The Limits of Hedge Fund Activism

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Robert B. Thompson
New York Alumni Chancellor’s Chair in Law and Professor of Management,
Vanderbilt University
(615) 322-1002
thompson@law.vanderbilt.edu
Abstract

Hedge funds have burst on to the corporate governance scene. Not just as one player among many, but one with the potential to be the long-sought shareholder champion who can effectively discipline management in a world where ownership is separated from control. The argument has been made, with some justification, that these investors face different economic incentives than do traditional institutional investors such as mutual funds or public or private pension funds. The business plan of a typical hedge fund is more compatible with shareholder activism and they lack some of the conflicts of interests that have deterred traditional institutional shareholders from becoming active in corporate governance. Empirical evidence shows that hedge funds have indeed become active in corporate governance.

To evaluate this phenomenon of hedge funds as shareholder activist, this article beings with a look at the four major prior responses to the problem of separation of ownership and control since Berle and Means first framed corporate governance in those terms in 1932. The reach and limits of those illustrations provides a setting to evaluate the relative strength of hedge funds as they move into this role as shareholder champion. A second necessary framework to understanding the current activities of hedge funds is the core structure of corporate law that narrowly defines what any shareholder can do. This analysis makes clear that hedge fund activism is both economically and legally contingent. The empirical evidence suggests that hedge fund activists take only a minority stake in companies that will remain publicly held, seeking value creation that is more due to financial as opposed to strategic, synergistic gains. The legal framework shows that activists are most likely to impact results in the specific settings where shareholders have the ability to vote, sell or sue. The most lasting change will likely be that hedge fund activists have, in combination with other institutional investors, disrupted the equilibrium of defensive tactics based on poison pills and staggered boards that has dominated takeovers for the last two decades.

The business plan which hedge funds have followed toward shareholder activism is not unique or endogenous to the governance process such that the same characteristics of nimbleness and aggressiveness that have made hedge funds effective as activist might take these funds elsewhere. And of greater concern, these same hedge funds portrayed as the way to bridge the separation of ownership and control have themselves used innovative financial instruments and strategies to create their own separation of ownership and control that ultimately will cabin their effectiveness as an activist shareholder.
The Limits of Hedge Fund Activism

Robert B. Thompson*

Hedge funds dominate many of the current discussions of corporate governance. These nimble, aggressive investment funds appear as the latest contender to solve what has been the continuing challenge at the core of corporate law over the last 75 years: who will monitor managers when there is a separation of ownership and control in the public corporations that dominate our economy?1 And, at the same time, hedge funds are also labeled as the latest in a series of villains portrayed as the bane of our economic system.2

This article examines hedge fund activism against the backdrop of this long-running separation debate. Prior work has shown that economic incentives and legal regulation provide hedge funds with advantages over previous

* New York Alumni Chancellor’s Chair in Law & Professor of Management, Vanderbilt University. I am grateful for helpful comments from the University of California, Berkeley Law & Economics Workshop, the Seventh Annual Vanderbilt Law & Business Conference and the Activist Investors, Hedge Funds and Corporate Governance Conference at the University of Amsterdam.

1 Marcel Kahan & Edward Rock, Hedge Funds in Corporate Governance and Corporate Control, at 2 available at http://ssrn.com/abstract_id=919881. (“Are hedge funds the “Holy Grail” of corporate governance, the long sought after shareholder champion with the incentive and expertise to protect shareholder interest in the publicly held firm”; id at 51 “we are inclined to be optimistic”); William Bratton, Hedge Funds and Governance Targets (working paper 2006) at 33 (“record supports the proposition that they [hedge funds] have shifted the balance of corporate power in the direction of outside shareholders and their financial agenda”); Frank Partnoy & Randall Thomas, Gap Filing, Hedge Funds, and Financial Innovation (working paper 2006) at 54 (“the sole constituency with incentives and resources to vote in the interest of shareholders.”)

While this paper focuses on the American experience, the pattern is similar in Europe. See Alistair MacDonald, Activist Hedge Funds Take Fight to Europe, Wall St. J. Jan. 17, 2007 at c5 (describing Centaurus fight with Stork NV and other transactions).

2 David A. Katz and Laura A. McIntosh, Corporate Governance: Advice on Coping with Hedge Fund Activism, Wachtell, Lipton, Rosen & Katz memo at 1, May 26, 2006 (“Every decade needs a villain; in the 1980s, it was corporate raiders, in the 1990s, it was corrupt executives. And in the 2000s it appears to be activist hedge funds.”); Hedge Funds Are the New Sheriffs of the Boardroom, Wall Street Journal December 4, 2005 at a2 (Sarbanes and Oxley have been knocked out of first place on the list of bogeymen haunting the corporate boardroom.); “Deutsche Borse Ex-chief Attacks “Locust” Hedge Funds Bloomberg April 3, 2006 available at http://www.bloomberg.com/apps/news?pid=71000001&ref=germany&sid=aYY_npCM1 (“They cause irreparable harm to the company they attack—that is why the comparison with locusts, which has become current in Germany, is so appropriate.”); Martin Lipton, Shareholder Activism and the ‘Eclipse of the Public Corporation’ February 7, 2007 (available at publications.wlrk.com) at 1 (“Today shareholder activism is ripping through the boardrooms of public corporations and threatening the future of American business.”)
contenders for the mantle of shareholder protector. The conflicts they experience seem less disabling; they seem better able to provide incentives for their management and are less constrained by liquidity pressures than the institutional investors earlier seen as possible shareholder champions. The first broad empirical studies of hedge fund activism, still moving through the publication pipeline, provide evidence that these investments produce positive returns and are not necessarily associated with fears that have been raised about hedge funds such as their short term orientation. Such reasoning and evidence suggest a substantial governance role for hedge funds.

Less developed (and where this article seeks to make a contribution) are the economic and legal realities that cabin the extent to which hedge funds can fully fill the role as an effective constraint on managers. On the economic side, the empirical work just described shows that hedge fund activism as a disciplinary device is less than plenary. It is focused in corporations that continue to be public after the intervention, where the activist is likely to maintain a minority position and not acquire control, and where the value to be created comes not from synergistic or strategic changes, but from financial cash-driven methods of value creation. More broadly, the economic drivers of hedge fund activism are not endogenous to governance. Governance activism for hedge funds is a tool to make money, one of many that these funds use. The same nimble characteristics that have brought hedge funds into the governance arena can also take them out as new barriers to their activism arise and new opportunities for their money arise elsewhere.

Third, fewer ties to other financial players do free hedge funds from conflicts of interest that have disabled other institutional investors from playing a more active role in governance. Yet, these hedge funds have a more disabling conflict of interest to the extent that their interests as investors--hedged, often short-term--place them out of alignment with the larger body of shareholders. To what extent must a shareholder champion possess interests aligned with the larger group of shareholders for this intended monitoring to work? Do these conflicting interests undermine Adam Smith’s belief that individual economic self-interest redounds to the common good? When this alignment breaks down, shareholder activism becomes a way to externalize costs and the special power given to shareholders in corporate doctrine loses its core attraction.

Just as hedge fund activism is necessarily bounded by the economic factors just described, the ability of hedge funds to perform a governance role necessarily reflects a legal system in which shareholder power is intentionally limited. Shareholders do only three things in corporate governance—they vote,

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3 This has been most effectively developed in Kahan & Rock supra note1, from which part IIIA of this article draws.

4 See e.g. Bratton, supra note 1; Alon Brav, Wei Jang, Frank Partnoy & Randall Thomas, Hedge Fund Activism, Corporate Governance, and Firm Performance (working paper September 2006); April Klein and Emanuel Zur, Hedge Fund Activism, (working paper, September 2006).
sell, and sue, each in limited doses. The ability of hedge funds to act as a brake on corporate managers necessarily must reflect those limits as well as the economic limits mentioned above. This shareholder role also reflects the longstanding concern that too much shareholder power sometimes turns out not to be the best for the corporation, a view that has informed the legal system’s willingness to sustain defenses developed by managers in prior shareholder uprisings. While hedge funds are better positioned to supply antidotes to some of the current defenses against shareholder activism, they cannot ignore the boundaries of the field of play imposed by corporate law.

Thus, this article observes that hedge fund activism is both economically contingent and legally contingent. Hedge funds can do more than other institutional investors in playing an activist role but their impact varies with factors such as the size of the target company and the source from which value will be created. Their greatest economic effect has been to increase the areas in which leveraged recapitalization transactions can be effectively accomplished. The legal framework suggests similarly that activism will reflect the areas in which law permits the shareholders to act and the defenses that law has permitted directors to erect against shareholder action. But these limits should not obscure the important impact of hedge funds on the legal structure of corporate governance—it has disrupted the equilibrium of takeover defenses anchored by poison pills and staggered boards that has been in place for the last two decades or so and this may turn out to be the most important impact of hedge fund activism.

This article proceeds as follows. The initial sections briefly set out the core problem of separation of ownership and control as presented by Berle and Means in 1932 and the solutions that have emerged prior to hedge funds. While this part is intentionally concise, it does seek to provide the necessary links so as to be able to position hedge funds as a reflection of tools implemented in earlier eras. The hedge fund portion of the paper begins with a typology of the contexts in which hedge fund activism is present in current corporate governance contests followed by a framework of the legal structure for the role of shareholders. This part focuses particularly on the room accorded management in previous eras to narrow or shut down the voting and selling avenues for shareholder action through poison pills and staggered boards and partial antidotes which developed in response. Part III addresses the advantages hedge funds possess as shareholder activists as compared to earlier players. Yet, as Part III also develops, hedge fund activism has inherent limits as a tool of corporate governance as foreshadowed in the earlier paragraphs of this introduction. The

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5 Robert B. Thompson, Preemption and Federalism in Corporate Governance: Protecting Shareholder Rights to Vote, Sell, and Sue, 62 Law & Contemp. Probs. 215 (1999). The role of shareholders is necessarily specific to a country’s legal system and there is some variance even among countries with the most developed economic systems. Other countries for example, do not permit the staggered board or poison pills discussed later, but the general system of passive shareholders is common.
article closes with a section summarizing predicted trends for shareholder activism that flow from this analysis and the extent to which there is a need for a legal response.

I. The Separation of Ownership and Control and the Prior Efforts to Address It

A. Berle and Means and the Separation of Ownership and Control

Economist Gardiner Means and lawyer Adolf Berle in their 1932 book set out to describe the revolution that had changed the fundamental nature of profit-seeking enterprises.\(^6\) They saw the separation of ownership and control in the early 20\(^{th}\) century American corporation as having destroyed "the very foundations on which the economic order of the past three centuries have rested."\(^7\) Berle and Means' new paradigm reflected the dispersion of ownership and the evolution of corporate governance toward management control.\(^8\) Historian Alfred Chandler set this development within a series of economic changes of size, greater productivity and the growth of a professional managerial class that spurred the evolution from entrepreneurial capitalism to financial capitalism to managerial capitalism.\(^9\) The move, first visible in the railroads and telegraph companies of the late 19\(^{th}\) century, was widespread among large American companies by the end of World War I and became standard within the succeeding generation.\(^10\)

With Berle and Means having given the popular label to this agency cost problem of management controlling other people’s money, successive generations of writers and reformers sought to identify solutions to this separation of ownership and control. Hedge funds, thus, follow in the line of: (i) efforts to empower shareholders through the federal securities laws; (ii) the takeover movement of the early 1980s that for the first time saw widespread use of markets and the shareholders’ power to sell as a discipline on managers; (iii) the leveraged buyout and private equity movement of the same era that suggested a finance driven response via an organizational structure that

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\(^6\) Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property at 6-7 (1932) (quasi-public corporation may fairly to be said to work a revolution in destroying the unity of ownership and control).

