Hedge Funds & Poison Pills: Can typical hedge fund activism really be considered a reasonable threat under Unocal?

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At a time when hedge fund returns have been stagnating and failing to meet expectations in the period from 2004-2007, they have also attracted significant amounts of capital as investors have eagerly sought to secure above market returns.\(^1\) Pressured to perform in the wake of the 2008 financial crisis, hedge funds have turned to shareholder activism as a means of maximizing profits and increasing their returns on investment, seeking to influence corporate policy and, if necessary, hold underperforming managers accountable. With significant amounts of funds available at their disposal, they have the means to pressure management and directly influence corporate policy through the use of proxy contests.

However, despite the recent legal reforms and court decisions that have deregulated proxy contests, poison pills has proven to be a daunting antitakeover mechanism, inhibiting a hedge fund’s ability to wage cost effective proxy contest without tying up large amounts of funds. Moreover, under Unocal, management may avail themselves of the business judgment rule if they are able to prove that the perceived a reasonable threat to corporate policy and took a proportional response to threat.

Therefore, in order to acquire an in depth understanding of the intricacies over whether hedge fund activism can really be considered a reasonable threat to corporate policy under Unocal, this paper will discuss (I) hedge funds as active investors, (II) the necessity of shareholder activism, (III) the specifics of hedge fund activism, (IV) how activist hedge funds influence corporate policy, (V) potential concerns over hedge fund activism and (VI) the poison pill as a deterrent to hedge fund activism activism.

I. Hedge Funds as Active Investors

Hedge funds are very different from other types of public and private equity funds in terms of objectives and strategies. These differences play a major role in explaining why hedge funds are particularly well-suited for their role as shareholder activists promoting change. In order to understand these differences, it is necessary to understand (1) how the fee structure of hedge funds allows the interests of fund managers and investors to align, (2) why the compensation structure of hedge funds provides incentives for fund managers to monitor the targets in which they invest and (3) how the regulatory framework affecting hedge funds allows them to monitor the targets in which they invest effectively.

1. The Fee Structure of Hedge Funds Promotes the Alignment of Manager and Investor Interests

While public equity funds, such as mutual funds and pension funds, usually charge a flat percentage fee based on the assets under management, regardless of the manager’s ultimate performance, private equity fund managers usually retain a percentage of any profits they produce as a result of their performance.\(^2\) Since the compensation of public equity funds is correlated to the size of the assets under management, they have a vested interest in seeking slow

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steady returns and attracting new capital through a combination of advertizing and cost reduction. Therefore, since performance matters only to the extent that it provides an additional advertizing venue, public equity fund managers are not incentivized to monitor their investment actively and are unlikely to make efforts to improve the performance of companies in which they invest.

The compensation framework of private equity funds, such as hedge funds, allows a manager to retain a “carried interest”, that is to say a percentage of any profits. The concept behind the “carried interest” is that a fund’s investors are entitled to receive 100% profits until their investment is paid back in full. Once they have been repaid, they will share any additional profits with the manager. For example, if investors invest $100 million in a hedge fund levying a 20% fee and the fund yields a net profit of $10 million, the fund manager will receive $2 million and the investors will receive $108 million (their initial investment amount and 80% of the net profit).

Moreover, the risk of managers taking excessive risks, especially when the fund is yielding losses, is tempered by the fact that managers are usually required to invest a significant portion of their personal wealth in the fund. The risk of managers remaining conservative and risk-averse is tempered by the fact that managers must reach a certain threshold yield before they may charge a carried interest. Therefore, since managers share in both the profits and losses of the fund, they are incentivized to make investments that will maximize profits.

Since fund managers are entitled to a direct share of the profits and this incentive never disappears or decreases, the interests of hedge fund managers and their investors is aligned as both seek to maximize their profits. Although hedge funds usually charge their investors a management fee that is intended to account for the firm’s expenses, this fee is returned before a manager receives any carried interest. Therefore management fees do not have an impact on the fundamental alignment of interests between investors and fund managers, both players seeking to maximize their profits.

2. A Hedge Fund’s Incentive to Monitor

Due to the nature of private equity funds, particularly hedge funds, they usually seek to acquire control over a limited portfolio of corporations, securing their investment by influencing management and prompting it to take actions that favor shareholder interests, thereby reducing

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agency costs. There are several distinct categories of private equity funds, such as venture capital funds, hedge funds and leveraged buyout funds, all of which develop and pursue a different strategy for maximizing returns, competing against each other based on their relative ability to reduce agency costs or inefficiencies. According to the Securities and Exchange Commission (SEC), a hedge fund is “an entity that holds a pool of securities and perhaps other assets, whose interests are not sold in a registered public offering and which is not registered as an investment company under the Investment Company Act.”

By reuniting ownership and control in their investments, hedge funds effectively resolve the fundamental agency issue of corporate law, achieving annual returns that can range from 20-40%. By aligning the objectives of hedge fund managers and investors, namely profit maximization, hedge funds have proven to be an effective means of reducing internal agency costs. Therefore, unlike public equity funds that have little incentive to monitor, the compensation framework and structure of hedge funds provide important incentives for managers to efficiently monitor the companies in which they invest.

Beyond the incentives to monitor induced by the compensation framework of hedge funds, it is also important to distinguish the average size and capital available to both hedge funds and mutual funds. On average, mutual funds held approximately $964 million under management in 2004. As a result of their size, mutual funds enjoy significant economies of scale in so far as they will usually own a greater number of shares of a corporation than typical investors. The average size of hedge funds is approximately $100 million, with the largest hedge funds totaling over $10 billion in assets. With most hedge funds being independent investment vehicles, in so far as they are not affiliated with any other institution, the largest hedge funds can freely deploy large amounts of funds in developing and effectively implementing a strategy. Therefore, hedge funds are effective monitors because they have a vested interest in maximizing returns because

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of their fee structure, striving to achieve high absolute returns, rather than returns relative to an index, and performing well in order to retain existing investors and attract new ones.20

3. The Regulatory Framework Facilitates Hedge Fund Monitoring

Although the compensation and fee structure of hedge funds play an important role in the incentive to monitor investments actively, the regulatory framework is also important. The lack of regulation on hedge fund managers has encouraged the development of a market that incentivizes managers to engage in active monitoring, whereas more stringent regulation on public equity fund managers has inhibited their ability to engage in active monitoring.21

However, without a compensation framework that provides incentives to monitor, public equity funds are likely to continue in their pursuit of passive investment strategies, regardless of whether legal barriers are relaxed.22

Mutual funds, for example, are subject to specific disclosure requirements in so far as they must file semiannual lists showing the amounts and values of the securities under management.23

This increases the difficulty for mutual funds to accumulate positions in targeted companies without the entire market become aware of their activities.24 Moreover, to qualify for significant tax benefits, they must comply with the diversification requirements found under subchapter M of the Internal Revenue Code.25 Pursuant to these requirements, a fund may not own more than 10% of the outstanding securities of a portfolio company in 50% of the assets under management and the stock of any portfolio company may not constitute more than 5% of the value of the assets of the fund.26

In 2003, the SEC adopted rules that compel registered investment advisers to vote proxies “in the best interest of clients”, while registered mutual funds must disclose both their proxy voting policies and how they actually voted.27 The implementation of these rules has led mutual funds to hire Institutional Shareholder Services (ISS) to vote these shares in their stead, resulting in additional costs and a strategy change because ISS has a distinct tendency towards engaging in shareholder activism.28 For example, ISS voting policies usually support weak poison pills that must be ratified by shareholders within a year and voting against board members that do not

follow this approach. Moreover, ISS has become increasingly willing to support dissident candidates, thereby weakening corporate defenses. Therefore, in practice, because of their reliance on ISS, mutual funds in particular have developed an indirect tendency towards shareholder activism, even if they are not quite as active as hedge funds. Unlike public equity funds, hedge funds usually seek to avoid these regulatory schemes, relying on the Investment Advisers Act of 1940 to avoid registration and the use of private advisers. Previously, hedge funds could be exempt from regulation under the Investment Advisers Act if they limited the number of investors in the fund to 15. This allowed hedge funds to remain exempt from most disclosure requirements and enabled them to engage in risky investment strategies with their investors’ consent. However, the Private Fund Investment Advisers Registration Act of 2010 virtually eliminated this exemption. Consequently, hedge funds have to maintain and file reports with the SEC on the assets under management, the use of leverage, trading and investment positions, and types of assets, unless the hedge fund is relatively small and foreign-based. However, since more than half of hedge fund managers were already registered with the SEC by 2009 and those who managed $100 million or more already had to report their holdings quarterly by filing a Form 13F with the SEC, the new registration requirements are likely to have very little effect on hedge fund operations.

