The Limits of Hedge Fund Activism

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Preliminary Draft—Please do not quote or cite without the permission of the author
Abstract

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

To evaluate this phenomenon of hedge funds as shareholder activist, the paper beings with a look at the four major prior responses to the problem of separation of ownership and control since Berle and Means first framed corporate governance in those terms in 1932. The reach and limits of those illustrations provides a setting to frame the relative strength of hedge funds as they move into this role as shareholder champion. A second necessary framework to understanding the current activities of hedge funds is the core structure of corporate law that narrowly defines what any shareholder can do. Against this backdrop, the economic incentives of hedge funds as governance activists are re-examined. The business plan which hedge funds have followed toward shareholder activism are not unique or endogenous to the governance process such that the same characteristics of nimbleness and aggressiveness that have made hedge funds effective as activist might take these funds elsewhere. And of greater concern, these same hedge funds portrayed as the way to bridge the separation of ownership and control have themselves used innovative financial instruments and strategies to create their own separation of ownership and control that ultimately will cabin their effectiveness as an activist shareholder.
The Limits of Hedge Fund Activism

Robert B. Thompson∗

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

This article examines hedge fund activism against the backdrop of this long-running separation debate. Economic incentives and legal regulation are such that hedge funds have advantages over previous contenders for the mantle of shareholder protector. The conflicts they experience seem less disabling; they seem better able to provide incentives for their management and are less constrained by liquidity pressures than institutional investors earlier seen as possible shareholder champions. Yet other economic realities cabin the extent to which hedge funds can fully occupy the stage as a constraint on managers. First, governance activism is for hedge funds a tool to make money, one of many that these funds use. The

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

2 David A. Katz and Laura A. McIntosh, Corporate Governance: Advice on Coping with Hedge Fund Activism, Wachtell, Lipton, Rosen & Katz memo at 1 May 26, 2006 (“Every decade needs a villain; in the 1980s, it was corporate raiders, in the 1990s, it was corrupt executives. And in the 200s it appears to be activist hedge funds.”); Hedge Funds Are the New Sheriffs of the Boardroom, Wall Street Journal December 4, 2005 at a2 (Sarbanes and Oxley have been knocked out of first place on the list of bogeymen haunting the corporate boardroom.)
same nimble characteristics that have brought hedge funds into the governance arena can also take them out as new barriers to their activism arise and new opportunities for their money occur elsewhere. Second, the current fascination with this new, new thing has obscured that hedge fund activism as a disciplinary device is less than plenary, focused more on mid-cap companies where there is an opportunity for financial, as opposed to strategic gains and likely to be most prominent during the “up” portions of the economic cycle.

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

This latest chapter of the separation debate, like its predecessors, is necessarily framed within a legal system in which shareholder power is intentionally limited. Shareholders do only three things in corporate governance—they vote, sell and sue, each in limited doses.3 The ability of hedge funds to act as a brake on corporate managers necessarily must reflect those limits as well as the economic limits mentioned above. And this shareholder role also reflects the longstanding concern that too much shareholder power may sometimes turns not to be the best for the corporation, a view that has informed the legal system’s willingness to sustain defenses developed by managers in prior shareholder uprisings. While hedge funds are better positioned to supply antidotes to some of the current defenses against shareholder activism, they cannot ignore the boundaries of the field of play imposed by corporate law.

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This article proceeds as follows. The initial sections briefly set out the core problem of separation of ownership and control as presented by Berle and Means in 1932 and the solution that have emerged prior to hedge funds. While this part is intentionally cursory, it does seek to provide necessary links so as to be able to position hedge funds as a reflection of tools implemented in earlier era. The hedge fund portion of the paper begins with a typology of the contexts in which hedge fund activism is present in current corporate governance contests followed by a concise framework of the legal structure for the role of shareholders. This part focuses particularly on the room accorded management in previous eras to narrow or shut down the voting and selling avenues for shareholder action and partial antidotes which developed in response. Part III addresses the advantages hedge funds possess as shareholder activists as compared to earlier players. More attention is devoted to the areas in which hedge fund activism is more problematical as foreshadowed in the earlier paragraphs of this introduction. The article closes with section summarizing predicted trends for shareholder activism that flow from this analysis and the extent to which there is a need for a legal response.

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

A. Berle and Means

Economist Gardiner Means and lawyer Adolf Berle in their 1932 book set out to describe the revolution that had changed the fundamental nature of profit-seeking enterprises.\(^4\) They saw the separation of ownership and control in the early 20\(^{th}\) century American corporation as having destroyed “the very foundations on which the economic order of the past three centuries have rested.”\(^5\) Berle and Means documented the dispersion of ownership and the evolution of control toward management control as the new

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\(^4\) Adolf A. Berle, Jr. & Gardiner C. Means, The Modern Corporation and Private Property at 7 (1932) (quasi-public corporation may fairly to be said to work a revolution in destroying the unity of ownership and control).

\(^5\) Id at 8.
paradigm. Historian Alfred Chandler set the move within the series of economic changes of size, greater productivity and the growth of a professional managerial class that spurred the move from entrepreneurial capitalism to financial capitalism to managerial capitalism. The move, first visible in the railroads and telegraph companies of the late 19th century, was widespread among large American companies by the end of World War I and became standard within the succeeding generation.

With Berle and Means having given the popular label to this agency cost problem, successive generations of writers and reformers have sought to identify solutions to this separation, although the economic facts giving rise to their concern have not disappeared. Hedge funds, thus, follow in the line of: (i) efforts to empower shareholders through the federal securities laws; (ii) the takeovers movement of the early 1980s that for the first time saw widespread use of markets and the shareholders' power to sell as a discipline on managers; (iii) the leveraged buyout and private equity movement of the same era that suggested a finance driven response via an organizational structure that eliminated the separation by eliminating the public ownership; (iv) the new focus in the 1990s on institutional investors as activist shareholders. Each of these efforts showed weakness as well as strength and each provoked reaction. Evaluation of the staying power of hedge funds and governance players should be informed by the evolution of these earlier efforts.

Berle and Means expressed the core concern that this separation of ownership and control displaced the “traditional logic of profit” dating back to Adam Smith, that by an individual seeking profit, the individual satisfies the wants of others. They saw the modern corporation as having wrought such a change as to have made the

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

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

8 Id at 417, (by 1917 the majority of mergers structured like GE and DuPont); id at 451 (with a generation that type of management had become standard.)

9 Berle and Means, supra note 4 at 338.
traditional concepts of competition and profit inapplicable and calling for new concepts to be forged.\textsuperscript{10} Their preferred solution, judicially enforced duties on management toward passive owners\textsuperscript{11} and to the community\textsuperscript{12} have not shaped the search for solutions as completely as their book framed the problem. But their concern about the breakdown of the traditional logic of profit and whether individual pursuit of self-interest produced societal good echoes a current concern about hedge funds: do the different economic incentives available to hedge funds as a short seller through use of other sophisticated financial strategies mean that their voting or other individual action operates to the detriment of the common good.


