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The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance

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I. Introduction

Hedge fund activism has recently spiked, almost hyperbolically.[1] No one disputes this, and most view it as a significant change. But their reasons differ. Some see activist hedge funds as the natural champions of dispersed and diversified shareholders, who are less capable of collective action in their own interest.[2] A key fact about activist hedge funds is that they are undiversified and typically hold significant stakes in the companies in their portfolios.[3] Given

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[1] See text and notes infra at notes 21 to 36.

[2] For a leading statement of this view, see Ronald J. Gilson & Jeffrey N. Gordon, The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights, 113 Colum. L. Rev. 863 (2013). See also Lucian Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005).

[3] At the outset, it is necessary to acknowledge here that no generally accepted definition exists for the term "hedge fund." Many commentators make this observation at the outset of their article or memorandum and then suggest a working definition. See Linda Chatman Thomsen, Daniel M. Hawke, and Pauline E. Calande, Hedge Funds: An Enforcement Perspective, 39 Rutgers L.J. 541, 543 (2008). Four characteristics usually identify hedge funds (and in any event most commentators seem to believe that they "know one when they see one"). Those four key characteristics are:

> "(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 cater to a small number of sophisticated investors and are not generally readily available to the retail-investment market; and
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> (4) they mostly operate outside of securities regulation and registration requirements."

See Richard Lee and Jason D. Schloetzer, Director Notes: "The Activism of Carl Icahn and Bill Ackman," (The Conference Board May 2014) at 2. Because hedge funds are largely unregulated, they are not subject to the diversification requirements applicable to pension funds and most mutual funds.

their larger stakes and focused holdings, they are less subject to the "rational apathy" that characterizes more diversified and even indexed investors, such as pension and mutual funds, who hold smaller stakes in many more companies. So viewed, hedge fund activism can bridge the separation of ownership and control to hold managements accountable.

Others, however, believe that activist hedge funds have interests that differ materially from those of other shareholders. Presidential contender Hillary Clinton has criticized them as "hit-and-run activists whose goal is to force an immediate payout,"[4] and this theme of an excessively short-term orientation has its own history of academic support.[5] From this

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[4] See Andrew Ross Sorkin, "Clinton Aim Is to Thwart Quick Buck on Wall Street," N.Y. Times, July 28, 2015 at B-1. For the full text of Hillary Clinton's speech, see "Former Secretary of State Hillary Clinton, Democratic Presidential Candidate, Delivers Remarks at A Campaign Event in New York City," Federal News Service, July 24, 2015.

[5] See, e.g., Iman Anabtawi, Some Skepticism about Increasing Shareholder Power, 53 UCLA L. Rev. 561 (2006); Iman Anabtawi and Lynn Stout, Fiduciary Duties for Activist Shareholders, 60 Stan. L. Rev. 1255 (2008); Marcel Kahan & Edward B. Rock, Hedge Funds in Corporate Governance and Corporate Control, 155 U. Pa. L. Rev. 1021, 1083 (2007) (viewing hedge funds as the "archetypal short-term investor"); William W. Bratton and Michael Wachter, The Case Against Shareholder Empowerment, 158 U. Pa. L. Rev. 653 (2010); Justin Fox and Jay W. Lorsch, The Big Idea: What Good Are Shareholders?, 48 Harv. Bus. Rev. 50, 51 (2012). Still others believe that "activist" hedge funds (or at least those with a high portfolio turnover) are systematically biased towards the short-term and thus persistently undervalue long-term investments. See Brian Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acc. Rev. 315 330 (1998). See also text and notes infra at notes 89 to 91. For similar views, see Lynn Stout, The Mythical Benefits of Shareholder Control, 93 Va. L. Rev. 789 (2007); Lynn Dallas, Short-Termism, The Financial Crisis and Corporate Governances, 37 J. Corp. L. 265 (2011).

perspective, the rise of activist funds to power implies that creditors, employees and other corporate constituencies will be compelled to make wealth transfers to shareholders.

This article explores this debate in which one side views hedge funds as the natural leaders of shareholders and the other side as "short-term" predators, intent on a quick raid to boost the stock price and then exit before the long-term costs are felt. We are not comfortable with either polar characterization and thus begin with a different question: Why now? What has caused activism to peak over the last decade at a time when the level of institutional ownership has slightly subsided? Here, we answer with a two-part explanation for increased activism: First, the costs of activism have declined, in part because of changes in SEC rules, in part because of changes in corporate governance norms (for example, the sharp decline in staggered boards), and in part because of the new power of proxy advisors (which is in turn a product both of legal rules and the fact that some institutional investors have effectively outsourced their proxy voting decisions to these advisors).[6] Second, activist hedge funds have recently developed a new tactic—"the wolf pack"—that effectively enables them to escape old corporate defenses (most notably the poison pill) and to reap high profits at seemingly low risk.[7] Unsurprisingly, the number of such funds, and the assets under their management, has correspondingly skyrocketed.[8] If the costs go down and the profits go up, it is predictable that activism will surge (and it has).

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[6] See text and notes infra at notes 38 to 49.

[7] The "wolf pack" tactic and the case law on group formation are examined in the text and notes infra at notes 63 to 91. The term "wolf pack: was first recognized by the Delaware courts in Third Point LLC v Ruprecht, 2014 Del. Ch. LEXIS 64 (May 2, 2014)(upholding use of a novel poison pill because of threat posed by "wolf pack").

[8] See text and notes infra at notes 29 to 35.

But that does not answer the broader question (to which we then turn) of whether externalities are associated with this new activism.