Moreover, the structure of hedge funds is also designed to take advantage of the exclusions in the securities law as well as exempt them from key mandates of the Securities Act of 1933 and the Securities Exchange Act of 1934. This does not mean that hedge funds are unregulated. They still remain subject to antifraud provisions in the securities and commodities laws and the anti-fraud provision of the Advisers Act. Hedge funds must also comply with general rules that seek to protect investors, such as disclosure requirements under section 13(d) of the Securities Exchange Act, which require disclosure by persons who own more than 5% of the equity securities of a public company, and the short-swing profit rules under section 16(b), which are applicable to officers, directors, and 10% shareholders of a company. Consequently, although hedge funds remain subject to some regulatory constraints, these limitations are far less than those imposed on other types of investment funds. These rules provide hedge funds with a comparative advantage over other investors and do not limit their incentive to monitor.

II. The Necessity of Shareholder Activism

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The corporate system in the United States is characterized by separation between ownership and control. In theory, shareholders monitor the elected directors, who act as the shareholders’ fiduciary in managing the company. The right to vote allows investors to effectively monitor management by replacing managers in the event that they fail at their task. Consequently, if a company’s board of directors makes a poor decision, such as maintaining unnecessary and excessive cash balances or adopting a corporate policy that ostracizes the market, causing its stock price to drop, anyone could purchase the company’s shares after they drop and rapidly replace the directors or, in so doing, convince them to adopt a new corporate policy. These steps should then compel management to make the right choices, causing the stock price to rise and allowing the intervening activist to earn a profit by selling the stock. Therefore, in order to understand the necessity of shareholder activism, it is important to consider whether (1) directors should be in control of a company or (2) shareholders should be in control of a company and (3) the types of activism available to shareholders in their exercise control.

1. Director Primacy

Pursuant to the tenants of director primacy, boards usually exercise control over the corporation because a strong board can reduce agency costs and improve efficiency through direct control.\(^{39}\) However, director primacy has an important shortfall, in so far as the theoretical framework justifies the exclusion of shareholder control, thereby limiting the effectiveness of shareholder activism and their influence over management.\(^{40}\) Therefore, an activist hedge fund, for example, cannot believe in director primacy until it is in control of a board of directors, otherwise it would not have become a shareholder activist attempting to influence management or replace it.\(^{41}\)

Reliance only on the fiduciary duty of directors to manage the company effectively is insufficient. To comply with his duty of loyalty and care, a director needs only be honest and tolerate independent committee board procedures.\(^{42}\) Most management decisions are protected by the business judgment rule, which essentially condones any actions performed by directors, provided that they are not grossly negligent.\(^{43}\) With courts being reluctant to second-guess management decisions that do not clearly violate a director’s fiduciary duties, shareholders cannot rely on the fiduciary duties of a director to protect them and ensure positive returns on their investment.\(^{44}\)

In light of the proliferation of anti-takeover strategies enacted by management, reliance on the disciplining effect of takeovers has also proved, in the past, to be an insufficient mechanism for ensuring the protection of shareholders. However, as a result of the increase in capital available


\(^{43}\) See In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 52-62 (Del. 2006) (holding that the board was not grossly negligent in firing the CEO); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985) (applying the gross negligence standard); Kamin v. American Express Co., 54 A.D.2d 654 (N.Y. 1976) (finding that the distribution of a dividend is protected by the business judgment rule); Sinclair Oil Corp. v. Levi en, 280 A.2d 717 (Del. 1971); In re Citigroup Inc. Shareholder Derivative Litigation, 2009 WL 481906 (Del. Ch. Feb. 24, 2009) (finding that directors that acted in good faith but made a poor business decision were protected by the business judgment rule); In re the Goldman Sachs Group, Inc. Shareholder Litigation, 2011 WL 4826104 (Del. Ch. Oct. 2011) (finding that the board is protected by the business judgment rule if it made an informed decision about the compensation scheme).

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to hedge funds, the possibility of successfully running a proxy contest against an incumbent board is becoming a reality. 45 Therefore, an actual or threatened proxy contest can be a direct and effective means of influencing corporate policy and governance. This is particularly true in Delaware, where antitakeover defenses, such as poison pills, do not usually work against proxy fights. 46

2. Shareholder Primacy

Pursuant to the theory of shareholder primacy, shareholders should be in control of the corporation. 47 However, in practice, this seldom occurs because of collective action issues affecting strategic shareholder activism, such as conflicts of interest between the various shareholders, legal obstacles, management’s power to override shareholder influence and insufficient incentives to prompt shareholders into action, due to the cost and time associated with exercising the voting rights necessary to access control. 48 Specifically, since strategic activism is expensive, the investor must anticipate that the benefits it will derive will outweigh the costs, especially since an offensive shareholder activist usually bears all the costs associated with the intervention while receiving a benefit proportional to its stake in the company. 49

Meanwhile, other shareholders can enjoy the “free ride” without bearing most of the financing and transaction costs of a proxy campaign. 50 Financing costs include forgoing the benefits of risk-spreading available to passive diversified investors and expending substantial amounts of liquidity in exchange for shares in the target company. 51 Transaction costs include expenses spent identifying and investigating potential targets, expenses resulting from broker commissions and the price of purchasing shares on the open market rather than negotiating the purchase with a private shareholder and communication expenses used in financing the proxy contest (security filings, distribution of materials to shareholders and fees owed to individuals, such as attorneys, advisers and investment banks). 52

If shareholders are unwilling to monitor management because of shareholder apathy, which many experts view as inevitable, the relationship allowing for the efficient reduction of agency costs is severed. 53 This is an issue of critical importance because without robust monitoring, managers can use their discretion to make business decisions that benefit themselves at the expense of shareholders. 54 In light of this problem, the essential concern has become how

54 Robert C. Illig. What Hedge Funds can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight, 57 Am. U.L. Rev. 225, 269 (2007) (arguing that the scandals of Enron and WorldCom are manifestations of the phenomenon that weak monitoring encourages
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Shareholders (the owners) can effectively control and monitor the directors and managers (the agents) while minimizing the monitoring costs designed to limit the aberrant activities of the agents.\textsuperscript{55}

Hedge funds, however, are different from other shareholders, including public equity funds, in so far as they have a vested interest in accessing corporate power directly by winning board seats and making its voting franchise effective.\textsuperscript{56} The business model of a hedge fund consists in using aggressive strategies in acquiring assets and securities in the hope that they will appreciate over time.\textsuperscript{57} Although the cost of shareholder activism may dissuade most potential investors because the costs can exceed the benefits,\textsuperscript{58} this is not the case for hedge funds because of the size of the funds under management.

If management is underperforming or not acting in the best interest of the company, a hedge fund may use the resources at its disposal to intervene and replace the underperforming incumbents or block harmful transaction. By rectifying the deviation caused by the incumbent management, the hedge fund can enhance the value of the target company and profit when the stock price increases to reflect the value of the correction. Therefore, unlike public equity funds that diversify, the fee structure of hedge funds incites managers to monitor closely and directly their investments through direct control or influence, while the availability of funds allows them to engage in strategic shareholder activism.

3. Types of Shareholder Activism

Public equity funds, such as mutual funds and pension funds, have typically engaged in passive shareholder activism, waiting for other shareholders to make proposals and voting on those that align with their interests.\textsuperscript{59} This type of activism tends to be incidental and ex post, in so far as the funds will become active once the company’s governance regime is defunct or the company is already underperforming.\textsuperscript{60} Part of the reason for this strategy is because traditional institutions face regulatory hurdles, political constraints and conflicts of interests, which render offensive activism less profitable. Moreover, passive activism is suitable to the diversification objective of public equity funds.

However, in order to facilitate change, should change be needed, mutual funds have usually refused to support corporate governance rules that allow the current board to entrench their position in the corporation.\textsuperscript{61} Unlike hedge fund activism that is directed at influencing specific aspects of corporate decision making, such as spin-offs and mergers and acquisitions, mutual funds focus on modifying corporate governance rules.\textsuperscript{62} By engaging in such tactics, mutual funds can achieve subtle changes in multiple companies at a relatively low cost. However, this
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type of activism is unlikely to drastically alter the corporate strategy of the company, making it unsuitable for turning around underperforming companies rapidly.63

Defensive shareholder activism occurs when an investor with a pre-existing stake in a company becomes dissatisfied with corporate performance or governance and reacts by seeking change, whether by negotiating directly with management or engaging it publicly, such as through a proxy contest.64 In these situations, the shareholder is acting ex post that is, after having already acquired shares. Although the shareholder is unlikely to be successful with only the existing shares at his disposal, this can act as a useful platform for advocating change, garnering support and eventually launching a proxy contest.65 This type of shareholder activism is usually pursued by mutual funds and pension funds that become active in order to protect the value of their existing investments.66

Offensive shareholder activism is more suited for investors, such as hedge funds, that pursue activism as a profit making strategy.67 It is strategic and ex ante, which means that hedge fund managers first determine whether a company would benefit from activism, then take a position and become active. Driven by the belief that the company is not currently maximizing shareholder returns, the hedge fund will encourage change to unlock shareholder value.68 Since strategic activism is expensive, it requires a fund to take comparatively large positions in few companies,69 anticipating that the benefits it will derive will outweigh the costs.