As Congress considered its legislative response to the stock market crash of 1929 and the Great Depression, a recurring concern was corporate management overreaching of shareholders on things within the traditional shareholder realm, such as approval of mergers and election of directors.\textsuperscript{13} Congress chose not to replace state corporate law, but it did seek to shift the balance between managers and shareholders by shoring up shareholders’ ability to act in response to management. Disclosure was a principal feature of this approach, particularly information mandated by Section 14(a) of the Securities Exchange Act of 1934 to be provided to shareholders when they were solicited for proxies as to their voting rights.\textsuperscript{14} These efforts were a response to the economic position of dispersed shareholders with relatively small stakes in corporations and the rational apathy that was a likely result. There is little incentive for an individual shareholder to incur costs to become informed and

\begin{flushleft}
\textsuperscript{10} Id at 351.
\textsuperscript{11} Id at 221 (the law governing the duties of management toward security owners is perhaps the only section of corporate jurisprudence which has not undergone a substantial weakening process.)
\textsuperscript{12} Id at 356 (Control groups have placed the community in a position to demand the modern corporation serve not alone the owners or the control but all society...Control should develop into a purely neutral technocracy balancing a variety of claims by various groups.)
\textsuperscript{14} 15 U.S.C. §78n(a). As Berle and Means put it, “the shareholder is practically reduced to the alternative of not voting at all.” Id at 87.
\end{flushleft}
collective action problems abound in shareholders coordinating a response. Yet this federally mandated support of shareholder voting did little to produce real shareholder activism. Proxy fights to replace directors occurred only in a small number of companies each year.

The Securities and Exchange Commission moved beyond a focus on disclosure as to information before the shareholder body, by expanding the ability of individual shareholders to control the agenda of those items to be presented to the shareholders. By Rule 14a-8, the SEC has provided shareholders a sometimes powerful means to contest issues of corporate policy.\(^{15}\) For most of the period of this rules existence, this platform was largely a vehicle for discussion of social issues in the larger society—to debate issues of war and peace, or environmental or animal rights issues.\(^{16}\) More recently, this forum has provided a vehicle for shareholder voice as to governance issues such as classified boards and the process for election of directors.

What is particularly relevant for this discussion of hedge fund activism is the extent to which this activism is necessarily framed by the limited governance role provided to shareholders by corporate statutes. All state corporations statutes provided that all corporate powers will be exercised by the board, not the shareholders.\(^{17}\) Shareholders get to elect directors, and to vote on mergers or amendments to articles, but only after the board has asked them to do so.\(^{18}\) The federal access to proxy rule is carefully framed to apply to precatory proposals only, recognizing that shareholders can only ask, but not compel the board to do something (and implicitly raising the possibility of a voter rebellion if they don’t). The effectiveness of this strategy will ultimately depend on the likelihood that this implied threat can be carried forward.

\(^{15}\) 17 C.F.R. §240.14a-8.

\(^{16}\) See e.g. Lovenheim v. Iroquois Brands, Ltd. 618 F. Supp. 554 (D.D.C. 1985) (shareholder proposal relating to company distribution of pate de foie gras raising issues of force-feeding of geese.)

\(^{17}\) Mod. Bus. Corp. Act § 8.01.

\(^{18}\) Mod. Bus. Corp. Act §§ 7.28, 10.01, 11.02.
In 1968, Congress broadened the reach of the Securities Exchange Act to address shareholder selling as well as voting. The Williams Act expanded disclosure obligations to require information be available to shareholders who were facing a decision as to whether to tender their shares in response to a bidder’s effort to purchase control of a company. Here the legislation was playing a supporting role to markets, principally the market for corporate control discussed in the next subsection. And the reach of this effort to empower shareholders always included a counterbalance to protect managers against too much oversight from shareholders. For example, the federal law never intervened to block the powerful defensive tactics to hostile tender offers that quickly were thrown up.

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

C. The Market for Corporate Control.

Prior to the rise of hedge fund activism, the most sustained and dramatic response to the Berle and Means question occurred in the early 1980s with the explosive growth of the market for corporate control. The change in the shareholder census combined, particularly the growth of institutional investors, meant more shareholders had sufficient size and sophistication to counter some of the traditional barriers to rational apathy. The wider access to financing with junk bonds and other pools of capital meant there was greater ability to

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20 See Black supra note 13 at 564 (describing 1956 proxy amendments as reflecting concern for managers).
21 See the discussion of poison pills infra.
use shareholder selling rather than voting as a means to address collective action problems of shareholders who wanted to change management policy. Federal tender offer law provided some additional protection for such moves. The combination created new economic incentives for entrepreneurs or raiders to engage in a pattern of corporate takeovers.

At times, it seemed like all management was at risk. And this touched off a vigorous public debate, particularly in industries most affected by change, and by employees and other corporate constituencies adversely affected by changes, that resulted from corporate takeovers. Most states passed multiple anti-takeover statutes, generally protecting management against hostile takeovers.22 More importantly, common law courts approved the innovative private ordering defensive tactics such as the poison pill.23

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

The poison pill works to dramatically raise the costs of any hostile offer that would permit shareholders to sell into a tender offer that target management opposed. Since its introduction in the mid 1980s, poison pills have not been triggered (although often redeemed or a basis for subsequent negotiations).24 The staggered board


24 There was one example of triggering of one of the earliest poison pills in a form that was later modified and in unusual circumstances that seems to have little bearing on its broader use.
similarly raises the costs for shareholder voting. Because the board, like the U.S. Senate, is divided into three classes and only one third of the members are elected during each election cycle, it takes two annual meetings to replace a majority of the board. To the extent that a potential raider needs to buy shares or otherwise spend substantial money to be successful in the first meeting, that investment is at the mercy of the incumbent manager for an entire year, an economic disincentive for any raider to make a large investment.

The second point to bring forward from this earlier era is the importance of antidotes to reopen the avenues of shareholder voting and selling that have been shut down by defensive tactics. It turns out that both of the principal defensive tactics have antidotes. Poison pills can be redeemed by the target board prior to their being triggered.\textsuperscript{25} Thus if critics of management can obtain control of the board, this impediment to selling can be easily removed. This, however, involves shareholder voting and requires a successful proxy fight to replace the board. At this point a staggered board raises a likely barrier. Shareholder efforts to bring shareholder proposals to remove staggered board provisions from corporate charters run up against the precatory nature of these proposals and blocking position given to the board by corporate law as to any changes in the articles of incorporation.\textsuperscript{26} Shareholders can use market pressure in an effort to move the board, and sometimes partial voting success can work, but an effective defense is necessarily multifaceted and is directly shaped by the core structure of corporate governance law.

\textit{D. Private Equity as a Response to Berle and Means}

The takeovers era of the 1980s also produced another, somewhat related response to the challenge identified by Berle and Means, one which resolved the problem of the separation of ownership and control simply by removing the company from the public sector and unifying the owners with control. One thread of the 1980s takeover movement was the leveraged buyout segment where the new pools of capital were assembled by financial entrepreneurs to buy out the entire public ownership of a company. This move was

\textsuperscript{25} Moran v. Household International, Inc., 500 A.2d 1346 (Del. 1985) (noting in the approval of poison pill does not relieve directors of their fundamental duties as to possible redemption).

\textsuperscript{26} See Mod. Bus. Corp. Act § 11.02.
often financed by large amounts of debt to take advantage of the tax benefits that debt provided and the possible leveraging of the return of the equity investors after the debt was paid off. These leveraged buyouts often, but not always, included the company’s management as investors and provided much stronger incentives than before for managers to produce positive payouts.

