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Corporate Governance Update: Heightened Activist Attacks on Boards of Directors

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This has been called "the heyday of hedge fund activism,"[1] and it is certainly true that today boards of directors must constantly be vigilant to the many and varied ways in which activist investors can approach a target. Commencing a proxy fight long has been an activist tactic, but it is now being used in a different way. Some hedge funds are engaging in proxy fights in order to exercise direct influence or control over the board's decision-making as opposed to clearing the way for a takeover of the target company or seeking a stock buyback. In some cases, multiple hedge funds acting in parallel purchase enough target shares to hold a voting bloc adequate to elect their director nominees to the board. A recent Delaware case addressed a situation in which a board resisted a threat from hedge funds acting together in this manner. The court determined that a shareholder rights plan, or poison pill, could, in certain circumstances, be an appropriate response. As a general matter, boards of directors facing activist share accumulations and threats of board takeovers can take comfort in this latest affirmation of the respect accorded to an independent board's informed business judgment.

Similarly, hostile takeovers are not new, but the tactics being used by today's activist investors in their approaches to corporate targets are unprecedented. Boards are facing carefully crafted attacks that exploit (or seek to exploit) legal loopholes and take advantage of the climate of corporate governance that has led to the dismantling of many takeover defenses. Boards should be forewarned and forearmed as they pursue their plans for long-term value creation in the current, precarious environment that clearly favors the activist investor.

Third Point v. Ruprecht

In *Third Point v. Ruprecht*, the Delaware Court of Chancery recently upheld the actions of the Sotheby's board of directors and refused to enjoin the company's annual meeting

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[1] John C. Coffee, "Hedge Fund Activism: New Myths and Old Realities," The CLS Blue Sky Blog, May 19, 2014 available at clsbluesky.law.columbia.edu/2014/05/19/hedge-fund-activism-new-myths-and-old-realities/.

based on claims by hedge funds that the board had breached its fiduciary duties.[2] By way of background: In May 2013, Third Point, along with two other hedge funds, announced in SEC filings that they had purchased Sotheby's stock. A few months later, Third Point amended its filing to disclose that it had increased its holdings to 9.4 percent and attached a letter as part of the filing. The letter, from Daniel Loeb, the CEO of Third Point, outlined the fund's intentions to push for changes to the company's management, strategic direction, and board of directors. The letter emphasized Loeb's view of the need to replace Sotheby's CEO and to put Loeb and others identified by him onto the board. At that point, the group of three hedge funds had accumulated approximately 19 percent of Sotheby's outstanding shares. At its October meeting, the board decided to adopt a rights plan that, it stated in its press release, was "intended to protect Sotheby's and its shareholders from efforts to obtain control that are inconsistent with the best interests of the Company and its shareholders."[3]

The rights plan adopted by Sotheby's had several interesting features. The rights plan had a one-year term, unless the rights plan was approved by a stockholder vote. It contained a "qualifying offer" exception, which permitted a cash tender offer for all of the shares of the company. Most important from the activists' perspective, it had a two-tier triggering structure. The threshold for triggering the rights plan was 10 percent for all stockholders other than passive investors, or Schedule 13G filers, who were permitted to acquire up to 20 percent of Sotheby's stock. As discussions proceeded between Third Point and Sotheby's, Third Point continued to increase its stake closer to the 10 percent limit and commenced a short-slate proxy contest for three board seats. Third Point then requested that the board waive the 10 percent limit so that it could acquire up to 20 percent of the company's stock. The board rejected this request, believing that with Third Point's and the other funds' current stock ownership levels, it was basically in a dead heat in the short-slate proxy contest. Thus, permitting Third Point to acquire additional shares by waiving the 10 percent limit would have given Third Point a greater likelihood of prevailing in the proxy contest. Days later, Third Point sued for a preliminary injunction to delay the annual meeting.

Third Point's claim was that the Sotheby's board had breached its fiduciary duties by adopting and refusing to waive the rights plan. They argued that the board had adopted the plan for the "primary purpose" of preventing Third Point from prevailing in the proxy contest, without any "compelling justification" to support their actions. Third Point also argued that the board had acted in a manner that was both "disproportionate"—because in their view there was minimal, if any, threat to the company—and "discriminatory"—because the rights plan was allegedly designed to favor the incumbent board.[4]

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[2] *Third Point v. Ruprecht*, C.A. No. 9469-VCP (Del. Ch. May 2. 2014) available at courts.delaware.gov/opinions/download.aspx?ID=205180.