\(^7\) Id at 8.

\(^8\) Id at 94 (categorizing control among management, via legal device, minority control, majority ownership and private ownership and finding the largest (44%) of the 200 largest companies in 1930 were management controlled).

\(^9\) Alfred D. Chandler, Jr., The Visible Hand, The Managerial Revolution in American Business (1977) at 9 (as the multiunit business enterprise grew in size and diversity and as its managers became more professional, the management of the enterprise became separated from its ownership).

\(^10\) Id at 417, (by 1917 the majority of mergers structured like GE and DuPont); id at 451 (with a generation that type of management had become standard.)
eliminated the public ownership and thus the separation of ownership and control; (iv) the new focus in the 1990s on institutional investors as activist shareholders. Each of these efforts showed weakness as well as strength and each provoked reaction. Evaluation of the staying power of hedge funds as governance players should be informed by the evolution of these earlier efforts.

Berle and Means expressed the core concern that this separation of ownership and control displaced the “traditional logic of profit” dating back to Adam Smith: that by an individual seeking profit, the individual satisfies the wants of others. They saw the modern corporation as having wrought such a change as to have made the traditional concepts of competition and profit inapplicable. Their preferred solution, judicially enforced duties on management toward passive owners and to the community have not shaped the search for solutions as completely as their book framed the problem. But their concern about the breakdown of the traditional logic of profit and whether individual pursuit of self-interest produced societal good echoes a current concern about hedge funds: Do the different economic incentives available to hedge funds as a short seller through use of other sophisticated financial strategies mean that their voting or other individual action operates to the detriment of the common good?


As Congress considered its legislative response to the stock market crash of 1929 and the Great Depression, a recurring concern was corporate management’s overreaching of shareholders on matters within the traditional shareholder realm, such as approval of mergers and election of directors. Congress chose not to replace state corporate law, but it did seek to shift the balance between managers and shareholders by shoring up shareholders’ ability to act in response to management. Disclosure was a principal feature of this approach, particularly information mandated by Section 14(a) of the Securities Exchange Act of 1934 to be provided to shareholders when they were solicited for proxies as to their voting rights. These efforts were a response to the

11 Berle and Means, supra note 4 at 338.

12 Id at 351.

13 Id at 221 (“the law governing the duties of a management toward security owners is perhaps the only section of corporate jurisprudence which has not undergone a substantial weakening process.”)

14 Id at 356 (Control groups “have placed the community in a position to demand that the modern corporation serve not alone the owners or the control but all society...’Control’ of the great corporations should develop into a purely neutral technocracy, balancing a variety of claims by various groups in the community.”)


16 15 U.S.C. §78n(a). As Berle and Means put it, “the shareholder is practically reduced to the alternative of not voting at all.” Id at 87.
economic position of dispersed shareholders with relatively small stakes in corporations and the rational apathy that was a likely result. There is little incentive for an individual shareholder to incur costs to become informed and collective action problems abound in shareholders coordinating a response. Yet this federally mandated support of shareholder voting did little to produce real shareholder activism. Proxy fights to replace directors occurred only in a small number of companies each year.\(^\text{17}\)

The Securities and Exchange Commission moved beyond a focus on disclosure as to information before the shareholder body by expanding the ability of individual shareholders to control the agenda of items to be presented to the shareholders. By Rule 14a-8, the SEC has provided shareholders a sometimes powerful means to raise issues of corporate policy.\(^\text{18}\) For most of the period of this rule’s existence, this platform was largely a vehicle for discussion of social issues in the larger society—to debate, for example, issues of war and peace, environmental protection or animal rights issues.\(^\text{19}\) More recently, this forum has provided a vehicle for shareholder voice as to governance issues such as classified boards and the process for election of directors.\(^\text{20}\)

What is particularly relevant for this discussion of hedge fund activism is the extent to which this activism is necessarily framed by the limited governance role provided to shareholders under corporate statutes. All state corporations statutes provided that all corporate powers will be exercised by the board, not the shareholders.\(^\text{21}\) Shareholders get to elect directors.\(^\text{22}\) They also get to vote on mergers or amendments to articles, but only after the board has initiated and approved the transaction.\(^\text{23}\) The federal rules providing shareholder access to the corporation’s proxy statement is carefully framed to apply only to “precatory” proposals, recognizing that shareholders can only ask, but not compel the board to do something (and implicitly raising the possibility of a voter rebellion if they

\(^{17}\) Ronald Schrager, Corporate Conflicts: Proxy Fights in the 1980s (Investor Responsibility Research Center 1986) (about 20 proxy fights for control on average from the 1950s to 1980s).

\(^{18}\) 17 C.F.R. §240.14a-8.

\(^{19}\) See e.g. Lovenheim v. Iroquois Brands, Ltd. 618 F. Supp. 554 (D.D.C. 1985) (shareholder proposal relating to company distribution of pate de foie gras raising issues of force-feeding of geese.)


\(^{21}\) Mod. Bus. Corp. Act § 8.01(b) (“All corporate powers shall be exercised by or under the authority of the board…”); Del Code Ann. tit 8 §141 (“The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors…”).


\(^{23}\) Mod. Bus. Corp. Act §§ 10.03 (articles amended by board adoption and shareholder approval), 11.04 (merger plan adopted by board and approved by shareholders).
don’t).24 The effectiveness of this strategy will ultimately depend on the likelihood that this implied threat can be carried forward.

In 1968, Congress broadened the reach of the Securities Exchange Act to address shareholder selling as well as voting.25 The Williams Act expanded disclosure obligations to require information be available to shareholders who were facing a decision as to whether to tender their shares in response to a bidder’s effort to purchase control of a company. Here the legislation was playing a supporting role to markets, principally the market for corporate control discussed in the next subsection. Yet, this effort to empower shareholders also recognized a counterbalance to protect managers against too much oversight from shareholders.26 For example, the federal law never intervened to block the powerful defensive tactics to hostile tender offers that quickly were thrown up.27

More generally, this federal effort to empower shareholders has always had a limited effect. The limits on shareholder activism in our corporate laws have meant that the actions of individual shareholders are seldom the main event of corporate governance. The impact of these efforts to empower shareholders has grown, however, to the extent that these rules interact with the expansion of the market-provided ability to exercise corporate control. In the hands of hedge funds, which are willing to use these shareholder rules in conjunction with market activity, the combination of voting and selling has a greater disciplinary impact on management than previously.

C. The Market for Corporate Control.

Prior to the rise of hedge fund activism, the most sustained and dramatic response to the Berle and Means worry about the separation of ownership and control occurred in the early 1980s with the explosive growth of the market for corporate control. The change in the shareholder census, particularly the growth in the shareholdings of institutional investors, meant more shareholders had sufficient size and sophistication to counter some of the traditional barriers that made rational apathy the dominant shareholder response to most questions of corporate governance. The wider access to financing from junk bonds and other pools of capital meant there was greater ability to use shareholder selling rather than voting as a means to address collective action problems of shareholders who wanted to change management policy. Federal tender offer law provided some additional protection for such moves. The combination created new


26 See Black supra note 13 at 564 (describing 1956 proxy amendments as reflecting concern for managers).

27 See the discussion of poison pills infra.
economic incentives for entrepreneurs or raiders to engage in a pattern of corporate takeovers.

At times, it seemed like all management was at risk. And this touched off a vigorous public debate, particularly by employees and other corporate constituencies adversely affected by changes that resulted from corporate takeovers. Most states passed multiple anti-takeover statutes, generally protecting management against hostile takeovers. More importantly, common law courts approved the innovative private ordering defensive tactics such as the poison pill.

The architecture of takeovers fights in this earlier era informs our consideration of hedge fund activism. There were so many defensive tactics, all seemingly with catchy names invoking medieval combat, that it was easy to lose track of any underlying order. Yet these legally motivated defensive tactics can be best understood as an effort to shut down the only two avenues by which shareholders can interfere with the directors’ plenary power to run the corporation: selling or voting. Any well-defended corporate management had to possess an effective remedy against each. As it turns out, the principal defense against shareholder selling became the poison pill and the principal defense against shareholder voting became the staggered board. All the other defenses were gravy, filing in where these two may not be available or simply providing surplusage that adds to an appearance of impregnability.

The poison pill works to dramatically raise the costs of any hostile offer that would permit shareholders to sell into a tender offer that target management opposed. Since its introduction in the mid 1980s, poison pills have not been triggered (although sometimes redeemed after pushing an unwanted bidder toward discussions with the board of directors.) Judicial sanctioning of “just say no” responses by targets boards when confronted with hostile bids and requests to redeem a poison pill have provided an effective weapon for target company boards of directors.


29 Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (approving board’s power to issue a poison pill). A poison pill is a rights plan that when triggered by a hostile takeover permits all shareholders except the raider to purchase additional shares in the company at what is often half price).


31 There was one example of triggering of one of the earliest poison pills in a form that was later modified and in unusual circumstances that seems to have little bearing on its broader use. See the discussion of the Crown Zellerbach plan in Moran v. Household International, Inc. 500 A.2d at 1345 (Del. 1985).

32 See e.g. Paramount Communications, Inc. v. Time, Inc. 571 A.2d 1140 (Del 1990) rejecting the Chancery Court’s approach in City Capital Assoc. v. Interco, Inc., 551 A2d 787 (Del Ch. 1988)
The staggered board similarly raises the costs an activist pursuing a voting strategy. When a corporation adopts a staggered board structure, its directors (like the U.S. Senate) are divided into three classes and only one third of the members are elected during each election cycle. Thus it would take two annual meetings to replace a majority of the board. To the extent that a potential raider needs to buy shares or otherwise spend substantial money to be successful in the first meeting, that investment is at the mercy of the incumbent managers for an entire year, an economic disincentive for any raider to make a large investment.

The second point to bring forward from this earlier era is the importance of antidotes to reopen the avenues of shareholder voting and selling that have been shut down by defensive tactics. It turns out that both of the principal defensive tactics have antidotes. Poison pills can be redeemed by the target board prior to their being triggered. Thus if critics of management can obtain control of the board, this impediment to selling can be easily removed. This, however, involves shareholder voting and requires a successful proxy fight to replace the board. At this point a staggered board raises an imposing barrier as just discussed. Shareholder efforts to bring shareholder proposals to remove staggered board provisions from corporate charters run up against the precatory nature of Rule 14a-8 proposals and blocking position given to the board by corporate law as to any changes in the articles of incorporation. Shareholders can use market pressure in an effort to move the board toward such a change, and sometimes a board might respond to shareholders who have demonstrated such success, but an effective defense is necessarily multifaceted and is directly shaped by the core structure of corporate governance law.