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

E. Institutional Investors as the Champion of Shareholders

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

27 Michael C. Jensen, Eclipse of the Public Corporation, 67 Harv. Bus. Rev. 61 (1989) ("The publicly held corporation, the main engine of economic progress in the United States for a century, has outlived its usefulness in many sections of the economy and is being eclipsed.")
share within that group. Such investors, at least to many academics at the time, seemed able to overcome several of the economic barriers that had made traditional shareholder activism so ineffective. They had economies of scale both collectively and within individual investment that could support a non-passive approach to their shareholding investment. They were financially sophisticated, as a byproduct of their day to day business which they could apply to questions of corporate governance at little additional cost. Their other business interests may well give them access to information at a lower cost. The percentage of shares owned among a relatively small group of institutional investors, each of whom is repeat players as to matters of corporate governance had the potential to reduce the collective action problem.

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

The reality never really fulfilled the promise. The reasons have been well-analyzed elsewhere. For purposes of this discussion they can be summarized as conflicts of interest, a business plan that often includes inadequate incentives and liquidity constraints, and regulatory constraints. Traditional institutional investors are sometimes affiliated or controlled by financial institutions who would feel a push back from clients from other parts

31 Bratton, supra note 1 at 9 (“Observers of corporate governance have spent two decades encouraging these fund advisers to take the lead for the shareholder interest and actively challenge the authority of unsuccessful corporate managers. But the requisite financial incentives have never fallen into place.”); Partnoy & Thomas, supra note 1 at 3 (“we find that on balance institutional investors have been of marginal importance at a targeted firms, and that many institutions such as mutual funds and pension funds, have not been as successful as some had initially predicted.”)
32 See Black, supra note 13; Bratton supra note 1; Kahan & Rock, supra note 1.
of their business if the institutional shareholders engaged in shareholder activism. Alternatively, the institutional investors themselves may engage in other businesses, such as managing corporate pension plans that could be hurt if they engaged in activism (and hostile) shareholder activity. Incentives for managers of institutional investors to pursue activist strategy (such as performance based fees) are also weak either because of the funds investment strategy, such as to pursue a low cost index strategy, or regulatory constraints. Many institutional investments have liquidity obligations that may not be consistent with an activist strategy. Activism of many institutional investors is hobbled by regulations that may require disclosure that would make activism difficult, or require diversification inconsistent with an activist strategy. Public pension funds may have fewer constraints from regulation, and conflicts with related financial entities, but they may feel pressure from their role set within the political process.  

II. Hedge Funds as Activist Shareholders

A. Situating Hedge Fund Investments

Hedge funds are pools of investment capital most often defined, from a legal perspective, by what they are not. They are exempt from regulation under the Investment Company Act. A federal appellate court recently struck down an SEC effort at minimal regulation by requiring registration under the Investment Advisers Act. The most common affirmative definition derives from how the term is presented in the financial marketplace, a fund with a goal to deliver above market returns by pursuing a variety of aggressive economic strategies. The name itself suggests one such strategy, they often hedge their investment positions, by selling stock short to eliminate unwanted risk, something that traditional institutional investors such as...
as mutual funds do not typically do.\textsuperscript{36} Situating them in a discussion of corporate governance is more difficult because many of these methods have little to do with governance or corporate transactions. Hedge funds, for example, may make directional bets on movements of currency exchanges or interest rates. Some invest principally in debt securities or securities of distressed firms. A firm may focus on convertible arbitrage, going long in convertible bonds and shorting the underlying stock. Such arbitrage strategies overlap corporate transactions as when a hedge fund engages in merger arbitrage after a takeover announcement by buying the shares of the target and selling short the shares of the bidder.

All of these strategies are passive as they describe any interaction with the management of the corporations involved. They can be done, and are, by the proprietary trading desks of many traditional financial firms. My focus in this paper and the focus of hedge fund activism more generally is when an investor seeks to combine such a financial strategy with active engagement with the governance system of a corporation.

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

Hedge fund governance activism is focused on public companies and typically involves the activist investor taking only a minority position in a company. Making offers to acquire the entire company is regularly part of the arsenal of a hedge fund activist, actually acquiring control in a different story with K-Mart being a very notable exception.\textsuperscript{37} Most hedge fund activism can be sorted into those activities related to an existing merger or related transactions and those related to efforts to change a company’s business plan.\textsuperscript{38}

\begin{footnotesize}
\textsuperscript{36} Sell short that is. Traditional mutual funds do seek to eliminate unwanted risk by use of a diversified portfolio.


\textsuperscript{38} Bratton reports that about 16 of the 130 firms in his sample that experienced hedge fund intervention involved a single merger transactions and nine others when the activist stayed on for an extended engagement after a merger transaction’s disposition. Bratton, supra note 1 at 10 and 46. His count would correspond to the first two categories I describe here, but not the third. See also Kahan & Rock, supra note 1.
\end{footnotesize}
1. Activism Related to Existing Acquisition Transactions

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

Several of the most high profile hedge fund activism cases of recent years have arisen in efforts to block a corporation from making an acquisition that the investors believe will be value decreasing. The failed Deutsche Borse effort to acquire the London Stock Exchange was a highly visible and successful effort where the opposition of hedge funds who held shares of the acquiring company caused the transaction to be abandoned.39 Carl Icahn’s efforts to persuade Mylan to abandon its effort to acquire King Pharmaceuticals is another example, overshadowed in that case by Richard Perry’s well-known effort to use a hedging strategy to obtain votes (but not economic interests) in the buyer in order to insure a favorable outcome for his investment on the target side.40 Since the common reaction after the announcement of takeovers is for the stock of the target to go up and the stock of the bidder to go down, it is not surprising that hedge funds might seek to be active on the acquirer side.

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

Given the usual economics of takeovers described above, hedge funds activity to block an acquisition from the target side is less likely, at least in an arm’s length merger. Instead, target side hedge fund activity occurs in contexts driven by conflicts of interest. Most often, hedge fund activism on the target side has occurred when there is a controlling shareholder who has proposed a cash out transactions on terms the minority believes is too low. The Novartis acquisition of the remaining 42% of the shares of Chiron is one example.41 Sears Canada’s effort to cash out minority shareholders is another recent example. Second, hedge funds have been active

40 See text accompanying notes xx infra.
41 Shareholder Insurrection Infects Novartis’s $5.1 billion Chiron bid, Wall St. J. Apr. 3, 2006 at C3.
when the form of the acquisition is private equity seeking to acquire all of the target, often with the participation of management which can raise conflict of interest questions. Third, there are some apparent arm’s length mergers where hedge fund investors have been active, but even here there is sometimes a conflict of interest as in the Molson-Coors merger.

What is common about these settings is that there is a strong legal challenge that can be the foundation for activism. Both fiduciary duty and appraisal claims are available in this setting and hedge fund investors have made use of both of these legal claims. This is exactly the setting in which shareholder litigation is most likely to be successful. A recent empirical study of all Delaware shareholder litigation found that almost all shareholder litigation occurs in a takeover setting and that the cash out conflict of interest setting is the context where there is most likely to be a positive outcome to the litigation. The second most likely area for a positive outcome from litigation is a leveraged or management buyout. Positive outcomes in arm’s length mergers often occur when there is a special benefit of some sort for an inside group.

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

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

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43 Id at.
44 Id at.
45 This is the same transaction in which Carl Icahn was active on the other side in an effort to kill the transaction. Ultimately other problems led to the end of the deal short of its consummation so the battle of the hedge fund titans ended with a no-decision.
questionable context of hedge fund activism and has provoked an extensive debate around empty voting.\textsuperscript{46}

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

In addition to trying to influence an existing acquisition transaction, hedge funds also pursue a variety of other tactics to change a company’s existing business plan in a way designed to produce an immediate positive bump in the company’s share price. This could include an acquisition offer by the hedge fund itself. More likely is an effort by the hedge fund to prod the board to make an immediate cash payment to shareholders, to sell a unit or particular assets, or other governance changes.\textsuperscript{47}

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

As previously mentioned hedge funds tend to operate as minority shareholders, but occasionally their strategy includes an outright offer to purchase the company. The failure of these offers to lead to an actual closing, suggests this is a tool geared toward a more general strategy of influencing the behavior of current management more than a desire to own the company. The relative paucity of this strategy suggests that poor management is not the prime input that hedge funds seek to replace, but rather to prod current management to strategies that can produce a positive and immediate return.