In theory, an offensive hedge fund can launch a tender offer if it believes it can benefit from the deal.70 Hedge fund activists believe that greater control over their investments, through board representation, can increase their returns.71 However, they are rarely interested in acquiring the corporation or sufficient voting power to succeed in a proxy contest on their own because it would involve tying up substantial capital, preferring to profit as a minority shareholder when performance improves once corporate policy had been modified.72

Proxy fights and the threat of proxy fights operate more as a means of efficiently and effectively exercising control over directors, supplementing the purely legal alternatives.73 The threat of a proxy contest often results in a compromise rather than an outright victory for either hedge funds or management.74 If the hedge fund is actually willing to go through with the proxy contest, the threat is credible and provides leverage for the fund. However, even when hedge funds commence a proxy contest, they usually seek only minority representation on the board.75 At this point, it is important to distinguish between attempts to use a sizeable minority stake in a public company as a platform to advocate change and bids to obtain full voting control.76 The

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former is a key element of offensive shareholder activism, whereas the latter pertains to accessing the market for corporate control.\textsuperscript{77}

III.  Hedge Fund Activism

While shareholder activism has been defined as “the exercise and enforcement of rights by minority shareholders with the objective of enhancing shareholder value over the long term”,\textsuperscript{78} “hedge fund activism” exacerbates this exercise and enforcement of these rights by initiating or threatening to initiate a proxy contest or any other concerted and direct attempt to change the fundamental strategic direction of any solvent public corporation other than a mutual fund.\textsuperscript{79} Hedge funds can play a pivotal role in overcoming the classical agency problem of public traded companies by replacing underperforming managers, challenging ineffective strategies or proposing positive alternative strategies and ensuring that mergers and acquisition are in the best interest of the company.\textsuperscript{80} Therefore, they are particularly well-suited to be activists and play a role in re-establishing the owner-agent relationship, especially if the interests of a hedge fund activist are aligned with those of the target company. In light of these considerations, it is important to explore (1) the strategy adopted by most hedge funds and (2) their ability to exert pressure on management in order to better understand (3) the threat posed to hedge fund activism by the use of poison pills.

1.  Hedge Fund Strategy

The investment strategy of activist hedge funds usually reflects the belief that the companies share are undervalued, have low dividend payout ratios and have a low share price relative to book value, despite having sound returns on assets and operating cash flows.\textsuperscript{81} Rather than simply adopting a passive approach and waiting for the market to self-correct the anomaly, activist hedge funds are prepared to take the initiative and accelerate the turnaround of the company, lobbying for change and seeking to influence management in order to increase shareholder returns.\textsuperscript{82} Hedge funds usually try to influence financial or capital structure decisions, strategic decision or simply engage in discussions with management to identify new strategies. Strategic goals tend to be the most difficult to influence because it usually conflicts with the strategic vision and plan of management.

This involves identifying a company that would benefit from activism and developing a corporate strategy that would raise its share price in order to maximize the fund’s profits. In identifying an appropriate target, hedge funds typically rely on the “value approach”,\textsuperscript{83} targeting a corporation that remains undervalued despite being profitable and having a sound operating cash flow. Once a suitable strategy has been devised, the fund managers must find a way to pressure the company’s management into adopting the strategy.\textsuperscript{84}

\textsuperscript{78} Armour Brian R. Cheffins John. The Past, Present, and Future of Shareholder Activism by Hedge Funds, 37 Iowa J. Corp. L. 51, 56 (2011).
\textsuperscript{80} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1050 (2007).
\textsuperscript{82} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1050 (2007).
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usually probe management with a phone call, e-mail or letter, urging management to agree to implement the hedge fund’s proposal designed to increase shareholder value. 85

As agents of change with specific objectives, a hedge fund’s strategy will depend on the particular target company, although hedge funds usually seek to incite management to adopt finance-oriented changes. For example, if a company is diversified, the hedge funds will seek divestitures. 86 Hedge funds will increase the balance sheet of corporations by pushing for the sale of non-core assets or a change in management if the company is underperforming. In situations where the corporation has excess cash available, the hedge fund will lobby the company to engage in stock repurchases or one-off dividend distribution to shareholders. 87 When the company has assets on its balance sheet that can be monetized, such as real estate, they lobby to monetize those assets. 88 A hedge fund activist may even lobby for an outright sale of the target as a result of financial concerns or through divestiture of key operations. 89 Hedge funds also sometimes lobby in favor of increased operational efficiency and reputedly began putting more emphasis on strategic changes when the credit markets tightened as a result of the 2008 financial crisis, increasing the difficulty for target companies to engage in financial engineering, hedge funds have advocated for an increase in operational efficiency, pushing for strategic changes instead of financial engineering. 90

2. Exerting Private Pressure on Management

Although hedge funds try to avoid proxy contest due to the high costs involved and the fact that managing a corporation falls outside the scope of action of a hedge fund, achieving sweeping changes through behind-the-scenes negotiations without the shareholder’s efforts becoming public is almost impossible. 91 First, if management is not receptive to the investor’s proposed changes, the investor must either give up on the proposed changes or go public. Also, if management is aware of the investor’s reluctance to go public, management’s incentive to agree and adopt the proposals is limited. Unlike most investors however, hedge fund activists are willing to launch a proxy contest for corporate control if necessary.

Second, private negotiations do not allow other investors to learn of the proposal and lend their support to the proposal, effectively preventing it from using concerted and coordinated efforts to pressure management. Since federal proxy rules have imposed significant costs on shareholders that seek to communicate with others about outstanding proxy proposals, hedge funds proposals tend to be advisor or require a proxy contest before they are adopted. 92 If the hedge fund seeks to adopt coordinated pressure with other investors, it could be considered a group and fall under

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the scope of the Securities Exchange Act, which would require a public filing. Given the scarcity of such filings and the absence of any reports to the contrary, it is likely that traditional investors do not coordinate when trying to pressure management privately.

Despite the federal proxy rules that make it more difficult for hedge funds to coordinate their pressure on management, hedge funds have a tendency to “attack” companies in wolf packs (i.e. other hedge funds targeting the same entity that are careful not to form group defined in Schedule 13D). If this causes management to reexamine their businesses and “review basic strategy” accordingly, corporate governance has unquestionably been improved. In particular, decisions such as In Hallwood Realty Partners, L.P. v. Gotham Partners, L.P., have allowed hedge funds to engage in “wolf pack” tactics against companies without having to fear that they will be considered a group merely because the target the same entity.

If private negotiations fail to produce the desire results, the hedge fund can increase pressure by openly criticizing management or threatening to initiate a lawsuit. If this fails, the hedge fund can launch a proxy contest for board control. However, beyond the pecuniary expenditures and federal proxy contest rules, a shareholder must overcome the legal obstacles that make it burdensome for shareholders to acquire more than 5 or 10% in a company. Consequently, by launching a proxy contest, hedge funds are sending a clear signal to the board and other potential targets that they are prepared to invest heavily in order to attain their objectives.

3. Poison Pills: A Tangible Threat to Hedge Fund Activism

A more important concern to the market is the danger posed to shareholder activism by the use of the poison pill. The role of the board of directors in a hostile tender offer has changed in recent years under Delaware law. A hostile tender offer, usually a public invitation made by an investor to all shareholders of a corporation to tender their shares for a limited time for a specified price, is a takeover mechanism by which an investor seeks to acquire a controlling interest in the target corporation. Previously, directors were practically powerless against tender offers because tender offers were made directly to the company’s shareholders and did not require the director’s approval.

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98 Thomas W. Briggs. Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 Iowa J. Corp. L. 681, 691-92 (2007) (finding that ISS phenomenon described earlier appears to assist in drawing additional “wolves” to the “prey”. ISS backed dissidents won 12 out of the 13 proxy fights for board seats and 1 ISS backed management dissident won out of 4 contests. Despite proxy contest guidelines that state that ISS follows a case by case approach, practice has revealed that ISS has a pronounced tendency to back dissidents. When ISS backs dissidents, they usually win).

