

COMMENT

Unpacking Wolf Packs

Wolf-pack activism has surged in the past three years. A wolf pack is composed of a group of activist investors working in unison to gain control of corporate boards.¹ These activist investors collectively buy stock in a public company and then leverage their aggregate stake to influence corporate decision making.² Wolf packs allow activist investors to pool their informational and financial resources, thereby greatly reducing the cost of seizing corporate control.³ In the past two years, wolf packs have targeted companies including Sotheby's, Allergan, and DuPont.⁴ The rise of wolf packs may permanently shift the balance of power between corporate boards and control-seeking shareholders.⁵

This Comment examines the law's seemingly inconsistent treatment of wolf packs, and it advances a disclosure framework that seeks to rebalance the powers of corporate boards and wolf packs. Securities law and corporate law

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1. Martin Lipton, *The Threat to Shareholders and the Economy from Activist Hedge Funds*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Jan. 14, 2015), <http://corpgov.law.harvard.edu/2015/01/14/the-threat-to-shareholders-and-the-economy-from-activist-hedge-funds> [<http://perma.cc/6Y29-5RCZ>]. Lipton described 2014 as the "year of the wolf pack."
 2. See John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance* 28-39 (Columbia Law & Econ., Working Paper No. 521, 2015), <http://ssrn.com/abstract=2656325> [<http://perma.cc/F3YZ-M2MA>].
 3. See *id.* at 28-31.
 4. Robert Cyran & Richard Beales, *Ackman and Valeant Drum Up Stealth Activism*, N.Y. TIMES: DEALBOOK (Apr. 22, 2014, 8:16 AM), <http://dealbook.nytimes.com/2014/04/22/ackman-and-valeant-drum-up-stealth-activism> [<http://perma.cc/SPN3-Z69J>]; Steven Davidoff Solomon, *In DuPont Fight, Activist Investor Picks a Strong Target*, N.Y. TIMES: DEALBOOK (Jan. 27, 2015, 6:58 PM), <http://dealbook.nytimes.com/2015/01/27/in-dupont-fight-activist-investor-picks-a-strong-target> [<http://perma.cc/ED8Z-7FLA>].
 5. See David Benoit & Kirsten Grind, *Activist Investors' Secret Ally: Big Mutual Funds*, WALL ST. J. (Aug. 9, 2015, 10:38 PM), <http://www.wsj.com/articles/activist-investors-secret-ally-big-mutual-funds-1439173910> [<http://perma.cc/5HW3-PE4N>]; Coffee & Palia, *supra* note 2, at 100.

diverge in their approach to wolf packs. On the one hand, section 13(d) of the Securities Exchange Act—designed to alert corporate boards and shareholders to takeover threats—construes wolf packs narrowly. As a result, boards and shareholders may not receive advance notice of wolf-pack activism. On the other hand, the Delaware Court of Chancery recently adopted a relatively expansive conception of wolf packs that may overly punish activist investors. I argue that requiring wolf packs to make prophylactic disclosures will strike the right balance. It will allow boards to better respond to wolf-pack activism and enable courts to better adjudicate the proportionality of such responses.

The Comment proceeds as follows: Part I discusses the history and characteristics of wolf-pack activism. Part II argues that current laws simultaneously underregulate and overregulate wolf packs to the detriment of both boards and investors. Finally, Part III explains how prophylactic disclosures can help restore the balance of power between wolf packs and corporate boards.

I. THE ORIGINS AND ANATOMY OF A WOLF PACK

Wolf packs emerged from the recent growth in shareholder activism.⁶ Activist shareholders are typically hedge funds that generate profit by implementing major changes in public companies. Such changes may involve altering a company's financing structure, investment strategy, or number of employees.⁷ To effectuate change within a public company, activist investors often purchase a large stake in the public company and then lobby the company's management to implement changes that the investors believe would increase shareholder value. Activist investors may also seek to win the support of the company's other shareholders via a proxy contest to install the activist investors' choice of directors on the corporate board.⁸ Fights to win over shareholders are aggressive and highly public; oftentimes, they create tremendous pressure for a company's incumbent directors to acquiesce to the activists' demands.⁹

Activist hedge funds took off in the early 1990s after the Securities and Exchange Commission (SEC) began loosening its proxy statement rules.¹⁰ In

6. Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 686-94 (2007).

