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## Shareholder Activism as a Corrective Mechanism in Corporate Governance

*Paul Rose and Bernard S. Sharfman\**

*Under an Arrowian framework, centralized authority and management provides for optimal decision making in large organizations. However, Kenneth Arrow also recognized that other elements within the organization, beyond the central authority, occasionally may have superior information or decision-making skills. In such cases, such elements may act as a corrective mechanism within the organization. In the context of public companies, this Article finds that such a corrective mechanism comes in the form of hedge fund activism, or, more accurately, offensive shareholder activism.*

*Offensive shareholder activism operates in the market for corporate influence, not control. Consistent with a theoretical framework that protects the value of centralized authority and a legal framework that rests fiduciary responsibility with the board, authority is not shifted to influential, yet unaccountable, shareholders. Governance entrepreneurs in the market for corporate influence must first identify those instances in which authority-sharing may result in value-enhancing policy decisions, and then persuade the board and/or other shareholders of the wisdom of their policies, before they will be permitted to share the authority necessary to implement the policy. Thus, boards often reward offensive shareholder activists that prove to have superior information and/or strategies by at least temporarily sharing authority with the activists by either providing them seats in the board or simply allowing*

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*them to directly influence corporate policy. This Article thus reframes the ongoing debate on the value of shareholder activism by showing how offensive shareholder activism can co-exist with—and indeed, is supported by—Kenneth Arrow’s theory of management centralization, which undergirds the traditional authority model of corporate governance.*

*This Article also provides a much-needed bridge between the traditional authority model of corporate law and governance as utilized by Professors Steven Bainbridge and Michael Dooley and those who have done empirical studies on hedge fund activism, including Professor Lucian Bebchuk. This bridge helps to identify when shareholder activism may be a positive influence on corporate governance.*

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## INTRODUCTION

Shareholder activism can be defined to include any action(s) of any shareholder or shareholder group with the purpose of bringing about change within a public company<sup>1</sup> *without trying to gain control*.<sup>2</sup> In contrast to Henry Manne's famous description of the "market for corporate control,"<sup>3</sup> shareholder activism exists in a "market for corporate influence."<sup>4</sup> However, both markets share two important premises: First, there is "a high positive correlation between corporate managerial efficiency and the market price of shares of that company."<sup>5</sup> Second, "[a]part from the stock market, we have no objective standard of managerial efficiency."<sup>6</sup>

The debate on shareholder activism tends to focus on whether shareholder activism in general is appropriate, with zealous advocates

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1. For our purposes, a public company can be defined as a for-profit organization that is publicly traded but does not have a controlling shareholder. Thus, public companies include the largest of companies, such as Apple, General Electric, Microsoft, ExxonMobil, IBM, and General Motors, as well as thousands of other much smaller corporations that are still of significant size. For a more theoretical definition, see Michael P. Dooley, *Two Models of Corporate Governance*, 47 BUS. LAW. 461, 463 n.9 (1992) ("The term 'publicly held firm' is meant to describe . . . economic organizations in which (i) management and residual claimant status (shareholding) are separable and separated functions; (ii) the residual claims (shares) are held by a number of persons; and (iii) the residual claims are freely transferable and neither entry to nor exit from the firm is restricted.").

2. Professors Stuart Gillian and Laura Starks note: "Shareholder activists are often viewed as investors who, dissatisfied with some aspect of a company's management or operations, try to bring about change within the company without a change in control." Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 J. APPLIED CORP. FIN. 55, 55 (2007).

3. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 115–17 (1965). Manne's contribution to our understanding of how markets, especially the stock market, influence corporate governance cannot be understated. See William J. Carney, *The Legacy of "The Market for Corporate Control" and the Origins of the Theory of the Firm*, 50 CASE W. RES. L. REV. 215 (1999).

4. Brian R. Cheffins & John Armour, *The Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51, 58 (2011). As pointed out by Henry Manne, there is a significant inter-relationship between the market for corporate control and the market for corporate influence. Manne, *supra* note 3. The development of the market for corporate influence has no doubt been helped by federal securities and state corporate laws that have greatly inhibited the market for corporate control.

5. Manne, *supra* note 3, at 112. Manne used this premise to establish that the control of corporations may constitute a valuable asset in and of itself. *Id.*

6. *Id.* at 113.

lauding its virtues and opponents drawing attention to its vices. If shareholder activism is a front in a wider battle between managerial capitalism—an approach to corporate governance that incorporates the primary norm of managing the corporation for the benefit of all stakeholders—and shareholder-centric capitalism—managing the corporation primarily for the benefit of shareholders—the shareholder-centric model is increasingly gaining control.<sup>7</sup> Managerial capitalism, whatever its virtues, is fighting a rearguard action against the proponents of shareholder power.<sup>8</sup> This defensive action is made more difficult by the fact that federal regulation increasingly supports the shareholder-centric view.<sup>9</sup> This support suggests that shareholder activism will likely continue to be a central feature of corporate governance for years to come.

Shareholder activism comes in at least two primary forms and several sub-forms. Performance-driven activism, usually instigated by hedge funds, focuses on advocating for significant changes in corporate strategy to increase the market price of a company's stock. Corporate governance activism, on the other hand, focuses on changes in a public company's governance arrangements, executive compensation, and social policy.<sup>10</sup> In some cases, this second type of activism is used as a vehicle to achieve the first. For example, an activist hedge fund may support or even initiate corporate governance changes, such as the elimination of a staggered board, in order to reduce managerial insulation, which in turn allows the hedge fund to more effectively influence performance-driven corporate changes.

Even though shareholder activism has been a feature of corporate governance for over one hundred years,<sup>11</sup> only recently

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7. See Edward B. Rock, *Adapting to the New Shareholder-Centric Reality*, 161 U. PA. L. REV. 1907, 1911–26 (2013).

8. The decline of managerial capitalism can be directly linked to the rise of the independent director. See Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950–2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007).

9. See Paul Rose, *Common Agency and the Public Corporation*, 63 VAND. L. REV. 1355, 1356–59 (2010) (describing the shareholder-empowering function of numerous recent federal regulations).

10. James R. Copland, Yevgeniy Feyman & Margaret O'Keefe, *Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism*, CTR. FOR LEGAL POLICY AT THE MANHATTAN INST. 11 (2012), [http://www.proxymonitor.org/forms/pmr\\_04.aspx](http://www.proxymonitor.org/forms/pmr_04.aspx).

11. See Gillan & Starks, *supra* note 2. Gillan and Starks trace shareholder activism back to the early 1900s when U.S. financial institutions were active participants in corporate

have all the pieces come together for shareholder activism to become a powerful force in corporate governance. These pieces include the growing dominance of institutional investors in the investment of publicly held stock,<sup>12</sup> helping to reduce investors collective action costs;<sup>13</sup> the shift from managerial capitalism to shareholder-centric capitalism, such that the board of a public company now feels an increased need to respond to shareholder demands;<sup>14</sup> the Department of Labor's interpretive bulletin advising pension funds that proxy voting constituted part of the funds' fiduciary duties to investors;<sup>15</sup> the related rise of shareholder advisory services such as Institutional Shareholder Services;<sup>16</sup> the rise of hedge funds as shareholder activists<sup>17</sup> and the increasing ability of these hedge funds to raise large pools of funds so as to seek significant positions in public companies;<sup>18</sup> and the SEC's ideological support of shareholder interests.<sup>19</sup> This support is evident in various SEC rules and policies, including the liberalization of communications between shareholders with respect to proxy voting,<sup>20</sup> elimination of

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governance. *Id.* They also note that the modern version of shareholder activism received a big boost in 1942 when the SEC first allowed shareholders to submit proposals for inclusion on corporate ballots. *Id.*

12. See Ronald J. Gilson & Jeffrey N. Gordon, *Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863, 865 (2013) (noting that institutional investors hold over 70% of the outstanding stock of the top thousand U.S. public companies).

13. Collective action costs means that "shareholders generally will not make an effort to effect governance changes unless the benefits resulting from the efforts equal or exceed the costs of such an effort. Even when such efforts are made, the benefits may only inure to a particular shareholder or a small group of shareholders." Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 898 (2007).

14. See Martin Gelter, *The Pension System and the Rise of Shareholder Primacy*, 43 SETON HALL L. REV. 909, 913 (2013) (identifying the shift in the structure of pension plans from defined benefit to defined contribution plans as a significant cause of this increased need to listen to shareholders). As a result of this shift, pensioners have become less dependent on their former employers and more dependent on the capital markets for their pension wealth. *See id.*

15. See Department of Labor Rule on Shareholder Rights Under ERISA, 29 C.F.R. § 2509.08-2 (2008).

16. See Iman Anabtawi & Lynn Stout, *Fiduciary Duties for Activist Shareholders*, 60 STAN. L. REV. 1255, 1277-78 (2008). For a discussion of the costs and benefits of proxy voting firms, such as Institutional Shareholder Services, see Rose, *supra* note 13, *passim*.

17. See Gilson & Gordon, *supra* note 12.

18. See Anabtawi & Stout, *supra* note 16, at 1278-79.

19. See Rose, *supra* note 9, at 1359.

20. See Regulation of Communications Among Shareholders, Exchange Act Release No. 31,326, 52 SEC Docket 2028 (Oct. 16, 1992).

discretionary broker voting for the election of directors,<sup>21</sup> required disclosure of proxy voting by investment companies,<sup>22</sup> the SEC's promulgation of Investment Adviser's Act Rule 206 (4)-6 in 2003 (requiring investment advisers such as mutual fund companies, to "[a]dopt and implement written policies and procedures that are reasonably designed to ensure that [advisers] vote client securities in the best interest of clients"),<sup>23</sup> and some SEC commissioners' use of the populist argument that shareholders must take a more active role to constrain reckless risk-taking<sup>24</sup> by corporate managers in order to prevent another financial crisis.