Others have criticized hedge fund activism, but their predominant criticism has been that such activism amounts in substance to a "pump and dump" scheme under which hedge funds create a short-term spike in the target stock's price, then exit, leaving the other shareholders to experience diminished profitability over the long-run.[9] This claim of market manipulation is not our claim (nor do we endorse it). Rather, we are concerned that hedge fund activism is associated with a pattern involving three key changes at the target firm: (1) increased leverage; (2) increased shareholder payout (through either dividends or stock buybacks), and (3) reduced long-term investment in research and development ("R&D"). The leading proponent of hedge fund activism, Harvard Law Professor Lucian Bebchuk, has given this pattern a name: "investment-limiting" interventions.[10] He agrees that this pattern is prevalent but criticizes us for our failure to recognize that "investment-limiting" interventions by hedge funds "move targets

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[9] These claims frequently emanate from the prestigious law firm of Wachtell, Lipton, Rosen & Katz. See, e.g., Martin Lipton & Steven A. Rosenblum, Wachtell, Lipton, Rosen & Katz, "Do Activist Funds Really Create Long Term Value?," The Harvard Law School Forum on Corporate Governance & Financial Regulation (July 22, 2014)(http://blogs.law.harvard.edu/corpgov/2014/07/22/do-activist-hedge-funds-really-create-long-term-value/). For a fuller statement, see Martin Lipton and Steven A. Rosenblum, A New System of Corporate Governance: The Quinquennial Election of Directors, 58 U. Chi. L. Rev. 187 (1991). See also Bratton and Wachter, supra note 3, at 653-54, 657-59; Justin Fox and Jay W. Lorsch, The Big Idea—What Good Are Shareholders?, 48 Harv. Bus. Rev. 49, 51 (July-Aug. 2012).

[10] See Lucian A. Bebchuck, Alan Brav, and Wei Jiang, The Long-Term Effects of Hedge Fund Activism, 115 Colum. L. Rev. 1085, 1138 (2015).

toward…optimal investment levels" because "managements have a tendency to invest excessively."[11] We think this assumption that managements typically engage in inefficient empire-building is today out of date and ignores the impact of major changes in executive compensation. The accuracy of this assertion that managements are systematically biased towards inefficient expansion and investment becomes the critical question, as the scale and magnitude of "investment-limiting" interventions by activists have begun to call into question the ability of the American public corporation to engage in long-term investments or R&D. Is the new activism a needed reform to curb managerial self-interest or a hasty overreaction? Or somewhere in between?

This article has three basic aims: First, we attempt to understand and explain the factors that have caused the recent explosion in hedge fund activism. Second, we focus on the impact of this activism, including in particular whether it is shortening investment horizons and discouraging investment in R&D. Finally, we survey possible legal interventions, and evaluate them in terms of our preference for the least restrictive alternative. Although others have conducted lengthy surveys, the landscape of activism is rapidly changing, and thus we have doubts about the relevance of empirical papers that study hedge fund activism in earlier decades.[12] We also suspect that the recent success of such activism may be fueling a current

[11] Id. 1137, n. 103. For our reply, see text and notes infra at notes 134 to 139 and 201 to 207.

[12] For example, Bebchuk, Brav and Jiang (2015) examine approximately 2,000 activist hedge fund interventions between 1994 and 2007. Id. at 1090. Substantial as this effort is, hedge fund behavior in that era is different from today. In that era, there were relatively few activist hedge funds and possibly more opportunities for legitimate activist intervention. More recent studies support somewhat different results. Here, we give special attention to two such studies: (1) Marco Becht, Julian Franks, Jeremy Grant and Hammes F. Wagner, "The Returns to Hedge Fund

"hedge fund bubble" under which an increasing number of activist funds are pursuing a decreasing (or at least static) number of companies that have overinvested (that is, made allegedly excessive investments in R&D or other long-term projects). This article is particularly focused on those market and legal forces that may be driving this bubble.

Here, a leading cause of increased hedge fund activism appears to be the development of a new activist tactic: namely, the formation of the hedge fund "wolf pack" that can take collective (or, at least, parallel) action without legally forming a "group" for purposes of the federal securities laws (which would trigger an earlier disclosure obligation).[13] This new tactic, of course, explains our title. Hedge funds have learned that to the extent they can acquire stock in the target firm before the "wolf pack" leader files its Schedule 13D, announcing its proposed intervention, significant gains will follow for those who have already acquired that stock. Also, as later explained, this tactic allows activists to acquire a significant stake and negotiating leverage without triggering the target's poison pill.

Of course, new tactics are not necessarily bad and may be efficiency-enhancing. All studies have found that hedge fund activist campaigns result *on average* in short-term gains for shareholders, but the evidence (as we will show) is decidedly more mixed with respect to long-

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Activism: An International Study" (Center for Economic Policy Research Discussion Paper No. 10507)(March 15, 2015)(available at http://ssrn.com/abstract=2376271), and (2) Yvon Allaire and Francois Dauphin, "Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence" (Institute for Governance of Public and Private Corporations, April 1, 2015).

[13] The "wolf pack" tactic and the case law on "group" formation is examined infra in the text and notes at notes 63 to 91.

term gains.[14] Here, a word of caution needs to be expressed at the outset about these studies and the reliance that can be placed on them. Even if all these studies were to show long-term gains, they would still not resolve the key policy questions because of the following limitations on them:

(1) The distribution of the returns from hedge fund activism shows high variance, with a significant percentage of firms experiencing abnormal stock price losses;[15] thus an individual company may be well advised to resist an activist's proposal, even if such proposals enhance shareholder value on average;

(2) The positive abnormal stock returns on which the proponents of hedge fund activism rely do not necessarily demonstrate true gains in efficiency;[16] but may only indicate that the

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[14] See Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, Hedge Fund Activism, Corporate Governance and Firm Performance, 63 J. Fin. 1729 (2008) (finding on average an abnormal short-term return of 7% to 8% over the period before and after the filing of a Schedule 13D announcing an activist's acquisition of 5% or more of the stock of a target firm). A more recent (and entirely consistent) study is that by Lucian Bebchuk, Alon Brav, and Wei Jiang, supra note 10. They find an approximately 6% average abnormal return during the 20-day window before and after a Schedule 13D filing. Id at 1122 and Figure 2. This and other studies are considered infra at notes 142 to 196.

[15] See text and notes infra at notes 152 to 154.