7. See Bill George & Jay W. Lorsch, *How To Outsmart Activist Investors*, HARV. BUS. REV., May 2014, at 88, 90.

8. See *id.* at 92.

9. See *id.*

10. See Briggs, *supra* note 6, at 686-94.

1992, the SEC stopped censoring proxy statements, allowing activist shareholders to be more vocal in their criticisms of incumbent corporate boards.¹¹ Seven years later, the SEC adopted Rule 14a-12, which allowed activist investors to lobby other shareholders before filing a proxy statement.¹² The rule allowed activists to gauge the level of support from other shareholders and mitigate the risk of losing a costly proxy contest.

The growth of activist hedge funds led to the emergence of wolf packs. The phenomenon first came to the attention of the courts in 2002 when a real estate company sued three investment funds for securities fraud in *Hallwood Realty Partners, LP v. Gotham Partners, LP*.¹³ Under section 13(d)(3) of the Securities Exchange Act, groups of persons must disclose beneficial ownership of more than five percent of a company's stock.¹⁴ The Second Circuit, however, construed section 13(d)(3) narrowly and held that the discussions between investment firms regarding their purchases did not make the firms a "group."¹⁵ The *Hallwood* decision loosened regulatory oversight of wolf packs and fueled their growth.¹⁶ In the last two years, as the markets have recovered, wolf packs have rapidly reemerged.¹⁷

Economists believe that wolf packs tend to form when a single lead investor acquires a substantial stake in a target company.¹⁸ After the lead company makes its purchase, it often encourages other activist investors to purchase stocks in the target company.¹⁹ The activist investor makes these tips in the hopes of securing a broader coalition of votes for its proxy fight. The lead activist's large purchase may also independently spur purchases from other activist investors.²⁰ These investors may catch wind of upcoming activist activity and buy stocks in an attempt to profit from the lead activist's success. In short, although wolf packs may not be deemed a "group" under securities law, there is both empirical and anecdotal evidence of coordination among

11. *Id.* at 687.

12. *Id.* at 689.

13. 286 F.3d 613 (2d Cir. 2002); see Briggs, *supra* note 6, at 691.

14. 15 U.S.C. § 78m(d) (2012).

15. *Hallwood*, 286 F.3d at 617-18.

16. See Briggs, *supra* note 6, at 691; Coffee & Palia, *supra* note 2, at 35.

17. Lipton, *supra* note 1, at 1.

18. See Alon Brav et al., *Wolf Pack Activism* 3-4 (Robert H. Smith Sch., Research Paper No. RHS 2529230, 2015), <http://ssrn.com/abstract=2529230> [<http://perma.cc/K358-W8JR>]; Coffee & Palia, *supra* note 2, at 23-33.

19. Coffee & Palia, *supra* note 2, at 23-33.

20. *Id.* at 34.

activist investors.²¹ Studies indicate that stock prices of a target diverge from market averages in the ten to twenty days before activists publicly disclose securities purchases.²²

Wolf packs, however, appear to collapse as quickly as they form. The duration of an activist's participation is tied to how the activist plans to generate return.²³ In cases where a proxy fight merely seeks to replace a company's board of directors, wolf-pack participants tend to sell their shares shortly after the change is accomplished.²⁴ In cases where the wolf pack seeks to restructure the company, the participants may hold onto their stakes for a longer period of time while the changes are carried out.²⁵ Most participants in a wolf pack do not hold onto their portfolio in the long run, with most exiting within a year.²⁶ Some participants will even drop out before the proxy fight.²⁷