D. Private Equity as a Response to Berle and Means.

The takeovers era of the 1980s produced another, somewhat related response to the challenge identified by Berle and Means, one which resolved the problem of the separation of ownership and control simply by removing the company from the public sector and unifying the owners with control. One thread of the 1980s takeover movement was the leveraged buyout segment where the

where the Chancellor had suggested that price inadequacy alone could not justify failure to redeem a poison pill, leaving the target company’s future in the hands of its shareholders).

33 See e.g. Del Code Ann. tit. 8 §141(d) (permitting directors to be divided into 1, 2 or 3 classes).

34 Redemption was a characteristic of poison pills as initially drafted by their inventors. See Wachtell, Lipton, Rosen & Katz, The Share Purchase Rights Plan (March 1994) reprinted in Ronald S. Gilson and Bernard Black, The Law and Finance of Corporate Acquisitions (2d Ed. 1995) at 741. In turn, the Delaware Supreme Court, in approving the poison pill, noted that directors could have a fiduciary duty to exercise this redemption right. Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (noting in the approval of poison pill does not relieve directors of their fundamental duties as to possible redemption).

35 See Mod. Bus. Corp. Act § 10.03 (shareholders cannot make changes to the articles until board has first approved the changes).
pools of capital were assembled by financial entrepreneurs to buy out the entire public ownership of a company. This move was often financed by large amounts of debt to take advantage of the tax benefits that debt provided and the possible leveraging of the return to the equity investors after the debt was paid off. These leveraged buyouts often, but not always, included the company’s management as investors and provided much stronger incentives than before for managers to produce positive payouts.

To the extent that these buyouts were associated with higher risk financial structures with fixed debt repayment obligations that could stretch the corporation’s repayment capacity, these buyouts triggered public policy concerns that the company would later fail and imperil employees’ jobs. As the takeover industry matured, private equity groups became repeat players in transactions seeking out profit opportunity. This part of the industry differs from other acquisitions in that the purchasers usually take control of the business, thereby making it unnecessary to address separation of ownership from control. The agency costs advantages of this form are so strong to theorists, that one prominent academic suggested the end of the public corporation in many sections of our economy, which would not be able to economically compete with this new form of business. In our current economy the line between private equity and hedge fund activists has gotten a bit fuzzier as the time frames of hedge funds have gotten longer and private equity firms broaden their strategies for making money.

E. Institutional Investors as the Champion of Shareholders.

As the takeover wars receded from the high rates of the 1980s in the face of a slow down in the business cycle and the growing effectiveness of defensive tactics to resist hostile takeovers, attention turned toward institutional investors as potential activist shareholder who could address the separation of ownership and control. By the turn of the decade to the 1990s, institutional investors had replaced individuals as the dominant shareholders in American public corporations. Mutual funds, public and private pension funds, banks, insurance companies and the like collectively owned the majority of most large American companies and often very large majorities. The twenty largest institutional

36 Interest paid on debt is deducted from a taxpayer’s income, such that the government is in effect sharing in the cost of raising money by debt as opposed to new equity offerings. Since this obligation is a fixed amount (as opposed to an equity claim) once the debt amount is paid off, the equity owner receive the entire residual gain that may be left, meaning that the debt can be used to leverage up the return to the equity (assuming the debt has been successfully paid off)

37 In which case they receive the appellation, MBO (Management Buyout).

38 Michael C. Jensen, Eclipse of the Public Corporation, 67 Harv. Bus. Rev. 61 (1989) (“The publicly held corporation, the main engine of economic progress in the United States for a century, has outlived its usefulness in many sections of the economy and is being eclipsed.”) See also Lipton, supra note 2 at 10 (going private as “the solution to the problem created by rampant unrestrained and unregulated shareholder activism.”)
investors often held a large share within that group. Such investors, at least in the view of many academics at the time, seemed able to overcome several of the economic barriers that had made traditional shareholder activism so ineffective. They had economies of scale both collectively and within individual investment that could support a non-passive approach to their shareholding investment. They were financially sophisticated, in part as a byproduct of their day to day business, and they could apply such sophistication to questions of corporate governance at little additional cost. Their other business interests sometimes would give them access to information at a lower cost. The percentage of shares owned among a relatively small group of institutional investors, each of whom is repeat players as to matters of corporate governance had the potential to reduce the collective action problem.

In this vein, Professor Black speculated that shareholder passivity may be both historically and legally contingent and that the promise of institutional voice was substantial. Also in the early 1990s in the face of the decline of hostile takeovers, Professor Pound declared the reemergence of the political model of corporate governance not as an arid prediction, but as a reality.

The reality never really fulfilled the promise. The reasons have been well-analyzed elsewhere. For purposes of this discussion they can be summarized as conflicts of interest, a business plan that often includes inadequate incentives and liquidity constraints, and regulatory constraints. Traditional institutional investors are sometimes affiliated with, or controlled by, financial institutions that would experience a push back from clients of other parts of their business if the institutional shareholders engaged in shareholder activism. Alternatively, the institutional investors themselves may engage in other businesses, such as managing corporate pension plans that could be subject to customer exit if they engaged in activism. Incentives for managers of institutional investors to pursue activist strategy (such as performance based fees) are also weak either because of the funds investment strategy, such as to pursue a low cost index strategy, or regulatory constraints. Many institutional investments have liquidity obligations that may not be consistent with an activist strategy.

42 Bratton, supra note 1 at 9 (“Observers of corporate governance have spent two decades encouraging these fund advisers to take the lead for the shareholder interest and actively challenge the authority of unsuccessful corporate managers. But the requisite financial incentives have never fallen into place.”); Partnoy & Thomas, supra note 1 at 3 (“we find that on balance institutional investors have been of marginal importance at a targeted firms, and that many institutions such as mutual funds and pension funds, have not been as successful as some had initially predicted.”)
43 See Black, supra note 13; Bratton supra note 1; Kahan & Rock, supra note 1.
Activism of many institutional investors is hobbled by regulations that may require disclosure that would make activism difficult, or require diversification inconsistent with an activist strategy. Public pension funds may have fewer constraints from regulation, and fewer conflicts with related financial entities, but they may feel pressure to the extent they are embedded within a political process, where elected officials determine policy.44

II. Hedge Funds as Activist Shareholders

A. Situating Hedge Fund Investments

Hedge funds are pools of investment capital most often defined, from a legal perspective, by what they are not. They are exempt from regulation under the Investment Company Act.45 A federal appellate court recently struck down an SEC effort at minimal regulation that required registration under the Investment Advisers Act.46 The most common affirmative definition derives from how the term is presented in the financial marketplace, a fund with a goal to deliver above market returns by pursuing a variety of aggressive economic strategies. The name itself suggests one such strategy, such funds often hedge their investment positions by selling stock short to eliminate unwanted risk, something that traditional institutional investors such as mutual funds do not typically do.47 Situating them in a discussion of corporate governance is more difficult because many of their methods have little to do with governance or corporate transactions. Hedge funds, for example, may make directional bets on movements of currency exchanges or interest rates. Some invest principally in debt securities or securities of distressed firms. A firm may focus on convertible arbitrage, going long in convertible bonds and shorting the underlying stock. Such arbitrage strategies overlap corporate transactions as when a hedge fund engages in merger arbitrage after a takeover announcement by buying the shares of the target and selling short the shares of the bidder.46 Only a small fraction of hedge funds are activists about corporate governance—about 100 of

44 See Kahan & Rock, supra note 1 at 25.

45 15 U.S.C. § 80a-3(c)(1) & (7) (exempting issuers with one hundred or fewer beneficial owners who do not offer their securities to the public or because their investors are qualified high net-worth individuals or institutions).


47 Sell short that is. Traditional mutual funds do seek to eliminate unwanted risk by use of a diversified portfolio.

48 The shares of a target company typically rise after the announcement of a takeover and those of the acquirer fall or remain unchanged. See studies collected at Ronald Gilson and Bernard Black, The Law and Finance of Corporate Acquisitions (2d Ed. 1995).
the perhaps almost 9000 hedge funds in the United States and even those 100 combine governance with other hedge fund strategies.\(^{49}\)

The strategies just discussed are usually passive in that they require no interaction with the management of the corporations whose securities are traded. They can be done, and are, by the proprietary trading desks of many traditional financial firms. My focus in this paper and the focus of hedge fund activism more generally is when an investor seeks to combine such a financial strategy with active engagement with the governance system of the corporation.

\textbf{B. Typology of Hedge Fund Governance Activism}

Hedge fund governance activism is focused on public companies and typically involves the activist investor taking only a minority position in a company. Making offers to acquire the entire company is regularly part of the arsenal of a hedge fund activist, but actually acquiring control is a different story with K-Mart being a very notable exception.\(^{50}\) Most hedge fund activism can be sorted into those activities related to an existing merger or related transactions and those related to efforts to change a company’s business plan.\(^{51}\)

1. Activism Related to Existing Acquisition Transactions

(a) Blocking Acquisition on the Acquirer Side: Monitoring Acquirer Management’s Empire Building

Several of the most high profile hedge fund activism cases of recent years have arisen in efforts to block a corporation from making an acquisition that the investors believed would be value decreasing for the acquirer. The failed Deutsche Borse effort to acquire the London Stock Exchange was a highly visible and successful example where the opposition of hedge funds who held shares of

\[^{49}\text{Julie Connelly, \textit{Hedge Funds into the Boardroom}, Corporate Board Member magazine, (Jan. Feb. 2007 at 29, 32 (quoting \textit{Hedge Fund Research} as saying only 100 of 8800 Hedge Funds are activists.) The 100 is consistent with contemporary empirical studies. See Brav et al supra note 4 at 10 (reporting 110 funds as activist in their study); \textit{Klein and Zur, supra note 4 (reporting 102 firms as activist in a similar period). The denominator of hedge funds is more variable. About 2500 firms registered pursuant to the SEC’s regulation prior to the rule’s invalidation described in note 35 supra. As of July 2006, the SEC estimated there were about 8800 hedge funds. See SEC Chairman Christopher Cox, \textit{Testimony Concerning Hedge Funds} (July 25, 2006), available at http://www.sec.gov/news/testimony.2006/ts072506cc.htm.}

\[^{50}\text{Robert Berner, \textit{Eddie’s Master Stroke: The Sears Kmart Merger Creates a Retail Giant}, Bus. Wk. Nov. 29, 2004.}

\[^{51}\text{Bratton reports that about 16 of the 130 firms in his sample of firms experiencing hedge fund intervention involved a single merger transaction and in nine others the activist stayed on for an extended engagement after a merger transaction’s disposition. \textit{Bratton, supra note 1 at 10 and 46. His count would correspond to the first two categories I describe here in B1(a) & (b) below, but not the third in B1(c). See also Kahan & Rock, supra note 1.}
the acquiring company caused the transaction to be abandoned.\textsuperscript{52} Carl Icahn’s efforts to persuade Mylan to abandon its effort to acquire King Pharmaceuticals is another example, overshadowed in that case by Richard Perry’s well-known effort to use a hedging strategy to obtain votes (but not economic interests) in the buyer in order to insure a favorable outcome for his investment on the seller side.\textsuperscript{53} Since the common reaction after the announcement of takeovers is for the stock of the target to go up and the stock of the bidder to go down, it is not surprising that hedge funds might seek to be active on the acquirer side.\textsuperscript{54}

(b) Blocking Acquisitions on the Target Side: Monitoring Cashout Conflict of Interests.