Such developments mean that shareholder activism is here to stay,<sup>25</sup> and that both sides in the debate must now consider how activism can be utilized to allow corporate decision making to be executed in the most efficient manner. This Article seeks to answer that question by showing how a certain type of performance-driven activism, offensive shareholder activism (typically as a form of hedge fund activism), can promote shareholder value and therefore serve a beneficial role in corporate governance. In an Arrowian framework of corporate governance, offensive shareholder activism is a corrective mechanism that can reduce error in corporate decision making. As evidenced by the empirical studies described below, offensive shareholder activism has established itself as a legitimate tool of accountability in corporate governance. The key to the utility of such activism on an individual company basis is the transmission of information, from the activist to the board, which can enhance public company decision making.

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21. See Self-Regulatory Organizations, Exchange Act Release No. 60,215, 96 SEC Docket 654 (July 1, 2009) (discussing the amendment eliminating broker discretionary voting for the election of directors).

22. See Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, Exchange Act Release No. 8,188, 2003 WL 215451 (Jan. 31, 2003) (codified at 17 C.F.R. §§ 239, 249, 270, 274).

23. SEC Proxy Voting Rule, 17 C.F.R. § 275.206(4)-6 (2011).

24. Christopher M. Bruner, *Corporate Governance Reform in a Time of Crisis*, 36 J. CORP. L. 309, 332-35 (2010). This argument is not supported by any evidence that such shareholder empowerment would actually reduce reckless risk-taking in the financial sector or that such risk-taking was an issue in the non-financial sectors of the economy leading up to the 2008 financial crisis.

25. This is consistent with Professor Edward Rock's argument that we have completed the transition from a manager-centric to a shareholder-centric system of corporate governance; shareholder activists who claim to carry the mantle of shareholder wealth maximization will have increased leverage in making their case. See Rock, *supra* note 7.

This Article is timely not only because of the general rise of shareholder activism, but also because the debate on corporate governance has now shifted to a focus on the market for corporate influence. Moreover, this Article provides a much-needed bridge between the traditional authority model of corporate law and governance, as utilized by Stephen Bainbridge and Michael Dooley, and those who have empirically studied hedge fund activism, including Lucian Bebchuk, and have found it to be value enhancing. The bridge formed in this Article helps to identify when shareholder activism may be a positive influence on corporate governance.

The discussion that follows, when it references state corporate law, has been pragmatically framed in the context of Delaware corporate law. Delaware is the state where the majority of the largest U.S. companies are incorporated,<sup>26</sup> and its corporate law often serves as the authority that other U.S. states look to when developing their own statutory and case law.<sup>27</sup> Therefore, the primary examples are from Delaware, but the thinking is meant to be global in nature.

This Article proceeds as follows. Part I discusses the fundamental conflict in corporate law that creates shareholder activism. Part II explains the various categories of shareholders and why only one type of shareholder, the information trader, has the potential to improve corporate decision making. Part III examines a specific type of information trader, the offensive shareholder activist, and what empirical analysis can tell us about their activism. Part IV discusses the debate over the alleged short-term time horizon of hedge fund activists. Part V concludes by discussing how shareholders, boards, and regulators should understand the proper role of shareholder activism in corporate decision making.

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26. See LEWIS S. BLACK, JR., WHY CORPORATIONS CHOOSE DELAWARE I (2007), available at [corp.delaware.gov/whycorporations\\_web.pdf](http://corp.delaware.gov/whycorporations_web.pdf) (stating that Delaware is the “favored state of incorporation for U.S. businesses”). According to the State of Delaware website, Delaware is the legal home to “[m]ore than 50% of all publicly-traded companies in the United States including 64% of the Fortune 500.” *About Agency*, STATE DELAWARE, <http://corp.delaware.gov/aboutagency.shtml> (last visited Oct. 15, 2014).

27. See Nadelle Grossman, *Director Compliance with Elusive Fiduciary Duties in a Climate of Corporate Governance Reform*, 12 FORDHAM J. CORP. & FIN. L. 393, 397 (2007).

## I. THE INTERSECTION BETWEEN SHAREHOLDER ACTIVISM AND CORPORATE LAW

This Part describes how corporate law centralizes authority in the board of directors and how shareholder activism challenges this authority. This Part then introduces the argument that in discrete situations activism can serve as an important corrective mechanism within public companies.

Shareholder activism is primarily confined to public companies, which for our purposes is limited to publicly traded companies with no controlling shareholder.<sup>28</sup> Public companies almost always take the corporate form, not merely because of limited liability, legal personality, or transferrable shares—those attributes shared with other legal entities, such as limited liability companies (LLCs)—but also because of what can be considered corporate law’s most underrated attribute: its use of statutory default rules and court decisions to protect board decision making from shareholder interference.<sup>29</sup>

As Robert Clark observed, “the single most important fact of corporate law is that managerial power is legally centralized.”<sup>30</sup> To facilitate a centralized, hierarchical management structure, corporate law provides a public company’s board the exclusive authority to manage and execute the various forms of explicit and implicit contracts that encompass a firm’s contractual makeup.<sup>31</sup> However, board involvement in day-to-day operations is not necessary, as statutory law allows the board to delegate its authority to executive management.<sup>32</sup> This decentralization frees up many board members from having to participate in the day-to-day management of the firm, but at the same time consolidates power at the top of a corporation’s hierarchy—the board and executive management—without providing shareholders a role in the decision-making process.<sup>33</sup> After all, it is the board who decides what authority is to

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28. *See supra* note 1.

29. This large concentration of corporate authority was first identified by Professor Adolph Berle and Dr. Gardiner Means writing just after the 1927 and 1929 amendments to the Delaware General Corporation Laws. *See* A.A. Berle, Jr. & Gardiner C. Means, *Corporations and the Public Investor*, 20 AM. ECON. REV. 54, 60 (1930).

30. ROBERT CHARLES CLARK, *CORPORATE LAW* 21 (1986).

31. DEL. CODE ANN. tit. 8, § 141(a) (2011).

32. *Id.* § 142(a).

33. *See* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad*

be delegated and to whom. As a result, there is a significant imbalance between the authority of the board and the accountability that shareholders can provide. Shareholder activism can be understood to be the inevitable response to this imbalance.

Corporate law defers to board authority in many ways, including, most notably, selecting the board of the directors to be the default locus of authority for corporate decision making. Corporate law vests in directors the power to control corporate assets,<sup>34</sup> including the payment of dividends and other distributions.<sup>35</sup> The board is not required to follow the commands of its shareholders, even if shareholders pass a unanimous resolution requesting the board to act in a specific manner.<sup>36</sup> Shareholders may ratify a board's action, but the board must first approve the action.<sup>37</sup> Corporate law also protects the decisions of the board of directors from shareholder challenge, and to a great extent immunizes the directors from individual liability, by applying the business judgment rule to even the board's most harmful or inept business decisions,<sup>38</sup> and allowing

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*Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 3 (2011). Professor Bruner has pointed out that “enacting, amending, and repealing bylaws are essentially the only corporate governance actions that shareholders can undertake unilaterally.” *Id.* Of course, the management of a public company still gets the advantage of excluding a number of proposals from its proxy materials under the SEC's Rule 14a-8(i). *See* SEC Shareholder Proposals Rule, 17 C.F.R. § 240.14a-8 (2012) (explaining when a company must include a proposal in its proxy materials).

34. Delaware General Corporation Law Section 141(a) provides that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.” DEL. CODE ANN. tit. 8, § 141(a) (2011).

35. *See* tit. 8, § 170(a).

36. *See* tit. 8, § 141(a). *See also*, Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (“A cardinal precept of the General Corporation Law of the State of Delaware is that directors, rather than shareholders, manage the business and affairs of the corporation.”), *overruled on other grounds by* Brehm v. Eisner, 746 A.2d 244, 254 (Del. 2000). For a discussion of how corporate law retains decision-making power in the board of directors, even where a majority of shareholders oppose the board's decision, see Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 841 n.8 (2005).

37. For example, when a corporation has decided to proceed with a merger proposal, the statutory process requires that the board of directors take the lead by initiating the proposal with the shareholders participating by voting on the proposal. *See* tit. 8, § 251(b).

38. According to the Delaware Supreme Court:

Our law presumes that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.” Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care

for exculpation clauses to relieve directors of personal liability for alleged breaches in their duty of care.<sup>39</sup> Directors also have the right to implement defensive measures to ward off an unwelcome takeover bid through the application of the *Unocal* test, even when a majority of shareholders may be willing to accept the bid.<sup>40</sup>

Corporate law promotes centralized management because it recognizes that a centralized, hierarchical authority—the board of directors—is necessary for the successful management of a large for-profit organization such as a public company. According to Clark, hierarchies in large organizations lead to the “facilitation of cooperation in the carrying out of large-scale tasks.”<sup>41</sup> And according to Kenneth Arrow, information scattered over a large organization must be both filtered and transmitted to a centralized authority in order for a large organization to make informed decisions and minimize error in decision making.<sup>42</sup> The American Bar Association’s Committee on Corporate Laws also noted the benefits of centralized authority, stating, “the deployment of diverse investors’ capital by centralized management maximizes corporate America’s ability to

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or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.

*In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006) (quoting *Aronson*, 473 A.2d at 812). According to Henry G. Manne, the business judgment rule “will preclude the courts from any consideration of honest if inept business decisions, and that seems to be the purpose of the rule.” Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 271 (1967).

39. tit. 8, § 102(b)(7).

40. See *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

41. See CLARK, *supra* note 30, app. at 801–16 (arguing that “facilitation of cooperation” allows for efficiently completing large tasks).

42. KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 68–70 (1974). In his seminal article on corporate law, Professor Michael Dooley was the first to make the connection between the work of Kenneth Arrow and the structure of Delaware corporate law. Dooley, *supra* note 1, at 467. For equally influential articles on the application of Arrow’s work to corporate law, see Stephen M. Bainbridge, *The Board of Directors as Nexus of Contracts*, 88 IOWA L. REV. 1, 7 (2002); Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 VAND. L. REV. 83 (2004) [hereinafter Bainbridge, *The Business Judgment Rule*]; and Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547 (2003). See also Bernard S. Sharfman, *Shareholder Wealth Maximization and Its Implementation Under Corporate Law*, 66 FLA. L. REV. 389 (2014) [hereinafter Sharfman, *Shareholder Wealth Maximization*]; Bernard S. Sharfman, *Why Proxy Access is Harmful to Corporate Governance*, 37 J. CORP. L. 387 (2012) [hereinafter Sharfman, *Why Proxy Access is Harmful*].

contribute to long-term wealth creation.”<sup>43</sup> In sum, corporate law’s approach is to enhance corporate decision making and maximize shareholder wealth<sup>44</sup> by being extremely deferential to board decision-making authority.