II. HOW CURRENT LAW SIMULTANEOUSLY UNDERREGULATES AND OVERREGULATES WOLF PACKS

A fundamental goal of both securities and corporate law is the protection of shareholder interests.²⁸ An important component of this goal is preserving the balance of power between control-seeking shareholders and corporate boards.²⁹ The two parties serve as a check on each other: control-seeking shareholders help monitor corporate boards while corporate boards owe fiduciary duties to prevent control-seeking investors from exploiting their

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21. See Lucian A. Bebchuk et al., *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1122 (2015); Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1756 (2008); Susan Pulliam et al., *Activist Investors Often Leak Their Plans to a Favored Few: Strategically Placed Tips Help Build Alliances for Campaigns at Target Companies*, WALL ST. J. (Mar. 26, 2014, 10:37 PM), <http://www.wsj.com/articles/SB10001424052702304888404579381250791474792> [<http://perma.cc/33N2-UR53>].
22. See sources cited *supra* note 21.
23. See Coffee & Palia, *supra* note 2, at 36; Charles Nathan, *Observations on Short-Termism and Long-Termism*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 12, 2015), <http://corpgov.law.harvard.edu/2015/10/12/observations-on-short-termism-and-long-termism> [<http://perma.cc/YU8S-6PVG>].
24. Coffee & Palia, *supra* note 2, at 36.
25. *Id.* at 36-37.
26. Brav et al., *supra* note 21, at 1769; Alon Brav et al., *Hedge Fund Activism: A Review*, 4 FOUND. & TRENDS FIN. 185, 205 (2010); Coffee & Palia, *supra* note 2, at 36.
27. Coffee & Palia, *supra* note 2, at 36.
28. See WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATIONS 269-70 (4th ed. 2012); STEPHEN J. CHOI & A.C. PRITCHARD, SECURITIES REGULATION: CASES AND ANALYSIS 1-2 (4th ed. 2015).
29. See Briggs, *supra* note 6, at 708.

holdings to the disadvantage of minority shareholders.³⁰ Securities law seeks to balance the competing interests of control-seeking shareholders and boards through disclosure rules.³¹ Meanwhile, corporate law seeks to achieve the same end through ex post review of board decisions.³² In the case of wolf packs, however, neither securities law nor corporate law appears to adequately balance the power of boards and control-seeking activist investors.

A. How Wolf Packs Defeat Section 13(d) of the Securities Exchange Act

Enacted in 1968 under the Williams Act, section 13(d)³³ was a response to the growth of all-cash takeovers that escaped the disclosure requirements under section 14 of the Securities Exchange Act.³⁴ Congress believed disclosures were necessary to ensure that shareholders were promptly alerted to possible changes in company management and corporate control.³⁵ Consequently, section 13(d) requires all persons or groups holding a five percent or greater stake in a public company to disclose their ownership within ten days of surpassing the five percent threshold.³⁶

Wolf packs, however, are able to evade section 13(d) in three ways. First, wolf packs can simply avoid detection if each of the activist investors acquires less than a five percent stake in the target. In 2011, the Second Circuit reaffirmed the narrow scope of “group” under section 13(d) in *CSX Corp. v. Children’s Investment Fund Management (UK) LLP*.³⁷ The court held that specific evidence of coordination among the shareholders is required in order for them to be deemed a group.³⁸ Currently, it is particularly difficult for

30. See Lucian A. Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 39, 45 (2012); Briggs, *supra* note 6, at 718.

31. ALLEN ET AL., *supra* note 28, at 612, 621.

32. CHOI & PRITCHARD, *supra* note 28, at 2.

33. 15 U.S.C. § 78m(d) (2012).

34. See Adam O. Emmerich et al., *Fair Markets and Fair Disclosure: Some Thoughts on the Economics of Blockholder Disclosure, and the Use and Abuse of Shareholder Power*, 3 HARV. BUS. L. REV. 135, 144 & n.30 (2013).

35. *Id.*

36. 15 U.S.C. § 78m(d).

37. 654 F.3d 276, 284 (2d Cir. 2011) (holding that “a precise finding, adequately supported by specific evidence, of whether a group existed for purposes of acquiring CSX shares outright during the relevant period needs to be made”).