[16] Even the leading advocates of hedge fund activism have softened their claims about causality. In the most recent revisions to their paper, Professors Bebchuk, Brav, and Jiang now concede that "causality issues in corporate governance and finance are notoriously difficult to resolve with absolute confidence" See Bebchuk, Brav and Jiang, supra note 10, at 1120. In contrast, we believe that causality in this contest is difficult to resolve with any reasonable confidence. Bebchuk, Brav and Jiang further acknowledge that they cannot identify "the extent to which improvements are due to activist interventions." Id. We agree. Although we think they have largely discredited the

market has given the target firm a higher expected takeover premium; that difference is important because not only will this temporary increase later erode if no takeover results, but in any event it does not demonstrate a true efficiency gain;[17]

(3) These studies overlook (or give only inadequate attention to) the possibility that whatever shareholder wealth is created by hedge fund activism may reflect only a wealth transfer from bondholders, employees, or other claimants;[18] and

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"pump and dump" theory that a stock drop automatically follows once activists exit the firm, they have not shown convincingly that activist interventions improve operating performance at target firms.

[17] Economists tend to assume that the takeover premium paid by the bidder reflects its ability to manage the target's assets more efficiently (and thus justifies its willingness to pay an above market price for the target's assets). But there are at least two significant reasons why the premium paid by a bidder in a takeover need not necessarily reflect the bidder's greater efficiency: (1) the bidder may be acquiring market power and an increased market share that will result in oligopolistic pricing and a loss in social welfare; and (2) empirically, bidders frequently overpay (in which case, the premium is simply a wealth transfer from bidder shareholders to target shareholders). See Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597 (1989).

[18] The evidence on wealth transfers is discussed infra at notes 178 to 179. A related possibility is that apparent gains reflect only a reversion to the mean. See Yvan Allaire and Francois Dauphin, "Activist hedge funds: creators of lasting wealth? What do the empirical studies really say?" at 12-13 (Institute for Governance of Private and Public Organizations) (July 2014) (reporting a "clear pattern of convergence towards the mean"). Their point is that firms that outperform or underperform the mean over one period move closer to the mean over the next period. Professors Allaire and Dauphin have renewed their criticisms of Bebchuk, Brav, and Jiang, supra note 10, after the latter's revision of their paper in December 2014. See Yvan Allaire and Francois Dauphin, "Still Unanswered Questions (and new ones) to Bebchuk, Brav and Jiang," January, 2015 (Institute for Governance of Private and Public Organizations).

(4) The impact of hedge fund activism on American corporations (and long-term investment) cannot be adequately measured by looking only to the post-intervention performance at those companies that experience a hedge fund intervention; this ignores the deterrent impact of such activism on the many more companies that experience no such intervention, but that increase leverage and dividends or reduce long-term investments, in fear of the growing risk of such an activist intervention. This perverse deterrent effect, as many firms cease to invest in R&D or other long-term investments and instead increase shareholder payout, has been largely ignored by most commentators.[19]

Our primary concern is with the possibility that the increasing rate of hedge fund activism is beginning to compel corporate boards and managements to forego long-term investments (particularly in R&D) in favor of a short-term policy of maximizing shareholder payout in the form of dividends and stock buybacks. This would represent a serious externality, even if private gains resulted. We do not suggest that this evidence justifies barring hedge fund activism, but we do suggest (with Hillary Clinton) that it may justify greater transparency and reducing the tax subsidy for such activities.

With these concerns in mind, we begin in Section II with an analysis of those factors that have spurred greater activism on the part of hedge funds. Then, in Section III, we consider evidence suggesting that, as the composition of a firm's shareholder population shift towards more "transient" holders, so too does its investment horizon shorten. Growing evidence shows that hedge fund engagements with firms result in dramatic decreases in investments by such firms in R&D in subsequent years. Our broader concern is not simply with the immediate targets

[19] A few commentators have noticed this impact. See text and notes infra at notes 112 to 118 and 134 to 139.

of activism, but with the general deterrent effect of hedge fund activism. Does it reduce managerial agency costs or deter long-term investments—or both?

In Section IV, we survey recent studies to reach assessments about: (1) who are the targets of hedge fund activism; (2) the stock price returns from hedge fund activism and the distribution of those returns; (3) the degree to which wealth transfers explain the positive stock price returns to activism; (4) the post-intervention evidence about changes in operating performance of hedge fund targets; and (5) the holding periods and exit strategies of hedge fund activists.

In Section V, we evaluate some policy options, looking for the least drastic means of accomplishing policy goals. Our conclusion in earlier sections that causality has not been adequately established leads us to examine both (i) what policy options should be considered that would protect shareholders and other constituencies without precluding hedge fund interventions; and (ii) what forms of private ordering could be reasonably employed by target companies to adjust the balance of advantage in these corporate battles (and how should courts respond to these efforts). Finally, Section VI offers a brief conclusion that surveys how the changing structure of shareholder ownership and the recent appearance of temporary shareholder majorities complicates corporate governance, both empirically and normatively.

II: The Changed Environment: What Factors Have Spurred Enhanced Activism by Hedge Funds?

Once upon a time, institutional investors followed the "Wall Street Rule": if dissatisfied with management, they sold their stock, but they did not attempt to intervene or challenge management. This passivity was probably the consequence of shareholder dispersion (which made activism costly) and conflicts of interest (large banks—both commercial and investment—did not want to alienate corporate clients). With the growth in institutional ownership, however, behavior changed. This was particularly true in the case of hedge funds,[20] which, unlike mutual funds, typically hold concentrated blocks in a limited number of companies (rather than a broadly diversified portfolio). Concentrated ownership makes shareholder activism rational from a cost/benefit standpoint.

The types of activist campaigns run by hedge funds range from modest interventions in corporate governance (e.g., proposals to separate the positions of CEO and Board Chairman) to more intrusive interventions seeking to sell the company, fire the CEO, or spin off divisions. As will be seen, the more intrusive the intervention, the greater the likely positive stock market response. The frequency of such campaigns has skyrocketed, with one recent survey counting 1,115 activist campaigns between 2010 and early 2014.[21] 2014 alone saw a record 347 campaigns by "activist" hedge funds.[22] Clearly, this escalating rate of intervention is in sharp

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[20] A number of commentators date the appearance of "activist" hedge funds conducting proxy fights to 2005. See Thomas W. Briggs, Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis, 32 J. Corp. L. 681, 685 (Summer 2007). We make no claim as to when they first appeared, but they at least began to receive widespread press attention in 2005. But see statistics discussed infra at note 23.