[3] *Id.* at 22.

[4] *Id.* at 32.

In its opinion, the court affirmed that the standard for analyzing rights plans, even outside the takeover context, remains *Unocal Corp. v. Mesa Petroleum Co.*,[5] the seminal 1985 case holding that a board's response to a legitimate corporate threat had to be proportionate and reasonable in relation to the threat posed.[6] In *Third Point*, the court found sufficient evidence that the threat of "creeping control" posed by the hedge fund group led by Third Point did indeed create a legitimate and objectively reasonable threat. The court further found evidence that the primary purpose of the Sotheby's board's actions was not to disenfranchise its shareholders but to address that threat. The court also noted that the Sotheby's board was not entrenched, pointing out the board's higher-than-average turnover rate, high proportion of outside directors, and lack of any financial conflicts of interest.

The court concluded that the Sotheby's rights plan was likely a proportionate response to the threat of collusive action by the hedge funds. The opinion noted that Third Point was the corporation's largest shareholder and that a trigger level much higher than 10 percent would make it easier for a small group of activist investors to obtain effective control of the company without paying a control premium. In finding that the Sotheby's rights plan met the proportionality test of *Unocal*, the court noted that the "discriminatory" element of the plan—its two-tiered structure—arguably made it a more tailored, proportionate response.[7] Finally, the court concluded that the board's refusal to waive the rights plan in response to Third Point's request was reasonable and supported by evidence that Third Point still posed a threat—particularly, of "negative control"—*i.e.*, permitting it to achieve 20 percent ownership would enable the activist fund to effectively control certain corporate actions despite having no actual or explicit power to do so.[8] The court noted that it did not intend for the specter of negative control to be a license for the unreasonable deployment of defensive measures, but that due to Third Point's aggressive behavior and position as the largest single stockholder in the company, in this case it was a valid threat. The court also pointed out that nothing in the rights plan coerced shareholders to favor the incumbent slate over the dissident slate in the proxy contest.

Somewhat surprisingly, the discriminatory feature of the rights plan that permitted "passive" Schedule 13G filers to acquire up to 20 percent of Sotheby's stock did not appear to be very beneficial to Sotheby's. Third Point claimed that the discriminatory feature was an effort to give Schedule 13G filers who were more likely to vote in favor of management the ability to acquire additional shares. Noting that Third Point was Sotheby's largest shareholder, the court rejected this contention noting "there do not appear to be any restrictions whatsoever on a Schedule 13G filer who wishes to vote for a dissident slate in a proxy contest."[9] Similarly, it does not appear that institutional holders appreciated the ability to acquire shares above the 10

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[5] 493 A.2d 946 (Del. 1985).

[6] *Third Point*, at 34-37.

[7] *Id.* at 47-48.

[8] *Id.* at 50-51.

[9] *Id.* at 48 n.37.

percent triggering threshold so it is not clear that the distinction created by the discriminatory feature was helpful.

Though Sotheby's prevailed in the Delaware litigation, shortly after the opinion was issued, but prior to the annual meeting, the company entered into a settlement with Third Point under which the Sotheby's board was expanded to give Third Point nominees three new seats, the company's rights plan was terminated at the annual meeting, and Third Point entered into a voting and standstill agreement under which Third Point was permitted to acquire up to 15 percent of Sotheby's stock.[10]

Collusive activist attacks on companies such as the one at issue in *Third Point* are a relatively new phenomenon, but already they have fallen into a familiar pattern. First, activists build up a stake in a target, individually or by teaming up with other institutional or activist stockholders to form a 'wolf pack.' Next, they apply pressure on the target, including by threatening to oppose a board's preferred strategic alternatives. Finally, they take action against the board by threatening "withhold the vote" campaigns, demanding board seats, launching a short-slate proxy contest, seeking control of the board, or making aggressive use of derivatives.[11] As Sotheby's found, activist funds can achieve their objectives, in whole or in part, even when the target "wins" in a court of law or public opinion. Activists' willingness to use aggressive, high-profile tactics is a powerful weapon that is difficult for target companies to deflect.