38. *Id.*

corporate boards to identify and classify activist shareholders who purchase less than a five percent stake as a “group.”³⁹

Second, wolf packs can partially evade section 13(d) when only the lead activist shareholder discloses its ownership stake. Such a move can lead corporate boards to underestimate the activist threat. For example, in the fight over control of Barnes and Noble, the lead activist investor held an 18.7% stake in the company.⁴⁰ However, the actual wolf pack controlled a 36.14% stake.⁴¹ The wolf pack’s sizeable stake meant that the activist investors only needed 13.87% of the shareholder votes to establish the majority required to oust the incumbent board.

Third, the ten-day disclosure window under section 13(d) critically undermines the value of any potential disclosures from wolf-pack members. Activist investors typically engage in a buying frenzy during this ten-day period⁴² in order to maximize their profits from future increases in share price. A wolf pack’s aggregate shareholdings thus concentrate potential gains among a small handful of activist investors.

The ability of wolf packs to evade section 13(d) procedurally and substantively shifts power away from other shareholders and corporate boards and toward activist funds that may have relatively short investment horizons. Investors with short investment horizons may be less keen on costly but potentially lucrative research and development spending, preferring instead to use excess cash reserves to bolster immediate earnings and stock prices. In particular, institutional shareholders with long-term investment objectives and corporate management seeking to implement long-term strategic goals may find themselves particularly disadvantaged in the face of increasing wolf-pack activism.⁴³

39. See Coffee & Palia, *supra* note 2, at 28.

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

41. *Id.*

42. See Emmerich et al., *supra* note 34, at 150-53.

43. Whether shareholder activism generates long-term value for shareholders is subject to intense debate. Compare Bebchuk et al., *supra* note 21 (arguing that shareholder activism does not have a detrimental effect on long-term interests of companies), with Martin Lipton, *Empiricism and Experience; Activism and Short-Termism; the Real World of Business*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Oct. 28, 2013), <http://corpgov.law.harvard.edu/2013/10/28/empiricism-and-experience-activism-and-short-termism-the-real-world-of-business> [<http://perma.cc/Z3HA-2WYC>] (arguing that activism has led to serious adverse effects on companies).

B. How Judicial Doctrine in Corporate Law May Cast an Overbroad Net over Wolf Packs

Corporate boards traditionally adopt poison pills in response to control-seeking shareholders.⁴⁴ The poison pill is a share dilution device invented in the 1980s that makes it very costly to acquire control of the target company.⁴⁵ The Delaware Chancery Court's recent decision upholding Sotheby's poison pill, *Third Point LLC v. Ruprecht*,⁴⁶ appears to have adopted a broad stance against collaboration among activist investors.

Third Point involved the ongoing contest for control of Sotheby's. In May 2013, three activist funds—Third Point LLC (Third Point), Trian Fund Management, L.P. (Trian), and Marcato Capital Management LLC (Marcato)—began purchasing shares in auction giant Sotheby's.⁴⁷ In response to the possibility that the three investors would form a wolf pack, the Sotheby's board adopted a poison pill that would be triggered if any of the three funds acquired more than a ten percent ownership stake.⁴⁸ In reviewing the proportionality of Sotheby's response, Vice Chancellor Parsons considered the threat to include parties acting with “conscious parallelism”⁴⁹—a significantly broader concept than the “group” definition under section 13(d). Ignoring the absence of formal agreements between Trian, Marcato, and Third Point, Vice Chancellor Parsons noted that there “was the objectively reasonable possibility that Third Point was working in connection with one or more other hedge funds in an attempt to create a control block within the Company's stockholder base.”⁵⁰

Third Point is no outlier. In *Yucaipa American Alliance Fund II, LP v. Riggio*,⁵¹ a case decided in 2010, then-Vice Chancellor Strine suggested that a poison pill that capped activist share ownership at twenty percent was justified to prevent two activist investors from forming “a de facto control bloc . . . through conscious parallelism.”⁵² In short, corporate law has seemingly adopted a much broader view of wolf packs than securities law.