The value of centralized authority is especially critical to widely held public companies. Michael Dooley observed that the value of centralized authority in an organization is magnified as the knowledge and interests of its members diverge.<sup>45</sup> In a public company, information and interests differ between management and shareholders.<sup>46</sup> Especially where there are a large number of shareholders, it is much more efficient, in terms of maximizing shareholder value, for the board of directors and executive management—the corporate actors that possess overwhelming advantages in terms of information, including nonpublic information, and whose skills in the management of the company are honed by specialization in the management of this one company—to make corporate decisions rather than shareholders.<sup>47</sup> Moreover, as we subsequently discuss in Part II, most shareholders, including value traders, have no interest in managing the company, even if they have acquired a significant amount of information about the company.

In general, we believe that the explanation behind why public companies take the corporate form is consistent with the

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43. Stephen M. Bainbridge, *Preserving Director Primacy by Managing Shareholder Interventions*, in RESEARCH HANDBOOK ON SHAREHOLDER POWER & ACTIVISM 4 (forthcoming), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2298415](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2298415) (citing COMM. ON CORP. LAWS OF THE AM. BAR ASS’N SECTION OF BUS. LAW, REPORT ON THE ROLES OF BOARDS OF DIRECTORS AND SHAREHOLDERS OF PUBLICLY OWNED CORPORATIONS (2009), available at [http://www.hunton.com/media/SEC\\_Proxy/PDF/SEC\\_Agenda\\_Section2.PDF](http://www.hunton.com/media/SEC_Proxy/PDF/SEC_Agenda_Section2.PDF)).

44. For purposes of this Article, we assume that shareholder wealth maximization is the corporate objective both in terms of corporate governance and corporate law. See *Shareholder Wealth Maximization*, *supra* note 42, for a discussion of shareholder wealth maximization as the objective of both corporate governance and corporate law.

45. Dooley, *supra* note 1, at 467 (“Where the residual claimants are not expected to run the firm and especially when they are many in number (thus increasing disparities in information and interests), their function becomes specialized to risk-bearing, thereby creating both the opportunity and necessity for managerial specialists.”).

46. *See id.* at 466–67. The value of centralized authority is not as great in general partnerships and closely-held corporations because the same persons perform both the managerial and risk-taking (investment) functions. *See id.* at 466. Management and partners or shareholders are essentially one and the same. *See id.*

47. *See id.*

contractarian explanation, that the default rules provided by corporate law are, for the most part, “market mimicking.”<sup>48</sup> This is especially true for rules that govern the relationship between the board and shareholders. We say this because, as we have already discussed, we believe corporate law correctly provides authority to the board and its executive officers, and therefore it is doubtful that private ordering that significantly shifts decision making to shareholders will enhance the efficiency of this relationship.<sup>49</sup>

But even in the context of the largest corporations,<sup>50</sup> corporate law’s great deference toward board authority is not absolute and was

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48. This phrase was coined by Professor Bernard Black. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 552 (1990).

49. However, we concede that because of transaction costs that exist in the real world, the extensive use of corporate law’s default rules by public companies is not entirely the result of these rules being contractually efficient. In that regard, we are sympathetic to the argument made by Michael Klausner, who persuasively argues that the uniformity and stickiness in corporate governance arrangements at public companies is due to significant transaction costs and not the result of efficient private ordering in a theoretically cost-free environment. Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 791–93 (2006) [hereinafter Klausner, *The Contractarian Theory*]; see also Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 826–29 (1995). Klausner provides the following, non-market mimicking explanation for the prevalent use of corporate law’s default rules in corporate charters:

There is inherent uncertainty regarding how courts will apply and interpret any but the most simple legal rules, contract terms, or charter terms. This uncertainty is a cost of legal enforcement. As a legal rule or charter term is interpreted and applied in a variety of settings, however, the term acquires more content, and uncertainty regarding its application declines. As a result, enforcement costs decline.

Klausner, *The Contractarian Theory*, *supra* at 793 (citing Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 719–25, 731–33 (1997)). The result is that the corporate charter is a relatively simplistic and abbreviated document that by its silence incorporates the default rules of corporate law. See *id.* at 789–90. For example, Klausner discusses empirical evidence that describes how the governance arrangements of companies filing for initial public offerings are remarkably uniform. See *id.* at 790–91; see also Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1336–37 (2013). The only significant variability occurs in how much protection should be given a board from the threat of a hostile takeover. See Klausner, *The Contractarian Theory*, *supra* at 790.

50. Why a corporation would decide to produce what it needs internally, and thereby grow to great size, instead of contracting for all its needs in the relevant market, is a function of *transaction costs* and the marginal analysis that goes into determining the better alternative. See Ronald H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386, 393–97 (1937). Such a need for large size arises in this because “managers continuously compare the incremental costs and payoffs of internal production (expansion or vertical integration) against external procurement, choosing [sic] whichever alternative provides the best payoff until the two are

never meant to be. Corporate law recognizes that a certain amount of accountability, even if infrequently and lightly applied, is required to control for error in corporate decision making as it relates to a board's cognitive and behavioral limitations in the context of small-group decision making,<sup>51</sup> as well as the more widely discussed opportunistic (self-interested) behavior by directors and executive management when there is a wide separation of authority between share ownership and management.<sup>52</sup> Such opportunistic behavior includes corporate management shirking its duties or trying to extract private benefits from the corporation.<sup>53</sup> These types of behavior lead to agency costs in public companies.<sup>54</sup>

Given this preference for centralized authority, it is not unexpected that corporate law has created significant roadblocks for shareholder activists to overcome. However, these roadblocks are not

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equalized at the margin." Herbert Hovenkamp, *Coasean Markets*, 31 EUR. J.L. & ECON. 63, 68 (2011). The point of optimal firm size, which means the corporation may become very large in size, is a function of this marginal analysis. *See id.* at 71.

51. Arrow discussed this in terms of the centralized authority (the small group in charge of decision making such as a board of directors) becoming a victim of information overload. ARROW, *supra* note 42, at 74. The problem of information overload is compounded "by the tendency in that situation to filter information in accordance with one's preconceptions." *Id.* at 75. Another issue is group polarization, the tendency of a small deliberative group with an initial tendency to move in a given direction to move to even more extreme positions in that direction following group deliberations. *See* Cass R. Sunstein, *Deliberative Trouble? Why Groups Go to Extremes*, 110 YALE L.J. 71, 74 (2000); Cass R. Sunstein, *Group Judgments: Statistical Means, Deliberation, and Information Markets*, 80 N.Y.U. L. REV. 962, 1004 (2005); Cass R. Sunstein & Reid Hastie, *Four Failures of Deliberating Groups* 20 (Univ. of Chi. Law & Econ., Olin Working Paper No. 401, 2008), *available at* [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1121400](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1121400); *see also* Bernard S. Sharfman & Steven J. Toll, *Dysfunctional Deference and Board Composition: Lessons from Enron*, 103 NW. U. L. REV. COLLOQUY 153, 155 (2008).

52. *See* Bainbridge, *The Business Judgment Rule*, *supra* note 42, at 107.

53. *See* Dooley, *supra* note 1, at 465.

54. *See* Rose, *supra* note 9, at 1361 (citing Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976)). As explained by Professor Rose:

Under a classic theory of the firm, agency costs in the corporate context increase as ownership is separated from control. As the manager's ownership of shares in the firm decreases as a percentage of the total, the manager will bear a diminishing fraction of the costs of any nonpecuniary benefits he takes out in maximizing his own utility. To prevent the manager from maximizing his utility at the expense of the shareholders, shareholders will seek to constrain the manager's behavior by aligning the manager's interests with the shareholders' interests.

*Id.* at 1361 (citations omitted).

insurmountable. Shareholder activists still have the right to advocate for a voice in operational decision making not only through engagement with executive management, but also through the threat of a proxy contest, binding by-law proposals,<sup>55</sup> or non-binding shareholder proposals if such changes are not implemented. Shareholders may also legally challenge board decisions on both a derivative and direct basis, seeking either to enjoin the board decision or to obtain an award of damages for decisions already made. Finally, shareholders also have the right to inspect a corporation's books and records for a proper purpose.<sup>56</sup>

However, an increase in accountability brought about by shareholder activism does not necessarily result in enhanced corporate decision making. The risk is that in the process of trying to correct or prevent errors resulting from poor managerial decisions, "the genuine values of authority" will be destroyed.<sup>57</sup> Such "a sufficiently strict and *continuous* organ of responsibility can easily amount to a denial of authority."<sup>58</sup> Arrow suggests, "if every decision of A is to be reviewed by B, then all we have really is a shift in the locus of authority from A to B and hence no solution to the original problem."<sup>59</sup> For example, allowing every major board decision to be reviewed and voted on by shareholders inhibits the ability of corporate managers to make the most efficient and wealth-maximizing decisions on a timely basis. This implies that "[i]n such a scenario, accountability can be understood to cross over the line to where a new and competing locus of authority is created—a locus of authority, such as uninformed shareholders, that does not benefit from the informational advantages of the original authority."<sup>60</sup> Thus, in order to make sure that corporate decision making is allowed to maximize the value of centralized authority, thereby getting as close to shareholder wealth maximization as possible, shareholders must accept a certain amount of group decision-making error and agency

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55. See DEL. CODE ANN. tit. 8, § 109 (2011).

56. See, e.g., *Compaq Computer Corp. v. Horton*, 631 A.2d 1, 3–4 (Del. 1993) (discussing the statutory right of stockholders under Delaware General Corporation Law Section 220(b) to inspect the company books if they have a proper purpose and how public policy may allow inspection even if it is adverse to the corporation's interests).

57. ARROW, *supra* note 42, at 78.

58. *Id.* (emphasis added).

59. *Id.*

60. Sharfman, *Shareholder Wealth Maximization*, *supra* note 42, at 406.

costs as a part of this decision-making process.