[21] See Liz Hoffman and David Benoit, "Activist Funds Dust Off Greenmail Playbook," The Wall Street Journal Europe, June 13, 2014 at 22.

[22] See Jacob Bunge and David Benoit, "DuPont Repels Push by Peltz to Join Its Board," May 14, 2015, at p. 1. This number, compiled by FactSet, is up from 219 in 2009. Because there were 148 such campaigns in the first six months of 2014 (see Rob Copeland, "Activists' Returns Rise about the Din," The Wall Street Journal, July 9, 2014

contrast to earlier periods when, for example, only 52 campaigns could be identified over a 20 consecutive month stretch in 2005-2006.[23] That amounts to a more than 1,000% increase

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at C-1 (citing data from FactSet SharkWatch)), the above total of 347 activist campaigns for 2014 implies that there were nearly 200 campaigns in the last half of 2014 and thus that the trend is still accelerating.

[23] See Briggs, supra note 20, at 695-696. This study covered all of 2005 and the first eight months of 2006 and found only 52 corporations "to have become the subject of a significant hedge fund campaign" during this time period. Id. at 696. Similarly, a Conference Board study reports that the number of "shareholder activist events" rose from 97 events in 2001 to 219 events in 2012. See Lee and Schloetzer, supra note 3, at 1.

Different definitions of activist "interventions" are possible. If we look simply to the number of Schedule 13D filings by activist hedge funds, Bebchuk, Brav, Jackson and Jiang present the following data:

Schedule 13D Filings By Activist Funds

Year	Filings
1994	10
1995	37
1996	99
1997	212
1998	161
1999	118
2000	120
2001	96
2002	134
2003	127
2004	148
2005	237
2006	269
2007	272

between that period and today and again raises the possibility of a bubble: namely, that more and more hedge funds are pursuing fewer and fewer legitimate opportunities for activist interventions.

Historically, hedge fund activism focused on smaller cap companies because it was too costly to assemble a sizeable stake in a larger cap company. But this has changed. In 2013, for the first time, almost one third of activist campaigns focused on companies with a market capitalization of over $2 billion.[24] If we instead use $10 billion as our dividing line for "large cap" stocks, we find that only 17 such companies were targeted by activist investors in 2010,[25] but then in 2011 to 2013, the number of such activist campaigns rose to 21, 23, and 42, respectively.[26] In effect, they have doubled since 2011. Finally, in 2014, Pershing Square Capital Management L.P. joined with a strategic bidder to make an over $60 billion joint tender offer for Allergan, Inc,[27] and Trian Fund Management conducted a proxy campaign that narrowly failed at DuPont, one of the oldest, largest and most iconic of U.S. companies, but, more importantly, a highly profitable firm that had consistently outperformed all relevant

Total	2040

See Lucian A. Bebchuck, Alon Brav, Robert J. Jackson, Jr., and Wei Jiang, Pre-Disclosure Accumulation by Activist Investors: Evidence and Policy, 39 Iowa J. Corp. L. 1 (2013) at *9 (Table I). Although the number of filings has waxed and waned in the past, the years 2005 to 2007 showed a marked increase. Activism then waned with the 2008 financial crisis, but rebounded sharply since 2010.

[24] See Lee and Schloetzer, supra note 3, at 3.

[25] Id.

[26] Id.

[27] See text and notes infra at notes 119 to 127.

benchmarks for corporate performance.[28] In short, whatever their size or profitability, few companies today seem immune from the reach of hedge fund activism. Seemingly, if a credible scenario can be offered to the market that breaking up a company will yield shareholder gains, activist funds will assemble to attack even those companies with a long record of profitability.

Only a specialized group of hedge funds engage in activist campaign and proxy fights, but they have recently done very well. Over a ten year period, activist hedge funds appear to have earned a 13% return, which more than doubled the 5.8% return for all hedge funds as a group.[29] Equally important, the assets managed by "activist" hedge funds have soared, growing over seven times from $23 billion in 2002 to $166 billion in early 2014, and the top ten activist hedge funds alone attracted $30 billion in new investment in 2013.[30]

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[28] In 2014, DuPont's stock price gained 20% on the year to easily beat the S&P index. See Steven Davidoff Solomon, "In DuPont Fight, Activist Investor Picks a Strong Target," New York Times, January 28, 2015 at B-7 (noting that "By about any measure, DuPont has beaten the benchmarks over the last three years and throughout the five-year tenure of (its CEO).") See also Bunge and Benoit, supra note 22 (noting that DuPont's market capitalization exceeded $68 billion). DuPont's size made it the largest target to date of a proxy campaign by activist shareholders.

[29] See Michelle Celarier, "Cash Flowing to Activists Because They're Delivering Best Returns," N.Y. Post, January 14, 2015, at p. 32 (also noting also that the S&P index gained only 8% over the same period). For another study finding "activist" hedge funds to have earned a 6.5% return in the first half of 2014, thus more than doubling the 3.1% rate of return for hedge funds as a group, see Copeland, supra note 22, at C-1.

[30] See Lee and Schloetzer, supra note 3, at 2. For slightly different numbers, see David Benoit, "Activists On a Roll, With More to Come," The Wall Street Journal, January 2, 2015 at B-2 (calculating that the assets managed by activist funds rose to $115.5 billion in November, 2014, up from $93 billion at the start of 2014). See also Juliet Chung and David Benoit, "Activist Investors Add to Their War Chests." The Wall Street Journal, September 12,

Hedge funds initiated the majority of proxy contests in 2013, accounting for 24 of the 35 contests conducted with respect to Russell 3000 companies.[31] Although long more active than other investors, hedge-fund initiated proxy contests have represented a steadily increasing percentage of all proxy contests, rising from 39% in 2009 to 69% in 2013.[32] More importantly, they are winning these fights, securing partial or complete victories in 19 of the 24 contests they initiated in 2013.[33] In 2014, "activists won in a record 73% of battles for board seats, up from 52% in 2012."[34] Revealingly, once the activists win a board seat, 44% of those companies changed their CEO within 18 months thereafter.[35]

2014 at C1 (finding that the assets under management at a specific group of activist hedge funds grew by $9.4 billion in the first half of 2014 and now total $111 billion). The size and reach of activist hedge funds may soon increase significantly, as hedge fund manager William Ackman has announced plans for a $2 billion IPO of a new fund in London, which will be listed on Euronext Amsterdam, thus giving him more permanent capital that cannot be withdrawn by investors. See Maarten van Tartwijk, "Pershing Square, $2 billion IPO planned," The Wall Street Journal, September 16, 2014 at C2.