44. See ALLEN ET AL., *supra* note 28, at 522-32.

45. *Id.*

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

47. *Id.* at *3-4.

48. *Id.* at *9-11.

49. *Id.* at *20.

50. *Id.*

51. 1 A.3d 310 (Del. Ch. 2010).

52. *Id.* at 359-60 n.254.

While securities law underregulates wolf packs, corporate law may well do the opposite. First, using “conscious parallelism” to identify wolf packs may overestimate the actual strength of activist alliances. Wolf-pack activists have different agendas and some may exit before a proxy contest.⁵³ In *Third Point*, Triani sold its stake in Sotheby’s a month after the company implemented its poison pill.⁵⁴ Meanwhile, Marcato, unlike Third Point, was more interested in getting Sotheby’s to return its cash reserves to investors than in implementing management changes. After the Sotheby’s board negotiated an end to Third Point’s agitation earlier this year, Marcato was left to lobby against the board alone.⁵⁵ The Sotheby’s saga suggests that, in some instances, wolf packs can be relatively loose coalitions with different investment agendas and timelines.

Second, the Delaware courts’ sparse conceptualization of “conscious parallelism” may have a chilling effect on activists. Neither *Third Point* nor *Yucaipa* clearly articulated what constitutes “conscious parallelism.” Rather, the courts’ opinions rely heavily on the facts and weigh the perceived threat against the specific provisions of the board’s poison pill.⁵⁶ Such analysis introduces significant legal uncertainty and may lead to excessive deterrence against wolf packing. In an increasingly crowded activist market, there is a real risk of overpunishing wolf-pack activism: stock prices may suffer due to increased market uncertainty over the legality and potential success of activist campaigns, including those that may yield value for shareholders. Activist investors may also be less inclined to share information regarding potential target companies, as they have done in the past.⁵⁷

Finally, the Delaware courts’ use of “conscious parallelism” to uphold a poison pill may encourage corporate boards to adopt more expansive poison pills. Currently, most poison pills use the securities law definition of “group” to define wolf packs.⁵⁸ However, corporate boards may be inclined to adopt the broader Delaware definition as an additional means of deterrence. While these pills would likely be contested in court, the fact-intensive review required to

53. See Brav et al., *supra* note 18, at 4-8; Coffee & Palia, *supra* note 2, at 36.

54. See Margaret Collins, *Peltz’s Triani Sold State Street Shares in Third Quarter*, BLOOMBERG BUS. (Nov. 15, 2013, 12:00 AM), <http://www.bloomberg.com/news/articles/2013-11-14/peltz-s-triani-sold-sotheby-s-state-street-stakes-last-quarter> [<http://perma.cc/TJ9S-N3NK>].

55. David Benoit, *Marcato Urges Sotheby’s To Buy Back Stock*, WALL ST. J. (Feb. 20, 2015, 1:19 PM), <http://www.wsj.com/articles/marcato-urges-sothebys-to-buy-back-stock-1424456393> [<http://perma.cc/U4UF-M2BJ>].

56. See Leonard Chazen & Jack S. Bodner, *Conscious Parallelism May Justify a Wolf Pack Pill*, LAW360 (May 27, 2014, 9:45 PM), <http://www.law360.com/articles/540818/conscious-parallelism-may-justify-a-wolf-pack-pill> [<http://perma.cc/349E-GBKP>].

57. Pulliam et al., *supra* note 21.

58. *Id.*

determine the validity of such pills may place undue time and cost burdens on activist investors.

III. TAMING THE WOLF PACK: THE VALUE OF PROPHYLACTIC DISCLOSURES

The law's treatment of wolf packs faces timing and identification problems. Securities law allows wolf packs to slip under its disclosure rules. Corporate law, meanwhile, may cast an overbroad net on wolf packs.