Given the usual economics of takeovers described above, hedge funds activity to block an acquisition from the target side is less likely, at least in an arm’s length merger. Instead, target side hedge fund activity occurs in contexts driven by conflicts of interest of a controlling shareholder. Most often, hedge fund activism on the target side has occurred when there is a controlling shareholder who has proposed a cash out transactions on terms the hedge fund investor believes is too low. The Novartis acquisition of the remaining 42\% of the shares of Chiron is one example.\textsuperscript{55} Sears Canada’s effort to cash out minority shareholders is another recent example.\textsuperscript{56} Second, hedge funds have been active when the form of the acquisition is private equity seeking to acquire all of the target, often with the participation of management which can raise conflict of interest questions. Third, there are some apparent arm’s length mergers where hedge fund investors have been active, but even here there is sometimes a conflict of interest as in the Molson-Coors merger.\textsuperscript{57}

What is most relevant in this setting is that there is a strong legal claim that can be the foundation for activism. Both fiduciary duty and appraisal claims are available in this setting and hedge fund investors have made use of both of these legal claims. This is exactly the setting in which shareholder litigation is most likely to be successful. A recent empirical study of all Delaware shareholder litigation found that almost all shareholder litigation occurs in a


\textsuperscript{53} See text accompanying notes 135 infra.

\textsuperscript{54} See note 48 infra.

\textsuperscript{55} Shareholder Insurrection Infects Novartis’s $5.1 Billion Chiron Bid, Wall St. J. Apr. 3, 2006 at C3.


\textsuperscript{57} Molson Coors Merger May Lack Support, http://www.msnbc.com/id/59434432 (merger, which was eventually approved, required voting by two classes of stock, one held by one branch of the family who would receive management positions in the new company and another by funds and retail investors who expressed concern about the merger)
takeover setting and that the cash out conflict of interest setting is the context where there is most likely to be a positive outcome to the litigation. The second most likely area for a positive outcome from litigation is a leveraged or management buyout. Positive outcomes in arm’s length mergers often occur when there is a special benefit of some sort for an inside group. Hedge funds are making a rational choice to pursue those particular transactions on the target side where legal rights are most likely to produce monetary results.

(c) Facilitating Acquisitions on the Target Side via Activism on the Acquirer Side.

A third setting in which holdings in a target have motivated hedge fund activism is illustrated by controversial Mylan Labs/ King Pharmaceuticals takeover where Richard Perry’s fund, in order to protect an interest in the target, bought shares of Mylan and through a hedging transaction laid off the economic risk of the transaction, retaining only voting rights which could be used to ensure the success of the transactions even if it was not in the economic interest of the acquirer to do so. This context is the most questionable context of hedge fund activism and has provoked an extensive debate around empty voting discussed in more detail below.  

2. Activism to Change a Company’s Business Plan.

In addition to trying to influence an existing acquisition transaction, hedge funds also pursue a variety of other tactics to change a company’s existing business plan in a way designed to produce an immediate positive bump in the company’s share price. This could include an acquisition offer by the hedge fund itself. More likely is an effort by the hedge fund to prod the board or


59 Id at 204 (describing monetary results in settlements of litigation involving MBOs as less than controlling shareholders, but still a small increase in cash to shareholders).

60 Id at 205 (most of the claims in which monetary settlement was paid in third party mergers arise out of a claim that managers have shifted too much consideration to themselves in negotiating the terms of the deal).

61 This is the same transaction in which Carl Icahn was active on the other side in an effort to kill the transaction. Ultimately other problems led to the end of the deal short of its consummation so the battle of the hedge fund titans ended with a no-decision.

management to make an immediate cash payment to shareholders, to sell a unit or particular assets, or other governance changes.63

(a) A Hedge Fund’s Offer to Buy the Company.

As previously mentioned hedge funds tend to operate as minority shareholders, but occasionally their strategy includes an outright offer to purchase the company. Bratton found 18 offers by an activist investors to buy the firm in his sample of 130 interventions and none led to a merger.64 The failure of these offers to lead to an actual closing, suggests this is a tool geared toward a broader strategy of influencing the behavior of current management more than a desire to own the company. The recent empirical studies of hedge funds suggest that the relative performance characteristics of targets are as good or better in operating measures than companies not targeted by hedge funds65 This suggests that poor management is not the prime input that hedge funds seek to replace, but rather to prod current management to strategies that can produce a positive and immediate return.66

(b) Prodding the Company to Make a Large Cash Payment to Shareholders.

A cash payment, of course, produces an immediate return on investment. Bratton marshals evidence as to the attractiveness of this strategy. About 38% of the targets of hedge fund activism in his sample are cash-rich and overall cash levels stand at the highest point since the 1980s.67 Klein and Zur’s findings are similar and consistent with the motivating incentives of free cash flow long discussed by economists.68 Cash payments can occur either via a dividend payment or a share repurchase. The cash itself may come from the corporate treasury that management have been reluctant to let go, or by borrowing if the

63. Klein and Zur supra note 4 at 24 report that hedge funds have a 73% success rate (31 of 41) when they seek seats on the board and 100% success rate in getting the firm to buyback its own stock, replace the current CEO and initiate a cash dividend. The numbers are not as impressive as they might seem in isolation because they are percentages of the denominator measured by purposes stated on the Rule 13D disclosure made by the hedge fund. Even so, it shows that hedge funds have had considerable success on the "changing the business plan" leg of their efforts.

64. Bratton supra note 1 at 50. (finding the offers as a whole were not particularly generous and in some seemed to be a ploy to put the company in play, which did not seem to often success.)

65. See Klein & Zur, supra note 4 at 19 (hedge fund targets relatively profitable and don’t improve in accounting measures of firm performance after activism)

66. See Brav et al supra note 4 at 18 (target firms for hedge funds fared no worse than comparable non-target firms measured by sales growth and return on assets.)

67. Bratton, supra note 1 at 19. He notes that larger targets predominate in the cash payout as the result as opposed to providing board seats or other results.

68. see Klein & Zur supra note 4 at 33 (targets of hedge funds rich in cash and short term investments, consistent with Michael Jensen's free cash flow theory)
Thompson, *The Limits of Hedge Fund Activism* -17

company has not made complete use of the tax shield that the tax code provides for financing via debt.69

(c) Unbundling the Company via the Sale or Spin-off of a Large Division or Other Assets.

Assets themselves can sometimes be easily monetized and this possibility often gets the attention of hedge fund activists.70 This goal could also be implemented by the sale of a division, perhaps to private equity in which the division’s management will be given an ownership interest, or by a spin-off of a division to the shareholders of the parent company. This de-conglomeratization has long been a source of creating value in the deals arena.71

These last two categories replicate what has occurred in earlier periods under a leveraged recapitalization label. Such changes are often motivated by the same economic factors as leveraged buyouts, but, unlike LBOs, the company in the leveraged recap remains publicly held.72 The value comes not from any form of synergy or replacing inefficient management or even the value that current LBOs can achieve by avoiding the Sarbanes-Oxley costs that now go with being a public company.73 Instead, the gain comes from operational or financial changes, including the more efficient use of the tax shield that can result from greater borrowing. Data from earlier leverage recaps show such improved operational efficiency, although less than LBOs.74 To this point hedge fund activism is producing mixed or negative results as to operational efficiencies separated from financial changes. What hedge funds add to this earlier pattern is the additional impetus that the effective threat of a hostile proxy fight can bring to the push for such a recapitalization or related change.

(d) Obtaining Board Seats or Other Governance or Business Changes Short of Control.

The goal of hedge fund activists sometimes has a less immediate transaction focus and evolves toward a relationship that will last a bit longer.

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69 See note 36 discussing the tax shield arising from companies being able to deduct interest payments from their corporate tax return.

70 Bratton, supra note 1 reports that for 32% of the companies in his sample, such unbundling was a disclosed purpose. Klein and Zur supra note 4 at 12, 24 report that changing board composition is stated as a purpose in 41 of the 155 events that they trace and hedge funds obtain board representation in 31 of those times.

71 See e.g. Gilson & Black supra note 48 at 357-362.


73 See e.g. the costs relating to internal controls now required by Section 404 of Sarbanes-Oxley.

Achieving board representation is one of the most common results for hedge fund activists, one that seems more common with smaller to mid cap companies. Such board representation, however, does not seem to mimic venture capital investments where angel or other investors have a long-term seat at the board room table. In the hedge fund context, board representation seems designed to reflect the more specific financial purposes discussed above. It makes economic sense for the hedge fund to remain active on the board of the portfolio company even after the initial policy change if these recap transactions follow the pattern of earlier cycles where an acquisition frequently followed the recap, offering the hedge fund a second opportunity for profit.

Occasionally, hedge fund activism leads to the immediate replacement of the CEO and some activists’ efforts become more focused on the policies of the CEO. Yet the more common track for hedge fund activism seems to be persuading managers to take value producing actions, not in displacing bad management or replacing management so as to stop a ruinous strategy such as occurred in Technicolor where the takeover was based on ending the company’s ill-advised venture into one hour photo processing.

In seeking to obtain board seats hedge funds are forging a trail different from the post-Enron reforms by which Congress, the SEC and the stock exchanges have emphasized independent directors as the preferred way to monitor management. The theoretical gap, not yet filled even after a large increase in stock compensation for directors, is the source of sufficient motivation for these independent directors to do the job asked of them if they lack direct economic incentives from the changes they might make. In contrast, the hedge fund model presents the possibility of directors with more skin in the game of public corporations than most directors of the last couple of directors and a close

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75 Bratton, supra note 1 at 32.
79 See the current fight at Heinz Foods. Public pension funds and other institutional investors have been more involved in “Just Say No” campaign see e.g. Diane Del Guerico, Laura Wallis & Tracie Woidtke, Do Boards Pay Attention When Institutional Investors ‘Just Vote No’?: CEO and Director Turnover Associated with Shareholder Activism, (Working Paper 2006) (finding activist campaigns associated with abnormal higher forced CEO and director turnover and significant positive valuation effects and operating performance improvements; Public pension funds, proxy advisory services or mutual fund managers were included in the sample from 1996 to 2003; hedge funds were not separately identified).
80 See Cede & Co. v. Technicolor, Inc. 684 A.2d 289 (Del 1996).
81 See e.g. the NYSE listing standards which require independent directors exclusively on three key committee). See New York Stock Exchange Listed Company Manual §303.00 et seq.
link to the time before Berle and Means when directors were the owners of the company or representatives of those owners.