[31] See Lee and Scholetzer, supra note 3, at 3.

[32] Id.

[33] Id.

[34] See David Benoit and Kirsten Grant, "Activists' Secret Ally: Big Mutual Funds—Large investors quietly back campaigns to force changes at U.S. companies," The Wall Street Journal, August 10, 2015, at A-1; For similar findings, see Benoit, supra note 30, at B-2; Dana Mattoli and Liz Hoffman, "New Activist Hedge Fund Has CEO Backing," The Wall Street Journal, January 20, 2015 (citing FactSet Shark Watch for 73% figure). Benoit and Grant further find that activists won one or more board seats at a record 107 companies in 2014. Id.

[35] See David Benoit and Joanne S. Lublin, "Activist Investors Turn CEO Pickers," The Wall Street Journal, November 14, 2014 at C-1 (citing data compiled by FactSet Shark Watch). They further report that activists won some 39 board seats in 2013.

To be sure, increased engagement between shareholders and management has entered the mainstream. An Ernst & Young report finds that half of all S&P 500 companies disclosed engaging with investors in 2013, up from only 23% in 2012, and these contacts are often between institutional investors and members of the board outside the presence of management.[36] Yet, even if there is a broader shareholder desire for engagement with management, hedge fund activism is qualitatively different. As others have stressed, traditional institutional investors—basically, pension funds and mutual funds—have long been essentially "defensive" in their activism (e.g., by seeking, for example, to resist a management initiative), while hedge funds are "offensive," deliberately seeking out an underperforming target in which to invest in order to pursue a proactive agenda and change their target's business model.[37]

Initially, we need to focus on what factors explain the increased frequency and success of activism. We do not suggest that these factors are exclusively legal in nature. Indeed, one

[36] See EY Center for Board Matters, "2014 Proxy Season Review: New developments raise bar for effective communication" (August 6, 2014). A recent survey of large institutional investors finds that 63% of responding institutions had directly approached management to offer advice and/or criticisms within the past five years and that 45% had approached board members outside the presence of management. See Joseph A. McCahery, Zacharies Sautner, and Laura T. Sparks, Behind the Scenes: The Corporate Governance Preferences of Intuitional Investors (available at http://ssrn.com/abstract=1571045)(October 2014) at p.4. Some groups, most notably The Conference Board, are currently working to develop standards to apply in this new environment. See The Conference Board, Recommendations of the Task Force on Corporate/Investor Engagement (Research Report 1539-14-RR) (2014). At present, it seems at least uncertain and probably unlikely that "activist" hedge funds will accept these standards.

[37] See Brian Cheffins and John Armour, The Past, Present and Future of Shareholder Activism by Hedge Funds, 37 Iowa. J. Corp. L. 51 (2011). As they argue, "defensive" activists take action to protect an existing investment, whereas "offensive" activists seek a target to fit their agenda for activism.

reason that many hedge funds may have shifted to a “proactive” strategy is that they recognized that they could not consistently outperform the market (at least in the absence of “inside” information). By investing in industry laggards and seeking to improve them, they outflanked the problem that even the best of stock pickers cannot regularly beat an efficient market. Still, legal factors and other secular changes do help to explain the timing of this transition. The following factors stand out, but are not exhaustive:

A. The Decline of Staggered Boards. A threat to sell the company or fire the CEO is an empty one if the activist faces a staggered board and can only elect one third of the directors at the next annual election. Although once popular, staggered boards have recently declined to the point that they will soon be rare. In 2000, 300 of the S&P 500 had staggered boards, but as of the end of 2013, only 60 did.[38] This decline is directly attributable to a campaign led by Harvard Law School Professor Lucian Bebchuck, whose Harvard Law School Shareholder Rights Project has successfully sponsored numerous shareholder resolutions calling on boards to eliminate the staggered board.[39] But the disappearance of staggered boards probably owes even more to the growing influence of the proxy advisors (and most notably Institutional Shareholder

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[38] See David Benoit, “Clash Over Board Will Be Measure of Activist Clout,” The Wall Street Journal, May 23, 2004 at C-1.

[39] See Steven Davidoff, “The Case Against the Staggered Board,” New York Times Blogs (Dealbook) (March 20, 2012). Overall, the Shareholder Rights Project has been extraordinarily successful. In the 2012 proxy season alone, the Shareholder Rights Project succeeded in destaggering one third of the staggered boards in the S&P 500. See Brandon Gold, Agents Unchained: The Determinant of Takeover Defenses in IPO Firms (available at http://ssrn.com/abstract=2262095) (May 6, 2013), at 20. Although the board need not respond affirmatively to these shareholder resolutions, they are likely to incur the displeasure of ISS (or other proxy advisors) if they do not.

Services ("ISS"), which regularly supports proposals seeking to declassify the board and may oppose the board nominees of companies that maintain staggered boards.

With the decline in staggered boards, corporate management came under greater pressure and faced the prospect of a proxy fight that could remove the entire board. In 2012-2013, proxy campaigns to obtain full or majority control rose to 42% of all proxy battles, which is a substantial increase over prior years.[40] The threat of sudden ouster is thus real and increasing.

B. The Enhanced Power of Proxy Advisors. Even more important than the decline of staggered boards has been the rise of proxy advisors. Their rise to prominence began in the early 1980s in the wake of a U.S. Department of Labor's interpretation of the Employees Retirement Income Security Act ("ERISA"), which seemed to require a prudent trustee to vote the shares it held in portfolio companies.[41] Failing to vote shares in its view implied wasting a portfolio asset and signaled that the fiduciary was breaching its duty of care. Somewhat belatedly, the SEC took a similar position in 2003, adopting rules that are at least read by the registered investment advisors to mutual funds to require them both to vote their shares "in the best interests of clients" and to disclose annually how they actually voted.[42] This year, under

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[40] See Benoit, supra note 38, at C-1. Only about 20% of the 520 proxy fights since 2008 have attempted to replace the entire board (according to data compiled by FactSet SharkWatch). Id.