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Under the Delaware General Corporation Law 105 and the Securities Exchange Act of 1934, the role of the directors was limited to providing an opinion to shareholders about the merits of the tender offer, assisting shareholders in their evaluation of the offer. 106 However, with the advent and judicial sanctioning of antitakeover devices to prevent unsolicited tender offers, the target board has taken a more prominent role in the tender offer process. 107 The ability to enact an antitakeover device, or redeem an existing one, has vastly increased the target board’s power to defeat, or at the very least, greatly inhibit unsolicited tender offers and proxy contests not approved by the board. 108

The poison pill (also known as “Shareholder Rights Plan”) is an antitakeover mechanism that essentially attaches dormant rights to each share of a corporation’s common stock. 109 These rights are activated when an investor acquires a certain percentage of the company’s outstanding shares, usually 15-20%. 110 Poison pills are usually triggered when the corporation receives a hostile offer to acquire shares from shareholders at a specified price, typically at a significant premium to market price. Although shareholders would like to tender their shares because of the premium, managers block the offer with defensive tactics, arguing that the long-term value of the firm is higher than the offer price. 111

Once triggered, all the shareholders, except for the shareholder triggering the pill, are allowed to purchase additional shares in the corporation at a significantly discounted price, thereby diluting the ownership position of the shareholder having triggered the pill and rendering a hostile bid unprofitable and unfeasible. 112 Before a shareholder’s rights become exercisable, the board of directors typically has the opportunity to redeem these rights. 113 This provides the board of directors with flexibility when the corporation is presented with a tender offer, in so far as it allows the poison pill to take effect, or, should the board consider the offer to be in the best interest of shareholders, redeem the rights and disable the defensive measures. 114

This assumption of power in the tender offer context creates an inherent conflict of interest for the directors of the targeted corporation. 115 The fiduciary duty of directors to the shareholders requires them to maximize shareholder value, such as the company’s stock value. 116 This duty

106 Gregg, H. Kanter, Judicial Review of Antitakeover Devises Employed in the Non-Coercive Tender Offer Context: Making Sense of the Unocal Test, 138 U. Pa. L. Rev. 225 (1989) (citing SEC Rule 14e-2, issued under the Securities Exchange Act of 1934, requires the target board to recommend acceptance or rejection of the tender offer, to express neutrality towards the offer, or to state reasons for an inability to take a position on the offer, within 10 days after the commencement of the offer.)
112 Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 182 (Del. 1986) ("[W]hen it became apparent . . . that the break-up of the company was inevitable...[t]he duty of the board...changed from the preservation of [the target company] as a corporate entity to the maximization of the company’s value at a sale for the stockholders’ benefit...[O]btaining the highest price for the benefit of the stockholders should have been the central theme guiding director action.").
Hedge Funds & Poison Pills:
Can typical hedge fund activism really be considered a reasonable threat under Unocal?

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When they try to influence the management decisions of targeted companies. Examples of corporate governance activism include the pressure exercised by Pershing Square, a hedge fund, on McDonalds, prompting it to sell company owned restaurants and spinning off major assets in an IPO. In 2005, Carl Icahn, a notorious hedge fund manager, pressured Time Warner into changing its business strategy and spinning off Time Warner Cable and other divisions. Hedge funds have also pushed for a merger between Euronext and Deutsche Borse, although this attempt ultimately failed.

Some of the recent targets of Third Point, a hedge fund with approximately $4 billion under management, include Ligand, Salton, Western Gas Resources, Massey Energy, Potlatch, Intercept, Warnaco, Penn Virginia, and Star Gas Partners. In the case of Star Gas Partners, a heating oil distributor, Third Point acquired a 6% stake in the company. In an attempt to acquire corporate governance of the corporation and replace management, they criticized the CEO Irik Sevin’s management of the company and attacked him personally, stating that: “It is time for you to step down from your role as CEO and director so that you can do what you do best: retreat to your waterfront mansion in the Hamptons where you can play tennis and hobnob with your fellow socialites.” Third Point’s strategy worked and the CEO resigned a month later as a result of the pressure exercised by Third Point.

Carl Icahn’s hedge fund has also been active, purchasing blocks in companies and pressuring them to change corporate policy. He even allied with Jana Partners in order to acquire a position in Kerr-McGee and press for change. This strategy resulted in a corporate restructuring of Kerr-McGee, which sold off its chemicals unit and its North Sea oil fields. More recently, Icahn has pressed for several changes in other corporation, such as Blockbuster, where he gained a board seat; Time Warner, where the company agreed to increase the size of its share repurchase program and add some independent directors to its board; KT&G, where the group led by Icahn gained board representation; and Motorola, where he is seeking board representation.

2. Corporate Control Activism in Corporate Transactions

Corporate control focuses essentially on the authority to make essential corporate decisions, such as capital allocations, mergers and acquisitions and key financial decisions. Corporate
control activists engage in transactions that involve a change of corporate control.\textsuperscript{133} The hedge funds engaged in corporate control activism usually focus on direct economic issues, such as blocking or forcing a corporate sale, or otherwise enhancing value with a stock buyback, asset sale, or other similar effort.\textsuperscript{134} In these situations, corporate governance issues are of secondary importance. Destaggering a board of directors is only valued as an objective to the extent that it enhances the economic performance of the hedge fund.\textsuperscript{135}

Hedge funds have been actively involved in opposing several proposed acquisitions, successfully improving the terms of the transaction. For example, in 2005, Novartis, the Swiss pharmaceutical giant, proposed to acquire 58\% of Chiron, a biotech company.\textsuperscript{136} Novartis made a tender offer for $40 per share before increasing it to $45 per share as a result of negotiations and pressure from Chiron’s independent committee.\textsuperscript{137} ValueAct Capital, a hedge fund and the third largest shareholder of Chiron, opposed the deal. This initiated shareholder revolt, with the second largest shareholder of Chiron, Legg Mason, joining ValueAct Capital in opposition to the transaction.\textsuperscript{138} This forced Novartis to increase its tender offer to $48 per share.\textsuperscript{139} By blocking the deal, ValueAct Capital’s intervention effectively increased the sale price and benefited Novartis shareholders.

Moreover, should a hedge fund be dissatisfied with the terms of an acquisition and be unable to obtain better terms, it will not hesitate to resort to litigation. Rather than forcing shareholders to receive the merger consideration, hedge funds have filed statutory appraisal actions, in which shareholders receive a court-determined fair value.\textsuperscript{140} For example, when the majority shareholder of Emerging Communications (ECM), Innovative Communications, sought to acquire EMC for $10.25 per share,\textsuperscript{141} Greenlight Capital, a hedge fund, intervened. Greenlight Capital increased its stake in ECM from 500,000 shares to 750,300 shares after the acquisition was announced, seeking appraisal for their shares.\textsuperscript{142} In conjunction to the appraisal suit, a plaintiff’s law firm filed a fiduciary duty action after the freeze-out merger was consumed.\textsuperscript{143} Having acquired litigation rights for over 2 million ECM shares, Greenlight objected to the settlement proposal that provided for $115,000 in legal fees and no additional payments to shareholders.\textsuperscript{144} Consequently, both the appraisal and the fiduciary duty action proceeded to trial, where the court found that $38.05 per share was the fair value. Therefore, Greenlight was

\begin{footnotesize}
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\item \textsuperscript{133} Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1029, 1034 (2007).
\item \textsuperscript{136} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa.L. Rev. 1021, 1037 (2007).
\item \textsuperscript{138} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
\item \textsuperscript{140} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
\item \textsuperscript{141} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
\item \textsuperscript{142} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
\item \textsuperscript{143} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
\item \textsuperscript{144} Marcel Kahan Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1037 (2007).
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awarded $38.05 per share in addition to compounded interest for its appraisal shares and $27.80 per share for damages (the difference between the fair value and the merger consideration).145

3. Corporate Control Activism in Acquiring Targets

Unlike traditional institutional investors, hedge funds are not limited to compelling third parties to acquire corporations. In some situations, a hedge fund will attempt to acquire these companies themselves as part of a strategy aimed at improving the company’s capital or governance structure or even just to sell off at a later time, thereby emerging as controlling shareholders of industrial corporations.146

GenCorp’s acquisition by Steel Partners is a good example of an acquisition offer that prompted corporate governance changes. GenCorp’s ownership of over 12,000 acres of undeveloped land in Sacramento attracted the interest of various investors.147 In November 2004, Steel Partners, a hedge fund, made public its intention to acquire GenCorp for $17 per share.148 The board rejected the offer, so the fund threatened to initiate a proxy contest.149 By February 2005, GenCorp and Steel Partners had come to an agreement. In return for Steel Partners promise to cast its votes in favor of GenCorp’s nominees, the board allowed a representative of Steel Partners to attend board meetings and the board’s consideration of corporate governance changes proposed by Steel Partners. In addition, the board would seek to appoint a new independent director with expertise in corporate governance, who would be identified through consultation with Steel Partners.150 In this process Steel Partners acquired corporate control over GenCorp, enabling it to effectively influence the corporation’s policy.