3. Hedge Fund Activism as Framed by the Legal Structure.

The hedge fund activism described above necessarily reflects the legal structure of the corporation. The most important legal principle is the plenary power given to board of directors to make all corporate decisions, including those most relevant to the hedge fund strategies.\(^{82}\) The second relevant legal principle is the limited right of shareholders to do only three things:

- **Vote** on directors and on fundamental corporate changes such as mergers but only after these changes have been approved and put forward by the directors;\(^{83}\)
- **Sell**, a right that is most useful in an activist setting if the selling is to a group that is able to acquire majority shares so as to elect a majority of directors and thereby gain access to the plenary power to run the corporation.\(^{84}\)
- **Sue**, usually implemented via a claim alleging a breach of fiduciary duty by the directors and managers in their exercise of the plenary power described above.\(^{85}\) The effectiveness of this right is limited by the usual judicial approach to begin consideration of a fiduciary duty suit from a position of deference to the directors and to require plaintiffs to show conflict or another breach of duty to move the court off of that position (an approach often labeled as the business judgment rule). Actions are also possible under federal law prohibiting fraud in connection with the purchase or sale of a security or in a proxy solicitation.

As discussed above, managers seeking to insulate their control of the corporation from challenge by shareholders, including hedge fund activists, have worked to close down selling and voting, the two main avenues of shareholder action provided by corporate law. In the United States, for example, these include inserting a classified board and staggered elections into the firm’s articles of incorporation at the time a company goes public so that a voting strategy for an activist requires success as two different annual meetings.\(^{86}\) In this setting it

\(^{82}\) Mod. Bus. Corp. Act § 8.01.

\(^{83}\) Mod. Bus. Corp. Act § 7.28; 10.03.

\(^{84}\) The right to sell derives from the common law property rights not from an affirmative grant in corporations statutes.

\(^{85}\) See e.g. subchapter D of Chapter 7 of the Model Business Corporation Act.

\(^{86}\) When inserted into the articles prior to going public, companies did not seem to suffer any significant negative financial disadvantage in selling their shares, but later mid-stream efforts to insert such a rule by amendment of the articles required a vote of the shareholders and at least since the early 1990s, institutional investors have been unwilling to vote for such a change.
become important to also block shareholder action outside of an annual meeting. The avenues available for such action include special meetings and actions by written consent. In Delaware the default rule in the statute effectively closely off effective shareholder action via a special meeting by providing that unless provided otherwise a special meeting can only be called by the board or whoever is named in the articles. Written consents, however, are not similarly limited in Delaware, but this avenue is usually closed in public corporations in Delaware by the insertion of a provision in the firm’s certificate of incorporation that prevent written consents. Selling is most effectively blocked by a poison pill, which effectively raises the financial cost to a bidder seeking to buy shares. Various anti-takeover provisions such as fair price provisions or other methods have a similar effect.

These defensive tactics work to shut down the avenues of shareholder action but they do have antidotes. The poison pill, for example, can be redeemed by the board, which would be effective once the activist has secured enough votes or shares to elect a majority of the directors. In a corporation with staggered board terms, an insurgent can gain a majority of the board by replacing one-third of the board each at two annual meetings. These voting and selling possibilities always remains as the backdrop for any efforts by hedge fund activists. Many of the activist strategies discussed above are pitched as value producing changes that can be implemented by current management. Much of the discussion is labeled friendly. Hedge funds acquire an ownership position, but usually only a minority position. In this context, an important part of their persuasive power is the plausible belief that they will go to a full-fledged proxy fight if necessary to displace the board (at two annual meetings if necessary) and that they will be persuasive in getting enough shareholders to join them. All of this legal posturing is done in the context of a constantly moving price of the shares of the companies and a constantly changing census of shareholders, changes that can interact with the actual use of the three legal rights described above. The typology of hedge fund activism described in the prior section thus can only be understood in the context of the specific legal context for each action, which is discussed here in the order previously presented.

Influencing the Acquirer Side of an Announced Acquisition. The strategy to influence the acquirer side of an existing acquisition realistically can only occur when the shareholders of the acquiring firm are required to vote on the transaction. Shareholder approval was once a requirement for all mergers. Yet, relaxation of statutory requirements has confined shareholder approval to only

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87 Del. Code Ann. tit. 8 §211.
88 Del. Code Ann. tit. 8 §228.
those cases where the management wants shareholders to vote. Otherwise planners can structure the transaction as a triangular merger or a purchase of assets or another form where shareholder approval of the acquiring company is not required. Stock exchange listing standards still hold acquirers feet to the fire (at least in a stock acquisition) in terms of requiring shareholder approval when the acquirer issues shares more than 1/5 of its prior total. It was this requirement that necessitated a shareholder vote by Time, Inc. shareholders in the merger with Warner Communications in a now classic takeover case. But that case also shows the limitations of such a requirement. When faced with the need for a shareholder vote for the merger, and rightfully fearing that Time shareholders would not approve a merger with Warner that the market had valued at no more than $140 when Paramount had made an all cash bid for Time of $200, the Time board abandoned the merger and restructured the transaction as a Time cash tender offer for Warner shares that did not require Time shareholder participation.

Thus, hedge fund activist are most likely to seek to influence the acquirer side in a setting where shareholder voting is required. Absent that, they are going to have resort to the threat of a proxy fight to replace directors down the road when the deal will have already been done.

Influencing the Target Side of an Announced Acquisition. Any effort to influence announced acquisitions from the target side cannot use the vote, at least in the common case where the cash out offer is by a controlling shareholder which already possess more than 50% of the vote. Rather, this type of shareholder activism illustrates the use of shareholder litigation rights. Conflict of interest clearly exists in a cash out merger proposal put forward by a majority shareholder which unilaterally sets the terms by which minority shares will be forced to exit the enterprise in exchange for a price set in the merger agreement. Conflict is the most common scenario in which a court has been willing to intervene in a corporate transaction, using common law principles of fiduciary duty. In the context of such possible litigation, the likelihood of a higher price gives room for profit-making opportunities for hedge fund activists. In addition,
investors can pursue appraisal rights, a statutory right made available to shareholders in a conflicted transaction to seek judicial determination (and payment) of the fair value of their shares.\textsuperscript{96} While appraisal has a host of procedural hurdles that have long made it a difficult route for individual shareholders to pursue successfully, some hedge fund activists have been able to use it to obtain fair price values well above what was offered in the initial cash out transactions.\textsuperscript{97}

**Influencing the Target Side of an Announced Acquisition by Acting on the Acquirer Side.** A hedge fund strategy to vote shares in the acquirer so as to assure a positive outcome for the target uses only the voting route. It too could only be used where a shareholder vote of the acquiring company is required. It will also likely require a sufficiently close division of the vote among the other shareholders that the hedge fund’s additional block could make a difference.

**Bids to Acquire Control.** Acquiring control of a company in the face of a reluctant or hostile target management usually requires combining the voting and selling avenues for shareholder action. The hedge fund thus must consider the full panoply of defensive tactics which have been put in place and the antidotes that may be introduced to preserve the shareholder avenues of selling and voting. The complexity of the strategy, the financial commitment required, and the risk to which that capital will be subjected, all combine to steer many hedge fund investors away from following this strategy to completion.

**Efforts to Change A Company’s Business Plan.** The other activists’ efforts to change a company’s business plan (large cash payments, unbundling the company or corporate governance changes) center on the activist’s use of a toe-hold to credibly signal the launching of a full-scale vote-based offensive if present corporate policy continues. A credible voting avenue needs to exist, either an unfettered route to replace the board at the next annual meeting (i.e. an unclassified board) or a credible threat to stay around for two annual meetings. To the extent that the activist does not itself purchase a large portion of the shares, the ability to credibly convey that they are other shareholders who will be aligned with the activist in this fight is important. Corporate managers know that when a takeover is announced, they can expect a shift in their shareholder population to arbitrageurs, and they have to base their strategy on such a population. An activist’s announcing of a position in a company can cause something of a similar shift in the shareholder population, but the greater uncertainty in the outcome of the strategy (as opposed to an acquisition already announced) and the longer time required for such a strategy to unfold make the credibility of this threat somewhat harder to map.

\textsuperscript{96} Del. Code Ann. tit. 8 §262 (triggered by merger or other fundamental transactions).

\textsuperscript{97} See In re Emerging Communications, Inc. Shareholders Litigation, 2004 WL 1305745 (Del Ch.),(finding fair value of $38.05 per share in a merger that had provided $10.25 per share to the minority shareholders; the case also included a fiduciary duty claim
4. Hedge Fund Activism as Changing the Legal Structure.

As shown in the previous subsection, hedge fund activism is contingent on legal rights. But at the same time there has been a substantial change in the legal structure during the period that hedge funds have become active. The prior subsection describes the limited rights accorded shareholders (and thus hedge fund investors) under corporate law, the two principal defensive tactics that boards have developed to close off the shareholder avenues of voting and selling, and the antidotes that are potentially available to reopen those avenues for shareholder action. This basic structure has been in place since the late 80s or early 90s. What has happened recently is a noticeable decline in the percentage of public companies that have a staggered board in their articles of incorporation. As previously described, the staggered board not only blocks the effectiveness of shareholder voting but it also protects against the effective sue of the shareholder selling avenue given that board control is necessary to redeem the pill. There has also been some decline in the percentage of companies that have a poison pill but this is not nearly as important because the poison pill can be reinstated by board action when a hostile takeover appears. In contrast, the staggered board in contained in the articles of incorporation, such that reinsertion would require a vote of the shareholders as well as the directors and institutional investors, at least since the early 90s, have been unwilling to support any such amendment to the articles.

This removal movement as to staggered boards has not been led by hedge funds. Instead, it has been the province mostly of public and private pension funds and various governance monitoring groups who otherwise have not been active investors as have the hedge funds. Yet these institutional investors have been willing to join proxy fights initiated by activist hedge funds and this possibility has been what has given hedge funds sufficient political clout to achieve their success in negotiating or when they have pursued proxy fights. The removal of staggered board is an example in which the direction of activism is somewhat reversed.

One further point could be made, although admitted somewhat speculative. One reason for the success of the effort to remove staggered board likely reflects that hedge fund activists are notable different from the raiders of the 1980s. They have not illustrated slash and burn tactics, as sometimes seem to occur in the 1980s such that other institutional investors have been willing to join them and managers of the target company have been willing to let down some of their defenses.

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98 See e.g. Mira Ganor, Why Do Managers Dismantle Staggered Boards (working paper 2006) (reporting a small but growing number of firms that have voluntarily destaggered their boards; Institutional Shareholder Services reports the percentage of public firms with staggered boards, has dipped bellow 60%.

99 See Bratton, supra note 1 at 6 (“it is not a slash and burn repeat of the high leverage, bust up takeovers of the 1980s).
III. The Advantages and Limits of Hedge Funds as Activist Investors.

