Chapter 28

Shareholder Activism and Merger Arbitrage

§ 28:1 Scope

The principal focus of this chapter is on issues arising with shareholder activism, principally by activist hedge funds. The chapter also presents a brief introduction to merger arbitrage, a market strategy employed by various investment firms, including hedge funds and mutual funds. Section 28:2 introduces three recent activist campaigns by the following leading hedge funds: Pershing Square, Icahn Capital, and Third Point. Documents from these campaigns are included in the appendices to this chapter. To help set the stage, section 28:3 addresses the question: What is a hedge fund? And, section 28:4 addresses the question: What is the basic mode of operation of activist hedge funds and the reactions of the targets? Section 28:5 discusses the "one-day pop," that is, the immediate increase in the price of the target's stock upon the announcement of the activist's position in the target's shares. Section 28:6 looks at the structure of hedge funds and their investments.

Sections 28:7 through 28:12 look at several economic issues with activist hedge funds. Section 28:7 addresses the level of activity by activist hedge funds; section 28:8 points out the likely targets; section 28:9 explores whether activist hedge funds generate shareholder value; section 28:10 looks at tactics; section 28:11 considers proxy contests by activist hedge funds; and section 28:12 discusses the appraisal arbitrage (as distinguished from merger arbitrage) strategy employed by some hedge funds.

Section 28:13 discusses the principal legal issues that can arise with hedge funds, including section 13(d) issues and Hart-Scott-Rodino pre-merger notification issues. Section 28:14 discusses the Delaware Chancery Court's decision regarding Sotheby's two-trigger pill, which was deployed against the Third Point hedge fund. Sections 28:15 through 28:17 examine the short-term, long-term debate regarding hedge funds, and ask whether (1) the 10-Day window in section 13(d) should be closed, and (2) derivative positions should count as beneficial interest under section 13(d). Section 28:18 looks at the issues involved with the payment by a hedge fund of tipping fees and "Golden Leash" payments to board members of a target who were elected as a result of efforts of the hedge fund.

Section 28:19 examines several aspects involved in the joint bid in 2014 by Pershing Square, a hedge fund, and Valeant, a publicly held corporation, for Allergan, a publicly held corporation. This was the first transaction in which a hedge fund joined with a strategic buyer in making a joint bid for a publicly held firm. Section 28:19.7 explores issues with the reporting requirements under the Hart-Scott-Rodino, pre-merger notification law. The section suggests both regulatory and legislative changes to those rules that would (1) in one respect, tighten the reporting rules for activist shareholders, and (2) in another respect, liberalize the rules. Finally, section 28:20 provides a brief introduction to merger arbitrage.

Summary of Author's Policy Prescriptions

There are many policy issues with activist shareholders, and I have expressed my own view on many of these issues at various places in this chapter. The following is a summary of my views:

- For the reasons set out in section 28:15.8, I reject the argument made by Martin Lipton that because of an emphasis on short-termism, shareholder activism is a "major cause [] of underinvestment, unemployment, and slow growth of GDP."
- For the reasons set out in section 28:16.6, I would not close the 10-Day window in section 13(d), but I would impose a 10% absolute cap on ownership prior to the filing of a Schedule 13D.
- For the reasons set out in section 28:17.6, I would require reporting of derivative and short positions under section 13(d).

- For the reasons set out in section 28:19.7[C], I believe the FTC should treat the acquisition of deep-in-the-money options like those used by Pershing Square in the Allergan transaction as acquisitions of voting securities that could give rise to a pre-merger reporting requirement under Hart-Scott-Rodino.
- For the reasons set out in section 28:19.7[D], I recommend a legislative amendment to Hart-Scott-Rodino that would add a percentage requirement (such as 5% of the target's stock) to the dollar threshold, thereby eliminating the reporting requirement where the dollar threshold represents, as with respect to Allergan, a very small percentage of the target's stock.
- For the reasons set out in section 28:19.8, I believe that the acquisition by Pershing Square of stock of Allergan does not constitute insider trading and, in any event, "clearly does not fall within the purposes of Rule 14e-3."

§ 28:2 Three 2014 Activist Campaigns

To illustrate many of the issues discussed in this chapter, references are made to the following three 2014 classic examples of activist hedge fund campaigns:

(1) Pershing Square's establishment (together with Valeant, a large publicly held pharmaceutical firm) of a 9.7% position in Allergan, another large publicly held pharmaceutical firm, with a view to facilitating the acquisition of Allergan by Valeant;

(2) Icahn Capital's establishment in June 2014 of a 9.4% interest in Family Dollar Stores, a publicly held firm, with a view to enhancing shareholder value by changing Family Dollar's business strategy; and

(3) Third Point's establishment of a 9.4% position in Sotheby's, a publicly held firm, with a view to changing its business strategy.

Various documents from these campaigns are included in the appendices to this chapter.

Pershing Square is run by William "Bill" Ackman; Icahn Capital is run by Carl Icahn; and Third Point LLC is run by Daniel Loeb. A May 2014 Conference Board article entitled *The Activism of Carl Icahn and*

Bill Ackman[1] describes them as "prominent figures in the activist world."[2] The same is true of Dan Loeb.

