing to the majority-of-the-minority shareholder votes used to ratify self-dealing transactions between companies and large shareholders.

The new characterization imports more comfort, but still breaks with the inherited conceptual framework, for we are not strictly-speaking talking here about shareholder ratification of a self-dealing transaction. Indeed, there is no self-dealing in the fact pattern, even as there is pervasive self-interest. So far as concerns the duty of loyalty, the activist is no more interested in the outcome of the vote than are the defending board members, and the short-termist shareholders voting in favor of the activist are no more self-interested than are the long-termist shareholders supporting the board. The difference between the two shareholder groups is a mere incident of their holding periods. Furthermore, corporate law has always been comfortable with the notion that self-interest motivates shareholder voting—there is no shareholder-level duty to vote with a view to the corporation's best interests.[70]

The theory described is hypothetical. Even so, markers pointed in its direction are being put down in Delaware cases. Consider the following from Vice-Chancellor Travis Laster's opinion in case about a trade sale of a venture capital startup, *In re Trados Inc. Shareholder Litigation*[71]:

> A Delaware corporation, by default, has a perpetual existence. Equity capital, by default, is permanent capital. In terms of the standard of conduct, the duty of loyalty therefore mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital, as warranted for an entity with perpetual life in which the residual claimants have locked in their investment. When deciding whether to pursue a strategic alternative that would end or fundamentally alter the stockholders' ongoing investment in the corporation, the loyalty-based standard of conduct requires that the alternative yield value exceeding what the corporation otherwise would generate for stockholders over the long-term. Value, of course, does not just mean cash. It could mean an ownership interest in an entity, a package of other securities, or some combination, with or without cash, that will deliver greater value over the anticipated investment horizon. The duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base. . . . . Stockholders may have idiosyncratic reasons for preferring decisions that misallocate capital. Directors must exercise their independent fiduciary judgment; they need not cater to stockholder whim.[72]

Vice-Chancellor Laster makes an important move with this purposive alignment of corporate law's basic framework with the long-term side of the conflict between short- and long-term time

[70] The only exception covers vote buying. See Goshen, supra note 64, at 789. For the suggestion that a fiduciary duty should apply, see Iman Anabtawi & Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008).
[71] 73 A.3d 17 (2013).
[72] Id. at 37-38.

horizons. Historically, such basic conceptual statements have elided the short-term/long-term distinction, treating the shareholder interest in unitary terms.[73] Vice-Chancellor Laster's formulation, which was quite unnecessary to the decision of the case, normatively situates corporate law firmly on the long-term side. As such, it builds a normative justification for management actions against disproportionately influential activists into corporate law's conceptual framework. Indeed, if the formulation was deployed foursquare in a litigated case, it would obviate any need to invoke the foregoing majority-minority characterization. The case becomes easy: to the extent that the core legal concept of the corporation includes a bias toward a long-term time horizon, there is no need to make reference to incentive impairments on the shareholders' part. Long-termism standing alone would suffice as a justification.

There remains a substantial question as to whether we can ever expect to see Vice-Chancellor Laster's statement deployed on the facts of a case so as to trump the conceptual framework's protection of shareholder voting discretion in board elections. But, for what is it worth, the statement is now embedded in the caselaw in neutral form, ready to be invoked to justify a 5 percent poison pill.

IV. PRACTICAL CONSEQUENCES

We have posited a justification for a 5 percent general purpose poison pill, remodeling corporate law's conceptual framework to characterize activist employment of the shareholder franchise as a threat. It now must be noted that even if the law were to follow the course charted, it probably would not make much practical difference. Therein lies a hidden justification for the change suggested.

A. Standing Pills and Grandfathered Shares

Standing poison pills are disappearing, even as the level of activism continues to increase slightly, year by year. The reason is that managers now cater to the concerns of institutional investors and their informational intermediaries, all of whom dislike poison pills. In 2005, 35

[73] See, e.g., American Law Institute, Principles of Corporate Governance: Analysis and Recommendations §2.01 (1994).

percent of public companies had a poison pill in place. As of 2012, only 805 companies had standing pills, amounting to 22.6 percent of publicly-traded companies. Ten percent of those pills were triggered at less than 15 percent, 61 percent were triggered at 15 percent and 15 percent were triggered at more than 15 percent.[74] By 2015 there were only 471 companies with a standing pill—12.7 percent of public companies—of which only 25 were two-tier, low threshold pills of type seen in *Sotheby's*.[75]

It follows that, like the board in *Sotheby's*, defending managers adopt pills only once activists materialize with rule 13d-1 filings or pre-filing complaints and demands. These delayed pills have no effect on purchases in advance of promulgation (at least so long as selective ex post dilution of shareholder interests is impossible under corporate (and maybe property) law).