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

A cash payment, of course, produces an immediate return on investment. Bratton marshals evidence as to the attractiveness of


\textsuperscript{47} April Klein and Emanuel Zur, Hedge Fund Activism, (working paper, September 2006). Klein and Zur at 24 report that hedge funds have a 73% success rate (31 of 41) when they seek seats on the board and 100% success rate in getting the firm to buyback its own stock, replace the current CEO and initiate a cash dividend. The numbers are not as impressive as they might seem in isolation because they are percentages of the denominator measured by purposes stated on the Rule 13D disclosure made by the hedge fund. Even so, it shows that hedge funds have had considerable success on the “changing the business plan” leg of their efforts.
this strategy. About 38% of the targets of hedge fund activism in his sample are cash-rich and overall cash levels stand at the highest point since the 1980s.\(^{48}\) Cash payments can occur either via a dividend payment or a share repurchase. The cash itself may come from the corporate treasury that management have been reluctant to let go, or by borrowing if the company has not made complete use of the tax shield that the tax code provides for financing via debt.

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

Assets themselves can sometimes be easily monetized and this possibility often gets the attention of hedge fund activists.\(^{49}\) This goal could also be implemented by the sale of a division, perhaps to private equity in which the division’s management will be given an ownership interest, or by a spin-off of a division to the shareholders of the current company. This de-conglomeratization has long been a source of creating value in the deals area.

These last two categories replicate what has occurred in earlier periods under a leveraged recapitalization label. Such changes are often motivated by the same economic factors as leveraged buyouts, but, unlike LBOs, the company in the leveraged recap remains publicly held. The value comes not from any form of synergy or replacing inefficient management or even the value that current LBOs can now achieve by avoiding the Sarbanes-Oxley costs that go with being a public company. Instead, the gain comes from operational or financial changes, including the more efficient use of the tax shield that can result from greater borrowing. Data from earlier leverage recaps show such improved operational efficiency, although less than LBOs.\(^{50}\) What hedge funds add to this earlier pattern is the additional impetus that the effective threat of a hostile proxy fight can bring to the suggestion of such a recapitalization or related change.

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\(^{48}\) Bratton, supra note 1 at 19. He notes that larger targets predominate in the cash payout as the result as opposed to providing board seats or other results.

\(^{49}\) Bratton, supra note 1 reports that for 32% of the companies in his sample, such unbundling was a disclosed purpose. Klein and Zur at 12, 24 report that changing board composition is stated as a purpose in 41 of the 155 events that they trace and hedge funds obtain board representation in 31 of those times.

\(^{50}\) See generally, David J. Denis and Diane K. Denis, Leveraged Recaps and the Curbing of Corporate Overinvestment, J. App. Corp. Finance 60 (1994).
(d) Obtaining Board Seats or Other Governance Changes Short of Control.

The goal of hedge fund activists sometimes has a less immediate transaction focus and evolves toward a relationship that will last a bit longer. Achieving board representation is one of the most common results for hedge fund activists, one that seems more common with smaller to mid cap companies.\footnote{Bratton, supra note 1 at 32.} Such board representation, however, does not seem to mimic venture capital investments where angel or other investors have a long-term seat at the board room table. In the hedge fund context, board representation seems designed to reflect the more specific purposes discussed above. It makes economic sense for the hedge fund to remain active on the board of the portfolio company even after the initial policy change if these recap transactions follow the pattern of earlier cycles where an acquisition frequently followed the recap, offering the hedge fund a second opportunity for profit.

Occasionally, hedge fund activism leads to the immediate replacement of the CEO\footnote{Third Point Demands That Star Gas CEO, Irik Sevin, Resign and Return Keys to Company Car, PR Newswire, Feb. 14, 2005, available at http://www.prnewswire.com.} and some efforts become more personal as to the policies of the CEO.\footnote{See the current fight at Heinz Foods.} Yet the more common track for hedge fund activism seems to be persuading managers to take value producing actions, not in displacing bad management or replacing management so as to stop a ruinous strategy such as occurred in Technicolor where the takeover was based on ending the company’s ill-advised venture into one hour photo processing.\footnote{See Cede & Co. v, Technicolor, Inc. 684 A.2d 289 (Del 1996).}

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

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

The hedge fund activism described above necessarily reflects the legal structure of the corporation. The most important principle is the plenary power given to board of directors to make all corporate decisions, including those most relevant to the hedge fund strategies.\footnote{Mod. Bus. Corp. Act § 8.01.} The second relevant legal principle is the limited right of shareholders to do only three things:

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

As discussed above, managers seeking to insulate their control of the corporation from challenge by shareholders, including hedge fund activists, have worked to close down selling and voting, the two main avenues of shareholder action provided by corporate law. These include, for example, inserting a classified board and staggered voting into the firm’s articles of incorporation at the time a company goes public so that a voting strategy for an activist requires success as two different annual meetings. In this setting it become
important to also block shareholder action by special meeting (already done for the directors in Delaware by a statute that limits the right to call special meetings to the board or anyone named in the articles)\textsuperscript{56} or by written consent (usually requiring a provision to that effect to be inserted in the firm’s articles of incorporation.\textsuperscript{57}) Selling is most effectively blocked by a poison pill, which effectively raises the financial cost to a bidder seeking to buy shares. Various anti-takeover provisions such as fair price provisions or other methods have a similar effect.

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

\textit{Influencing the Acquirer Side of an Announced Acquisition.} The strategy to influence the acquirer side of an existing acquisition usually occurs when the shareholders of the acquiring firm are required to vote on the transactions. While shareholder approval was

\textsuperscript{56} Del. Code Ann. tit. 8 §211.

\textsuperscript{57} Del. Code Ann. tit. 8 §228.
once a requirement for all mergers, relaxation of statutory requirements has permitted easy evasion in Delaware and many other states.\footnote{Del. Code Ann. tit. 8 § 252 (f) (no vote required for acquiring company shareholders in several circumstances).} Stock exchange listing standards still hold acquirers feet to the fire in terms of requiring shareholder approval when the acquirer issues shares more than 1/6 of its prior total. It was this requirement that necessitated a shareholder vote by Time shareholders in their merger with Warner in a now classic takeover case. But that case also shows the limitations of such a requirement. When faced with the need for a shareholder vote, and rightfully fearing that Time shareholders would not approve a merger with Warner that the market had valued at no more than $140 when Paramount had made an all cash bid for Time of $200, the Time board abandoned the merger and structure the transaction as a Time cash tender offer for Warner shares that did not require shareholder participation.\footnote{Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del 1990).}

Hedge fund activist have the best chance of influencing the acquirer side in such a setting where shareholder voting is required. Absent that, they are going to have resort to the threat of a proxy fight to replace directors down the road when the deal will have already been done.