Activists and Hostile Takeover Bids

Activists are beginning to take their attacks a step further, using collusive tactics to create an advantage in a hostile takeover situation. They are profiting from what they perceive as loopholes in the federal securities laws to quietly buy large stakes in companies and combine with allies to put a target into play. A recent situation involving this type of attack is the ongoing and highly public hostile takeover bid for Allergan by Pershing Square Capital Management, a well-known activist fund headed by William Ackman, and Valeant Pharmaceuticals International. The partnership of a hedge fund and a strategic buyer is unprecedented, and it has been described as "a harbinger of a much wider range of kinds of deals."[12] The hedge fund, with its aggressive tactics and ready cash, makes the strategic bidder a more formidable acquiror.

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[10] *See* Sotheby's Press Release, "Sotheby's and Third Point Reach Agreement," May 5, 2014 available at investor.shareholder.com/bid/releasedetail.cfm?ReleaseID=845166

[11] This pattern is discussed in *Third Point* at 10.

[12] David Gelles et al., "Ackman and Valeant Prepare Unusual Hostile Bid for Maker of Botox," NYTimes.com DealBook, Apr. 21, 2014 (quoting Stanford law professor Ronald J. Gilson) available at dealbook.nytimes.com/2014/04/21/william-ackman-and-drug-maker-prepare-bid-for-botox-maker/. *See also* Steven Davidoff Solomon, "Allergan Bid Charts New Territory in Takeovers," NYTimes DealProfessor, Apr. 22, 2014 available at http://dealbook.nytimes.com/2014/04/22/allergan-bid-charts-new-territory-in-takeovers/.

Pershing Square and Valeant have sought to carefully engineer their approach in an attempt to avoid restrictions in the securities laws designed to prevent secret accumulations of stock, insider trading and unfair collusion. For example, the pair formed a purchasing vehicle (funded primarily by Pershing Square) to purchase a large stake in Allergan using stock options rather than the underlying shares. They used the ten-calendar-day window between the acquisition and the required public disclosure of a 5 percent stake in a company to quickly go from just under 5 percent to nearly 10 percent ownership of Allergan. In their Schedule 13D filing at the end of that period, having amassed a very significant position without attracting any publicity, Valeant then disclosed its intention to make an offer for the target company. They also have attempted to avoid antitrust, fair disclosure, and insider-trading restrictions through a series of legalistic maneuvers.[13] While it has yet to be seen if their tactics will be successful or if they have indeed complied with the federal securities laws, their novel and unprecedented approach has prompted renewed calls for a long-overdue updating and tightening of the securities laws to prevent use of the exploited loopholes.[14]

Managing the Activist Threat

It remains to be seen how the Valeant-Pershing Square bid for Allergan will play out and whether these novel tactics will be adopted by other would-be acquirors in potentially hostile situations. In the meantime, boards should be aware that the activist threat is always looming and may become real at any time. As one recent article put it, "Other companies are wondering whether they too will wake up one morning to find a raider-activist team wielding a stealth block of their stock."[15]

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[13] *See, e.g.*, Liz Hoffman, "In Botox Alliance, Ackman and Valeant Navigated Maze of Rules," WSJ, Apr. 22, 2014 available at online.wsj.com/news/articles/SB10001424052702304049904579517970196604840; Steven Davidoff Solomon, *supra*.

[14] *See, e.g.*, Martin Lipton et al., "A New Takeover Threat: Symbiotic Activism," Wachtell, Lipton, Rosen & Katz Memorandum, Apr. 25, 2014, reprinted in The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2014/04/25/a-new-takeover-threat-symbiotic-activism/; David A. Katz & Laura A. McIntosh, "Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating," NYLJ, Apr. 12, 2012, reprinted in The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2012/04/12/section-13d-reporting-requirements-need-updating/. *See also* Stephen Bainbridge, "The Long Overdue Closure of the 10-Day Reporting Window Under Section 13(d) Remains Overdue," ProfessorBainbridge.com, Mar. 31, 2014, available at http://www.professorbainbridge.com/professorbainbridgecom/2014/03/the-long-overdue-closure-of-the-10-day-reporting-window-under-section-13d.html; Adam O. Emmerich & William Savitt, "Stealth and Ambush Equity Accumulation—Use of Synthetic Ownership Arrangements Continues To Pose Danger to Securities Markets and Public Companies," Wachtell, Lipton, Rosen & Katz Memorandum, Oct. 28, 2010, reprinted in The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2010/11/27/synthetic-ownership-arrangements-for-ambush-equity-accumulation/; Theodore Mirvis et al., "Activist Abuses Require SEC Action on Section 13(d) Reporting," Wachtell, Lipton, Rosen & Katz Memorandum, Oct. 28, 2010, reprinted in The Harvard Law School Forum on Corporate Governance and Financial Regulation, available at http://blogs.law.harvard.edu/corpgov/2014/03/31/activist-abuses-require-sec-action-on-section-13d-reporting/.