The central problem in the market for corporate influence is identifying when the costs of protecting board authority become large enough that corrective action by shareholders—beyond merely waiting until the next director election—is justified. Arrow, the intellectual godfather of the traditional authority model of corporate law and governance, suggested that from time to time it may be more efficient to allow for a corrective mechanism to exist in a large organization. That is, the central authority recognizes that a part of the organization outside itself may have superior information or decision-making skills.<sup>61</sup> From this we can infer that a shift in decision-making authority from the board to a company's shareholders may possibly be more efficient and enhance shareholder wealth in certain discrete situations. However, consistent with a legal framework in which fiduciary responsibility rests with the board and, to some extent, controlling shareholders, in practice, authority does not *shift* to unaccountable shareholders, but is at least temporarily *shared*.<sup>62</sup>

Governance entrepreneurs in the market for corporate influence must first identify those instances in which authority-sharing may result in value-enhancing policy decisions, and then persuade the board and/or other shareholders of the wisdom of their policies so that they will be permitted to share the authority necessary to implement the policies. The following Part discusses how and why some shareholder activists are successful in identifying these opportunities to influence.

## II. DIFFERENTIATING SHAREHOLDERS

The type and quality of shareholder activism is a function of the type of shareholder that is involved. To see why this is so, we must first understand that shareholders in a public company can differ not only in terms of how much information and skill they possess relevant to corporate decision making, but also in their interest in being involved in such decision making.

A public company's stockholders can be differentiated based on the roles they play in the equity markets. These groups include

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61. ARROW, *supra* note 42, at 74–75.

62. Because they only have influence and not control, governance entrepreneurs such as offensive activists rely on some degree of board and managerial cooperation in order to facilitate their desired changes.

insiders, liquidity traders, noise traders, market makers, and information traders.<sup>63</sup>

*Insiders* are stockholders, including directors and executive management, who have access to nonpublic information about the firm, but have significant restrictions in the trading of that information for profit.<sup>64</sup> Insiders, of course, do not participate in shareholder activism.<sup>65</sup>

*Liquidity traders* do not collect and evaluate information; rather, they participate in the market depending on their funding needs.<sup>66</sup> Liquidity traders are typically passive, index fund investors;<sup>67</sup> thus, combined with the benefits of limited liability, such index fund investors “utilize portfolio diversification to eliminate the unsystematic risk associated with their equity investment.”<sup>68</sup> These traders generally have little or no information about any of the companies they hold in their portfolio, no identified skills in decision making, and no interest in the particular corporate decision making of the hundreds or thousands of companies they invest in.<sup>69</sup> This group of investors is the stereotype for those who believe shareholders are “rationally apathetic.”<sup>70</sup> Therefore, the disparities between management and shareholders are maximized with respect to liquidity traders. Thus, because they have no information or interest in participating in corporate decision making, their participation in corporate decision making is likely to be weakly informed or perhaps driven by opportunistic behavior.

*Noise traders* are, in the context of informationally efficient

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63. See Zohar Goshen & Gideon Parchomovsky, *The Essential Role of Securities Regulation*, 55 DUKE L.J. 711, 722 (2006). This approach focuses on shareholders as having different functions in the equity markets versus having heterogeneous interests in the holding of company stock and the effects on corporate governance. See *id.* at 722–26. For the latter approach, see Rose, *supra* note 9.

64. Goshen & Parchomovsky, *supra* note 63, at 722.

65. As a reminder, shareholder activism only takes place in the market for corporate influence, not in the market for corporate control. See *supra* notes 1–4 and text accompanying notes.

66. Goshen & Parchomovsky, *supra* note 63, at 724.

67. *Id.*

68. Bernard S. Sharfman, *What’s Wrong with Shareholder Empowerment?*, 37 J. CORP. L. 903, 906 (2012).

69. See *id.*

70. *Id.*

markets, irrational investors. They utilize diverse investment strategies.<sup>71</sup> Some noise traders may invest based on fads and rumors, while others may rely on old information or are simply slower in analyzing information that is publicly available.<sup>72</sup> Like liquidity traders, when they participate in shareholder activism or corporate voting, their participation is most likely to be weakly informed or perhaps driven by opportunistic behavior.

*Market makers* are professionals who facilitate trading and maintain a market for securities by offering to buy or sell securities on a regular basis.<sup>73</sup> Although market makers are well informed about the demand and supply of a security, they may not be well informed regarding firm-specific information.<sup>74</sup> Again, like liquidity traders and noise traders, when they participate in shareholder activism or corporate voting, market makers are most likely to be weakly informed or perhaps driven by opportunistic behavior.

*Information traders* are those market participants who trade in the financial markets based on their own research or on recommendations from others.<sup>75</sup> These traders “are willing and able to devote resources to gathering and analyzing information as a basis for their investment decisions.”<sup>76</sup> Information traders include sophisticated professional investors such as activist hedge fund managers, money managers, and other market professionals.<sup>77</sup> Information traders look for differences between value and price based on the information they possess and “then trade to capture the value of their informational advantage.”<sup>78</sup> Information traders move security prices toward their fundamental values and are in essence “the agents who render markets efficient.”<sup>79</sup>

The value of information traders in the pricing of securities was

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71. See Goshen & Parchomovsky, *supra* note 63, at 724.

72. See *id.* at 724–25.

73. See *id.* at 725.

74. See *id.*

75. See *id.* at 723. Professors Goshen and Parchomovsky also include as information traders researchers and analysts who provide recommendations and advice. However, because we are describing investors in the context of shareholder activism, we will not include these market participants in our definition of information trader. See *id.* at 721.

76. *Id.* at 723

77. See *id.*

78. *Id.* at 726.

79. *Id.* at 719.

first pointed out by Sanford Grossman and Joseph Stiglitz.<sup>80</sup> They noted that it is not possible for securities markets to operate without market participants investing in information and earning positive returns for their efforts. They argued that “because information is costly, prices cannot perfectly reflect the information which is available, since if it did, those who spent resources to obtain it would receive no compensation.”<sup>81</sup> Instead, they argue, that what exists in capital markets “is an equilibrium degree of disequilibrium: prices reflect the information of informed individuals (arbitrageurs) but only partially, so that those who expend resources to obtain information do receive compensation.”<sup>82</sup>

The insights provided by Grossman and Stiglitz mean that we should understand the pricing of any individual stock more in terms of having varying degrees of effectiveness, not efficiency.<sup>83</sup> The efficient market hypothesis “states that in free and actively traded markets, stock prices will fully reflect all available information about the corporation.”<sup>84</sup> However, this mechanistic understanding of markets implies that the seeking out of new information is futile. Instead, under Grossman and Stiglitz’s understanding of capital markets, information traders can now be understood to be financially rewarded for helping to make the market more efficient when seeking out new information on specific companies, without ever achieving a perfect equilibrium.<sup>85</sup> They thereby help to expand the amount of data that can be utilized to value the stock of publicly traded companies,<sup>86</sup> using their analytical skills to create a competing source of pricing information on the value of a public company’s stock, or, as argued in this Article, to create a sharing of authority

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80. See generally Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

81. *Id.* at 405.

82. *Id.* at 393.

83. Goshen & Parchomovsky, *supra* note 63, at 730–31.

84. Barbara Black, *Fraud on the Market: A Criticism of Dispensing with Reliance Requirements in Certain Open Market Transactions*, 62 N.C. L. REV. 435, 437–38 (1984).

85. See Goshen & Parchomovsky, *supra* note 63, at 730–31.

86. For example, this has been helpful amidst the recent epidemic of Chinese companies that have utilized reverse mergers to trade on U.S. stock exchanges with inflated reported revenues and profits. See Sharfman, *Why Proxy Access is Harmful*, *supra* note 42, at 404–05. These misrepresentations would not have come to light without the costly information gathering of information traders, including the hiring of investigators to go out into the field and visit the operations of the targeted Chinese firms, into the activities of these companies. *Id.*

with the board of directors for certain discrete corporate decisions. All such activities make the market more efficient by moving the price of the stock toward its fundamental value.<sup>87</sup>

However, even information traders may be rationally apathetic or reticent when it comes to becoming involved in corporate decision making.<sup>88</sup> This is because, for the large majority of information traders, there are still large disparities in valuable, non-public information, skill in decision making, and interest in corporate governance between them and corporate management.<sup>89</sup> Instead, these “value investors”<sup>90</sup> specialize in utilizing the information they have gathered to identify differences between value and price and then trade the targeted stock to capture the value of this informational advantage.<sup>91</sup> Whatever limited time, resources, and skill they have to devote to their work are targeted toward valuation, not corporate governance.

Some information traders, including some hedge fund managers, are exceptions to this rule. These traders “take large positions in public companies as a means to effect change.”<sup>92</sup> They are distinguished from value investors by their willingness to spend resources to identify operational, strategic, or personnel changes that they believe will enhance shareholder value and then spend even more resources to try to get the corporation to implement those changes.<sup>93</sup> As detailed in the next Part, these traders are participating in what is called *offensive shareholder activism*.<sup>94</sup>

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87. See Goshen & Parchomovsky, *supra* note 63, at 730–31.

88. See Sharfman, *supra* note 68, at 906–07.

89. See *id.*

90. Gilson and Gordon refer to institutional investors who are value investors (earn returns based on fundamental analysis and diversification) and liquidity traders (earn returns through low cost diversification) as “rationally reticent.” Gilson & Gordon, *supra* note 12, at 867. They vote, but they do not propose or get involved in trying to influence the management of the corporation. See *id.* According to Gilson and Gordon, “[i]nstitutional owners who are not seeking private benefits of control are rationally reticent; they also will assign a low value to governance rights since their proactive exercise will not improve the relative performance on which the institutional investor’s profitability and ability to attract assets depends.” *Id.* at 895 (footnote omitted).