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

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

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

Efforts to Change A Company’s Business Plan. The other activists’ efforts to change a company’s business plan (large cash payments, unbundling the company or corporate governance changes) center on the activist’s use of a toe-hold to credibly signal the launching of a full-scale vote-based offensive if present corporate policy continues. A credible voting avenue needs to exist, either an unfettered route to replace the board at the next annual meeting (i.e. an unclassified board) or a credible threat to stay around for two annual meetings. To the extent that the activist does not itself purchase a large portion of the shares, the ability to credibly convey that they are other shareholders who will be aligned with the activist in this fight is important. Corporate managers know that when a takeover is announced, they can expect a shift in their shareholder

60 Del. Code Ann. tit. 8 §262.
61 See In re Emerging Communications, Inc. Shareholders Litigation, 2004 WL 1305745 (Del Ch.).
population to arbitrageurs, and they have to base their strategy on such a population. An activist’s announcing of a position in a company can cause something of a similar shift in the shareholder population, but the greater uncertainty in the outcome of the strategy (as opposed to an acquisition already announced) and the longer time for such a strategy to unfold make the credibility of this threat somewhat harder to map.

III. The Advantages and Limits of Hedge Funds as Activist Investors.

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

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

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

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

As hedge funds have spread across the corporate governance scene, their advantages have been well-displayed. Their business plan relies on economic incentives more likely to reward activism by their managers and they face less regulation that conflicts with those incentives. First, hedge fund compensation schemes for their managers provide much stronger performance incentives than in traditional institutional investors. Hedge fund managers may receive 20-30% of returns of the fund with incentive fees based on absolute, as opposed to relative performance. In contrast mutual funds and other institutional investors rely on modest incentive fees for their managers and overall performance is most often judged in comparison to relative performance to market indexes. In such a relativist world, activism is not a strategy that is likely to pay sufficient returns to induce their fund managers to become activists. Any individual fund is not likely to have enough of a different position in a company to derive excess positive gains as compared to comparable funds who may be free riding on the work and the costs incurred by the activist funds in seeking out companies in which an activist strategy would produce above average results.\(^{62}\)

Second, hedge funds typically operate in an organizational setting that provides fewer conflicts to interfere with an activist strategy or block consideration of a wide array of possible targets. For institutional investors such conflicts begin with the funds being part of larger investment organizations whose interest could be adversely affected by an activist strategy. Even apart from ownership ties, many institutional holders of stock obtain a significant portion of that position by managing 401(k) funds that come from corporations

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\(^{62}\) Kahan & Rock, supra note 1.
that themselves are part of the target pool of an activist strategy. Managers will worry that activism may cost them a chunk of their other business. And to the extent that conflicts do arise, the management incentives discussed above, and other features of the hedge funds business plan mean the hedge fund might not be as predisposed to resolve the conflict against an activism strategy as would occur in another institutional investor.\textsuperscript{63}

Third, hedge funds incur lower costs for their activism by operating in an area outside of the same intensity of regulation as occurs for alternative pools of institutional capital. They can disclose less about their investment holdings and trades which can provide them with additional flexibility of movement and the profit opportunities that can follow from that. As there name implies, hedge funds include hedging and more risk positions barred to some other institutional investors. They are able to avoid diversification requirements that can hobble the nimbleness of some mutual funds who might seek to pursue an activist strategy. These kinds of regulations often are the result of choices to pursue particular kinds of investment or a particular business plan. For example, by not seeking corporate pension funds, hedge funds can avoid the additional layer of ERISA regulation that comes with such money.

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

\textsuperscript{63} Kahan & Rock, supra note 1 at 30.
A final advantage of hedge funds as activist investors is the relative paucity of defense that, as yet, has arisen in response to their activism. Compare, for example, the response to the takeover threat of the 1980s to the threat of hedge fund activism of the current decade. One point of commonality is the role of Marty Lipton. As is well known, he was at the center of the development of the poison pill, the most creative governance tactic of recent decades. These shareholder rights plans effectively block shareholder selling as a device to discipline management by imposing a severe financial dilution of the investment of the unwanted purchaser who acquires the shares without the consent of the board. This financial hit is linked with an invitation for such a suitor to negotiate with the incumbent for the redemption of this poison pill. Those who are not able to come to agreement with the board, perhaps because the board would like to preserve its own position, are forced to resort to a proxy fight to replace the board (perhaps requiring two or more annual meetings because of staggered terms). All of this is neatly wrapped within an apparent issuance of rights to shareholders, a process normally intended to permit the corporation to raise capital, but nowhere near what is going on with the poison pill. And the effectiveness in drafting this new defense was linked with successfully shepherding this new creation through the Delaware court system. Although the judges have put some limits on the unfettered use of poison pills and have struck down some of the refinements as lawyers have sought to push the envelope, the poison pill has remained for two decades the most effective deterrent against unwanted takeovers.64

In contrast to the creativity and sophistication of that response to shareholder activism, the response to date against hedge funds has been a good bit tamer. Consider the memo to clients put out by Lipton and his firm earlier this year under the headline “Attacks by Hedge Funds.”65 The aide memoire as it was phrased recommended that clients “review dividend policy, “proactively address reasons for any shortfall in peer company benchmarks” and “review basic strategy ad evaluation of portfolio of business with board in light of possible arguments for spin-off, share buyback, special dividends,

65 Wachtell Lipton memo (on file with author).
sale of the company, or other structural change." This looks to be a wealth of sound advice, but as a defensive tactics it pales in comparison to those of earlier eras.

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

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

In seeking to evaluate if hedge fund activism provides a new paradigm in terms of describing shareholder and management relations or least to conclude if we have reached a new equilibrium in terms of shareholder disciplining of management, two sets of limits ought to be considered. The first is the internal limits from hedge funds as to whether they will want to continue, or be able to continue in this role and if so, on how broad a basis. The second, the extent to which we want them to continue, really a question about the degree to which their individual interests diverge from the overall social good, a question that has also been asked for earlier solutions that have come forward in the debate over the separation of ownership and control.

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

Some of the same economic drivers described above as to why hedge funds have more freedom to engage in activism than other investors also generates serious limits on their ultimate reach. Hedge funds are exogenous to corporate governance. Their primary goal is to deliver above average return on investments. Governance is only one of many tools toward that end. As the number of hedge funds

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66 Wachtell Lipton, Rosen & Katz memo, March 7, 2006 (on file with author.)
has grown in recent years, the field has become more crowded and the opportunities for delivering the above average returns have withered.\textsuperscript{67} The same ease with which hedge funds were able to adapt to this area also eases their move to alternative investment strategies. While some firms have invested task specific human capital in developing expertise on governance issues, those costs do not seem to be excessively large that would block redeployment. The pattern of the separation of ownership and control, as outlined earlier in this paper has been one of response and counter response such that opportunities for profit will open and close. Can we expect hedge funds to continue on as long-term repeat players in governance? It is unlikely that these funds, which pay little attention to transparency or governance activity for those who place money with them, have long-term incentives or interests that tie them to this activity.

Even if the interests and economic incentives of hedge funds propel them to continue or increase their disciplinary activity, the experience to date suggests that their role will not be plenary in terms of a global response to the separation of ownership and control but rather will be limited to particular segments. The gains that would flow from implementation of their advice reflect value that can be achieved more by financial buyers, as opposed to strategic buyers. They are not regularly pushing change that will bring economies of scale or value from vertical integration or economies of scope. They don’t necessarily bring knowledge for a particular industry or adjacent skills. Rather they are selling a discipline for an existing company and one that existing management could themselves implement. While a hostile takeover is often held in the background as an inducement to get management to implement the suggested strategy, the gain they plan to deliver does not necessarily come from displacing inefficient management.\textsuperscript{68} As a result, this discipline is more likely to show up in segments of the economy where such financial acquisition or changes are available. The inclination of

\textsuperscript{67} See Gregory Zuckerman, Hedge Funds Miss Their Target, Wall Street Journal September 13, 2006 at c1, col. 2 (“Some of the most hallowed names in the hedge fund world are producing very human returns this year.”); Susan Pulliam, Pirate Capital Draws SEC Focus, Wall Street Journal September 26, 2006 at C1, c. 3 (quoting Robert Chapman about certain hedge funds investors, “it’s the least sticky money in the world, and if they don’t see progress, they want to move on to something new.”)