Hedge funds have several advantages, as compared to traditional institutional investors, that would permit them to be a more effective champion for the shareholder group. They are better able to give their managers incentives necessary to nurture shareholder activism; they have fewer conflicts that would increase the costs of such activism; their relatively unregulated status frees them from other economic costs that accrue to traditional institutional investors; their business plan as to things like liquidity is better suited to an activist role; and the characteristics frequently attributed to them support a variety of activist behavior. When combined with the (as yet) so far underwhelming innovations in the defenses raised against them, the prospects seem high that they can reconnect takeovers to the discipline of managers seen during the 1980s and provide a new shareholder challenge to managerial autonomy.

Yet those advantages likely will not produce an equilibrium in which these investors will be the long-awaited shareholder champion against management self-interest. The economic motivations of hedge funds mostly are exogenous to the governance system. The same nimbleness and aggressiveness that has brought them to activism as a money-making strategy will also carry them, after a time, to new venues in pursuit of higher results. Even at their best, their economic incentives likely limit them to only segments of the governance markets most open to financial and opposed to strategic investors during the up portions of the economic cycle and for small to mid-cap public companies.

While hedge fund investors have fewer conflicts within their own financial organizations that could limit their activism, they do illustrate troubling conflicts with their co-owners of the enterprise that are likely to provoke reaction. These include the asserted short-term focus of hedge funds, the possible threat to those who invest in these funds and to the economy in general from their business strategy, a fear of a revival of the split between shareholders and other constituencies that boiled over in the 1980s in takeover settings, and perhaps most seriously, the concern that hedge funds and their economic strategies break the connection that permits shareholder voting to serve as a proxy for aligning corporate decision-making with society’s interest.

A. Hedge Fund’s Advantages as Compared to Traditional Institutional Investors in Disciplining Management.

As hedge funds have spread across the corporate governance scene, their advantages have been well-displayed. Their business plan relies on economic incentives more likely to reward activism by their managers and they face less regulation that conflicts with those incentives. First, hedge fund compensation schemes for their managers provide much stronger performance incentives than do traditional institutional investors. Hedge fund managers may receive 20-30% of returns of the fund with incentive fees based on absolute, as
opposed to relative performance. In contrast mutual funds and other institutional investors rely on modest incentive fees for their managers and overall performance is most often judged in comparison to relative performance to market indexes. In such a relativist world, activism is not a strategy that is likely to pay sufficient returns to induce their fund managers to become activists. Any individual fund is not likely to have enough of a distinctive position in a company to derive excess positive gains as compared to comparable funds who may be free riding on the work and the costs incurred by the activist funds in seeking out companies in which an activist strategy would produce positive results.

Second, hedge funds typically operate in an organizational setting that provides fewer conflicts to interfere with an activist strategy or block consideration of a wide array of possible targets. For traditional institutional investors such conflicts begin with the funds being part of larger investment organizations whose interest could be adversely affected by an activist strategy. Even apart from ownership ties, many institutional holders of stock obtain a significant portion of their assets by managing 401(k) funds that come from corporations that themselves are part of the target pool of an activist strategy. Managers will worry that activism may cost them a chunk of their other business. And to the extent that conflicts do arise, the management incentives discussed above, and other features of the hedge funds business plan mean the hedge fund might not be as predisposed to resolve the conflict against an activism strategy as would occur in another institutional investor.

Third, hedge funds incur lower costs for their activism by operating in an area outside of the same intensity of regulation as occurs for alternative pools of institutional capital. They can disclose less about their investment holdings and trades which can provide them with additional flexibility of movement and the profit opportunities that can follow from that. As there name implies, hedge funds include hedging and more risky strategies shunned by other institutional investors. They are able to avoid diversification requirements that can hobble the

100 Kahan & Rock, supra note 1 at 32 (reporting standard hedge fund charges of a base fee of 1-2% of assets under management and an incentive fee of perhaps 20% of profits earned).

101 Kahan & Rock, supra note 1 at 23 (discussing regulatory barriers and market forces that limit incentives in mutual funds).

102 Kahan & Rock, supra note 1 at 24 (reporting that nine of top 20 mutual funds were affiliated with another financial institution such as an investment bank or mutual fund).

103 Kahan & Rock, supra note 1 at 35 (hedge fund managers receive substantially greater returns from increased fund returns as compared to mutual fund managers; these incentives mean hedge fund conflicts are more likely to be resolved in favor of activism than form mutual funds facing conflicts).

104 Mutual funds, under Section 30(e) (2) of the Investment Company Act must twice a year disclose the amount and value of the securities they own. 15 U.S.C. §80a-5. Hedge funds, as well as other institutional investors, must disclose quarterly under Section 13f, of the 1934 Act but these disclosures do not cover options and other securities , 15 U.S.C. §78n-(f).
nimbleness of some mutual funds who might seek to pursue an activist strategy. These kinds of regulations often are the result of choices to pursue particular kinds of investment or a particular business plan. For example, by not seeking corporate pension funds, hedge funds can avoid the additional layer of ERISA regulation that can come with such money.\(^{105}\)

Fourth, hedge funds have chosen a business plan that permits them to avoid economic constraints that hobble mutual funds or similar institutional investors who might pursue an activist strategy. Many mutual funds stand ready to provide liquidity to their investors on an ongoing basis. Hedge funds intentionally avoid the need to provide such immediate liquidity and more recently the minimum commitment they require from their investors has been getting longer.\(^{106}\) Mutual funds have a governance structure that provides some shareholder oversight and recent regulation has heightened the role of independent directors.\(^{107}\) Hedge funds typically operate within a governance structure, a limited partnership for example, in which there are relatively few governance controls on managers from investors.\(^{108}\) More generally, the business plan of hedge funds emphasizes nimbleness and aggressiveness that support an activist strategy more so than adjectives typically associated with mutual funds.

A final advantage of hedge funds as activist investors is the relative paucity of defense that, as yet, has arisen in response to their activism. Compare, for example, the response to the takeover threat of the 1980s to the responses to the threat of hedge fund activism of the current decade. One point of commonality is the role of Marty Lipton. As is well known, he was at the center of the development of the poison pill, the most creative governance tactic of recent decades. These shareholder rights plans effectively block shareholder selling as a device to discipline management by imposing a severe financial dilution of the investment of an unwanted purchaser who acquires the shares without the consent of the board. This financial hit is linked with an invitation for such a suitor to negotiate with the incumbent board for the redemption of this poison pill. Those who are not able to come to agreement with the board, perhaps because the board would like to preserve its own position, are forced to resort to a proxy fight to replace the board (perhaps requiring two or more annual meetings because of staggered terms). All of this is neatly wrapped within an

\(^{105}\) ERISA regulations trigger when public and private pension funds account for more than 25% to the capital of the fund. See 29 C.F.R. §2510.3-101(f).

\(^{106}\) This move to longer-term investments has tax consequences to the extent that it risks “trader” status and loss of capital gains taxation rates. See Hedge Fund Tax Breaks Raises Flags, Wall St, J. Dec. 26, 2006 at c3.

\(^{107}\) See New York Stock Exchange Listed Company Manual §303A (specifying independent directors and compensation, audit and governance committees made up entirely of independent directors.)

\(^{108}\) In limited partnerships, limited partners frequently lack any statutory guarantee of exit and have little role in governance. See generally, Uniform Limited Partnership Act (2001).
apparent issuance of “rights” to shareholders, a process normally intended to
permit the corporation to raise capital, but hardly descriptive of what is going on
with the poison pill. And the effectiveness in drafting this new defense was linked
with successfully shepherding this new creation through the Delaware court
system. Although Delaware judges have put some limits on the unfettered use
of poison pills and have struck down some of the refinements as lawyers have
sought to push the envelope, the poison pill has remained for two decades the
most effective deterrent against unwanted takeovers.

In contrast to the creativity and sophistication of that response to the
shareholder activism of the 1980s, the response to date against hedge funds has
been a good bit tamer. Consider the memo to clients put out by Lipton and his
firm in 2006 under the headline “Attacks by Hedge Funds.” The aide memoire,
as it was phrased, recommended that clients “review dividend policy”,
“proactively address reasons for any shortfall in peer company benchmarks” and
“review basic strategy and evaluation of portfolio of business with board in light of
possible arguments for spin-off, share buyback, special dividends, sale of the
company, or other structural change.” This looks to be a wealth of sound
advice, but as a defensive tactic it pales in comparison to those of the earlier era.

In summary therefore, hedge funds, at least as compared to prior
contenders in the area of shareholder activism, look to be a juggernaut with the
potential to go well beyond what other shareholder champions have been able to
do in the 75 years since Berle and Means laid down the verbal framework for this
debate. But just as these investors have advantages as compared to other
institutional investors, they also have limits that likely are to cap what their
governance role will be.

B. The Limits on Hedge Fund Activism: Why They May Not Continue in
This Activist Role and Why We May Not Want Them to Continue.

In seeking to evaluate if hedge fund activism provides a new paradigm in
terms of describing shareholder and management relations or at least before
concluding that we have reached a new equilibrium in terms of shareholder
disciplining of management, two sets of limits ought to be considered. The first is
the internal limits from hedge funds that will influence whether they will want to
continue, or be able to continue in this role and if so, on how broad a basis. The
second, the extent to which we want them to continue, really a question about

109 The Delaware Chancery Court upheld the “novel and complicated” poison pill, and was
affirmed by the Supreme Court, Moran v. Household Intern’l, Inc., 500 A.2d 1346 (Del 1985)
affirming 490 A.2d 1059, 1065 (Del Ch. 1985).
110 Quickturn Design System v. Mentor Graphics, 721 A.2d 1281 (Del 1998) (striking a no hands
poison pill); Carmody v. Toll Brothers, Inc., 723 A.2d 1180 (Del Ch. 1998) (striking a dead hand
pill).
111 Wachtell Lipton Rosen & Katz memo, March 7, 2006 (on file with author).
112 Wachtell Lipton, Rosen & Katz memo, March 7, 2006 (on file with author.)
the degree to which their individual interests diverge from the overall social good, a question that has also been asked for earlier iterations of proposed solutions in the debate over the separation of ownership and control.

1. Internal reasons that block the growth of hedge fund as the prime shareholder discipline of management.

Some of the same economic drivers described above as to why hedge funds have more freedom to engage in activism than other investors also generates serious limits on their ultimate reach. Hedge funds are exogenous to corporate governance. Their primary goal is to deliver above average returns on investments. Governance is only one of many tools toward that end. As the number of hedge funds has grown in recent years, the field has become more crowded and the opportunities for delivering above average returns have withered.\(^{113}\) The same ease with which hedge funds were able to adapt to governance also eases their move to alternative investment strategies. While some firms have invested task specific human capital in developing expertise on governance issues, those costs do not seem to be excessively large that would block redeployment of hedge fund assets. The pattern of the separation of ownership and control, as outlined earlier in this paper has been one of response and counter response such that opportunities for profit will open and close. Can we expect hedge funds to continue on as long-term repeat players in governance? It is unlikely that these funds, which pay little attention to transparency or governance activity for those who place money with them, have long-term incentives or interests other than the relative return on investment that they get from to this activity.