91. Sharfman, *supra* note 68, at 907.

92. *Id.*

93. Cheffins & Armour, *supra* note 4, at 56–57.

94. *Id.*

## III. OFFENSIVE SHAREHOLDER ACTIVISM

Offensive shareholder activism, as identified by John Armour and Brian Cheffins,<sup>95</sup> is performance-driven activism initiated primarily by a specific type of institutional investor: the hedge fund.<sup>96</sup> It typically begins with a hedge fund<sup>97</sup> accumulating a significant amount of a company's stock.<sup>98</sup> The catalyst for the accumulation is a determination by the hedge fund that the target company is currently not maximizing returns, but that if management would implement the hedge fund's recommended changes, company performance would improve, the stock would increase in value, and the hedge fund would reap excess returns.<sup>99</sup>

This activism is distinct from "defensive shareholder activism," which refers to institutional investors that hold significant blocks of company stock and advocate for changes only when company fortunes decline.<sup>100</sup>

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95. *Id.* Since these companies are rarely interested in gaining corporate control, Professors Cheffins and Armour refer to these activities in sum as the "market for corporate influence." *Id.* at 58–59.

96. *Id.* at 53.

97. There is no consensus definition of "hedge fund." However, for purposes of this Article we will identify these institutional investors by the following four characteristics as provided by Professors Brav, Jiang, Partnoy and Thomas:

- (1) they are pooled, privately organized investment vehicles;
- (2) they are administered by professional investment managers with performance-based compensation and significant investments in the fund;
- (3) they are not widely available to the public; and
- (4) they operate outside of securities regulation and registration requirements. More specifically, hedge funds avoid the Investment Company Act of 1940 by having a relatively small number of sophisticated investors.

Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1735 (2008) (citation omitted).

98. Cheffins & Armour, *supra* note 4, at 56. Cheffins & Armour have identified instances of offensive shareholder activism going back to at least the first decade of the twentieth century. See Brian R. Cheffins & John Armour, *Offensive Shareholder Activism in U.S. Public Companies, 1900–49*, 5–6 (Univ. of Cambridge Faculty of Law Research Paper No. 09/2011), available at <http://ssrn.com/abstract=1759983>.

99. Cheffins & Armour, *supra* note 4, at 56.

100. *Id.* As explained by Marcel Kahan and Edward Rock:

Mutual fund and public pension fund activism, if it occurs, tends to be incidental and ex post: when fund management notes that portfolio companies are underperforming, or that their governance regime is deficient, they will sometimes be active. In contrast, hedge fund activism is strategic and ex ante: hedge fund managers first determine whether a company would benefit from activism, then take a position and become active.

According to Cheffins and Armour:

The readiness to take a hands-on role to shake things up is the crucial additional dimension to hedge fund activism. Activist hedge funds, rather than merely adopting the passive approach that characterizes value investing and waiting for the market to self-correct—which may well never happen if a company’s shares do not get noticed and instead drift lower—are prepared to take the initiative and accelerate matters by lobbying for changes calculated to boost shareholder returns.<sup>101</sup>

Therefore, offensive shareholder activists are proactive while defensive shareholder activists are reactive.<sup>102</sup> Moreover, relative to the typical information trader who is only value-investing and not participating in shareholder activism, offensive shareholder activists provide additional information to the corporation and the marketplace in the form of recommended changes to corporate strategy.

The following is an example of offensive shareholder activism. In early 2012, Relational Investors LLC (Relational) began accumulating shares of the Timken Co. (NYSE: TKR). By June 30, 2012, it had acquired approximately \$65 million of Timken stock,<sup>103</sup> and by September 30, 2012, it had increased its holdings to approximately \$120 million.<sup>104</sup> On August 23, 2012, Relational made its first reported presentation to the company’s board, urging the board to split the company into two, with one part focusing on steel production and the other on ball bearings.<sup>105</sup> This proposal was met with strong opposition from the board.<sup>106</sup>

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Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1069 (2007) (footnote omitted).

101. Cheffins & Armour, *supra* note 4, at 58 (footnotes omitted).

102. *See id.* at 56.

103. *See* Relational Investors LLC, Quarterly Report (Form 13F-HR/A) (June 30, 2012), *available at* <http://www.sec.gov/Archives/edgar/data/1047644/000104746912010843/a2211829z13f-hra.txt>.

104. *See* Relational Investors LLC, Quarterly Report (Form 13F) (Sept. 30, 2012), *available at* [www.sec.gov/Archives/edgar/data/1047644/000104746912010845/0001047469-12-010845.txt](http://www.sec.gov/Archives/edgar/data/1047644/000104746912010845/0001047469-12-010845.txt).

105. *See* Timken Co., Exhibit B (Form SC 13D/A) (Feb. 19, 2013), *available at* [www.sec.gov/Archives/edgar/data/98362/000110465913011766/a13-5429\\_1ex99db.htm](http://www.sec.gov/Archives/edgar/data/98362/000110465913011766/a13-5429_1ex99db.htm).

106. *See id.*

As a result, California State Teachers' Retirement System (CalSTRS), with approval from Relational, placed a non-binding resolution in the company's annual meeting proxy materials that called for such a split.<sup>107</sup> This proposal was approved by a 53% majority of Timken shareholders at the annual shareholders meeting held May 7, 2013.<sup>108</sup> As a result, the Timken board announced on June 10, 2013 that it had formed a Strategy Committee made up of independent directors to evaluate such a separation of businesses.<sup>109</sup> In addition, as reported on August 2, 2013, Relational increased its stake in Timken to 7.9%.<sup>110</sup>

On September 5, 2013, the board of Timken "approved a plan to separate the Company's steel business from its bearings and power transmission business through a spinoff."<sup>111</sup> Of most interest to Timken stockholders, the price of Timken stock responded by rising 2.9% to \$62.02, the highest price since at least January 4, 1978.<sup>112</sup> On June 30, 2014, Timken distributed 100% of its interest in its steel operations to the holders of the company's common stock.<sup>113</sup>

The Timken example illustrates how offensive shareholder activists can reap handsome rewards for themselves and for the company as a whole by successfully advocating for internal changes within the corporation that take advantage of unrealized value which only they, and not the board of directors, were able to perceive. We

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107. See Timken Co., Schedule 14A (Form SC 14A) (Mar. 21, 2013), available at <http://www.sec.gov/Archives/edgar/data/98362/000119312513118303/d494162ddef14a.htm>.

108. Timken Co., Current Report (Form 8-K) (May 8, 2013), available at <http://www.sec.gov/Archives/edgar/data/98362/000119312513207498/d534241d8k.htm>.

109. *The Timken Company Establishes Board Strategy Committee to Evaluate Separation of Steel Business*, PR NEWSWIRE (June 10, 2013, 4:05 PM), <http://news.timken.com/index.php?s=12504&item=136827>.

110. See Timken Co., Schedule 13D (Form SC 13D/A) (Aug. 2, 2013), available at [http://www.sec.gov/Archives/edgar/data/98362/000110465913059738/a13-17712\\_1sc13da.htm](http://www.sec.gov/Archives/edgar/data/98362/000110465913059738/a13-17712_1sc13da.htm).

111. Timken Co., Current Report (Form 8-K) (September 5, 2013), available at <http://www.sec.gov/Archives/edgar/data/98362/000119312513361485/d595784d8k.htm>.

112. Leslie Picker & Thomas Black, *Timken Jumps After Agreeing to Spin Off Steel Unit*, BLOOMBERG (Sept. 6, 2013, 4:36 PM), <http://www.bloomberg.com/news/2013-09-06/timken-jumps-after-agreeing-to-spin-off-steel-unit.html>.

113. See Timken Co., Current Report (Form 8-K) (June 30, 2014), available at <http://www.sec.gov/Archives/edgar/data/98362/000009836214000094/a8kforsteelspinof.htm>.

next turn to a theoretical explanation of offensive shareholder activism.

*A. Offensive Shareholder Activism as a Sharing of Authority*

According to Arrow, “[t]he basic deficiency of irresponsible authority from the functional view point is the likelihood of unnecessary error.”<sup>114</sup> Moreover, “[e]rror is unnecessary when the information is available somewhere in the organization but not available to or not used by the authority.”<sup>115</sup> According to Arrow, “others in the organization may have access to superior information on at least some matters.”<sup>116</sup> Therefore, it is legitimate to criticize such authority, allowing for a “corrective mechanism” when necessary.<sup>117</sup>

As noted earlier, it follows that a shift in decision-making authority or, more accurately, a sharing of authority between the board and a shareholder or small group of shareholders may be more efficient in certain discrete situations.<sup>118</sup> For those who seek enhanced corporate decisions through shareholder activism, the issue becomes identifying those situations in which it is more efficient to share decision making with shareholders.

Offensive shareholder activism often serves as a corrective mechanism and thus results in a legitimate sharing of authority on a discrete basis. The traditional understanding of shareholder activism is that it is a tool of accountability used to minimize agency costs. For example, activism may reduce agency costs that result from management shirking or rent seeking,<sup>119</sup> or from an inability by the board to breach implicit agreements that the corporation has maintained for a long period of time but have, for whatever reason,

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114. ARROW, *supra* note 42, at 73–74.

115. *Id.* at 74.

116. *Id.* at 75.

117. *Id.*

118. See Sharfman, *supra* note 68, at 905.

119. According to Professors Matsusaka and Ozbas, “[f]acing an active shareholder who seeks to maximize profit, a manager suffering from an agency problem may compromise by choosing an action that is closer to profit maximization than would otherwise have been chosen.” John G. Matsusaka & Oguzhan Ozbas, *Managerial Accommodation, Proxy Access, and the Cost of Shareholder Empowerment* 3–4 (Marshall Sch. of Bus. Working Paper No. FBE 02-12, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1984606](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1984606).

outlived their usefulness.<sup>120</sup> Alternatively, the cause for activism could be a lack of good decision-making ability on the part of the board and executive management as a group or in their respective capacities.<sup>121</sup> Whatever the cause, the real thrust of offensive shareholder activism is to challenge board decision making when it is not maximizing shareholder wealth. Very simply, the offensive shareholder activist thinks it has a superior approach to enhancing shareholder wealth. Additionally, while insiders have informational advantages over offensive activists regarding firm-specific information, offensive activists may possess, on a discrete basis, decision-making skills, superior information about competitors, or other important decision-making inputs that erode or even eclipse the overall informational advantages of the board and managers.

