Is Your Company at Risk of an Activist Attack? Outsmarting Wolf Packs

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IS YOUR COMPANY AT RISK OF AN ACTIVIST ATTACK?
OUTSMARTING WOLF PACKS

Wolves show deference to the leader in their pack by allowing them to be the first to eat. In the current hedge fund\(^1\) activism era, a wolf pack is formed when a lead investor acquires a sizable stake in a company, gathers and then divulges valuable nonpublic information to fellow activists to encourage them to purchase less than 5 percent stock in the same company, and avoid SEC shareholder disclosure rules. Not only are the SEC Shareholder disclosure rules vague, but the real challenge is to give teeth to monitoring them as there is no clear enforceable law. A lead or “an activist investor is an individual or group that purchases large number of public company’s shares and/or tries to obtain seats on the company’s board with the goal of effecting a major change in the company.”\(^2\) This goal is accomplished by waging proxy battles, liquidating assets and forcing sales of companies.\(^3\) One example of this unchecked investment strategy is of Jana Partners forcing PetSmart into a leveraged buyout in 2014.\(^4\) Jana Partners, the hedge-fund “cumulatively owned less than 20 percent of PetSmart, but received a windfall of 40 percent return on its investment.”\(^5\)

The lead investor and fellow activists who acquire “5 percent or more of an issuer’s stock must file a Schedule 13D with the SEC under section 13(d) of the Williams Act.”\(^6\) A group of investors who “collectively own 5 percent or more of a company’s stock, is required to jointly file a Schedule 13D.”\(^7\) A group is formed when, “investors act together, or agree to act together for the purpose of acquiring, holding, voting, or disposing of an issuer’s securities.”\(^8\) There is no bright line test for determining the formation of a group. This

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1 Justin Kuepper, *Activist Hedge Funds: Follow The Trail To Profit*, http://www.investopedia.com/articles/mutualfund/06/activisthedgefund.asp (explaining hedge funds are lightly regulated private investment funds that use unconventional investment strategies and tax shelters in an attempt to make extraordinary returns in any market).

2 http://www.investopedia.com/terms/a/activist-investor.asp.

3 Kuepper, supra note 1.


5 Id.

6 Id. at 2337.

7 Id.

8 Id at 2338.
creates a loophole for activists to exploit. Activists intentionally avoid a group status in order to avoid the 13(d) disclosure requirement. The renowned activist, Carl Icahn, has admitted, “there are bad activists. [A]ll they want to do is get in and rock the boat and make a quick trade.” Consequently, it is imperative that courts have clear guidelines to resolve uncertainties that develop from an investment strategy aimed at exploiting loopholes in SEC disclosure rules.

There has been an alarming growth in wolf pack momentum all across the United States in a short span of time. Nine of the Fortune 100 and 38 of the Fortune 500 companies dealt with an activist campaign in 2015, including big names like Sotheby’s, DuPont and Allergan. Furthermore, wolf pack activism is not confined to large public companies. It impacts all businesses. In 2015 alone, 343 public US companies were targets; 113 have been targeted as of May 2016.

This perspective will examine the United States’ Congress’s commitment to curb uncertainty surrounding wolf pack investment strategy. It will begin by addressing how wolf packs exploit targeted industries. It will then discuss proposed legislation to reform SEC loopholes used by wolf packs, more specifically, it will discuss the legal solution offered by the Brokaw Act and the ValueAct Settlement. Lastly, it will conclude with solutions in addition to the ones already proposed.

How Does A Wolf Pack Avoid Section 13(d) Disclosure Requirement?