[41] The Department of Labor codified these policies in 1994, after previously announcing them less formally in earlier advisory letters. See 29 C.F.R. §2509.94-2. Specialists disagree as to what both the Department of Labor and the SEC's rules actually require, but their impact on institutional investors seems clear.

[42] See Investment Advisers Act Release No. 2106 ("Proxy Voting by Investment Advisers"), 68 Fed. Reg. 6585, 6593 (Feb. 7, 2003) (adopting Rule 206(4)-6 ("Proxy Voting")), 17 C.F.R. §275. 206(4)-6. Rule 206(4)-6 requires "written policies and procedures to ensure that [advisers]…vote client securities in the best interests of clients." See also Securities Act Release No. 8188 ("Disclosure of Proxy Voting Policies and Proxy Voting Records by

criticism that its rules delegated too much power to proxy advisors, the SEC has suggested that investment advisers are not required to vote on every issue, but it still maintains that there is an obligation to vote in an election of directors.[43]

Because many mutual funds compete by attempting to minimize overhead costs and thus have only small in-house staffs, these funds found it easier to outsource the voting decision to a third party. Proxy advisors—most notably ISS and Glass-Lewis—developed to fill this role. Institutional investors differ in terms of how much they rely on ISS's recommendations, but many appear to defer almost entirely. One 2014 study finds that over 25% of mutual funds vote almost exactly as ISS recommends.[44] Other funds rely less and vote independently, but a Business Roundtable survey found that 40% of its member firms' shares were held by institutions that basically followed ISS's voting recommendations.[45]

Registered Management Investment Companies"), 68 Fed. Reg. 6564 (Feb. 7, 2003) (adopting Investment Company Act Rule 30b1-4). Rule 30b1-4 ("Report of Proxy Voting Record") requires the investment company to file an annual report with the SEC disclosing its "proxy voting record" for the previous twelve-month period.

[43] See Division of Investment Management, Division of Corporation Finance, Securities and Exchange Commission, Staff Legal Bulletin No. 20 ("Proxy Voting. Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisor Firms") (June 30, 2014).

[44] See Peter Iliev and Michelle Lowry, "Are Mutual Funds Active Voters?" (available at http://ssrn.com/abstract=2145398) (April 15, 2014) (finding over 25% of mutual funds "to rely almost entirely on ISS recommendations").

[45] See Briggs, supra note 20, at 692 (discussing 2003 memorandum by the Business Roundtable).

Both ISS and Glass Lewis publish their voting policies, and both strongly support shareholder activism, opposing takeover defenses and seeking to maximize shareholder power.[46] Both also determine their voting policies based on interactions with (and polling of) institutional investors, so that proxy advisors and their clients reciprocally influence each other. Estimates differ as to the impact that an ISS recommendation will have in a contested proxy vote,[47] but it is clearly significant and can easily make the difference between victory and defeat. One measure of ISS's influence is that most public companies, in order to comply with ISS's guidelines, have

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[46] See Institutional Shareholders Services Inc., "2014 U.S. Proxy Voting Summary Guidelines" (January 31, 2014); Glass Lewis & Co., "Guidelines 2014 Proxy Season: An Overview of the Glass Lewis Approach to Proxy Advice" (2014).

[47] For the finding that an ISS recommendation can change certain votes by 30% on average, see Yonca Ertimur, Fabrizo Ferri, and David Oesch, Shareholder Votes and Proxy Advisors: Evidence from Say on Pay (available at http://ssrn.com/abstract=2019239) (August 2, 2013). This 30% average impact was in the context of "say on pay" votes (where institutional investors may have less interest) and probably overstates the impact of an ISS recommendation on director elections. Conversely, Professors Choi, Fisch, and Kahan estimate that a recommendation from ISS, the most influential of the proxy advisors, shifts investor votes by between 6% and 10%. Stephan Choi, Jill Fisch and Marcel Kahan, The Power of Proxy Advisors: Myth or Reality, 50 Emory L. J. 869 (2010). This may understate the current impact of an ISS recommendation, given the increasing tendency of some mutual funds today to defer entirely to ISS. See Iliev and Lowry, supra note 44. Even if the proxy advisor's impact cannot be more precisely quantified than somewhere between 10% and 30%, this amount is sufficient to swing many elections where (a) retail shareholders may not vote, and (b) other hedge and mutual funds may bring the total activist ownership up to 30% or more. See text and note infra at notes 76 to 77 (describing silent ownership by hedge funds in the Sotheby's proxy contest).

either redeemed their poison pill or adopted a poison pill that is consistent with ISS's guidelines (and thus has a duration of one year or less).[48]

As noted later, controversy has arisen as to the propriety of the apparent deference given by many institutional investors to ISS, but no conservative challenger to ISS and Glass-Lewis's activist stance has been able to gain any significant market share. This probably reflects their clientele's satisfaction with their leadership. Still, some event studies have found that when institutions vote as ISS recommends, the outcome (at least in some contexts) is actually to decrease share value.[49]

C. SEC Rules. Once, the SEC's proxy rules swept very broadly and probably overregulated. Because those rules define the term "solicitation" to include any communication made "under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy,"[50] corporations could deem "almost any statement of views" by a shareholder (or an agent thereof) as amounting to a proxy solicitation, even when the maker of

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[48] ISS's policy is to require a shareholder vote for any poison pill plan having a duration longer than 12 months. That is, the board must put the poison pill to a shareholder vote within that period or face an ISS disapproval. See Institutional Shareholder Services, Inc., supra note 46, at 25.

[49] One recent study finds a statistically negative impact on stock price as the results of certain compensation program changes made by public companies in response to comments from proxy advisory firms. See David F. Lareker, Allan L. McCall, Gaizka Ormazabal, Outsourcing Shareholder Voting to Proxy Advisory Firms (available at http://ssrn.com/abstract=2101453) (June 13, 2014).