### *B. The Small Problem of Uninformed Shareholders*

The glitch in offensive shareholder activism is that if the challenge to board authority ultimately leads to a proxy vote, then shareholders as a body must decide how to proceed. In this scenario, the two competing loci of authority with the most specialized expertise and information to make corporate decisions, the board and the offensive shareholder activist, are relegated to the sidelines as pitchmen for their respective positions during the shareholder vote. Given that a significant percentage of a company's shareholders may be non-information traders, this may lead to sub-optimal decision making.

Fortunately, the problem of uninformed shareholders as the ultimate arbiters of whether or not offensive shareholder activism is wealth enhancing is mitigated by the fact that there has been relatively few proxy votes resulting from such activism. Brav, Jiang, Partnoy, and Thomas report that only 13% of hedge fund activism (as represented primarily by a hedge fund's filing of an SEC form Schedule 13D) resulted in a proxy contest, while Klein and Zur reported that only 12% of offensive shareholder activism initiated by hedge funds and other activists resulted in a proxy contest.<sup>122</sup> It

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120. Sharfman, *Shareholder Wealth Maximization*, *supra* note 42, at 417 n.151 (citing Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33, 33 (Alan J. Auerbach ed., 1988)).

121. See *ARROW*, *supra* note 42, at 74.

122. Brav et al., *supra* note 97, at 1743; April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 *J. FIN.* 187, 213, 215 (2009).

appears then that the mere threat of a proxy contest is often enough to get the board to seriously consider the recommendations of the offensive shareholder activist and implement those recommendations in a significant number of instances. Thus, the problem of allowing uninformed shareholders to participate in the decision-making process can be avoided in the overwhelming number of instances where offensive shareholder activism has been implemented.

### *C. Empirical Analysis of Offensive Shareholder Activism*

In an Arrowian approach to corporate governance, the key question is why should corporate board authority ever yield to shareholder accountability? In other words, under what circumstances should the board permit shareholders to influence corporate policy?

If we use as our metrics the creation of shareholder value and improved firm performance, the available empirical evidence suggests that board members should be cautious in how they allow shareholders to influence corporate strategy. In terms of performance-related activism, only offensive shareholder activism has been found to actually enhance shareholder wealth.<sup>123</sup> Furthermore,

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123. The empirical work of Boyson and Mooradian has led them to conclude that “aggressive activism [defined as “activism having a specific motive other than ‘communication’ or ‘investment purposes only’”] and activism targeting changes in corporate governance [board representation and enhanced cash flow] are strongly related to improvement in long-term performance and improvement in cash positions . . . .” Nicole M. Boyson & Robert M. Mooradian, *Corporate Governance and Hedge Fund Activism*, 14 REV. DERIVATIVES RES. 169, 178, 201 (2011);

Activism [hedge fund] that targets the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets, is associated with the largest positive abnormal partial effects . . . . In contrast, we find that the market response to capital structure-related activism—including debt restructuring, recapitalization, dividends, and share repurchases—is positive yet insignificant. We find a similar lack of statistically meaningful reaction for governance-related activism—including attempts to rescind takeover defenses, to oust CEOs, to enhance board independence, and to curtail CEO compensation.

Brav et al., *supra* note 97, at 1731. See also Christopher P. Clifford, *Value Creation or Destruction? Hedge Funds as Shareholder Activists*, 14 J. CORP. FIN. 323, 324 (2008) (finding that firms targeted by hedge funds for active purposes earn larger, positive returns than firms targeted by hedge funds for passive purpose; this control group contained hedge funds that filed Schedule 13Gs); Robin M. Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362, 368–70 (2009) (finding that activists are most successful at creating value when they are able to force a change in control); Klein & Zur, *supra* note 122 at 217 (focusing on activist campaigns by both hedge funds and other types of entrepreneurial

significant wealth enhancement has been found only where the activism has led to “the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets.”<sup>124</sup> An example of this would be Relational’s recommendation that Timken Co. spin off its steel operations into a separate public company in order to increase the price of the company’s stock. Recent research suggests we can delve even further and find that while both experienced and inexperienced offensive shareholder activists create significant wealth and performance enhancement within a corporation, experienced activists do better than inexperienced activists.<sup>125</sup>

In empirical research, offensive shareholder activists are usually identified by their filing of the SEC form Schedule 13D. Such a filing is required when an investor crosses over the 5% threshold of stock ownership and has at least some intention to influence the corporation either immediately or in the future.<sup>126</sup> The filing requirement applies not only to hedge funds, but also to all other types of entrepreneurial activist investors (private equity firms, venture capitalists, asset management groups, and private individuals).<sup>127</sup> An investor files the shorter Schedule 13G if it only intends to invest passively and not influence corporate decision making.<sup>128</sup>

Based on our prior discussion, the pricing of shares in the presence of offensive shareholder activism can be explained as follows: at the time the offensive shareholder activist reveals that it

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activists, the study found that both types of campaigns produced average abnormal returns for target shareholders).

124. Brav et al., *supra* note 97, at 1731. See also Greenwood & Schor, *supra* note 123, at 363 (finding that abnormal positive returns only existed when the activism was associated with the ultimate sale of the target to a third party).

125. Nicole M. Boyson, Linlin Ma & Robert Mooradian, *Are All Hedge Fund Activists Created Equal? The Impact of Experience on Hedge Fund Activism* 1 (March 21, 2014) (on file with authors) (“[O]ur results imply that more experienced activists deliver better short-term performance and long-term outcomes for target firms.”). Interestingly, they find that “relative to less frequent activists, more frequent activists choose larger firms with less cash, better stock and operating performance, and a larger distance to default.” *Id.* at 3.

126. See *Schedule 13D*, U.S. SEC. & EXCH. COMM’N (Dec. 5, 2012), <http://www.sec.gov/answers/sched13.htm>.

127. See *id.* April Klein and Emanuel Zur appropriately point out that offensive shareholder activism is not the sole province of hedge funds, but can also include any other type of private individual or entity who takes a significant stake in a company and then advocates for corporate change. See Klein & Zur, *supra* note 122, at 187.

128. See SEC Rule on Filing of Schedules 13D and 13G, 17 C.F.R. § 240.13d-1 (2011).

has made a significant investment in the company, the stock market does not know if the proposed changes are expected to be superior, equal, or inferior to what the board and management is expected to implement. All the market knows, at least at the time the hedge fund files its Schedule 13D, is that an information trader has made a significant investment in a particular company and expects excess returns if its recommended changes are implemented. Many investors who actively trade in the stock market will no doubt try to free ride on this investor's research, analysis, and recommendations and will invest in the company stock without having to expend resources in such work. This new demand among free-riding investors allows the stock to have at least a short-term run-up in market price, regardless of whether the hedge fund is right or wrong in its approach to enhancing corporate performance.<sup>129</sup>

If so, empirical studies on offensive shareholder activism, usually in the form of event studies, may simply be reporting on this short-term run-up in the prices of the targeted stocks. The abnormal returns may soon disappear once information traders have had time to properly evaluate the recommendations for the positive (or negative) value they may provide and then estimate the probability that these recommendations will actually be implemented.

However, it has not been the case that these abnormal positive returns have disappeared over time. Studies by Boyson and Mooradian<sup>130</sup> and Brav, Jiang, Partnoy, and Thomas<sup>131</sup> have demonstrated that the short-term run-up in stock prices from hedge fund activism persists for at least a year after the filing of a Schedule 13D. Perhaps most importantly, a recent study by Bebchuk, Brav, and Jiang has shown that hedge fund activism does not result in abnormal negative returns over a five-year period.<sup>132</sup> This indicates

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129. Based on the ability of offensive shareholder activists to earn consistent returns, it should not be surprising that a general herding effect has been observed where institutional investors, such as mutual funds, follow after the trading patterns of hedge funds. See Yawen Jiao & Pengfei Ye, *Mutual Fund Herding in Response to Hedge Fund Herding and the Impacts on Stock Prices* J. BANKING & FIN. (forthcoming 2014), available at <http://faculty.ucr.edu/~yawenj/mfhf.pdf>. Moreover, Jiao and Ye observed that “[m]utual funds’ following of hedge funds leads to a significant price impact in the same quarter and more importantly, a sharp price reversal in the next quarter, whereas hedge fund herding itself does not destabilize prices.” *Id.* at 35.

130. Boyson, Ma & Mooradian, *supra* note 125.

131. Brav et al., *supra* note 97.

132. Lucian A. Bebchuk, Alon Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund*

that the information provided to the marketplace and corporations by offensive shareholder activism is generally perceived to be valuable to shareholders and is being integrated into corporate strategy in a statistically significant way.

On a macro level, empirical studies have shown that at least certain types of offensive shareholder activism are beneficial for shareholders.<sup>133</sup> However, the results of empirical studies must be interpreted carefully so as not to overstate their informational value. Empirical research does not suggest that every time a hedge fund takes a substantial position in a company and then recommends changes that correspond to positive abnormal returns in empirical studies, those changes are correct for that particular company.<sup>134</sup> The reason for this can be found in the limitations associated with empirical analysis. For example, an event study focusing on the filing of a Schedule 13D, the type of study generally used to evaluate the value of hedge fund activity, requires a large sample size of companies because of the individual volatility of an individual company's stock price.<sup>135</sup> That is, the statistical power where the sample size is one is "likely to be quite low."<sup>136</sup> One reason for this is that the variability of returns for a sample size of one is much greater

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*Activism* (Columbia Bus. Sch. Research Paper No. 13-66, 2013), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2291577](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2291577). For empirical results consistent with these studies but focusing on hedge fund activity outside the United States, see Dionysia Katelouzou, *Myths and Realities of Hedge Fund Activism: Some Empirical Evidence*, 7 VA. L. & BUS. REV. 459, 479 (2013) ("Of the 379 investments for which a holding period could be determined, 100 (26.4%) were for less than one year (short-term), 131 (34.6%) were for between one and three years (medium term), and 148 (39.1%) were for more than three years (long term).").

133. See Nicole M. Boyson & Robert M. Mooradian, *Experienced Hedge Fund Activists* (AFA Chi. Meetings Paper, 2012), available at <http://ssrn.com/abstract=1787649> (finding that hedge fund activism by "experienced" managers significantly contributes to hedge fund profitability, justifying an investment in the pursuit of activism).