Section 13(d) serves the main purpose of providing notice to management and shareholders alike when there is a large issuance of stock to a third party. “A Schedule 13D filing must state, “the filer’s identity, funding source, investment purpose, number of shares, and information about contracts, arrangements or understandings with another person pertaining to the target company.” A wolf pack avoids section 13(d) disclosures in four ways. (1) It

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10 Paula Loop, Is Your Company at Risk for an Activist Attack?, PwC LLP, (July 28, 2016), https://corpgov.law.harvard.edu/2016/07/28/is-your-company-at-risk-for-an-activist-attack/ (Suggesting Activists are a new class of hedge fund that has grown tremendously: their AUM have surged 268% from 2010 to 2015 alone. They don’t just invest in a stock to make a profit; they shake up companies in which they invest and actively try to shape future performance).
11 Id.
12 See GAF Corp. v. Milstein, 453 F.2d 709, 717 (2nd Cir. 1971).
13 Tevlin, supra note 4, at 2339.
simply avoids detection by acquiring less than 5 percent stake in a company; (2) it blindsides corporate management and shareholders by having only the lead activist disclose its ownership stake; (3) it undermines future disclosures by using the ten-day window before filing; and (4) it exploits exemption 13(d)-one for passive investors.

First, the activists as a group may avoid detection if each activist investor acquires less than a five percent stake in the target. Currently, it is hard for corporate boards and courts alike to identify and classify activist shareholders who purchase less than a five percent stake as a group. Upon SEC’s inquiry whether Bulldog Investors had any agreements with Foundation Asset Management, a fund that ran a proxy fight at the same company as the Bulldog, Bulldog’s co-founder Phil Goldstein’s response was: “If you go to a Grateful Dead concert, you’re going to find a lot of Grateful Dead fans. They are not a group. They just like the same music.” Second, when only the lead activist shareholder acquires and discloses a large stake in the target, the management underestimates the overall influence of that lead activist concomitant with fellow activists. These fellow activists purchase a smaller share in the company, but their combined stake is significant. “For example, in the fight over control of Barnes & Noble, the lead activist investor held an 18.7% stake in the company.” However, the wolf pack as a whole controlled a 36.14% stake.

Third, the ten-day window under Section 13(d) allows for too much time for investors to accumulate significant ownership before filing, thereby undermining any future disclosures. Wolf packs are able to purchase large amounts of stocks largely undetected at a lower cost, since the stock price is generally cheaper prior to filing, as the market is not yet alerted of the acquisition. Fourth, wolf packs avoid Schedule 13(d) disclosure by using an exemption 13(d)-one for passive investors, pursuant to which they may beneficially own more than five percent but less than ten percent and need only

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14 Carmen S.W. Lu, Unpacking Wolf Packs, http://www.yalelawjournal.org/comment/unpacking-wolf-packs (suggesting Congress believed disclosures were necessary to ensure shareholders were promptly alerted to possible changes in company management and corporate control).
16 Yucaipa Am. All. Fund II, L.P. v. Riggio, 1 A.3d 310, 324 (Del. Ch. 2010).
17 Id.
18 Lu, supra note 14.
disclose through a short-form public filing. Here, wolf packs have longer than ten days for under the radar asset accumulations and may assertively and publicly advocate for strategic courses of action within the company.

**Proposed Legislation—The Brokaw Act and The ValueAct Settlement**

The wolf pack momentum necessitates a clear enforceable law for restoring a balance between control-seeking activists and board’s management independence. The Brokaw Act aims to end the exploitation of loopholes found in Williams Act of 1968, and offers four solutions.

First, it mandates the SEC to shorten the time for hedge funds to file Schedule 13D to two business days from ten business days to prevent tipping and disclosures of nonpublic information to make a profit. So far, the SEC has been reluctant to use the authority given to it under Dodd-Frank to shorten the 13D filing period as it may be exposed to criticism from institutional investors, who believe that the activists are ensuring corporate board’s accountability. Second, it requires the SEC to expand the definition of beneficial ownership to include, in addition to voting or investment power, a direct or indirect pecuniary interest in the security. This helps to make calculations about a wolf pack’s long and short term interests and whether they align well with the target company’s interests.

Third, it would define “person” to include two or more people, “working together to evade the requirements of” the Williams Act. This will essentially help identify smaller hedge funds that would benefit by the takeover. Fourth, Section 13 of the Exchange Act would be amended to add a broad concept of “short interest” and to require filing similar to Schedule 13D upon acquisition.