\textsuperscript{68} Klein & Zur, supra note 47, report that portfolio companies targeted by hedge funds are more likely to invest in healthy, profitable firms as opposed to underperforming firms.
hedge funds discussed above to push cash payment or liquefy assets has its greatest relative benefit at the point of the economic cycle where cash is most likely to accumulate.

The impact of hedge fund activism, at least to this point, has not been across the universe of public companies, but has focused on small to mid cap companies.\textsuperscript{69} To some extent that is a function of size of the hedge fund investors as compared to the size of the portfolio companies. Most hedge funds have not been big enough to take on the largest companies.\textsuperscript{70} But that size differential can likely be overcome to the extent large amount of money continues to flow into this segment of the market.\textsuperscript{71} In addition hedge funds use leverage more than mutual funds, for example, so that this expands their reach.\textsuperscript{72} These funds are adept at working with other hedge funds or raising the flag for a cause that mutual funds and other institutional investors are willing to support\textsuperscript{73} so it may not be that size of the hedge fund limits their choice of portfolio companies. More likely it is the size of the target that defines the ability to use a successful hedge fund strategy. The potential to create value as a financial buyer described above is likely to be greatest in those companies that are under researched or have been passed over by analysts and others who follow an industry. To the extent that a business plan depends on this kind of change, we should expect a continued focus on small and mid cap companies even if hedge funds grow.

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

The widespread growth of activism hedge funds has produced a new set of questions that revolve around whether the economic

\textsuperscript{69} Bratton supra note 1 at 12 (small firms dominate the sample, making up 61% of the targets.); Klein & Zur, supra note 47 at 17 (from a sample of 155 activist campaigns by hedge funds 2003-2005 finding that "hedge funds target relatively small companies.")

\textsuperscript{70} Kahan & Rock supra note 1 at 30 (suggesting average hedge funds with assets of $100 million and largest with assets of $10 billion.)

\textsuperscript{71} The estimates of assets managed by hedge fund vary, perhaps $1 trillion to $1.2 trillion.

\textsuperscript{72} Kahan & Rock supra note 1 at 30 (reporting that 30% of hedge funds use a leverage ratio in excess of two and another 30% use leverage, but at a lower ratio.)

\textsuperscript{73} See e.g. Bratton supra note 1 at 9 (describing wolf pack).
incentives and advantages described above present a conflict between hedge funds and fellow investors or other constituents. This discussion here is divided into three parts: Do hedge fund incentives lead them to push a short term agenda that is inconsistent with optimal long term-growth? Do the gains of hedge fund investors from shareholder activism come at the expense of other constituents? Do the innovative tactics pursued by hedge funds in an activist strategy undermine the underlying corporate governance system that relies on self-interested voting of shareholders as the foundation for aligning corporate activities with society’s interests?

(a) Short Termism

Short-termism has long been the weapon of choice to attack shareholder activism and that charge has been leveled at hedge fund activists as well. The large percentage of daily trading volume on our major exchanges attributed to hedge funds highlights this problem.\(^74\) The recurring fear is that investors out for a quick buck will force managers not to make crucial long-term investment. This was a charge made during the takeover mania of the 1980 and the growth of private equity in large part was a business model that permitted companies to manage without such undue concern for the short term.\(^75\)

Leaving aside for the moment whether the market fails to align short term and long term interests, recent empirical research suggests hedge fund investors don’t have short term time horizons. Bratton’s survey of 130 domestic firms since 2002 suggests that activist shareholders typically invest for 2 years or longer.\(^76\) He found that for 63% of his sample, the investor retained a substantial investment after two years and in another 20% of the cases the hedge fund investor had taken a pro rata return on sale, behavior which doesn’t seem to point to short term driven hedge fund investor exploitation.


\(^{75}\) Of course the economics of private equity rests on more than blocking any short term influence. The high-powered incentives to management and the closer monitoring, as compared to the typical public company also create value in this business model. Hedge fund activism does not seem associated with the same intense revamping of management incentives that typically follow a LBO, where a company is no longer publicly held and both new compensation packages and risk of bankruptcy give continuing managers incentives that they did not previously have.

\(^{76}\) Bratton, supra note 1 at 6.
Empirical data from Partnoy and Thomas appears to point in the same direction on this point.\textsuperscript{77}

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

Hedge fund activism may be constrained to the extent that perceived divergence between the interests of the hedge funds and other social goals leads to regulation or other constraints on their behavior. Prior regulatory concerns, which led to the SEC hedge fund registration provisions subsequently thrown out by the federal appellate courts,\textsuperscript{78} reflect not governance concerns in portfolio companies, but that hedge fund will harm their own investors.\textsuperscript{79} Not only is this a concern about the knowledge of individual investors in making such an investment, but also a concern that the volatility and size of hedge funds could lead to a run on the bank or a threat to markets.\textsuperscript{80}

There is also a concern about the economic incentives of hedge funds propelling them to engage in manipulative behavior as to other market participants.\textsuperscript{81} These same incentives make material insider information all the more valuable and exacerbate pressure on this regulatory system.

More generally, additional activism by shareholders seeking greater and immediate return on their investment reignites the threat that other corporate constituencies feel from this activity, similar to what occurred during the takeovers of the 1980s. To the extent that more highly volatile investments flow for hedge fund incentives or managers reflect short term incentives that differ form long term, the result could be more companies facing financial distress and costs imposed on employees, creditors or communities. This too is a reprise of the 1980s for which there is a richly layered debate, which

\textsuperscript{77} Partnoy, Thomas et al.
\textsuperscript{78} Goldstein v. SEC, 451 F. 3d 873 (D.C. Cir. 2006).
\textsuperscript{79} What Went Wrong at Amaranth, Wall Street Journal, September 20, 2006 at c1 co. 2 (reporting hedge funds loss of $5 billion in a week on natural gas investments.)
\textsuperscript{80} 38 Sec. Reg. L. Rep. 1312; SEC Finds…September 26, 2005 at 5.
\textsuperscript{81} 38 Sec. Reg. L. Rep. 1157.
need not be repeated here.\textsuperscript{82} Hedge funds are of interest in this paper to the extent that there economic incentives, as distinguished from prior shareholder activists, might lead to a greater imbalance of the interests of shareholders and other constituents.

\begin{quote}
\begin{enumerate}
\item[(c)] Hedge fund activism as disrupting the foundational assumption of the corporate voting system that individual shareholders voting for their self-interest properly aligns corporate decisions with the interest of society.
\end{enumerate}
\end{quote}

The most worrisome aspect of hedge fund participation in corporate governance is when they use their financial tools and strategy to separate the interests of ownership and control as opposed to bridging that divide which has been the premise for so much of the praise for their role in shareholder activism. This exploitation of the separation of ownership and control occurs most visibly as in the Mylan-King Pharmaceuticals deal when a hedge fund with a large position the target (which would be benefited by the closing of the deal) acquired a significant voting position in the acquirer (who may well have been hurt had the deal closed) but in such a way that the hedge fund had insulated itself from any financial exposure to a change in the value of the acquirer shares. Alternatively, the assets to be benefited need not be target shares, but could be bonds, as occurred in the MONY/AXA acquisition.\textsuperscript{83} As a result these modern financial instruments permit a new form of vote buying. This has the potential to undercut the central premise on which shareholder democracy (and thus shareholder activism) is based, unless there is an offsetting market or legal response.