134. For example, after a three-year attempt to turnaround J.C. Penney, Pershing Square Capital Management finally gave up and sold its 39.1 million shares in the company for a loss of approximately \$473 million. Mr. William Ackman, the manager of Pershing Square, thought he could turn around J.C. Penney with new management. However, his new management team was not successful in improving operating results or increasing the stock price by the time of Pershing Square's disinvestment. See Michael J. de la Merced, *His Links Severed, Ackman Sells Stake in J.C. Penney*, DEALBOOK (Aug. 26, 2013, 5:22 PM), <http://dealbook.nytimes.com/2013/08/26/ackman-moves-to-sell-stake-in-j-c-penney/>.

135. See Sanjai Bhagat & Roberta Romano, *Empirical Studies of Corporate Law*, HANDBOOK L. & ECON. 1, 12 (2005).

136. *Id.*

than even a sample size of just a couple of stocks.<sup>137</sup> Also, where the sample size is one, it is hard to separate out the significance of other events on the stock price.<sup>138</sup> Moreover, empirical studies have to be periodically replicated not just to test the validity of the results, but because the data changes over time, and therefore the statistical relationships change as well.<sup>139</sup>

Thus, one interpretation of the results of empirical studies is that they may support the argument that certain types of offensive shareholder activism have value, but they do not provide conclusive proof that offensive shareholder activism has value at any specific company at any specific time.<sup>140</sup> Instead, the use of empirical evidence supporting offensive shareholder activism should be understood as merely supporting the notion that offensive shareholder activists should be permitted to rebut the general presumption of superiority of existing managerial strategies. This understanding provides the board with the option of implementing the recommendations, in whole or in part, or explaining to the company's shareholders why some or all of the recommendations would not add value as a means to pre-empt a possible proxy contest.

Alternatively, when empirical analysis does not support a certain type of performance-driven activism, such as defensive shareholder activism or offensive shareholder activism that focuses on debt restructuring, the activist bears a commensurately higher burden in overcoming the general presumption in favor of the board's own strategies and policies.

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137. *See id.*

138. *See id.*

139. *See* Lee Epstein & Gary King, *The Rules of Inference*, 69 U. CHI. L. REV. 1, 38–54 (2002).

140. Hedge fund activism even results in unknown “spillover” effects that reach beyond the targeted firms. *See, e.g.*, Nickolay Gantchev, Oleg Gredil & Chotibhak Jotikasthira, *Governance Under the Gun: Spillover Effects of Hedge Fund Activism* (March 2014) (unpublished manuscript), available at <http://ssrn.com/abstract=2356544>.

## IV. SHORT-TERM VERSUS LONG-TERM INVESTORS

In this Part, we attempt to address one of the primary criticisms of offensive shareholder activism: that such activists promote “short-termism” since they ignore what is best for the corporation in the long-term.<sup>141</sup> According to Bebchuk:

Short-termism refers to companies taking actions that are profitable in the short term but value-decreasing in the long term, such as increasing near-term earnings by cutting research that would pay off later on. Activist investors with short investment horizons, it is argued, seek actions that boost short-term stock price at the expense of long-term value and often succeed in pressuring companies to take such actions.<sup>142</sup>

According to Martin Lipton, a leading corporate lawyer, such short-termism is a specialty of activist hedge funds:

Institutional investors on average own more than 70% of the shares of the major public companies. Their voting power is being harnessed by a gaggle of activist hedge funds who troll through SEC filings looking for opportunities to demand a change in a company’s strategy or portfolio that will create a short-term profit without regard to the impact on the company’s long-term prospects.<sup>143</sup>

Notwithstanding these concerns, a pejorative view of investors who have short-term investment time horizons, especially hedge fund activists, is mystifying on several counts. First, all shareholders, whether they have a short- or long-term investment horizon, value shares that have significant liquidity. That is, all shareholders want to have the ability to sell their shares at a moment’s notice at the maximum price possible. For example, a long-term investor such as a pension fund may suddenly become a short-term investor or invest in small amounts in order to meet the demands of its beneficiaries.

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141. Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARVARD LAW SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013, 9:22 AM), <http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/>.

142. Lucian A. Bebchuk, *The Myth that Insulating Boards Serves Long-Term Value*, 113 COLUM. L. REV. 1637, 1638–39 (2013).

143. Lipton, *supra* note 141.

Or short-term investors may decide to hold onto their stock for a much longer period of time than originally anticipated and then sell at a later date. A liquid market provides this sell/hold option. Thus, the more liquidity a stock is perceived to have, the greater its value to both types of investors, all else being equal.

Second, the process of valuing a company's stock is the same for investors no matter what their expected holding period. Both short- and long-term investors will estimate the company's expected cash flows out into the future and then utilize a discount rate to come up with a present value. Both will use a long-term time horizon to do this calculation, regardless of their expected holding period. Therefore, both types of investors want the board of directors and executive management to make the most efficient and shareholder-wealth-enhancing decisions—whether it be short-term cost cutting or investing in a long-term project—in order to maximize the current value of the stock price.<sup>144</sup>

If a hedge fund argues for short-term cost cutting at a company, this means it expects this approach to maximize the value of the company stock relative to other possible wealth-enhancing options. Indeed, such a recommended approach may simply be an attempt to shift the company to a lower risk level that is more in line with the company's potential returns. If so, then the stock price should rise. Alternatively, a hedge fund could argue for more investment in basic research if it thought that this would yield a higher stock market price. Ultimately, offensive shareholder activists should be indifferent to the types of recommendations they make as long as they believe the recommendations will result in the highest possible stock price. According to Kahan and Rock:

For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from myopia: that is, it must undervalue long-

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144. According to Black and Kraakman:

Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell (the unity of long- and short-term shareholder interests is known as Fisher separation).

Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 532–33 (2002).

term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons.<sup>145</sup>

Moreover, if the stock market thought hedge funds and other private individuals engaged in offensive shareholder activism were promoting recommendations that were heavily biased toward short-term opportunities, to the exclusion of many profitable long-term opportunities, then we would expect empirical studies to show such activism to be wealth reducing in the short term, not wealth enhancing. So far, the studies cited in Part III.C have shown this not to be the case.

Third, this perception of offensive shareholder activists as only caring about the short-term may simply be a result of their business model, which requires them to have relatively short holding periods. Think of offensive shareholder activists as specialists in identifying significant impediments to maximizing shareholder wealth that are not being addressed by the board of a targeted company. For offensive shareholder activists to maximize their returns, they cannot have long holding periods. This is because once they remove the impediment to shareholder wealth maximization, they must move on to the next corporation in order to maximize the number of interventions and thus the profits of their own investors. Alternatively, it is not possible for long-term investors like Warren Buffet and Berkshire Hathaway to participate in that market precisely because they have such long holding periods. Therefore, long-term investors must yield that market to offensive shareholder activists who complement and enhance the wealth of long-term investors.<sup>146</sup>

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145. Kahan & Rock, *supra* note 100, at 1084. See also George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 116–19, 122–28 (2010) (arguing that this alleged short-termism on the part of institutional investors, including hedge funds, is of dubious validity and noting that such short-termism has not been empirically verified).

146. An interesting example of how investors with different investment horizons complement each other comes from the market for corporate control. In 2014, H.L. Heinz was acquired by Berkshire Hathaway and 3G Capital, a Brazilian private equity firm, for \$23 million in a fifty-fifty split. The day-to-day operations will be handled by 3G Capital, and in a few years, after it has enhanced its operations, it is expected to sell its equity stake to Berkshire Hathaway. See LAWRENCE A. CUNNINGHAM, *BERKSHIRE BEYOND BUFFETT: THE ENDURING VALUE OF VALUES* 15–17 (Columbia Univ. Press 2014).

Fourth, the studies cited in Part III.C have demonstrated that the short-term run-up in stock prices from hedge fund activism persists for at least a year after the filing of a Schedule 13D,<sup>147</sup> and the initial positive stock price performance of hedge fund activism is not reversed over a subsequent five-year period.<sup>148</sup> Such results confirm the benefits of offensive shareholder activism for the long-term, not just the short-term.<sup>149</sup>

#### *A. The Intrinsic Value Argument*

Notwithstanding the foregoing, critics of offensive shareholder activism can make what can be referred to as the “intrinsic value” or “hidden value” argument.<sup>150</sup> They may claim that the board, and especially executive management, are specialists in the management of the company and are the only ones privy to confidential information on the performance and prospects of the company they manage. Unfortunately, it is not empirically known how much informational asymmetry exists between management and shareholders at any firm at any point in time.<sup>151</sup> It may be a little, it may be a lot; the extent of the asymmetry is not known and may be unknowable.<sup>152</sup> However, it is beyond doubt that information asymmetries do exist<sup>153</sup> and that shareholders, including offensive shareholder activists, are at an informational disadvantage relative to directors. In sum, the board and executive management are in the

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147. See Boyson & Mooradian, *supra* note 123; Brav et al., *supra* note 97; Klein & Zur, *supra* note 122 (such abnormal positive returns also persist for a year when the investor is a private individual or entity but not a hedge fund).

148. See Bebchuk, Brav & Jiang, *supra* note 132.

149. See *id.*

150. Black and Kraakman list nine assumptions upon which the “hidden value” model of valuation rests. Black & Kraakman, *supra* note 144, at 529–33. However, according to Kihlstrom and Wachter, only five are actually required to support the notion of hidden value. Richard E. Kihlstrom & Michael L. Wachter, *Corporate Policy and the Coherence of Delaware Takeover Law*, 152 U. PA. L. REV. 523, 533–34 (2003). These five assumptions are that (1) the board has private information as to company value, (2) there are barriers to this information being communicated to the market, (3) the valuation gap between valuations based on the company’s private versus the market’s public information can be large, (4) valuation gaps persist over a significant period of time, and (5) the market for corporate control cannot eliminate the valuation gaps. See *id.* at 534 n.34.

151. See William W. Bratton & Michael L. Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 696 (2010).

152. See *id.*

153. See *id.*

best position to estimate the company's intrinsic or fundamental value, not the market or any of its participants.