Even if the interests and economic incentives of hedge funds propel them to continue or increase their disciplinary activity, the experience to date suggests that their role will not be plenary in terms of a global response to the separation of ownership and control but rather will be limited to particular segments. The gains that would flow from implementation of their advice reflect value that can be achieved more by financial buyers, as opposed to strategic buyers. They are not regularly pushing change that will bring synergistic values from economies of scale, vertical integration, or economies of scope.\(^ {114}\) They don’t necessarily bring knowledge for a particular industry or from adjacent fields. Rather they are selling a discipline for an existing company and one that existing management

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\(^{113}\) See Gregory Zuckerman, Despite Bumps, Hedge Funds Push On, Wall St. J. Jan. 2, 2007 at R15 (hedge funds produced respectable gains in 2006 but failed to beat most market indexes); Gregory Zuckerman, Hedge Funds Miss Their Target, Wall Street Journal September 13, 2006 at c1, col. 2 (“Some of the most hallowed names in the hedge fund world are producing very human returns this year.”); Susan Pulliam, Pirate Capital Draws SEC Focus, Wall St. J. September 26, 2006 at C1, c. 3 (quoting Robert Chapman about certain hedge funds investors, “it’s the least sticky money in the world, and if they don’t see progress, they want to move on to something new.”).

\(^{114}\) See Gilson & Black supra note 48, chapter 10-17 discussing various ways that gain can be created.
could themselves implement. While a hostile takeover is often held in the
background as an inducement to get management to implement the suggested
strategy, the gain they plan to deliver does not necessarily come from displacing
inefficient management.\footnote{Klein & Zur, supra note 4, report that portfolio companies targeted by hedge funds are more
likely to invest in healthy, profitable firms as opposed to underperforming firms.} As a result, this discipline is more likely to show up in
segments of the economy where such financial acquisition or changes are
available. The inclination of hedge funds discussed above to push for cash
payment or to liquefy assets has its greatest relative benefit at the point of the
economic cycle where cash is most likely to accumulate.

The impact of hedge fund activism, at least to this point, has not been
across the universe of public companies, but has focused on small to mid cap
companies.\footnote{Bratton supra note 1 at 12 (small firms dominate the sample, making up 61% of the targets.); Klein & Zur, supra note 4 at 17 (from a sample of 155 activist campaigns by hedge funds 2003-
2005 finding that “hedge funds target relatively small companies.”)} To some extent that is a function of size of the hedge fund
investors as compared to the size of the portfolio companies. Most hedge funds
have not been big enough to take on the largest companies.\footnote{Kahan & Rock supra note 1 at 30 (suggesting average hedge funds with assets of $100 million
and largest with assets of $10 billion.)} But that size
differential can likely be overcome to the extent large amount of money continues
to flow into this segment of the market.\footnote{The estimates of assets managed by hedge fund vary, perhaps $1 trillion to $1.4 trillion.} In addition hedge funds use leverage
more than mutual funds, for example, so that this expands their reach.\footnote{Kahan & Rock supra note 1 at 30 (reporting that 30% of hedge funds use a leverage ratio in
excess of two and another 30% use leverage, but at a lower ratio.)} These
funds are adept at working with other hedge funds or raising the flag for a cause
that mutual funds and other institutional investors are willing to support\footnote{See e.g. Bratton supra note 1 at 9 (describing wolf pack).} so it
may not be that size of the hedge fund limits their choice of portfolio companies.
More likely it is the size of the target that defines the ability to use a successful
hedge fund strategy. The potential to create value as a financial buyer described
above is likely to be greatest in those companies that are under researched or
have been passed over by analysts and others who follow an industry. To the
extent that a business plan depends on this kind of value opportunity, we should
expect a continued focus on small and mid cap companies even if hedge funds
grow.

2. Possible Externalization by Hedge Funds as a Reason to Limit Their
Reach.

The widespread growth of activism hedge funds has produced a new set
of questions that revolve around whether the economic incentives and
advantages described above present a conflict between hedge funds and fellow
investors or other constituents. This discussion here is divided into three parts: Do hedge fund incentives lead them to push a short term agenda that is inconsistent with optimal long term growth? Do the gains of hedge fund investors from shareholder activism come at the expense of other constituents? Do the innovative tactics pursued by hedge funds in an activist strategy undermine the underlying corporate governance system that relies on self-interested voting of shareholders as the foundation for aligning corporate activities with society’s interests?

(a) Short Termism

Short-termism has long been the weapon of choice to attack shareholder activism and that charge has been leveled at hedge fund activists as well. The large percentage of daily trading volume on our major exchanges attributed to hedge funds highlights this problem.\(^\text{121}\) The recurring fear is that investors out for a quick buck will force managers not to make crucial long-term investment. This was a charge made during the takeover mania of the 1980 and the growth of private equity in large part was a business model that permitted companies to manage without such undue concern for the short term.\(^\text{122}\)

Leaving aside for the moment whether the market fails to align short term and long term interests, recent empirical research suggests hedge fund investors don’t have short term time horizons. Bratton’s survey of 130 domestic firms since 2002 suggests that activist shareholders typically invest for 2 years or longer.\(^\text{123}\) He found that for 63% of his sample, the investor retained a substantial investment after two years and in another 20% of the cases the hedge fund investor had taken a pro rata return on sale, behavior which doesn’t seem to point to short term driven hedge fund investor exploitation. Empirical data from Brav, Jang, Partnoy and Thomas and from Hermes investments in the United Kingdom appears to point in the same direction on this issue.\(^\text{124}\)

(b) Hedge fund behavior as inconsistent the social good.

Hedge fund activism may be constrained to the extent that perceived divergence between the interests of the hedge funds and other social goals leads


\(^\text{122}\) Of course the economics of private equity rests on more than blocking any short term influence. The high-powered incentives to management and the closer monitoring, as compared to the typical public company also create value in this business model. Hedge fund activism does not seem associated with the same intense revamping of management incentives that typically follow a LBO, where a company is no longer publicly held and both new compensation packages and risk of bankruptcy give continuing managers incentives that they did not previously have.

\(^\text{123}\) Bratton, supra note 1 at 6.

\(^\text{124}\) See Brav et al supra note 4; Marco Becht, Julian R. Franks, Colin Mayer & Stefano Rossi, Returns to Shareholder Activism: Evidence from a Clinical Study of the Hermes UK Focus Fund (Working paper 2006).
to regulation or other constraints on their behavior. Such regulatory concerns led to the SEC hedge fund registration provisions subsequently thrown out by the federal appellate courts.\textsuperscript{125} They reflected not governance concerns in portfolio companies, but that hedge fund will harm their own investors.\textsuperscript{126} Not only is this a concern about the knowledge of individual investors in making such an investment, but also a concern that the volatility and size of hedge funds could lead to a run on the bank or a threat to markets.\textsuperscript{127} A recent survey of economists found most saying that hedge funds pose a risk to financial markets and that government supervision of hedge funds is too light.\textsuperscript{128} Some European officials are pushing for additional regulation in apparent opposition to the U.S. financial regulators who have come down on the side of no further regulation.\textsuperscript{129}

There is also a concern about the economic incentives of hedge funds propelling them to engage in manipulative behavior as to other market participants.\textsuperscript{130} These same incentives make material insider information all the more valuable and exacerbate pressure on this regulatory system.\textsuperscript{131}

More generally, additional activism by shareholders seeking greater and immediate return on their investment reignites the threat that other corporate constituencies feel from this activity, similar to what occurred during the takeovers of the 1980s. To the extent that more highly volatile investments flow from hedge fund incentives or managers reflect short term incentives that differ form long term, the result could be more companies facing financial distress and costs imposed on employees, creditors or communities. This too is a reprise of the 1980s for which there was a richly layered debate, which need not be repeated here.\textsuperscript{132} Hedge funds are of interest in this article to the extent that their

\textsuperscript{125} Goldstein v. SEC, 451 F. 3d 873 (D.C. Cir. 2006).

\textsuperscript{126} What Went Wrong at Amaranth, Wall St. J. September 20, 2006 at c1 co. 2 (reporting hedge funds loss of $5 billion in a week on natural gas investments.)

\textsuperscript{127} 38 Sec. Reg. L. Rep. 1312; SEC Finds…September 26, 2005 at 5.

\textsuperscript{128} Phil Izzo, Economists See Hedge Fund Risks, Wall St. J., October 13, 2006 at C3 (reporting that about 60% of private economists surveyed gave those responses.)

\textsuperscript{129} Kara Scannell, Joellen Perry and Alistair MacDonald, No Consensus on Regulating Hedge Funds, Wall St. J. Jan. 5, 2007 at C1 (reporting that European officials are pushing for more disclosure and a rating system like that for corporate debt.); Deborah Solomon, Regulators’ Hedge-Fund Approach: Hands Off, Wall St. J. Feb. 23, 2007 at C1, c. 2)

\textsuperscript{130} 38 Sec. Reg. L. Rep. 1157.


\textsuperscript{132} Bratton, supra note 1 at 23 discusses the extent to which an outside attacker such as that from a hedge fund impairs the stable and cooperative environment necessary for value creation but can neither falsify nor confirm this possibility by his view of whether targets of hedge fund activism are underperformers or over performers.
economic incentives, as distinguished from prior shareholder activists, might lead to a greater imbalance of the interests of shareholders and other constituents.

(c) Hedge fund activism as disrupting the foundational assumption of the corporate voting system that individual shareholders voting for their self-interest properly aligns corporate decisions with the interest of society.

The most worrisome aspect of hedge fund participation in corporate governance is when they use their financial tools and strategy to separate the interests of ownership and control as opposed to bridging that divide which has been the premise for so much of the praise for their role in shareholder activism. This exploitation of the separation of ownership and control occurs most visibly as in the Mylan-King Pharmaceuticals deal when a hedge fund with a large position the target (which would be benefited by the closing of the deal) acquired a significant voting position in the acquirer (who may well have been hurt had the deal closed) but in such a way that the hedge fund had insulated itself from any financial exposure to a change in the value of the acquirer shares. Alternatively, the assets to be benefited need not be target shares, but could be bonds, as occurred in the MONY/AXA acquisition. 133 As a result these modern financial instruments permit a new form of vote buying. This has the potential to undercut the central premise on which shareholder democracy (and thus shareholder activism) is based, unless there is an offsetting market or legal response.

First there is no doubt that modern financial practices and entrepreneurial activity permit a whole host of ways of dividing ownership interests so that investors can carve up and then pass off or retain specific elements of ownership, including the right to vote. A takeover announcement often creates the possibility of new value which will be ultimately realized after the deal closes. An investor not wishing to wait that long but still wanting to lock-in much of that new value can sell the shares on the stock market for a price that reflects much, but not all, of the anticipated market premium from the merger. The buyers of those shares are usually merger arbitrageurs who are in effect providing a form of deal break insurance to the target shareholders and charging a premium (via the difference between the then current market price and the value upon completion of the takeover.) A merger arbitrageur who wanted to hedge this long position could buy an at the market put for a stock index fund that would lay off the risk of a market break, although not the risk of a deal break prior to closing.