The delay substantially diminishes the pill's potency, for grandfathered activist purchases tend to be sufficient to support a serious challenge. Given the 10-day filing window under rule 13d-1, the vast majority of purchases by the lead activist and any wolf pack members already have been made in advance of the filing of a form 13D and pill deployment. In fact, challengers do not even need the 10 days of breathing space held out by the rule. In practice, market purchases above the 5 percent threshold are disproportionately concentrated on the day the threshold is crossed and the day following.[76] It seems that even undisclosed wolf pack members have their blocks in place by the second day.[77] Given this purchase pattern, a reduction of the 13d-1 filing window to even one day might have little practical deterrent effect.

A standing 5 percent pill has more bite, for it is triggered by purchases above 5 percent irrespective of the timing of a 13d-1 filing. Indeed, at present this is the only defense providing ex ante protection against activist intervention. But the deterrent effect is only marginal. A five percent per fund cap contains the intervention's impact by limiting the number of safe votes and giving a defensive proxy solicitation a higher probability of success. Perhaps more importantly,

---

[74] See Lucian A. Bebchuk, Alon Brav, Robert J. Jackson, Jr. & Wei Jiang, Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy, 39 J. Corp. L 1, 26-27 (2013).
[75] Coffee & Palia, supra note 42, at 30 n. 67. The percentage figure assumes 3700 publicly-traded companies in 2015. See Barry Ritholtz, Where Have All the Public Companies Gone? June 24 2015 available at http://www.bloomberg.com/view/articles/2015-06-24/where-have-all-the-publicly-traded-companies-gone-.
[76] See Bebchuk, et. al., supra note 74, at 23-25.
[77] See Wong, supra note 40.

it also limits the arbitrage profit yielded on pre-announcement share purchases by the post-announcement price bump. But it does not necessarily tip the cost-benefit scale against intervention.

A pill with something approaching preclusive effect would take a bit more. The drafter would have to sweep all wolf pack members into a defined group and then cap the group at 5 percent.[78] Problems of verification probably would limit such a provision's effectiveness, for the cap changes the activists' cost-benefit calculations concerning public disclosure. If every wolf in the pack held less than 5 percent, federal filing would no longer be required (at least so long as the federal group definition rules were not traversed[79]). The lead hedge fund presumably would disclose itself anyway, as an inevitable incident of the campaign. Any others could remain undisclosed, disabling the target from proving their participation and hence from enforcing its 5 percent group pill. A benefit still follows for the target, for, given undisclosed fellow travelers, the lead fund's clout would be more a matter of speculation than it is with a large disclosed wolf pack. But there would be no guarantee that any hedge funds working in parallel were in fact limited to an aggregate 5 percent.

B. Policy Considerations

Let us now take a step back and ask whether a *Unocal* regime that accepted a 5 percent standing pill (with or without a provision extending to groups) would be a bad thing.

1. The Case Against.

The potential downsides of the regime posited are clear to all—advocates of shareholder empowerment have set them out at length. For them, hedge fund activism is an unadulterated good and any increase in management insulation adds to agency costs.[80] And even if the shareholder advocates' absolute claims are unsustainable—there are costs and benefits on both

---

[78] For drafting strategies, see Coffee & Palia, supra note 42, at 601-602.

[79] Rule 13d–5, promulgated under § 13 of the Exchange Act, provides:

> When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership, for purposes of Section 13(d) and (g) of the Act, as of the date of such agreement, of all equity securities of that issuer beneficially owned by any such persons.

[80] See Lucian A. Bebchuk, The Myth that Insulating Boards Serves Long-Term Value, 113 Colum. L. Rev. 1637 (2013); Mark J. Roe, Corporate Short-Termism—In the Boardroom and in the Courtroom, 68 Bus. Law. 9789 (2013).

sides after all—the policy bottom line still resonates strongly. On aggregate, hedge fund activism may very well do some good and has not been shown to do affirmative harm. Corporate law has accommodated it more or less without change. No change has been required, for activists work within the law's inherited framework, operating within the confines of board-centric governance. They effect changes in business plans by joining boards in a minority posture, not by displacing incumbents wholesale. Their opponents so far have not managed to prompt any disabling reform. Given all of this, a root-and-branch revision of corporate law that makes it much more difficult for activists to join boards of directors needs to be justified by a showing of systemic damage to business plans and productivity. Arguably, no such showing can be made on the present record. It follows that we should adhere to the regulatory *status quo*.

From this point of view, most of the questions considered in *Sotheby's* in connection with a two-tier 10 percent standing pill never should have come up in the first place. Instead, the 10 percent trigger should been deemed invalid absent a compelling justification—*Blasius* rather than *Unocal* review. In this reframing of the law, the traditional 20 percent trigger becomes a line drawn in the sand, with the party seeking to step over it with a lower threshold bearing a heavy policy burden to discredit activism. The argument is powerful, for, as we have seen, creeping control and negative control, the theories thus far deployed to this end of sanctioning low threshold pills, largely fail to grapple with the matters at hand and so import little policy traction against an argument favoring the twenty percent *status quo*.