First there is no doubt that modern financial practices and entrepreneurial activity permit a whole host of ways of dividing ownership interests so that investors can carve up and then pass off or retain specific elements of ownership, including the right to vote. A takeover announcement often creates the possibility of new value which will be ultimately realized after the deal closes. An investor not

\begin{footnotes}
\item[]\textsuperscript{82} Bratton, supra note 1 at 23 discusses the extent to which an outside attacker such as that from a hedge fund impairs the stable and cooperative environment necessary for value creation but can neither falsify nor confirm this possibility by his view of whether targets of hedge fund activism are underperformers or over performers.
\item[]\textsuperscript{83} In re MONY Group, Inc. Shareholder Litigation, 853 A. 2d 661 (Del Ch. 2004).
\end{footnotes}
wishing to wait that long but still wanting to lock-in much of that new
value can sell the shares on the stock market for a price that reflects
much, but not all, of the anticipated market premium from the merger.
The buyers of those shares are usually merger arbitrageurs who are
in effect providing a form of deal break insurance to the target
shareholders and charging a premium (via the difference between the
then current market price and the value upon completing of the
takeover.) A merger arbitrageur who wanted to hedge this long
position could buy an at the market put for a stock index fund that
would lay off the risk of a market break, although not the risk of a deal
break prior to closing.

A merger arbitrageur seeking to lay off some of the risk of a
deal break can couple the purchase of the shares in the target (to
provide the insurance just described) and then sell the bidder shares
short. In many takeovers, the target price moves up after the
announcement of takeover because target shareholders historically
have received the bulk of takeover premiums and bidder
shareholders have moved down. If a deal were to fail, the two shares
would likely move in opposite direction providing some degree of
diversification of this risk of the deal failing. Such uses of hedging
and financial instruments have been an accepted part of acquisitions.

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

While vote-buying has always been regulated by law,\textsuperscript{84} the
complex and sophisticated way that it has been done here raises
fears that investor creativity may have outpaced the law. In particular,
it creates a separation of ownership and control of those votes that
raises question about the ability of the voting process to align
corporate actions with the common good.

\textsuperscript{84} See generally Frank H. Easterbrook and Daniel R. Fischel, Voting in Corporate Law, 26 J. L. &
Econ. 395 (1983).
There are, and long have been, other areas where there is a separation of ownership and control of individual shares. One example is the establishment of a record date for shareholders entitled to vote on any shareholder action. The voting rights of these former shareholders who sold their shares after the record date introduces a possible distortion into the voting system. Yet purchasers can, and sometimes do, request proxies. In any event, the shareholder leaving an enterprise who has received cash for her interest lacks the strong incentive of the hedge fund activist in the above example to use the shell voting for personal advantage.

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

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

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85 Blasius Industries, Inc. v. Atlas Corp. 564 A.2d 651 (Del Ch, 1988).
use for personal gain can be relied upon to in the aggregate, and if constrained by competition and supply and demand, to result in the best collective decision. It was this assumption that Berle and Means believed had been undermined by the separation of ownership and control in 1932. It is a similar separation that provokes worries about shell voting in the 21st century.

Can we rely on competition and supply and demand to rein in selfish use of voting? To the extent that there is no disclosure of the practice there is potential for uncorrected abuse. Yet, every hedge fund operator who retains the vote but disposes of economic risk deals with a counterparty whose selfish incentives could work in the classic economic way to balance any abuse. Why would an investor in Mylan contract with a hedge fund investor such as Perry to take the economic risk when Perry sought to use those votes to the detriment of Mylan. Perhaps the counterparty was ignorant of the possibility and more disclosure is needed to cure that. To the extent that the transactions occurred after the initial announcement of the merger (and the change in price that would take into account the merger) Perry’s purchase would not add a new negative element to the valuation decision so that the counterparty would not care. (There could be an additional negative move of the price as the likelihood of the deal closing increases over the interim period thereby removing an element of uncertainty that had been earlier captured in the price.) Further, there could be other hedge fund investors who would engage in counterbalancing moves with an opposite effect. In Mylan, for example, Carl Icahn was active in seeking to get Mylan to block the sale. To the extent that either of these things happens, there is a market correction that means less need for law.

If persuaded that the problem is severe enough to warrant action, the challenge of finding a commercially reasonable solution will itself be daunting. Shell voting or overvoting or encumbered voting is controlled (or not) by a mix of SEC regulation, stock exchange rules and market practices.86 By all accounts, the controls are only crudely implemented. A fundamental economic challenge is that various solutions will impose costs on a very large category of hedging financial transactions outside of the takeovers context.
discipline what seems to be a very small number of transactions when hedging is allegedly misused in a voting context. So long as voting seems unimportant, they will be insufficient incentive to commit to a solution. Yet as important mergers like Hewlett Packard and Compaq turn on such close votes, and the continued recognition of voting as core to the process that hedge fund investors pursue, voting reform in corporations may be like voting reform in our political system since the 2000 election and become an issue that cannot be deferred.

IV. Conclusion

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

Yet all of this alignment has not yet coalesced to produce a lasting equilibrium for bridging the gap between ownership and control. The analysis here of the economic incentives of hedge funds reveals limits as well as positive incentives for shareholder activism. The business plan that have enabled hedge funds to be both nimble and aggressive in their approach to corporate governance also operate to redirect these nimble, aggressive investors toward other strategies as countermeasures erode some of advantages of the strategies that have worked until now. The strategies which have been so successful, however, reflect the specific advantages of value creation in particular circumstances they do not necessarily extend to governance generally. And perhaps, most importantly, hedge fund incentives and business plan can establish a separation of ownership and control parallel to that which worried Berle and Means.
Those evaluations suggest a peak at the future of this new trend of hedge fund activism that look something like this. First, hedge funds have reestablished the tie between takeovers and corporate governance activism first forged 25 years ago. Mergers and acquisition provide the most visible setting for hedge fund activism particularly when hedge funds have been able to block on the bidder side acquisitions that seem questionable for the bidder’s share value. Second, hedge funds have been active and frequently successful on the target side when the merger is pushed by a controlling shareholder where the investor is able to used litigation rights as well as voting and selling. The economic and legal incentives for these two actions are likely to continue, shaped by the general ups and downs of the merger cycle.

Thus hedge funds have the ability to shape the outcome of acquisition outcomes, at least in these two settings, where another actor has proposed an acquisition, but not necessarily any upward shift in the number of acquisitions. Any shift in the number of acquisitions from hedge fund activism seems to be linked to restructuring of various types, cash payouts, asset sales, spin-off and the like. To that extent the impact of hedge fund activism will be episodic, more than systematic. Hedge funds have not engaged in some of the systematic corporate governance efforts to change governance rules as have some pension funds and institutional investors. Thus hedge fund activism is also likely to be cyclical, prominent when economic conditions favor cash accumulation and appreciation of asset value. Beyond the specific merger settings described above, hedge funds are most likely to be active in areas where we have traditionally seen leveraged recapitalizations and other kinds of highly leveraged transactions. The greatest innovation that hedge funds have brought outside of the specific acquisition settings discussed above is to widen the area for leveraged transactions by adding a hostile dimension. The credible commitment to wage and win a proxy fight can more often and more quickly persuade management of the wisdom of various financial suggestions. Even so, the transactions reflect only a fractional slice of the menu of way in which value can be created, suggesting that hedge fund activism is not yet the plenary player that might be envisioned or needed in a Berle and Means world.
The continued presence of hedge fund in this pursuit will also be affected by their alternative opportunities to deliver the above average market returns that they seek. As economic conditions change and as management develops defenses to hedge fund activism, there will be a push in the direction of lesser impact for this activism.