[50] See SEC Rule 14a-1 ("Definitions") which defines the term "solicit" and "solicitation" for purposes of the proxy rules in this fashion. (17 C.F.R. §240.14a-1).

the statement was not seeking proxies.[51] As a result, the issuer (or the SEC) could sue the maker of such a statement or opinion, seeking to bar it from further solicitation on the ground that it had failed to file a proxy statement. This had a clearly chilling impact on shareholder speech and dissent, as compliance with the SEC's rules required the proponent to file a preliminary proxy statement with the SEC for its review before mailing it to shareholders. For decades, this had implied both delay and inhibited speech and had imposed substantial costs on insurgents to print and pay the costs of mailing an often lengthy document. Moreover, these rules made the SEC into a *de facto* censor of the proxy contestant's speech. The SEC could effectively determine that statements were unfair or unsubstantiated and bar them. The proponent could avoid these rules only if it solicited ten or fewer shareholders.

In 1992, the SEC responded to growing criticism and decided to deregulate, abandoning its former role as proxy censor.[52] This greatly reduced delay, and the new rules also permitted "freer" speech. For example, Rule 14a-2(b)(3) permits proxy advisors to distribute "proxy voting advice" to shareholders, at least so long as it was not acting as an agent for a proxy

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[51] The SEC conceded in a 1992 release that the term "solicitation" was broad and that "almost any statement of views" by a shareholder could be challenged as a proxy solicitation. See Securities Exchange Act Release No. 31, 326 ("Regulation of Communications Among Shareholders") (October 16, 1992).

[52] See Securities Exchange Act Release No. 31,326, supra note 49. The SEC finally recognized in 1992 that if it remained a censor with whom contestants had to pre-clear their materials, proxy contestants would not be able to respond to their opponents in a timely manner. Several commentators have made this argument, none more effectively than Professor Bernard Black. See Bernard S. Black, Shareholder Passivity Reexamined, 89 Mich. L. Rev. 520 (1990). For an overview of the impact of the SEC's 1992 reforms, see Briggs, supra note 20, at 686-689.

contestant.[53] Similarly, Rule 14a-2(b)(1) broadly allows statements amounting to a proxy solicitation so long as the solicitor does not seek proxy authority.[54] Effectively, this allowed institutional investors (and hedge funds) to communicate with each other in an uninhibited fashion. They could now publically oppose management's nominees (but not seek to obtain proxies for their own candidates) without preparing a proxy statement.

The 1992 reforms also authorized "short slates"—that is, proxy contests in which the insurgent sought only to elect a minority of the board seats up for election.[55] This was important because, in the absence of a takeover bid, shareholders will be understandably reluctant to pass control to an insurgent group that was not offering them any control premium. Instead, under the short slate rule, the insurgent could seek minority representation on the board in order to push a specific agenda (e.g., the spinoff of a division, a higher dividend payout, a stock buyback, etc.) This rule encouraged hedge funds to seek board representation with the possible objective of putting the company up for sale, but without themselves acquiring control.[56] Because hedge

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[53] See 17 C.F.R. §240.14a-2(b)(3). There are other preconditions to this rule, including that the proxy advisor discloses to the recipient of the advice "any significant relationship" that it has with the issuer or a proxy contestant.

[54] See 17 C.F.R. §240.14a-2(b)(1).

[55] See 17 C.F.R. §240.14a-4(d). Originally, this had not been much used, because strategic bidders wanted control. However, the "short slate" rule well suits the needs of hedge funds, who typically would rather play the role of auctioneer than the role of acquirer. As a result, most proxy contests initiated by hedge funds today are for a minority of the board.

[56] The goal of the short slate rule also was to encourage "constructive engagement" through minority board representation—without a confrontational battle between activists and the issuer. See Ronald J. Gilson et. al., How the Proxy Rules Discourage Constructive Engagement: Regulatory Barriers to Electing a Minority of Directors, 17 J. Corp. L. 29 (1991) (advocating the adoption of a short slate rule).

funds are not typically strategic bidders and traditionally did not want control (which carried some risk of liability), this rule well served their needs.

The next major step for the SEC toward deregulation came in 1999 with the adoption of Rule 14a-12.[57] So long as a proxy card was not furnished to shareholders, Rule 14a-12 permits virtually unlimited communication with other shareholders before any proxy statement is filed. In effect, the election contest could precede the filing of the proxy statement, if all written materials so used were promptly filed with the SEC and contained certain prescribed legends. Oral communications were entirely deregulated (subject to the antifraud rules) and did not need to be filed in any form with the SEC.

In practice, the impact of Rule 14a-12 was to eliminate the need for a proxy statement in several contexts. First, if the insurgent found that it could not attract majority support, it could simply abandon its campaign and never file a proxy statement. Second, facing a likely loss, the target corporation might decide to settle with the insurgent and voluntarily place some of the insurgent's nominees on its board, thereby again eliminating the need for the insurgent to file a formal proxy statement. After 2000, the broad shelter of this rule enabled insurgents to circulate lengthy documents, sometimes of several hundred page length, without any prior proxy statement being distributed.[58]

[57] Rule 14a-12 was adopted by Securities Act Release No. 7760 ("Regulation of Takeovers and Security Holder Communications"), 64 Fed. Reg. 61, 488 (Nov. 1999). For an overview of its impact, see Briggs, supra note 20, at 689-691.

[58] See Briggs, supra note 20, at 696-697 (discussing example of a 348 page "book" distributed by Carl Icahn's investment banker pursuant to Rule 14a-12).

Although insurgents faced high costs in mailing a proxy statement to all shareholders, they did not actually need to mail to all shareholders. The SEC has long permitted them to mail only to the shareholders whose votes they solicited.[59] Thus, they could direct their mailings to institutional shareholders and ignore retail shareholders with small holdings. In 2005, the SEC further reduced these costs to insurgents by eliminating any requirement for a mailing of the proxy statement.[60] Instead, consistent with the SEC's earlier-adopted "access-equals-delivery" model for registration statements in the public offering context, the proxy contestant needed only to email a short notice to shareholders that its proxy materials were available online, either at the corporation's website or at the SEC. Thus, a proxy statement would be filed, but not mailed, and the proxy contestant saved significant costs, but could still file and seek proxy authority if the contest went the full distance to a vote.