If so, the critics' argument follows, then the role of the board and its executive management is not necessarily to maximize the market share price, but to maximize the "intrinsic value" of the company's shares.<sup>154</sup> But we must also assume that the board is dedicated to maximizing this value and that they have the proper techniques for measuring intrinsic value.<sup>155</sup>

What Lipton and others who argue against offensive shareholder activism are suggesting when they refer to hedge fund activists suffering from short-termism is that these investors are not privy to the entire opportunity set of strategic options available to the corporation that will enhance shareholder wealth.<sup>156</sup> Moreover, even regarding the options that are publicly known, the activists do not have as much information as the board and executive management in regard to their benefits and costs. Also, if most of this confidential information relates to the board and executive management's vision for the company's long-term future, then the recommendations from offensive shareholder activists may look to management like they are focused on the short term.

Yet, this argument does not necessarily make offensive shareholder activists the purveyors of an inefficient approach to corporate decision making in all fact patterns. Perhaps they have less firm-specific information than management, but as compensation they may not be prone to agency costs resulting from management shirking, rent seeking,<sup>157</sup> or an inability to breach costly implicit

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154. Henry T.C. Hu, *Efficient Markets and the Law: A Predictable Past and an Uncertain Future*, 4 ANN. REV. FIN. ECON. 179 (2012). See also Roger J. Dennis, *Valuing the Firm and the Development of Delaware Corporate Law*, 17 RUTGERS L. J. 1 (1985).

155. See *id.* This "intrinsic value" approach has been endorsed by the Delaware courts. According to the Delaware Supreme Court, "it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock. We have so held in another context." *Paramount Commc'ns, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 n.12 (Del. 1990) (citing *Smith v. Van Gorkom*, 488 A.2d 858, 876 (Del. 1985)). In *Van Gorkom*, the court stated: "The fact that the Board had no reasonably adequate information indicative of the intrinsic value of the Company, other than a concededly depressed market price, was without question material to the shareholders voting on the merger." *Van Gorkom*, 488 A.2d at 890. For better or worse, intrinsic value is the default principle of corporate law. See Black & Kraakman, *supra* note 144, at 557.

156. See, e.g., Lipton, *supra* note 141.

157. According to Professors Matsusaka and Ozbas, "[f]acing an active shareholder who

agreements.<sup>158</sup> Alternatively, offensive shareholder activists may have relatively better decision-making skills in a particular area of expertise.<sup>159</sup> This is the inference that we believe is generated by empirical work on offensive shareholder activism, counteracting the intrinsic value argument.

### B. Proxy Access

Proxy access is one area which can immediately benefit from the elimination of the idea that activist hedge funds are practitioners of short-termism. Proxy access allows certain shareholders “the ability to place their director nominees alongside the board’s slate of director nominees in the company’s proxy card and proxy statement.”<sup>160</sup> Recently, the SEC amended Rule 14a-8(i)(8) to allow shareholder proposals on proxy access to become part of a public company’s proxy materials.<sup>161</sup> Sharfman has previously argued that proxy access proposals, if they must be proposed and approved by a majority of shareholders, should not include a minimum holding period for shareholders to participate in nominating a candidate for board membership.<sup>162</sup> Such a requirement would essentially deny offensive shareholder activists the ability to participate in proxy access. These activists want to participate in the corporate decision-making process now, not in two or three years from now, and unlike

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seeks to maximize profit, a manager suffering from an agency problem may compromise by choosing an action that is closer to profit maximization than would otherwise have been chosen.” Matsusaka & Ozbas, *supra* note 119, at 3.

158. See Sharfman, *Shareholder Wealth Maximization*, *supra* note 42, at 417 n.151 (citing Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* 33, 33 (Alan J. Auerbach ed., 1991)).

159. See ARROW, *supra* note 42, at 74.

160. See Sharfman, *Why Proxy Access is Harmful*, *supra* note 42, at 388.

161. On September 15, 2011, the SEC published a release providing notice that the amendment to Rule 14a-8(i)(8), allowing for shareholder proposals on proxy access, is to be effective with the publication of the notice in the Federal Register. See *Facilitating Shareholder Director Nominations*, Exchange Act Release No. 9259, 101 SEC Docket 3784 (Sept. 15, 2011) (codified at 17 C.F.R. §§ 200, 232, 240, 249). The notice was published in the Federal Register on September 20, 2011. See *Facilitating Shareholder Director Nominations*, 76 Fed. Reg. 58, 100-01 (Sept. 20, 2011). Prior to the recently enacted Section 112 of the Delaware General Corporation Law, an argument could have been made that proxy access proposals were not a proper subject for action by shareholders under state law, and therefore could be excluded from a company’s proxy materials under SEC Rule 14a-8(i)(1). Section 112 explicitly authorizes, but does not require, bylaws granting shareholders access to the corporation’s proxy materials to nominate directors. See DEL. CODE ANN. tit. 8, § 112 (2011).

162. See Sharfman, *Why Proxy Access is Harmful*, *supra* note 42, at 409–10.

the majority of shareholders, have made the necessary investment to understand the company. It is hard to understand the logic in having a two- or three-year holding period that favors passive investors such as liquidity traders over information traders such as offensive shareholders activists. Investors who have held large amounts of company stock for 20 years in one or more portfolios using passive strategies, and therefore do not analyze information about the company targeted for proxy access, are generally much less qualified to utilize proxy access than investors who have held company stock for six months but made their decision to invest based on fundamental analysis and the desire to implement significant change at a corporation.

#### V. CONCLUSION

A model of corporate governance that gives great deference to board authority is not inconsistent with tools of accountability that require a sharing of that authority under certain fact patterns. For example, under corporate law, judges and chancellors give great deference to board authority under the business judgment rule unless they find that such decisions were tainted with established filters such as gross negligence, conflict of interest, or lack of independence.<sup>163</sup> At that point, judges and chancellors have the right to weigh in on the merits of the decision.

For our purposes, the issue is identifying when, if ever, shareholder activism should lead to a similar sharing of decision making with shareholders. That is, how can we identify when shareholder activism is of value to corporate decision making? Identifying the value of shareholder activism begins with empirical studies that identify which types of shareholder activism will, in general, enhance shareholder wealth.<sup>164</sup> So far, empirical evidence has

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163. See Sharfman, *Shareholder Wealth Maximization*, *supra* note 42, at 392.

164. Even though it is beyond the scope of the Article, it should be noted that the only type of corporate governance activism that has been empirically demonstrated to enhance shareholder wealth is that associated with the elimination of staggered boards. Multiple empirical studies support the argument that staggered boards reduce shareholder wealth. See, e.g., Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 890–91 (2002); Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 410 (2005); Alma Cohen & Charles C. Y. Wang, *How Do Staggered Boards Affect Shareholder Value? Evidence from a Natural Experiment* 1, 3–4 (Harvard Bus. Sch. Acct. & Mgmt. Unit, Working Paper No. 13-068, 2013), available at <http://ssrn.com/>

only been able to demonstrate that one type of performance-driven activism—offensive shareholder activism associated with “the sale of the company or changes in business strategy, such as refocusing and spinning-off noncore assets”<sup>165</sup>—will, in general, enhance shareholder wealth.

From a theoretical standpoint, the empirical evidence provided allows us to argue that certain types of offensive shareholder activism have the potential to act as a legitimate corrective mechanism in an Arrowian framework of corporate governance. As such, these types of offensive shareholder activism are consistent with the traditional authority model of corporate law and governance, even accepting, as Bainbridge has stated, that the “[p]reservation of managerial discretion should always be the null hypothesis.”<sup>166</sup>

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abstract=2141410. *But see*, K. J. Martijn Cremers, Lubomir P. Litov & Simone M. Sepe, Staggered Boards and Firm Value, Revisited (July 14, 2014) (unpublished manuscript), available at SSRN: <http://ssrn.com/abstract=2364165> (finding staggered boards to be positively associated with shareholder wealth maximization).

However, empirical studies have not been able to show that corporate governance activism targeting other types of corporate governance arrangements enhances shareholder wealth. According to Brav, Jiang, Partnoy and Thomas, corporate governance activism does not enhance shareholder wealth when it involves an attempt to repeal takeover defenses, replace a CEO, increase board independence, or limit CEO compensation. Brav et al., *supra* note 97, at 1731. Bhagat and Black demonstrate that enhanced board independence does not increase shareholder wealth. Sanjai Bhagat & Bernard Black, *The Uncertain Relationship Between Board Composition and Firm Performance*, 54 BUS. LAW. 921, 924, 928, 932 (1999). *See also* Barry D. Baysinger & Henry N. Butler, *Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition*, 1 J.L. ECON. & ORG. 101, 101–04 (1985). Adams, Hermalin and Weisbach describe studies that show how splitting the CEO and chairman of the board positions does not enhance shareholder wealth. Renée B. Adams, Benjamin E. Hermalin & Michael S. Weisbach, *The Role of Boards of Directors in Corporate Governance: A Conceptual Framework and Survey*, 48 J. ECON. LITERATURE 58, 81–82 (2010) (surveying the literature on the separation of CEO and Chairman). Ali C. Akyol, Wei Fen Lim, and Patrick Verwijmeren find statistically significant negative returns associated with the SEC’s attempts to provide proxy access to certain shareholders. Ali C. Akyol, Wei Fen Lim, & Patrick Verwijmeren, *Shareholders in the Boardroom: Wealth Effects of the SEC’s Proposal to Facilitate Director Nominations*, 47 J. FIN. & QUANTITATIVE ANALYSIS 1029 (2012). *See also* Thomas Stratmann & J.W. Verret, *Does Shareholder Proxy Access Damage Shareholder Value in Small Publicly Traded Companies?*, 64 STAN. L. REV. 1431 (2012). Such studies create a presumption that activism encouraging such corporate governance arrangements are not good for the target firm and therefore requires the activist to make a convincing case that such changes can indeed enhance shareholder value. In contrast to offensive shareholder activism, the burden of proof is now on the activist, not the other way around.

165. Brav et al., *supra* note 97, at 1731.

166. Bainbridge, *The Business Judgment Rule*, *supra* note 42, at 109.