Another example of a hedge fund acquiring a target and increasing value can be seen with ESL’s acquisition of Kmart. In February 2002, Kmart filed for bankruptcy, emerging from Chapter 11 in May 2003.151 When it emerged, ESL, a hedge fund run by Edward Lampert, was Kmart’s largest shareholder. ESL had acquired $2 billion in financial claims for $200 million. These claims were converted into stock in the reorganization, giving ESL ownership over 50% of the company.152 At the time Kmart emerged from bankruptcy, its stock was valued at $15 per share.153 However, by July 2004, ESL had managed to unlock the value of Kmart’s real estate. By selling off stores, Kmart accumulated $2.2 billion and increased the value of its shares to $76 per share.154 Moreover, by November 2004, with ESL’s guidance and influence, Kmart was pushed into a merger with Sears.155 On news of the merger, Kmart’s shares rose to $109 per share, Sears shares also increased.156 This is an example of how a hedge funds knowledge and funds can be used in order to unlock the untapped value of a company.

145 In re Emerging Commc’ns, 2004 Del. Ch. LEXIS 70, at 155.
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V. Concerns with Hedge Fund Activism 

Despite the fact that hedge fund activism can be a beneficial force, academics and practitioners have raised several issues that provide that the interests of hedge funds sometimes diverge from those of their fellow shareholders, which can have negative repercussion on the company and its shareholders. Consequently, it is useful to address these concerns in order to acquire a better understanding of how the concerns over (1) conflicts of interests, (2) empty voting and (3) a tendency towards investing over the short term period, are ultimately tempered by other considerations that act as a counterbalance.

1. Conflicts of Interest 

As a result of the compensation structure of hedge funds, they seek to monitor corporations and influence corporate policy in order to maximize their profits and those of their investors. However, this strategy does not always benefit a target’s shareholders overall. For instance, a hedge fund may invest in a company by purchasing shares to increase their influence over management only to pursue a strategy that will increase the value of another company at the expense of maximizing the share price of the company.

In the event that a hedge fund seeks to acquire a company in which it has invested, its interests will not align with those of other shareholders of the targeted company. The hedge fund will seek to acquire the shares as cheaply as possible, whereas the shareholders will seek to obtain the highest price for their shares. However, the conflict of interest in this situation is obvious, allowing management and shareholder to take appropriate measure.

This is not the case when a hedge fund’s activities in the event of a merger or a sale, where the hedge fund is more interested in ensuring that the transaction is consummated, rather than ensuring that the shareholder overall receive the highest price. Hedge funds were on both sides of the proposed acquisition of MONY, a public trade life insurance company, by AXA, a large French insurance company. Highfields held nearly 5% in MONY and sought to oppose the deal, running a public add in the Wall Street Journal, convincing ISS to recommend to shareholder to oppose the deal and founding a website to assist MONY shareholder exercise their appraisal rights.

However, mutual funds also suffer from conflicts of interests that impair their ability to effectively monitor companies. Many mutual funds are affiliated with another financial institution, such as an insurance company or investment bank. For example, of the twenty largest mutual fund complexes in 2003, nine had such affiliations. Since managers of these mutual funds may be reluctant to alienate current or potential clients of their parent company as a

result of their activism, they may simply avoid the issue by not engaging in corporate governance activism in the first place.\textsuperscript{165} For example, the found and former head of Vanguard, John Bogle, suggested that merely voting against management could “jeopardize the retention of clients of 401(k) and pension accounts.”\textsuperscript{166} Therefore, corporate government activism could result in the loss of business not only for the mutual fund but also for the entire institution.\textsuperscript{167}

2. Empty Voting

The conflict of interest caused by empty voting and negative voting are also problematic. Empty voting essential exploits the separation of legal and beneficial ownership of shares, allowing a shareholder to vote without having an economic stake.\textsuperscript{168} Empty voting occurs “when an investor takes a short position equal to his equity interests in a company, enabling him to vote without concern of any downside risks”,\textsuperscript{169} whereas negative voting occurs when the investor hedges his position enough to have an incentive to cast his vote in a way that is contrary to the best interests of the company.\textsuperscript{170} The growth in equity swaps and equity derivatives have facilitated the ability of hedge funds to decouple their economic interests from their voting power.\textsuperscript{171}

The problem with decoupling can be best understood with the 2004 merger deal between Mylan Laboratories (“Mylan”) and King Pharmaceuticals (“King”).\textsuperscript{172} When Mylan announced its agreement with King for a stock merger, which valued King at a 61.8\% premium over the trading price, Mylan’s stock price fell from $18.51 to $15.51 per share.\textsuperscript{173} The deal was considered to have a positive impact for Mylan but negative on for King. Carl Icahn subsequently acquired a 6.8\% ownership in Mylan and, after filing a Schedule 13D, he announced his intention to launch a proxy contest to oppose the merger deal.\textsuperscript{174} However, this strategy directly conflicted with the strategy of Richard C. Perry, a hedge fund management who had acquired King’s shares and sold short Mylan’s shares in the anticipation of both companies consummating the merger.\textsuperscript{175} In order to secure his investment, Perry acquired 10 percent of Mylan to vote in favor of the merger and entered into an equity swap with several investment banks to hedge his economic exposure to Mylan’s share price, thereby giving a 10\% ownership vote without any economic interest in Mylan.\textsuperscript{176}

Despite the negative impact of decoupling economic interests from voting power, it is important to keep in mind that there exist limitations to their use. Hedge funds can be deterred from implementing value-decreasing strategies through investor and reputational sanctions or disclosure requirements that would enable board to implement tactics that could counteract the negative impact. Moreover, in the absence of empty voting, the effect of conflicted votes is self

\textsuperscript{171} William W. Bratton, Hedge Funds and Governance Targets, 95 Geo. L. J. 1375 (2007)
\textsuperscript{172} William W. Bratton, Hedge Funds and Governance Targets, 95 Geo. L. J. 1375 (2007)
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limiting, in so far as hedge fund are likely to be on both sides of the issue, their votes cancelling out, which was the case in the Mylan King merger.\textsuperscript{177}

In addition, it is important to note that the typical shareholder activism of hedge funds does not work well with empty or negative voting strategies. As senior partner of Cevian Capital, a European-based activist backed by U.S. investors, explained, "If you’re going on the board [of directors] you can’t be shorting companies."\textsuperscript{178} "Correspondingly, activist hedge funds were highly vulnerable to the falling stock prices associated with the financial crisis.\textsuperscript{179}

The corporate governance activities of hedge funds are typically conducted publicly, hedge funds issuing public releases prior to reaching the 5\% threshold mandating disclosure of adverse positions under section 13(d).\textsuperscript{180} The filling of a 13D schedule can shed light on information that would otherwise remain private, such as the presence of a conflict of interests through a empty or negative voting strategy.\textsuperscript{181} Specifically, section 13 (d) requires that a hedge fund disclose any contract or arrangement where the hedge fund has an economic interest.\textsuperscript{182} In the Mylan-King merger, it was the section 13(d) requirement that compelled Perry to reveal his hedged positions. As a result of this requirement, hedge fund activists rarely pursue strategies that will not withstand public scrutiny.\textsuperscript{183} Those that do not pursue such strategies will usually refrain from initiating a high-profile proxy fight or purchasing enough shares to require a Schedule 13D filing.\textsuperscript{184}

Pursuant to the SEC’s proxy antifraud rule and the U.S. Supreme Court’s interpretation, shareholders must include all “material” facts in their filings. A fact is considered to be “material” if a reasonable shareholder would consider the facts to be important in deciding how to vote.\textsuperscript{185} However, the vague definition of the term “group” can be problematic when trying to apply section 13(d) and the poison pill. Pursuant to rule 13-5, “when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of an issuer, the group formed thereby shall be deemed to have acquired beneficial ownership.”\textsuperscript{186} Consequently, the concerted action of shareholders will trigger the reporting requirements under § 13(d). However, the fact that multiple hedge funds target the same company for the same reasons does not, per se, establish the formation of a group.\textsuperscript{187}

For shareholders that own 10\% of the company, the insider ownership reporting rules of the SEC require that the shareholder disclose derivative positions as well as direct stock ownership, prohibiting short sales entirely.\textsuperscript{188} Since most hedge fund activists do not seek to exceed the 10\% threshold in the first place, these rules do not usually apply to them.\textsuperscript{189}
3. Short Term Investing

Some commentators believe that hedge funds focus on short term strategies that will yield profits rapidly at the expense of the long-term development of the company. However, this is not entirely accurate because the assumption that hedge fund activists are short-term investors has not been supported and it fails to consider the fact that the pursuit of short-term interests does not necessarily preclude promoting the long-term development of a company. Moreover, it fails to account for reputational sanctions, the presence of other investors that act as a deterrent to value decreasing activities and the fact that hedge funds will be compelled to become long term investors once they achieve board representation.

The argument that hedge fund activists pursue short term strategies is misguided because it presumes that hedge funds hold equity in a target company for only a brief period of time and that management strategy is not more short-term oriented. If these assumptions were correct, in order for hedge funds to generate profits in the short term, the market would need to consistently undervalue long-term investments relative to short-term investments or, at the very least, fail to take into account the long-term investment value in the stock price. In practice however, investor interests in both short-term and long-term tend to align.