The Third Point campaign against Sotheby's was also the subject of a 2014 court decision in Delaware, *Third Point v. Ruprecht*,[3] which is discussed later as an illustration of how Delaware law deals with a target's adoption and use of a poison pill. Although the court decision went against Third Point, it continued to wage a "short-slate" proxy contest against Sotheby's, and the contest was settled with Sotheby's agreeing to add three Third Point designees to its board, one of whom was Dan Loeb. Although as of the time of the writing of this chapter in early July 2014, the Third Point campaign had come to an end, at least temporarily, the results of the Allergan and Family Dollar Stores campaigns have not yet been determined.

§ 28:3 What Is a Hedge Fund?

Hedge funds are privately held investment funds that are run by a management company that acts as the investment adviser to the fund. The investors in the hedge fund are generally accredited investors, which, as defined in Reg. D, generally include wealthy individuals and sophisticated institutions. The SEC describes a hedge funds as follows:

> Like mutual funds, hedge funds pool investors' money and invest the money in an effort to make a positive return. Hedge funds typically have more flexible investment strategies than mutual funds. Many hedge funds seek to profit in all kinds of markets by using leverage (in other words, borrowing to increase investment exposure as well as risk), short-selling and other speculative investment practices that are not often used by mutual funds.
>
> Unlike mutual funds, hedge funds are not subject to some of the regulations that are designed to protect investors. Depending on the amount of assets in the hedge funds advised by a manager, some hedge fund managers may not be required to register or to file public reports with the SEC. [Such non-SEC registered hedge funds generally will have to register under the applicable state law.] Hedge funds, however, are subject to the same prohibitions against fraud as are other market participants, and their managers owe a fiduciary duty to the funds that they manage.

---

1. Richard Lee and Jason D. Schloetzer, *The Activism of Carl Icahn and Bill Ackman*, Director Noes, The Conference Board (May 2014) [hereinafter *Activism of Icahn and Ackman*].
2. *Id*. at 1–2.
3. Third Point LLC v. Ruprecht, 2014 Del. Ch. LEXIS 64 (May 2, 2014).

> Hedge fund investors do not receive all of the federal and state law protections that commonly apply to most mutual funds. For example, hedge funds are not required to provide the same level of disclosure as you would receive from mutual funds. Without the disclosure that the securities laws require for most mutual funds, it can be more difficult to fully evaluate the terms of an investment in a hedge fund. It may also be difficult to verify representations you receive from a hedge fund.[4]

The *Activism of Icahn and Ackman*[5] article points out that there is no generally agreed-upon definition of a hedge fund. The article also says that although a SEC roundtable discussion of hedge funds looked at fourteen different definitions, hedge funds generally have the following four characteristics:

> (1) they are pooled, privately organized investment vehicles [such as an investment limited partnership with investors as limited partners and the organizer of the hedge fund or his or her controlled entity, such as an LLC, serving as the general partner];
>
> (2) they are administered by professional investment managers with [i] performance-based compensation [generally 2% of assets under management (AUM) and 20% of annual profits], and [ii] significant investments in the fund;
>
> (3) they cater to a small number of sophisticated investors [through private offerings of the interests in the fund] and are not generally readily available to the retail investment market; and
>
> (4) they mostly operate outside of securities regulation and registration requirements.[6]

The article also points out as follows the differences between mutual funds and hedge funds:

> Unlike mutual funds, which are generally required by 1aw to hold diversified portfolios and sell securities within one day to satisfy investor redemptions, hedge funds are not subject to diversification and prudent investment requirements. Hedge funds can also allocate large portions of their capital to a few target companies, and they may require that investors "lock-up" their funds for a

4. SEC, Hedge Funds, *available at* www.sec.gov/answers/hedge.htm (last visited July 2, 2014).
5. *Activism of Icahn and Ackman*, *supra* note 1.
6. *Id*. at 2.

period of two years or longer. Moreover, because hedge funds do not fall under the Investment Company Act regulation, they are permitted to trade on margin and engage in derivatives trading, strategies that are not available to institutions such as mutual and pension funds. As a result, hedge funds have greater flexibility in trading than other institutions.[7]

§ 28:4 What Is the Basic Mode of Operation of Activist Hedge Funds and the Reactions of the Targets?

As discussed in greater detail later in this chapter, the basic mode of operation by activist hedge funds is as follows:

First, identify a publicly held firm whose stock is undervalued because of an ineffective business strategy;

Second, with capital provided by investment funds organized and controlled by the hedge fund, secretly acquire a significant amount of a target's stock at the undervalued prices, thus becoming a large block holder of the target's shares;

Third, publicly announce that stock position, with the expectation that there will be an immediate increase in the stock price of the target, that is a "one-day pop"; and

Fourth, by the use of, for example, (1) a proxy contest, and (2) the presentation of a white paper on the need for change (see, for example, Appendix 28N, *Third Point Investor Presentation Re Proxy Contest*), advocate for a change in the target's corporate strategy, which could include the sale of the target.

As one would expect, the target will generally react to the public announcement by the activist by (1) adopting a poison pill if it has not already done so, and (2) employing other defensive measures, such as modifications in the manner in which special shareholder meetings may be called.

The above mode of operation by the hedge fund and the reaction by the target is precisely what happened in the three campaigns discussed in this chapter: (1) Pershing Square/Valeant–Allergan, (2) Icahn Capital–Family Dollar Stores, and (3) Third Point–Sotheby's.

---

7. *Id.*