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Conscious Parallelism May Justify A Wolf Pack Pill

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Law360, New York (May 27, 2014, 9:45 PM ET) -- We are living in the era of the activist shareholder. Corporate boards and advisers, which in the past have focused on the risk of a hostile takeover bid, now often give their primary attention to the danger that an activist shareholder will try to pressure the company to put itself up for sale or otherwise follow corporate strategies that the board opposes.

One of the factors that makes activism hard to combat is the "wolf pack" phenomenon. Wolf pack is a colorful phrase for activist shareholders who advocate a common program for the company, but do not have an agreement to act in concert. Companies have particular difficulty dealing with wolf packs because they are generally not required to file as a "group" on a Schedule 13D and are beyond the reach of most shareholder rights plans. However, a recent Delaware case, Third Point v. Ruprecht (the Sotheby's case) raises the possibility that a target company could draft its shareholder rights plan to capture a wolf pack, even though the wolf pack may not be treated as a "group" for federal securities law purposes.

Shareholders rights plans (or poison pills) deter shareholders from accumulating certain large ownership positions in a company by drastically diluting the value of stock owned by investors who exceed its ownership threshold, typically 10 percent to 20 percent of the company's outstanding shares. A poison pill can be a powerful weapon against activists who constitute a "group" because it aggregates their stock ownership in determining whether they exceed the pill's ownership threshold.

However, a traditional poison pill follows the federal securities laws in determining when shareholders are considered a "group" and would generally aggregate their ownership if, and only if, they entered into an agreement to act in concert with respect to their stock in the company. There is no definitive legal authority on whether a poison pill would be legally valid if it aggregated stock ownership of

investors who patterned their behavior after one another, but did not have an agreement to act in concert. To avoid potential litigation, companies generally utilize the 13D definition of "group" in their shareholder rights plans although this means that their poison pill may not be an effective weapon against a wolf pack.

The Sotheby's case may cause practitioners to rethink the desirability of adopting a wolf pack pill. Sotheby's found that the acquisition of stock by members of a wolf pack could be a threat to the corporation based on a pattern of behavior the court described as "conscious parallelism." The same analysis may also justify a wolf pack clause in a poison pill.

Sotheby's involved a legal attack by activist investor Third Point LLC on a Sotheby's poison pill with a 10 percent ownership threshold. Under Delaware law, a shareholder rights plan must satisfy several requirements: it may not improperly interfere with shareholder voting rights; it must not be coercive or preclusive; it must be aimed at a threat to the corporation, and it must be a reasonable and proportionate way of dealing with that threat. Third Point claimed that the 10 percent pill improperly interfered with shareholder voting rights because the primary purpose of the pill was to thwart a Third Point proxy contest at the 2014 Sotheby's annual meeting.

In denying Third Point's request for a preliminary injunction, Vice Chancellor Donald Parsons found adequate support for Sotheby's contention that the pill was adopted primarily to address a different threat: namely, the risk that three hedge funds including Third Point, which together already owned 19 percent of the Sotheby's stock, would gain control of Sotheby's without paying a premium if they were able to continue accumulating shares. These hedge funds had not agreed to act in concert, and had not filed a 13D as a group. However, Vice Chancellor Parsons perceived a risk that the three hedge funds could form a control block by engaging in conscious parallelism. This occurs when shareholders model their actions after those of other shareholders who, they believe, have similar objectives.

He cited a footnote (254) from Chief Justice (then Vice Chancellor) Leo Strine's opinion in Yucaipa v. Riggio in which Chief Justice Strine indicated that it was reasonable for a corporation to be concerned about the formation of a control block through conscious parallelism. Based on this analysis, Vice Chancellor Parsons concluded that the Sotheby's board had an adequate basis for regarding the acquisition of a control block by the three hedge funds as a threat. This justified adopting a poison pill with a 10 percent ownership threshold and using it to prevent Third Point from going above that level.