A recent study investigating how long hedge fund activists held equity of their target companies found that investments typically lasted at least two years, 81% of them holding equity in a target company for three years or exiting when the company was sold during 2002-2004. According to Warren Lichtenstein, a notorious activist hedge fund manager and founder of Steel Partners II, stated in 2004: “The best situation is where we find a cheap stock with great management and a great business, and we can sit back and make money.” However, he also noted that when his hedge fund acquired shares, “Many times managements are happy there’s a long-term, supportive investor.” Therefore, it would appear that hedge funds usually invest over the long term.

Moreover, corporate managers may be interested in adopting short term strategies themselves, such as exaggerating earning, hiding losses or otherwise distorting the company’s financial statements in order to meet market expectations, as was the case in Kamin v. American
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Express Co.\(^{198}\), a derivative action where management chose to distribute dividends because it did not affect the profits on the company’s income statement, rather than selling shares at a loss which would have saved the company money but negatively impacted profits and possibly causing the company to miss its earning target.

Beyond the fact that hedge fund managers may be deterred from engaging in strategies favoring short term interests over long term interests because of the potential impact on their reputation,\(^{199}\) they are also unlikely to succeed because of the presence of other investors who value a long term approach. Should a hedge fund engage in offensive shareholder activism with a short term perspective in mind at the expense of the long-term interests of the target company, other shareholders who value longer-term interests will likely act as a counterbalance, supporting management in the event of a proxy contest.\(^{200}\) In particular, institutional investors, such as pension funds and mutual funds, have a tendency to support management, unless they are seriously dissatisfied with management or convinced that management is underperforming.\(^{201}\)

In 2005, Carl Icahn was unable to acquire the support of other shareholders and called off the proxy contest before it was initiated against Time Warner Cable.\(^{202}\) This example illustrates that, although shareholder apathy may inhibit shareholders from actively seeking change, its effects are lessened when they must choose whether or not to endorse hedge fund proposals. Therefore, hedge funds must ultimately persuade the market and shareholder to support them if they are to be successful. If hedge funds do provide proposals beneficial to the company, other shareholders, even other hedge funds, may simply free ride by supporting the proposals.\(^{203}\) Therefore, they provide an opportunity for other investors to voice their concerns by supporting hedge funds in the event of a proxy contest.\(^{204}\)

However, hedge funds need not always engage in a proxy contest in order to influence corporate governance. Sometimes, hedge fund activist can influence corporate governance by voicing its dissatisfaction with management and the board, proposing change and alternative strategies. The board or management may agree with the proposals, negotiate a compromise or reject the proposals.\(^{205}\) Consequently, the threat of a proxy contest acts as a means of influencing corporate governance by providing management and the board with an incentive (the fear of losing the proxy contest) to negotiate and, at the very least, listen to the proposals.

If a compromise cannot be reached, the hedge fund may have to consider defeating management in a proxy contest.\(^{206}\) In such situations, a hedge fund will not succeed in waging a proxy contest without the support of other shareholders, provided that the hedge fund has not

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\(^{198}\) 54 A.D.2d 654 (N.Y. 1976)


\(^{206}\) Chueh, Kuang-Wei Chueh Is Hedge Fund Activism New Hope for the Market?, 2008 Colum. Bus. L. Rev. 724, 754 (2008) (finding that without a shareholders’ resolution or restriction set forth in the article of incorporation or bylaws, the business of a corporation shall be managed by or under the direction of a board of directors. See Del. Code Ann., tit. 8, § 141(a) (2007).
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acquired sufficient shares to determine the outcome. Even though hedge funds have become more active in the area of corporate governance and purchased sizeable positions in companies due to their efforts to influence corporate strategies, they rarely acquire a controlling stake. Since they rarely acquire more than 5-10%, the support of other shareholders is paramount to their success.207

Once a hedge fund has secured direct board representation, federal securities laws require it to become a long term investor, especially since the fund will be precluded from selling its shares freely in the market if it communicates with the company about company business and some indeterminate time after the board relationship ends.208 If the fund’s directors are elected to the board after a proxy contest, they ultimately owe a fiduciary duty to the corporation, not the fund.209 However, if a fund only manages to achieve minority representation, this can increase tension between the fund and the board. Due to the collegiality of a board, dissident directors may be alienated by the board members and excluded from any managerial decision making.210 However, sometimes, a highly effective dissident prove useful in blocking transactions or even assuming a leadership role.

VI. The Poison Pill: Inhibiting Hedge Fund Activism

Given that hedge fund activism is generally value increasing and hedge funds typically make long term investments in target companies, they appear to be a positive force in the market. Not only do they have an incentive to monitor because of their fee structure and the alignment of interest between investors and hedge fund managers, but hedge funds also have the assets to engage in shareholder activism without being limited by a stringent regulatory framework. A catalyst for change, hedge funds target undervalued companies and seek to influence corporate policy in order to turn the company around, increasing the targeted company’s long term value as well as the value to shareholders. However, the implementation of poison pills and staggered boards by boards of directors that consider hedge fund activism as a threat to corporate policy jeopardizes the ability of hedge funds to effectively influence corporate policy and enhance a company’s value.

With its decision in Unocal, the Court has provided guidance about the application of poison pills and their validity. In particular, the decision provides insight into the issue by developing a standard of review under which the implementation of a poison pill by a board of directors can be assessed. Consequently, it is necessary (1) to understand the Unocal standard of review in order (2) to evaluate its effect on hedge fund activism and (3) determine whether hedge fund activism can reasonably be considered as a threat to corporate policy under the Unocal standard.

1. The Unocal Standard of Review

Although the board of directors of a Delaware corporation is charged by Delaware General Corporation Law211 with managing the business and affairs of the corporation, it also has a

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common law fiduciary duty to act in the shareholders’ best interest. This fiduciary duty consists of two components: the duty of loyalty and the duty of due care. The fiduciary duty of loyalty requires directors to act for corporate purposes rather than in their own self-interest, whereas the duty of care requires the directors to have an informed basis for action.

Before the *Unocal* decision, the Delaware courts enforced the directors’ fiduciary duties by employing two distinct standards for review of directors’ actions: (i) the business judgment rule and (ii) the entire fairness test.

Under the business judgment rule, directors need only demonstrate that their decision can be “attributed to any rational business purpose.” This presumption can be rebutted if it is proven that the “director’s decisions were primarily based on perpetuating themselves in office, or some other breach of fiduciary duty such as fraud, overreaching, lack of good faith, or being uninformed.” Although courts rarely find that directors have breached their fiduciary duty under the business judgment rule because of the difficulty of proving these elements, there are several reasons for applying the business judgment rule. Not only do courts lack the necessary expertise to make substantive evaluations of business decisions, but also any court-made evaluation will have the benefit of hindsight. Moreover, the rule shields directors from personal liability, thereby encouraging informed risk taking and preventing qualified directors from turning down directorships because of the risk of liability. The entire fairness review is usually applied to situations in which directors are involved on both sides of the corporate transaction because there is a risk that they will indulge in self-dealing. This test requires that

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1986) (“Under Delaware law the business and affairs of a corporation are managed by and under the direction of its board of directors.”); *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173, 179 (Del. 1986) (“The ultimate responsibility for managing the business and affairs of a corporation falls on its board of directors.”); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953 n.6 (Del. 1985) (“The general grant of power to board of directors is conferred by . . . § 141(a), which provides: (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . .”).


206 *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958.


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courts examine the substantive merits of the corporate transaction and uphold it only if the directors can demonstrate that the entire transaction was fair to the company. 222

In Unocal, Mesa made a tender offer for Unocal in an attempt to gain control. The offer was two-tiered and front-loaded, in so far as Mesa would make a cash purchase of 37% of the Unocal stock for $54. With 37%, Mesa would obtain a controlling block in the company and could use its majority control to force a freeze-out merger. The stockholders would get junk bonds valued at $54. The board of directors considered the hostile tender offer as a threat, in part because of its coercive nature, in so far as it incited shareholders to tender their shares in order to receive $54 in cash rather than junk bonds, regardless of whether the price offered was actually fair or adequate. In essence, the shareholders would not be tendering their shares in a free and voluntary manner. Consequently, after careful consideration, the board enacted a poison pill under which the corporation would purchase its own shares for $72 per share, thereby forcing Mesa to increase the price of its tender offer in order to be successful.