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21 Tevlin, *supra* note 4, at 2339 (explaining The Williams Act was added as an amendment to the Securities Exchange Act of 1934 in 1968, it governs acquisitions and tender offers).

22 *Id.*


25 *Id.*

26 *Id.*
of beneficial ownership of short interests aggregating five percent or more of
the same class, regardless of the form of short interest.27

In addition to the Brokaw Act’s futuristic solutions to close loopholes, the
recent ValueAct settlement by DOJ closed a loophole used by wolf packs to
evade Schedule 13D filing by using a narrow exemption under 13(d)-one that
permits delayed filings by using Schedule 13G. The exemption is a part of the
HSR Act28 and states that purchasers of less than ten percent of a company’s
outstanding voting securities are not required to notify the DOJ and FTC if the
acquisition is made “solely for the purpose of investment” with no intention of
participating in the company’s business decisions.29 The ValueAct precedent
assures that wolf packs are not able to avoid detection by positioning
themselves as passive investors (when in fact they are cooperating with
shareholders or taking an assertive role with portfolio companies) for the
purposes of qualifying for a less timely and burdensome Schedule 13G filing
in lieu of the tighter, more transparent 13D requirements.30 Effective August 1,
2016, the maximum civil penalties for failure to file HSR increased from
US$16,000 per day to US$40,000 per day.31

Conclusion

Six solutions must be considered to make the wolf pack tactic less
formidable. First, enforceable law is required. The next logical step would be
the passing and signing into law of the Brokaw bill. Second, shareholders who
did not invest with the intention to join forces with activists but who later
decide to do so must collectively come together and disclose themselves as a
group. This will force wolf pack leaders to disclose names of investors who
join them in their proxy battles to overthrow corporate management. Third,
corporations should be on a lookout for affiliations between coinciding new
buyers and the activist who has recently filed Schedule 13D. The shortening of

27 Id.
28 Klingsberg, supra note 19. (explaining that the Hart-Scott Rodino Act (“HSR”) requires that before
any entity accumulates more than $78.2 million of a company’s stock, the prospective purchaser must notify
the issuer, file a notification with the U.S. antitrust agencies and wait for the expiration or early termination
of the 30-day waiting period).
29 Rosemary Lally, Recent DOJ Move Could Have Implications for Institutional Investors, (Apr. 14,
30 Klingsberg, supra note 18.
31 Michael B. Bernstein and Justin P. Hedge, Continued Enforcement of HSR Violations and Increased
Civil Monetary Penalties Reinforce Need for Investor Compliance Monitoring, (Aug. 16, 2016),
the filing window in the bill may minimize the time required for tipping of nonpublic information. Nevertheless, underhand transactions may still occur.

Fourth, corporate boards should increase transparency and build better relations with shareholders. It may help gauge their votes for proxy battles. Almost 60 percent of campaigns targeting $25 billion-plus market cap companies were initiated by activists who owned less than one percent of shares outstanding at announcement.\(^{32}\) In lieu of engaging and increasing transparency, companies should make shareholders and directors alike aware when any amount of shares have been sold, depending on the company size, each company may internally decide the number. Fifth, businesses should keep detailed information regarding wolf pack manipulation of assets as well as their own business vulnerabilities. They may do so by reexamining their governance structure and preemptively adopting proposals by wolf packs; granted they are consistent with the company’s long-term value creation. This will help minimize the foreseeable activists’ influence and keep the wolf packs at distance. Lastly, even though the ValueAct Settlement has brought clarity concerning the 13G exemption of 13D filings, there must be enforceable law that defines and distinguishes active and passive investing to avoid any confusion that compels legal action.

Considering that there is still no bright line test for U.S. courts to address wolf pack investment strategy, one must question how genuinely concerned SEC is about controlling wolf packs. SEC Chairman Mary Jo White stated that, “Our role at the SEC is not to determine whether activist campaigns are beneficial or detrimental in any given circumstance, the agency’s central focus is making sure that shareholders are provided with the information they need and that all play by the rules.”\(^{33}\) The Brokaw bill will compel this notion by mandating disclosures before it is too late.

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\(^{33}\) Hoffman, supra note 15.

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