2. A Case in Favor.

Let us now attempt to justify a 5 percent poison pill in the teeth of the foregoing argument. The going is rough, for there is no aggregate evidence of injury from activism to support a policy case for across-the-board legal deterrence. Any case must be company-specific. To make such a case persuasively, one would have to avoid traditional *Unocal* factors, which tend to be beside the point. One instead would concentrate on the particular company's business plan, showing a capital-intensive investment program and a need to insulate long-term relationships with employees, customers, and suppliers from disruption. The case is more easily stated in theory than in practice, for its central empirical elements resist easy verification, even on a company-by-company basis. At the same time, the incentives of any managers making such a case are highly suspect.

Hypothesize a company whose managers can make an excellent case in all sincerity. Nothing would prevent them from submitting their pill to their shareholders for ratification, using the case to support the motion. Given shareholder approval and a pill of limited duration, say, no more than five years, fiduciary law arguably would hold out no basis for challenge. Shareholder approval simultaneously launders away any implication of management entrenchment and confirms the presence of a cognizable threat.

The scenario just posed holds out cold comfort to real world managers operating under uncertainty. Shareholders dislike pills, and would be disinclined to take seriously even a valid case. Sincerity is unverifiable and any management representations would be discounted for good reason. Even a case that remained persuasive net of a credibility discount still probably would fail. The institutional intermediaries who decide these questions are self-interested themselves and have a vested interest their own empowerment. Any discourse posing situational benefits from enhanced management insulation threatens their power structure by traversing the widely-held assumption that insulation is never cost beneficial due to stepped up agency costs. Meanwhile, the very attempt to make the case in the context of a proxy solicitation to approve a poison pill holds out risks for management. A failed solicitation sends a signal of vulnerability even as the case itself reveals information of interest to a potential activist. It comes as no surprise that such solicitations are not seen in practice.

We could stop here, leaving management with the burden of persuading its shareholders as a condition to justifying an effective deterrent pill. But let's give it one more try, shifting the burden over to the shareholders on a penalty default theory. We leave the managers free to promulgate a 5 percent pill unilaterally in the absence of searching *Unocal* scrutiny, remitting the job of punishing the managers to their disgruntled institutional shareholders rather than to the courts.

This defensive shift in the structure that sets the balance of power between shareholders and managers could prove beneficial in the long run. The positive projection relies on the assumption that standing pills—even 5 percent pills without risk of *Unocal* invalidation—are very unlikely to be seen in practice because managers now cater to shareholder preferences. A management promulgating such a pill would have a lot of explaining to do, even absent the burden of conducting a successful proxy solicitation. Let us once again posit that the promulgating company is unsuitable for activist targeting, and that management can make an excellent case by reference to the company's investment policy and relational commitments. Management promulgates the pill, simultaneously making the explanation. A set-to with ISS, Glass Lewis, and the large institutions no doubt would follow. The resulting dialogue could be beneficial—a learning experience for the institutional investor community.

Spinning the scenario out a bit, the poison pill emerges as a lever facilitating a productive sorting of companies among those well-suited and ill-suited to activist discipline, a sorting that will not occur under the present regime of *Unocal* scrutiny because managers have good reasons to avoid seeking shareholder ratification. It would achieve what anti-activist reformers tried and failed to get from the SEC—an activist baffler that deters purchases above 5 percent. It would be a superior means to the end because it would be a product of private ordering and would operate company by company.

The positive projection follows from the assumption that shareholder empowerment has waxed to the point at which most managers, even managers who believe in their own case, will refrain taking advantage of available defenses in order to avoid retaliation from the intermediary community. If the assumption is unsound and a green light prompted a massive turn to standing pills, without a beneficial informational back-and-forth, then the projection is unsound.

The projection's plausibility is remitted to the reader's judgment.

V. Conclusion

This chapter posed the question whether *Unocal*, a twentieth century doctrine keyed to hostile takeovers and control transfers, appropriately can be applied in a twenty-first century governance context in which the challenger limits itself to the shareholder franchise and does not seek control. The answer clearly is no. The doctrine fixes on the wrong threat. It likely will retain this refractory framing even so. There is no emergency—the *Sotheby's* ruling does next to nothing to crimp the strategies that determine most activist campaigns even as it strikes a blow for the defensive side. *Unocal* would have to be revamped conceptually in order to align itself with the right threat and so sustain a poison pill with enough bite even to begin to deter activism.

A reformulation would have such radical implications for corporate law's conceptual framework as to open it to widespread and severe questioning. But the context is changing. Shareholder power has waxed sufficiently to make it plausible to contemplate the renovation. Management agency costs just aren't as big a deal as they used to be.