In order for a poison pill to be valid under the Unocal test, directors must show that (i) “they had reasonable ground for believing that a danger to corporate policy and effectiveness existed”;223 and (ii) “the defensive measures undertaken are reasonable and proportional to the perceived threat.”224 Applying Unocal, the Delaware Supreme Court in Moran approved the legality of board’s implementing poison pill.225 Therefore, under Unocal, the directors must first show that they implemented the defensive measure to protect corporate policy rather than perpetuate themselves in office, before showing that their response was proportional to the perceived threat. If they satisfy the Unocal test, the actions of the directors is protected by the business judgment rule.226


223 Unocal, 493 A.2d. 946, 955 (citing Cheff v. Mathes, 199 A.2d 548, 554-55 (Del. 1964)). In determining whether the bid posed a threat, management must show “show a good faith and reasonable investigation” and may consider the effect of the bid on non-shareholder constituencies. Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341-42 (Del. 1987) and Revlon, Inc. v. MacAndrews & Forbes Holdings, 506 A.2d 173, 180-81 (Del. 1986) Moran v. Household Int’l, 500 A.2d 1346, 1356 (Del. 1985) (discussing factors that led directors to reasonably believe that the tender offer posed a threat); Polk v. Good, 507 A.2d 531, 537 (Del. 1986) (finding that good faith and reasonable investigation were not sufficient without reasonable “reasonable grounds for a justifiable belief by the directors that there was a threat”); Grand Metro. P.L.C. v. Pillsbury Co., 558 A.2d 1049, 1059-60 (Del. Ch. 1988) (finding that, despite demonstration of good faith and reasonable investigation, there was no threat to “corporate policy and effectiveness”).

224 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955. The reasonableness test under Unocal “entails an analysis . . . of the nature of the takeover bid and its effect on the corporate enterprise.” Appropriate concerns “may include: inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders . . . , the risk of non-consummation, and the quality of securities being offered in the exchange.” The court determined that the board’s decision to offer what it determined to be the fair value of the corporation to 49% of its shareholders, who would otherwise be forced to accept highly subordinated “junk bonds,” was reasonable and consistent with the directors’ duty to ensure that the minority stockholders receive equal value for their shares. Moreover, the 11-hour board meetings helped to prove that the board had performed a reasonable investigation and reached its decision in good faith. It is also important to note that the tender offer was coercive and a board could reasonably believe that it would not maximize shareholder value.

225 Moran v. Household Int’l, Inc., 500 A.2d 1346, 1348 (Del. 1985) (holding that the poison pill satisfied the Unocal test and that the Unocal test was applicable to poison pills that were adopted by board of directors and to poison pills that were not redeemed after the pill was triggered. The Court discusses a board’s duty when faced with a request to redeem the pill: “[T]hey will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards . . . as they were held to in originally approving the Rights Plan.”); Michal Barzuza, The State of Antitakeover Law, 95 Va. L. Rev. 1973, 1981 (2009) (finding that “while Delaware courts approved the poison pill, they invalidaded “dead hand pills” and “slow hand pills”, which are two extreme types of poison pills that are inconsistent with management fiduciary duties and exceed their authority. The former limits the redemption of the pill only to continuing directors (or their approved successors) and the latter makes the pill non-redeemable and non-amendable for a certain period of time”); Joseph M. Grieo, The Ever-Evolving Poison Pill: The Pill in Asset Protection and Closely Held Corporation Cases, 36 Del. J. Corp. L. 625, 629 (2011).

226 Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (finding that, although board decisions are typically subject to the business judgment, a higher standard is needed to assess defensive measures: “[b]ecause of the omnipresent specter that a board may be acting primarily in its own interests . . . there is an enhanced duty which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.”

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2. Impact of Unocal on Hedge Fund Activism

In order to provide a recourse against the potential abuse made by directors seeking to entrench themselves, the Court emphasized that the use of poison pills would be scrutinized under the Unocal standard of review, not only when the pill is initially adopted by the board of directors, but also when the directors do not redeem the rights after the pill is triggered.  

However, there are several reasons why affording managers with the protection of the Business Judgment Rule is undesirable. First, knowing that managers have the possibility of using their power to impose a challenging obstacle to hedge fund activism may dissuade hedge funds from actually investing in the first place, leading to renewed shareholder apathy. Second, since managers would be less prone to hostile takeovers or the disciplinary pressure from the market for corporate control, they may become more resistant to hedge fund influence.

The pill has substantially altered the dynamic of hostile tender offers, the resulting effect being a substantial transformation in the market for corporate control. In particular, the poison pill effectively limits a bidder’s ability to acquire shares, forcing the bidder to pursue a proxy contest unless it has the board’s approval. If a staggered board is in place the bidder must wage two proxy contests to gain control of the board since only one third of a typical classified board is elected each year, making any attempt to secure corporate control even more difficult, onerous and time consuming.

Although the advantages offered by the use of a poison pill are non-negligible, in so far as it provides management with the ability to effectively reject inadequate offers or offers it considers may be harmful for long-term shareholder value, the potential for abuse remains ever present. More importantly, it presents a series of interesting conundrums. A non-coercive tender offer only truly threatens shareholder interests to the extent that the price tendered is less than “full” value or a higher value in an alternative transaction. If the tender offer is given the opportunity to succeed, shareholders may not obtain the “full” value and the tender price. However, if the antitakeover device thwarts the tender offer, denying shareholders the opportunity to tender their shares at a premium, and the directors are unable to realize the “full”

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227 Moran v. Household Int’l, Inc., 500 A.2d 1346, 1354 (discussing a board’s duty when faced with a request to redeem the pill: “[T]hey will not be able to arbitrarily reject the offer. They will be held to the same fiduciary standards . . . as they were held to in originally approving the Rights Plan.”).


230 See Account v. Hilton Hotels Corp., 780 A.2d 245, 249 (Del. 2001). (upholding a corporation’s right to adopt a poison pill: “[i]t is settled Delaware law that a corporation chartered under the laws of this State may adopt shareholder rights plans.”)

231 Unitrin Inc. v. Am. Gen. Corp., 651 A.2d 1361, 1379, 1385-86 (Del. 1995) (“If a board selected one of several reasonable alternatives, a court should not second guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination.” (citing Paramount Commc’n, Inc. v. QVC Network, Inc., 637 A.2d 34, 45-46 (Del. 1994)).

232 Air Prods. & Chems, Inc. v. Airgas, Inc., 16 A.3d 48, 113. (finding that the combination of a poison pill and a staggered board are not preclusive under the Unocal test).

233 Gregg, H. Kanter, Judicial Review of Antitakeover Devises Employed in the Non-Coercive Tender Offer Context: Making Sense of the Unocal Test, 138 U. Pa. L. Rev. 225, 243 (1989) (citing BNS, Inc. v. Koppers Co., 683 F. Supp. 458, 475 (D. Del. 1988) (“[T]he inadequacy of the offering price does present a threat to the company and its stockholders.”); Grand Metro, PLC v. Pillsbury Co., 558 A.2d 1049, 1056 (Del. Ch. 1988) (“Whatever danger there is relates solely to shareholders and that concerns price only.”); Robert M. Bass Group v. Evans, 552 A.2d 1227, 1241 (Del. Ch.) (“The Court thus concludes that if the [noncoercive] offers posed a cognizable, reasonably perceived threat, it was only in the minimal sense that the [tender price], although fair, is less than the highest price that the defendants’ financial advisors believed might be obtained [through alternative means].”), appeal dismissed sub nom. MacMillan, Inc. v. Robert M. Bass Group, 548 A.2d 498 (Del. 1988). See Intercpl, Inc. v. Koppers Co., 558 A.2d at 797-98 (“Even where an offer is noncoercive, it may represent a ‘threat’ to shareholder interests in the special sense that an active negotiator with power, in effect, to refuse the proposal may be able to extract a higher or otherwise more valuable proposal, or may be able to arrange an alternative transaction or a modified business plan that will present a more valuable option to shareholders.”); AC Acquisitions v. Anderson, Clayton & Co., 519 A.2d 103, 112 (Del. Ch. 1986) (stating that a tender offer at a “fair” price might not be in shareholders’ best interest if they prefer an alternative developed by the directors).
value, the shareholders will lose the difference between the original tender price and the subsequent value of the target’s stock.\(^{234}\)

In the event that a company is greatly undervalued as a direct result of poor management, the use of a poison pill would insulate the board by making it more onerous for a hedge fund to acquire sufficient shares to wage a proxy contest. Although this is not directly an issue for hedge funds, since they usually seek to acquire only 5-10% of a target’s shares, it greatly weakens the hedge fund’s ability to pressure management. Moreover, even though a board might pass the Unocal standard of review, the shareholders are adversely impacted by the opportunity cost of either having to maintain capital in an otherwise undervalued company, or selling their shares and taking a loss. Therefore, in a world where time is money for many investors, the poison pill not only increases the costs of hedge fund activism (reducing the cost-benefit of activism), but it also increases the time before which underperforming managers can be replaced.