A merger arbitrageur seeking to lay off some of the risk of a deal break can couple the purchase of the shares in the target (to provide the insurance just described) and then sell the bidder shares short. In many takeovers, the target price moves up after the announcement of takeover because target shareholders historically have received the bulk of takeover premiums and bidder share value has moved down. If a deal were to fail, the two shares would likely move in

133 In re MONY Group, Inc. Shareholder Litigation, 853 A. 2d 661 (Del Ch. 2004).
opposite direction providing some degree of diversification of this risk of the deal failing. Such uses of hedging and financial instruments have been an accepted part of acquisitions.

Empty voting, or what might better be termed “shell voting”, takes this financial arbitrage strategy a step further. A hedge fund activist purchases shares with voting rights and then via financial transactions disposes of all of the financial rights and risks from the shares leaving only voting rights. The motivation of such a strategy is usually to enhance the value of another asset, for example acquiring votes in a bidder to help ensure approval of the takeover of a target where the investor has a large stake.

While vote-buying has always been regulated by law, the complex and sophisticated way that it has been done here raises fears that investor creativity may have outpaced the law. In particular, it creates a separation of ownership and control of those votes that raises question about the ability of the voting process to align corporate actions with the common good. Recent examples propelled SEC Chairman Christopher Cox to remark that the practice “is almost certainly going to force further regulatory response to ensure that investors’ interests are protected.”

There are, and long have been, other areas where there is a separation of ownership and control of individual shares. One example is the establishment of a record date for shareholders entitled to vote on any shareholder action. The voting rights of these former shareholders who sold their shares after the record date but before the vote introduces a possible distortion into the voting system. Yet purchasers can, and sometimes do, request proxies. In any event, the shareholder leaving an enterprise who has received cash for her interest lacks the strong incentive of the hedge fund activist in the above example to use shell voting for personal advantage.

Even without using financial instruments, shareholders voting on takeovers sometimes possess obvious conflicts. Diversified mutual funds often own stakes in both a target and the bidder in an acquisition. If, as could easily happen, the takeover looks good for the target and not so good for the bidder, should a mutual fund owning a larger stake in the target vote its own self-interest by casting both sets of votes in favor of the transaction? To the extent all mutual funds follow a similar strategy, and so long as mutual fund portfolio imbalances were randomly distributed in favor of bidders and targets, we wouldn’t expect

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136 See Mod. Bus. Corp. Act §7.07 (providing for a record date that may not be more than 70 days before the shareholders’ meeting or action).
such self-interested voting would impose a systematic bias on takeover decisions.

Does shell voting by hedge funds offer a conflict that cannot be so easily met? As just mentioned, the motivation is stronger and the incentives to invoke the strategy financially greater than for those who may hold shell shares because of sales after the record date. More generally our voting system relies on the alignment of the ownership and control of votes as the core discipline that insures the alignment of shareholder voting with transactions that are good for society. Delaware’s Chancellor Allen observed “whether the vote is seen functionally as an unimportant formalism, or an important tool of discipline, it is clear that it is critical to the theory that legitimates the exercise of power by some (directors and officers) over vast aggregations of property that they do not own.”

More generally the legal theory that relies on shareholder voting reflects the basic learning of Adam Smith that self-interest of a property-owner to use that property as the owner sees fit and to receive the full fruits of its use for personal gain can be relied upon in the aggregate, and if constrained by competition and supply and demand, to result in the best collective decision. It was this assumption that Berle and Means believed by 1932 had been undermined by the separation of ownership and control. It is a similar separation that provokes worries about shell voting in the 21\textsuperscript{st} century.

Can we rely on competition and supply and demand to rein in selfish use of voting? To the extent that there is no disclosure of the practice there is potential for uncorrected abuse. Yet, every hedge fund operator who retains the vote but disposes of economic risk deals with a counterparty whose selfish incentives could work in the classic economic way to balance any abuse. Why would an investor in Mylan contract with a hedge fund investor such as Perry to take the economic risk when Perry sought to use those votes to the detriment of Mylan? Perhaps the counterparty was ignorant of the possibility and more disclosure is needed to cure that. To the extent that the transactions occurred after the initial announcement of the merger (and the change in price that would take into account the likelihood of the merger) Perry’s purchase would not add a new negative element to the valuation decision so that the counterparty would not care. The bidder’s shares would have already sustained a loss attributable to a bad acquisition with little additional loss expected. Further, there could be other hedge fund investors who would engage in counterbalancing moves with an opposite effect. In Mylan, for example, Carl Icahn was active in seeking to get

\begin{itemize}
  \item[137] Blasius Industries, Inc. v. Atlas Corp. 564 A.2d 651 (Del Ch, 1988).
  \item[138] Kara Scannell, How Borrowed Shares Swing Company Vote, Wall St. J. Jan. 26, 2007 at A1 (reporting that several large pension funds have established internal systems to allow them to recall shares ahead of a vote and better monitor which shares are lent.)
  \item[139] There could be an additional negative move of the price as the likelihood of the deal closing increases over the interim period thereby removing an element of uncertainty that muted the original drop in the price.
\end{itemize}
Mylan to block the sale. To the extent that either of these things happens, there is a market correction that means less need for law.

If persuaded that the problem is severe enough to warrant action, the challenge of finding a commercially reasonable solution will itself be daunting. Shell voting or overvoting or encumbered voting is controlled (or not) by a mix of SEC regulation, stock exchange rules and market practices. By all accounts, the controls are only crudely implemented. A fundamental economic challenge is that various solutions will impose costs on a very large category of hedging financial transactions outside of the takeovers context to discipline what seems to be a very small number of transactions when hedging is allegedly misused in a voting context. So long as voting seems unimportant, there will be insufficient incentive to commit to a solution. Yet as important mergers like Hewlett Packard and Compaq turn on such close votes, and the continued recognition of voting as core to the process that hedge fund investors pursue, voting reform in corporations may be like voting reform in our political system since the 2000 election and become an issue that cannot be deferred.

IV. Conclusion

The recent flurry of hedge fund activity relating to corporate governance has produced the latest in a series of “solutions” to the key corporate law challenge set out by Berle and Means 75 years ago. Hedge fund economic incentives are more conducive to effective shareholder activism than the incentives of the immediately previous contender as shareholder champion, the institutional shareholders such as pension funds. For many hedge funds, their self-chosen businesses plans are better aligned with what is necessary to provide successful shareholder discipline of management. The lesser amount of regulation faced by hedge funds provides them another stronger relative incentive for activism. The economic environment around them adds a further support as many traditional institutional shareholders are willing to join in action spearheaded by such activists.

140 See Hu and Black; Martin & Partnoy see e.g. NYSE Regulation fines Deutsche Bank Securities $1 million for Failure to Supervise Handling of customer Proxies available at http://www.nyse.com/press/1139915694987.html (reporting 12 of 15 instances during 2003 in which the firm over-voted ranging form 16,710 shares to 4,304,284 shares.)

141 See e.g. Marcel Kahan & Edward Rock, The Hanging Chad of Corporate Voting (Working Paper 2007).

142 Kara Scannell, How Borrowed Shares Swing Company Vote, Wall St. J. Jan. 26, 2007 at A1 (reporting the value of securities borrowed on any given day for all purposes has reached $1.6 trillion and that Calpers, the California retirement system, and one of the most visible institutional investors, tit reported $129 million in net income from lending securities in a recent year.)

143 See Hewlett v. Hewlett-Packard Co., 2002 WL 818091 (Del. Ch.) (ruling in favor of the company as to disclosure and vote buying claims).
Yet all of this alignment has not yet coalesced to produce a lasting equilibrium for bridging the gap between ownership and control. The analysis here of the economic incentives of hedge funds reveals limits as well as positive inducements for shareholder activism. The business plan that enabled hedge funds to be both nimble and aggressive in their approach to corporate governance also operates to redirect these nimble, aggressive investors toward other strategies as countermeasures erode some of advantages of the strategies that have worked until now. The strategies which have been so successful, however, reflect the specific advantages of value creation in particular circumstances they do not necessarily extend to governance generally. And perhaps, most importantly, hedge fund incentives and their business plans can establish a separation of ownership and control parallel to that which worried Berle and Means.

Those evaluations suggest a peak at the future of this new trend of hedge fund activism that look something like this. First, hedge funds have reestablished the tie between takeovers and corporate governance activism first forged 25 years ago. Mergers and acquisitions provide the most visible setting for hedge fund activism particularly when hedge funds have been able to block on the bidder side acquisitions that seem questionable for the bidder’s share value. Second, hedge funds have been active and frequently successful on the target side when the merger is pushed by a controlling shareholder where the investor is able to used litigation rights as well as voting and selling to counter the self-interests of majority shareholders. The economic and legal incentives for these two actions are likely to continue, shaped by the general ups and downs of the merger cycle.

Thus hedge funds have the ability to shape the outcome of acquisitions, at least in these two settings where another actor has proposed an acquisition, but not necessarily any upward shift in the number of acquisitions. Any shift in the number of acquisitions from hedge fund activism seems to be linked to restructuring of various types, cash payouts, asset sales, spin-off and the like. To that extent the impact of hedge fund activism will be episodic, more than systematic. Hedge funds have not engaged in some of the systematic corporate governance efforts to change governance rules as have some pension funds and institutional investors, but their impact, along with pension and mutual funds has combined to prod a reduction in the use of staggered boards in a way that will change the legal structure more than any time in the last two decades.

Hedge fund activism is likely to be cyclical, prominent when economic conditions favor cash accumulation and appreciation of asset value. Beyond the specific merger settings described above, hedge funds are most likely to be active in areas where we have traditionally seen leveraged recapitalizations and other kinds of highly leveraged transactions. The greatest innovation that hedge funds have brought outside of the specific acquisition settings discussed above is to widen the area for leveraged transactions by adding a hostile dimension. The credible commitment to wage and win a proxy fight can more often and more
quickly persuade management of the wisdom of various financial suggestions. Even so, the transactions reflect only a fractional slice of the menu of ways in which value can be created, suggesting that hedge fund activism is not yet the plenary player that might be envisioned or needed in a Berle and Means world.

The continued presence of hedge fund in this pursuit will also be affected by their alternative opportunities to deliver the above average market returns that they seek. As economic conditions change and as management develop defenses to hedge fund activism, there will be a push in the direction of lesser impact for this activism.

Finally, some segment of hedge fund activism occupies a setting in which hedge funds act in conflict with the interest of the other shareholders of the same corporation. In this setting the economic incentives and the business plan of the hedge fund have created the exact opposite impact that hedge fund activism is said to support. Instead of being an effective bridge of the separation of ownership and control, it introduces a new separation of ownership and control, this time in the hands of the hedge fund as an active shareholder. As such it will likely trigger the kinds of response that raiders provoked in the 1980s. This is yet a small set of raider activism and there is the potential for market solutions, but it is likely this is one area where a legal response is likely and appropriate.