Preemptive disclosures may provide a means of resolving both the timing and identification problems surrounding wolf packs. This Part recommends a preemptive disclosure framework that requires three amendments to Rule 13d under the Securities Exchange Act: (1) shortening the current ten-day grace period for making a Schedule 13D filing disclosing when an investor or group acquires a five percent or greater stake in a public company, (2) broadening the definition of "group" under Rule 13d-5 in order to require all activist investors to name the other investors to whom they have disclosed their intention to engage in a proxy fight once they collectively acquire a five percent or greater stake in a public company, and (3) imposing penalties for activists who fail to fully disclose the identities of wolf-pack members.

The framework's first requirement provides earlier notification of potential changes to a targeted company. The requirement also limits activist investors' ability to use the current ten-day reporting period to amass a de facto controlling stake. While this requirement affects all shareholder activists, its impact would be most acutely felt by wolf packs that benefit from the coordination opportunities provided by the ten-day buffer and reap the greatest profits from a successful activist campaign. As such, this requirement would not only better alert boards to possible wolf-pack activity, but also level the playing field for activists who are not part of the wolf pack.

The second requirement for prophylactic disclosure from activist investors addresses the fact that wolf packs are most likely to form when a lead activist investor tips off other activists about an upcoming proxy fight.⁵⁹ This requirement is designed to identify wolf-pack members without having to resort to circumstantial evidence or proxy measures such as "conscious parallelism." Rather than trying to establish a bright-line test for what constitutes a wolf pack and risk substantive evasion, the SEC and the courts ought to shift the task to activists who, as insiders, are most apt to know their membership. Since activists may seek to conceal the identity of the wolf pack by either overdisclosing or underdisclosing the names of participants,

59. See Brav et al., *supra* note 18, at 24-26; Coffee & Palia, *supra* note 2, at 23-33.

I recommend, as a third requirement, introducing penalties to deter such behavior. For example, funds that have received solicitations but fail to disclose their membership in a wolf pack should be penalized. Membership in a wolf pack could be identified *ex post* by establishing a rebuttable presumption that major purchasers of target company stock in the days immediately leading up to a Schedule 13D filing are members of the wolf pack. Penalties for investors that fail to disclose their membership in a wolf pack could include requirements to disgorge profits or dispose of stock holdings.

While this proposal is novel, it is well situated within the bounds of both securities and corporate law. Under the Dodd-Frank Wall Street Reform and Consumer Protection Act, Congress expressly provided that the SEC could shorten reporting windows.⁶⁰ Additionally, Schedule 13D, which shareholders are required to file when they exceed a five percent ownership threshold, asks shareholders to declare the purpose of their purchases and “contracts, arrangements, understandings or relationships . . . with respect to any securities of the issuer.”⁶¹ Moreover, the Second Circuit has explicitly held that “the purpose of section 13(d) is to alert the marketplace to every large, rapid aggregation or accumulation of securities, regardless of technique employed, which might represent a potential shift in corporate control.”⁶² Additionally, corporate law requires that corporate boards only deploy poison pills that are proportional to the threat posed.⁶³ The disclosure framework would not only help corporate boards better determine what constitutes a proportional response to a wolf pack, but would also make boards more accountable for disproportionate responses.

CONCLUSION

This Comment argues that current securities law and corporate law are inconsistent and ineffective in their treatment of wolf packs. Securities law adopts an excessively narrow view of wolf packs, allowing them to slip past its disclosure rules. Corporate law, on the other hand, has construed wolf packs far more broadly and risks overpunishing investors. I argue that a prophylactic disclosure framework will correct the gaps in the current law and

60. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 929R, 124 Stat. 1376, 1866 (2010) (modifying section 13(d)(1) of the Securities Exchange Act of 1934 to require disclosure “within ten days after such acquisition . . . or within such shorter time as the Commission may establish by rule”).

61. 17 C.F.R. § 240.13d-101 (2015).

62. *GAF Corp. v. Milstein*, 453 F.2d 709, 717 (2d Cir. 1971).

63. ALLEN ET AL., *supra* note 28, at 522-31.

restore the proper power balance among corporate boards and control-seeking shareholders.

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