The rights plan that was upheld by the court was of limited value against a wolf pack since it was a conventional poison pill that did not aggregate the holdings of the members of the pack. Under the Sotheby's poison pill, each of the three hedge funds could have increased its ownership to 9.9 percent without triggering the pill, although this could have brought their aggregate ownership to a level that would have given them a veto power over major corporate decisions (see discussion of "negative control" below). To gain an effective remedy against a wolf pack, a company would need a pill that aggregated the holdings of the members of a wolf pack for purposes of determining whether the threshold had been exceeded.

Vice Chancellor Parsons' opinion goes a long way toward justifying the adoption of a wolf pack pill, both in his endorsement of the theory of conscious parallelism and his finding that the Sotheby's board had an adequate basis for concluding that the wolf pack was a threat. However, there would be numerous issues in designing a wolf pack pill which, if not dealt with properly, could lead a court to conclude that the wolf pack pill failed the reasonable and proportionate test, applicable to poison pills and other corporate defenses. Here are some initial thoughts on the potential design of a wolf pack pill.

1. Notice and Opportunity to Cure. To trigger the pill the board would have to make a reasonable determination that a group of shareholders, who owned more than the threshold amount of stock in the aggregate, was pursuing an activist agenda through conscious parallelism. A shareholder would not be treated as a member of the group until it had received notice of the board's determination. If the shareholders (or individual members of the group) promptly end the activities that led to the board's determination, they should not suffer the dilution that results from acquiring shares in excess of the pill threshold. If these activities continue, however, they would be treated like a newly formed 13D group under a conventional rights plan. Namely, the formation of the group would result in the acquisition of shares in excess of the pill threshold, the pill would be triggered, and the members of the pack would have their ownership diluted.

2. Set Wolf Pack Ownership Threshold Above 10 Percent. Vice Chancellor Parsons did not find that the wolf pack would be a threat if its aggregate ownership exceeded the 10 percent ownership level set in the Sotheby's pill. Rather, he found that Third Point ownership in excess of 10 percent, combined with shares owned by the other two hedge funds, could result in the formation of a control block that would be a threat to Sotheby's. To come within the scope of the Sotheby's opinion, the board should set the ownership threshold for the wolf pack pill at a level that could give the members of the pack effective control. While 20 percent may seem like the logical threshold for a wolf pack pill, the Sotheby's opinion provides some support for a lower threshold. Vice Chancellor Parsons upheld the Sotheby board's refusal to allow Third Point to increase its ownership to 20 percent, because a 20 percent stockholder may be able to exercise negative control over important corporate decisions.

3. Should the Wolf Pack Pill be limited to 13D filers? A wolf pack pill would initially be perceived as an aggressive defensive measure, and first adopters should be careful to limit it to situations in which it is clearly warranted. With this in mind, they may be well advised to set a 20 percent ownership threshold and apply the pill only to 13D filers. This would limit the wolf pack provisions to very large shareholders who have acknowledged that they are activists by filing a 13D. It would also allow wolf pack members to escape from the pill by becoming passive investors and disclosing this change in a 13G or amendment to their 13D.

While these restrictions could be helpful in protecting against a legal attack on the wolf pack pill, they could also impair the effectiveness of the pill, particularly when the pack includes one or more large shareholders who are clearly activists, but fall below the 5 percent stock ownership level that triggers a 13D filing requirement. Therefore, once the concept of a wolf pack pill is well established, companies may wish to consider whether there are circumstances in which it is appropriate to use a lower threshold and apply the wolf pack pill to activist shareholders who own less than 5 percent.

Shareholder rights plans are an important part of the overall balance of power between companies and activist shareholders. However, a conventional poison pill may not be an effective tool against a wolf pack. Vice Chancellor Parsons' opinion in Sotheby's holds out the prospect that companies targeted by wolf packs will be able to adopt rights plans that address this threat.

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