[15] *See* Lipton et al., *supra*.

We are also seeing a new paradigm where activist investors actually seek to acquire control of companies without paying any control premium by pursuing all or a majority of the seats on a board of directors through a proxy contest. According to a recent Wall Street Journal Article, "Fights for at least a majority of the seats, including full control, increased to about 42% of all proxy fights announced in 2013 and 2012, exceeding the prior four years, according to FactSet data. This year [2014] has started off with 35% of campaigns going for control, the data provider said."[16] To the extent that shareholders allow activists to acquire control of a board, the activist will be able to pursue their own agenda, whether or not it will ultimately benefit all shareholders. Moreover, shareholders will have turned over control of the corporation to the activist without receiving any control premium.

Takeover defenses such as staggered boards and shareholder rights plans have for many years been under fire from shareholder activists and proxy advisory firms. As a result, public companies seeking to avoid controversy and show goodwill toward activist investors have willingly dismantled many of their structural defenses. Unfortunately, doing so leaves companies open to attack. Allergan, for example, declassified its board only a few years ago—as many companies have done in recent years—in response to a gadfly activist's pressure to do so. One commentator observed that "As a result of a small shareholder's activism … Allergan shareholders have put their directors at a major disadvantage in negotiating with Valeant."[17] As hedge fund activism becomes more creative, more predatory, and more mainstream, companies may find it advantageous to reassess the advantages and disadvantages of structural takeover defenses and take steps to maintain or strengthen their positions with the legal tools that are available and appropriate to their situation.

As boards anticipate or respond to activist attacks, there is no substitute for preparation, communication, and vigilance. Every situation is different, and each board must consider, and regularly revise, its plans and strategies as needed. The board should be updated periodically on steps that the company is taking to maintain a state of preparedness for an activist approach. Board consensus in the event of an attack is extremely important, and solid preparation—including a thorough understanding of the options and alternatives that have been analyzed by management and the company's outside advisors—will be invaluable in achieving and presenting a united front. Activists will constantly seek to drive a wedge between the board and the management team. By keeping the board fully apprised of the evolving situation and alternatives and avoiding surprises, management can prevent the activist from achieving its objective to split the board and the management team. Board trust and confidentiality are crucial in high-pressure, public situations, as the psychological elements of proxy contests and takeover battles are, in many cases, as significant as the business, financial and legal elements.

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[16] David Benoit, "Clash Over Darden Board Will Be Measure of Activist Clout," WSJ.com, May 22, 2014 available at online.wsj.com/news/articles/SB10001424052702303749904579578481272657694.

[17] Ronald Barusch, "Dealpolitik: How Corporate Technicalities Can Influence Takeovers," WSJ.com, Dealpolitik, Apr. 25, 2014 available at blogs.wsj.com/moneybeat/2014/04/25/dealpolitik-how-corporate-technicalities-can-influence-takeovers/.

As activists and their partners become ever more aggressive, legislation likely cannot keep pace with their efforts. Nonetheless, we hope that the Securities and Exchange Commission or Congress will heed the repeated calls for revision of the Section 13(d) reporting requirements, as the current regulations are repeatedly shown to be anachronistic.[18] In the meantime, companies and boards need to be their own watchdogs and protectors, using careful preparation, expert advice, and sound business judgment to control their own destiny to the best of their ability.

[18] *See, e.g.*, Andrew Ross Sorkin, "For Activist Investors, a Wide Reporting Window," NYT.com DealBook, May 19, 2014 available at dealbook.nytimes.com/2014/05/19/for-activist-investors-a-wide-reporting-window/?_php=true&_type=blogs&_r=0