These issues are of particular relevance in so far as they pose an important obstacle to the offensive activism of hedge funds. Seeing an opportunity to increase the value of a company rapidly by replacing management or influencing corporate policy, they are prevented from being effective by the poison pill. This is what has happened to Carl Icahn when he tried to expand his investment in Netflix. Netflix had lost nearly three quarters of its value following several management mistakes in 2011 and Mr. Icahn sought to increase his investment because he considered Netflix undervalued.\(^{235}\) However, Netflix’s shareholder rights plan was triggered when he acquired more than 10% of the company, even though investors have welcomed Mr. Icahn’s investment, which drove the company’s shares up 14%.\(^{236}\) However, Netflix’s management has claimed that “[i]ts goal is to maximize long-term value for shareholders,” refusing to redeem the poison pill.\(^{237}\)

If one considers that directors are responsible for the corporate decision making structure, then shareholders effectively become a monitoring device, the purpose of which is to monitor the directors and make them accountable for their actions. Since directors derive their power from being elected by shareholders, it is reasonable to believe that directors should not be able to impede shareholders in replacing directors that underperform. Although stock prices are not a reliable or exact metric of board performance and corporate success, it is a useful tool in determining whether shareholder wealth is being maximized and whether management underperformance warrants replacement. Therefore, this raises question whether a shareholder’s duty to monitor and take the steps necessary to replace management should be considered a reasonable threat to corporate policy, especially if the corporate policy is the cause of the target company being undervalued.

### 3. Hedge Fund Activism is not a Reasonable Threat under Unocal

Although some may argue that hedge fund activism poses a threat to corporate policy and effectiveness because hedge fund strategy focuses on exerting influence over corporate control or corporate governance, this view does not account for the degree of control hedge funds actually seek to exercise. Hedge funds are rarely interested in acquiring a target corporation or

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\(^{234}\) Gregg, H. Kanter, Judicial Review of Antitakeover Devises Employed in the Non-Coercive Tender Offer Context: Making Sense of the Unocal Test, 138 U. Pa. L. Rev. 225, 254 (1989) (citing Paramount Communications, Fed. Sec. L. Rep. (CCH) at 93,265 (“It is very unlikely that the market price of Time stock immediately following consummation of the now planned two-stage Warner transaction will equal the initial $ 175 price offered by Paramount.”); Grand Metro. PLC v. Pillsbury Co., 558 A.2d 1049, 1058 (Del. Ch. 1988) (noting potential loss to shareholders “if the Pill remains in place and Grand Met’s offer is withdrawn”).


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sufficient voting power to ensure success in a proxy contest because it would involve a significant investment into one company. Instead, hedge funds seek to locate an undervalued company, determine whether activism could benefit the corporation and profit as a minority shareholder once performance improves due to the changes in corporate policy they advocated. Since hedge funds do not have a vested interest in running a company, they typically do not seek to acquire actual control over a company or make drastic changes, only to influence policy by providing alternative strategies or influencing specific transactions. Therefore, in order to influence corporate control and corporate governance, hedge funds are not seeking to acquire actual control but rather secure access to these methods of control in order to assist in implementing beneficial strategies that will enhance the long term value of the target company.

Even though hedge funds usually try to avoid engaging in proxy contests because of the high costs, which decrease a hedge fund’s profitability, hedge funds are prepared to take the initiative to turnaround an undervalued company by initiating a proxy contest. Although the prospect of a proxy contest may appear threatening, the purpose of the proxy contest is only a means of exerting pressure on management until it adopts the strategy advocated by the hedge fund. Without the possibility of hedge funds running a proxy contest, management could easily disregard beneficial strategies proposed by hedge funds and other shareholders and continue to pursue a corporate policy that was ineffective. Consequently, since a hedge fund’s initiation of a proxy contest is not inherently in the best interest of management or the hedge fund, its purpose is to act as a balancing mechanism, meant to make management accountable for underperforming and pressure management rather than actually threatening to make fundamental changes in corporate policy.

In Yucaipa Am. Alliance Fund II, L.P. v. Riggio,238 the threat to corporate policy by hedge fund activism was ever present because the hedge fund (Yucaipa) clearly voiced its intention to acquire up to 50% of Barnes & Noble’s shares239 and, in doing so, there was an imminent threat that the corporation’s shareholders would relinquish control without receiving a control premium.240 Although this case pertained to a situation in which the hedge fund was obviously not engaging in typical hedge fund activism, posing a conspicuous threat to corporate policy, the discussion provided by Vice Chancellor Strine offers valuable insight into which factors play crucial roles in determining when hedge fund activism becomes a threat.

Yucaipa had expressed the intention to acquire up to 50% of the company and initiated a proxy contest in order to gain access to corporate control and governance. A successful proxy contest would provide Yucaipa with access to corporate control, limiting “the incumbent board majority’s ability to be intransigent in the face of stockholder sentiment.”241 Moreover, Yucaipa confirmed its intention to exert considerable control of Barnes & Noble when it doubled its stake in the company over a short time period, increasing its stake to 17%, and published its 13D disclosure forms, which publicly criticized Barnes & Noble’s policies.242 In its 13D filings, Yucaipa clearly stated that it reserved the right to make proposals to acquire all the company shares and propose M&A transactions.243 Meanwhile, the fact that Burkle, Yucaipa’s manager,
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was meeting with key HP executives and investment bankers with the prospect of forcing Barnes & Noble into a partnership agreement revealed that Yucaipa was determined to dictate its strategies upon Barnes & Noble. Therefore, Yucaipa’s actions and expressed statements confirmed its intention not only to gain access to corporate control and governance, but also to exert significant influence on management decisions, regardless of whether management was in agreement.

While Yucaipa was increasing its stake in Barnes & Noble, Eichler, the manager of Aletheia, a California-based investment advisor, increased its stake in Barnes & Noble from 6.37% to 17.44%, nearly tripling its stake in the company. This alerted Barnes & Noble of the possibility of both Yucaipa and Aletheia taking control of the company, especially since Burkle and Eichler both met on the day Burkle complained in a letter about Barnes & Noble’s College Booksellers deal and after the Rights plan was implemented. Therefore, Yucaipa and Aletheia’s behavior strongly suggested that both managers planned to use their stakes in the company concert to exert considerable control over management, thereby posing a direct threat to corporate policy since they could unilaterally impose the strategies they advocated.

Moreover, by effectively wielding voting control, which they would acquire without paying a control premium; Yucaipa and Aletheia could impose strategies, such as the leveraged buyout strategy envisioned by Burkle. If the leveraged buyout strategy were implemented, Yucaipa and Aletheia would effectively become equity investors and other shareholder would be cashed out. This strategy would greatly benefiting Yucaipa and Aletheia at the expense of other shareholders. Given Yucaipa prior history of investing in companies and treating other shareholders differently, using its influence and control to make important managerial changes, the Vice Chancellor Strine found that the threat to corporate policy perceived by Barnes & Noble was legitimate.

By proposing to enter into a partnership with a technology company, revamp the company’s product offerings, adding independent directors to the board, proposing M &A transactions and, more importantly, possibly taking the company private in a leveraged buyout, the hedge fund was not seeking to gain access to corporate governance and control like a typical hedge fund, but rather outright control. Therefore, it is not surprising that the Court found that the hedge fund posed a reasonable threat to corporate policy. Had Yucaipa not only refrained from openly expressing and acting on its desire to exert significant control over the company but also avoided mentioning the possibility of a leveraged buyout that would negatively affect other shareholders, the Court may have determined that Yucaipa’s initiation of a proxy contest and acquisition of almost 20% in Barnes & Noble did not pose a reasonable threat or that a poison pill was not a reasonable response.

VII. Conclusion

Consequently, typical hedge fund activism is only concerned with access to corporate control and governance as means to influence corporate policy, not drastically altering it or acquiring

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244 Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 349 (Del. Ch. 2010).
249 Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 313 (Del. Ch. 2010).
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full control over it. At its core, hedge fund activism only seeks to effectively exercise and enforce the shareholder right franchise in order to enhance shareholder value over the long term. Since hedge funds are usually attracted to undervalued targets, hedge fund activism centers on replacing underperforming management, challenging ineffective corporate strategies or proposing beneficial alternatives and ensuring that transactions are in the best interest of the company, thereby maximizing shareholder value. However, when access to corporate control and governance permeates the management structure and begin to take on distinct features of outright control, hedge fund activism crosses the line and becomes a threat to corporate policy.

In light of the foregoing considerations, it is clear that typical hedge fund activities do not constitute a reasonable threat under Unocal because they do not pose a reasonable or real threat to corporate policy or effectiveness, notwithstanding the hedge fund’s intent to make a tender offer or acquire a majority ownership of the company. In fact, because of the value increasing nature of typical hedge fund activism in its efforts to challenge the failing corporate policy of underperforming companies, hedge funds effectively act as a catalyst for shareholder activism, allowing other shareholders to act as a balancing force.