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

Robert B. Thompson
Vanderbilt University
Law & Economics Workshop
University of California, Berkeley School of Law
Boalt Hall
October 9, 2006

Predictions as to Hedge Funds and Corporate Governance

- “[T]he Holy Grail of corporate governance, the long sought after shareholder champion?” - Kahan & Rock
- “[T]hey have shifted the balance of corporate power” - Bratton
- “The sole constituency with incentives and resources to vote in the interests of shareholders.” - Partnoy & Thomas
The Dark Side

- “Every decade needs a villain; in the 1980s, it was corporate raiders, in the 1990s, it was corrupt executives. And in the 2000s it appears to be activist hedge funds” - Katz & McIntosh.
- “Sarbanes and Oxley have been knocked out of first place on the list of bogeymen haunting the corporate boardroom” – *Hedge Funds Are the New Sheriffs of the Boardroom*, Wall Street Journal, December 4, 2005 at A2

The Problem Being Solved

- *Berle & Means*, The Modern Corporation and Private Property (1932) – the separation of ownership and control as a revolution
- Has destroyed “the very foundations on which the economic order of the last three centuries has rested”
- Has made the traditional concepts of competition and profit inapplicable
- *Chandler*, The Visible Hand (1977) -managerial capitalism
- Agency costs
Prior Efforts and What They Can Tell Us About Hedge Fund Activism

- Empowering Shareholders (the federal securities laws 1934 et seq.)
- The Market for Corporate Control
- Going Private & Private Equity
- Institutional Investors
- Never took hold
- Defensive tactics; the end of easy money
- Eliminates separation; still with us and growing
- Unfulfilled promise

The Faces of Hostile Takeovers-1980s style

Wachtell, Lipton, Rosen & Katz

Marty Lipton

Carl Icahn
Net Worth: $3.8 Billion  Source: Investments

Gold Diggers
Core legal principles applied in corporate law

- Rule #1 – Trust directors (most of the time) to make corporate decisions including mergers;
- Rule #2 – Let shareholders do three things (i.e. vote, sell and sue; each in limited doses) to constrain agency costs arising from giving directors such power;
- Caveat: too much shareholder power could be bad for others
### Shareholder Action - How much of a check can each action be?

<table>
<thead>
<tr>
<th><strong>Vote</strong></th>
<th><strong>Sell</strong></th>
<th><strong>Sue</strong></th>
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<tbody>
<tr>
<td>- elect/ remove directors</td>
<td>Tender offers</td>
<td>Fiduciary duty of care, loyalty or good faith</td>
</tr>
<tr>
<td>- on Mergers etc. only after directors initiate (gatekeeper role)</td>
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### The Template for Effective Defensive Action

<table>
<thead>
<tr>
<th><strong>Vote</strong></th>
<th><strong>Sell</strong></th>
<th><strong>Sue</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shut down by staggered board</td>
<td>Shut down by poison pill</td>
<td>Rely on rule #1</td>
</tr>
<tr>
<td>Requires proxy fight at 2 annual meetings; carrying costs raise raider’s $</td>
<td>Dilution raises raider costs</td>
<td>Deference from BJR; Avoid Unocal, Revlon triggers for more intrusive judicial review</td>
</tr>
<tr>
<td>Removal after precatory 14a-8?</td>
<td>Redemption requires proxy fight &amp; 2 annual meets if staggered</td>
<td></td>
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</tbody>
</table>
Situating Hedge Fund Activism

- Investing to deliver above-average market returns
- Aggressive economic strategies in various settings
  - Betting on currency movements
  - Focus on debt securities or distressed firms
  - Merger arbitrage
- Combining financial strategy with active engagement with governance

Typology of Hedge Fund Activism

- Related to Acquisitions
  - Blocking acquisition on the Acquirer side
  - Blocking acquisition on the Target side
  - Facilitating Target acquisition via activism on Acquirer side
- Related to Changing Company’s Business Plan
  - Hedge fund offer to buy the company
  - Prodding board to make large cash payment
  - Unbundling i.e. sale/ spin-off
  - Obtaining board seats
Typology as Reflecting the Legal Structure: Acquisition Related

- Influencing Acquirer Side
  - Blocks empire building
  - Dependent on acquirer shareholders having the right to vote (e.g. Time/Warner)
- Influencing Target Side
  - Checks conflicts: Usually a cash out where >50% shareholder
  - Law protects via appraisal, fiduciary duty
- Influencing Target Outcome via Acquirer
  - Mylan/King Pharmaceuticals

Typology as Reflecting the Legal Structure: Impacting Business Plan

- Offer to acquire the whole company
  - More offers than completions
- Prodding cash payments, unbundling assets, board representation
  - Credible threat to use full-scale proxy fight if manager doesn’t accept advice
  - Credible threat that other institutional investors will join
Hedge Fund Advantages vs. Other Institutional Investors

- Better able to offer incentives to their managers that will facilitate activism
- Fewer conflicts with their own organization that would interfere w/ activist strategy
- Less regulation = lower costs
- Business plan avoids economic constraints (e.g. liquidity obligations)
- Paucity of defenses (so far)

Hedge Fund Limits: Their Internal Reasons

- Internal financial motives are exogenous to governance: the same economic characteristics that brought them in will take them elsewhere
- Business plan is usually that of a financial buyer, not a strategic buyer, so not a universal player
- Focus is on small to mid-cap companies
  - Limits from hedge fund capital?
  - Linked to targets under researched
Hedge Fund Limits: Externalization

- Short termism
  - Theory
  - Data- doesn’t appear to be short term
- Risks to others
  - Investors in hedge funds: SEC regulation
  - Counterparties: Manipulation; Insider Trading
  - Financial meltdown: Impact on employees, creditors, communities

Hedge Fund Limits: Undermining Voting System

- Using financial tools to separate ownership and control of individual shares; voting of one asset used to increase the value of another
  - Mylan/King: To protect gain in target, buying acquirer, but selling off all but the vote
  - MONY/AXA-similar but using bonds
- Extension of “ordinary” financial transactions
  - To split up bundle of ownership rights
  - Deal break insurance
Hedge Fund Limits: Empty or Shell Voting

- Vote buying: examples of less concern
  - Post record date voting by sellers
  - Diversified mutual fund netting out positions
- Why hedge funds separation might be different
  - Reprise of Berle/Means departure from Adam Smith
  - Individual voting via self interest ≠ common good
- Responses
  - Self-interest of counterparties
  - Hedge funds on the other side

The Future of Hedge Fund Activism

- Acquisition-related strategies (only) in specific contexts where legal rights enables activism
  - Acquirers whose s/h must vote
  - Targets where appraisal, FD available
- Changing business plan in episodic contexts
  - Financial not strategic acquisitions
  - In continuing public companies (e.g. leveraged recaps)
  - More effective use of proxy fights
  - Directors who own shares!