In sum, deregulation has greatly reduced the costs of proxy contests and thereby encouraged hedge fund activism.

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[59] See Securities Exchange Act Release No. 55, 146 ("Internet Availability at Proxy Materials"), 72 Fed. Reg. 4148, 4158 (January 29, 2007) (noting that insurgents can economize by soliciting only "those with large holdings").

[60] Instead, the proxy contestant could simply email a Notice of Internet Availability of Proxy Materials and leave it to the shareholder to seek out its proxy statement on the dissident's website. See Securities Exchange Act Release No. 55, 146 ("Internet Availability of Proxy Materials"), 72 Fed. Reg. 4148, 4150-60 (January 29, 2007). The insurgent will have to mail or otherwise send its proxy statement to requesting shareholders, but such requests are few.

This policy change followed the SEC's earlier and similar decision in 2005 to move the distribution of prospectuses to a "notice equals access" model. See Securities Act Release No. 8591, 70 Fed. Reg. 44, 722, 44, 782-86 (August 3, 2005).

D. Broker Votes. Historically, brokers were permitted to vote shares held in their "street name" for their clients, at least on "routine" matters.[61] As a practical matter, this did not significantly affect contested elections for board seats (which were not considered "routine" and thus brokers were not authorized to vote), but it did mean that in voting on shareholder proposals or on corporate governance issues, brokers would typically vote the shares held by retail shareholders in favor of management's position. Institutional shareholders would still vote their own shares in order to comply with the policies on voting of the Department of Labor and the SEC. Then, in 2010, both the New York Stock Exchange and the Dodd-Frank Act acted independently to change this landscape, by barring brokers from voting shares held in their names without shareholder instructions in most circumstances.[62]

The net impact is that the shares held by retail shareholders are less likely to be voted (as they tend toward passivity), thus giving greater relative weight to the voting preferences of institutional shareholders. In effect, in a vote on a shareholder proposal, management loses its previously built-in advantage based on brokers voting the shares of passive retail shareholders for management. Even more importantly, if the corporation's own bylaws require a director to submit his resignation if the director fails to receive a majority of the votes cast in an uncontested

[61] For the old rule, see New York Stock Exchange Listed Company Manual §452 (2003) (permitting brokers to vote shares held in their name on an uninstructed, discretionary basis on "routine" matters). The New York Stock Exchange voted to change this practice even before the 2008 financial crisis, but had to await SEC approval of its rule change, which approval came only in 2009, effective for shareholder meetings occurring after January 1, 2010. For an overview, see Marcel Kahan and Edward Rock, Embattled CEOs, 88 Texas L. Rev. 987, 1015-1018 (2010).

[62] Section 957 of the Dodd-Frank Wall Street Reform and Consumer Protection Act amended Section 6(b) of the Securities Exchange Act of 1934 to prohibit discretionary voting by brokers with respect to director elections and with respect to "any other significant matter" (as determined by the SEC).

election (and such "majority vote" provisions are now widely prevalent), broker votes can no longer be relied on to provide this majority, thus increasing the insurgent's chances to unseat an incumbent in a "withhold the vote" campaign. As a result, hedge funds can pressure boards to increase the payout to shareholders with the threat of a "withhold the vote" campaign, even when they do not choose to run their own candidates for the board. This is low-cost pressure.

E. The "Wolf Pack" Tactic. The term "wolf pack" is often used (including by courts), but it is seldom defined.[63] As used herein, it will mean a loose network of activist investors that act in a parallel fashion, but deliberately avoid forming a "group" under Section 13(d)(3) of the Securities Exchange Act of 1934. That provision states that "[w]hen two or more persons act as a…group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for the purposes of this subsection."[64] Thus, if three "persons" each acquire 2% of the stock in a target company and their relationship makes them a "group", their shares are aggregated by Section 13(d), which treats them as a single "person" who must file a Schedule 13D within ten days of the formation of the group because they have collectively crossed its 5% beneficial ownership threshold.

Why is it important not to form a "group" for Section 13(d) purposes? Multiple reasons can be given. First, it is possible that all members of a Section 13(d) "group" will be sued by the

[63] For a careful review of the "wolf pack" strategy, see Briggs, supra note 20, at 697-99. Published in 2007, this article shows that the technique was being used at least as early as 2005. Only its prevalence has truly changed.

[64] See Section 13(d)(3) of the Securities Exchange Act of 1934, 15 U.S.C. §78m(d)(3). For the conclusion that hedge funds perceive themselves to face little risk of being deemed a group (so long as they do not explicitly agree to cooperate), see Briggs, supra note 20, at 691 ("hedge funds…engage in 'wolf pack' tactics against companies undeterred by a fear of somehow magically becoming a group because they hunt together and seek 'the same prey.'") Later, we will assess the prospects for changing this attitude.

target company, who will assert alleged disclosure violations in their Schedule 13D. Avoiding joining a "group" protects those activist investors who individually own less than 5% of the target's stock, because the target will usually not know of their existence. Unless these investors declare themselves part of a group, they are basically invisible so long as they individually stay below the 5% ownership level. Although Section 13(d) litigation is unlikely to result in significant civil liability, it can be costly to defend, and hedge funds (other than the leader of the "wolf pack") can sidestep this cost by not joining a "group."

Second, and more importantly, avoiding a "group" delays the moment at which the Schedule 13D must be filed. The individual hedge fund organizing the activist campaign can quietly buy up to 5% of the target's stock at a price that does not reflect its incipient campaign (which campaign may likely be read by the market as signaling a possible takeover or control contest). Then, it can buy even more stock in the ten-day window that Section 13d(1) gives it after the acquirer crosses 5% before it must file its Schedule 13D. Shares acquired during this ten-day statutory window period may be more costly (as active purchasing will be detected and may alert the arbitrageurs), but the price will still be less than the level to which it will rise on the filing of the Schedule 13D. Acting in this fashion, the hedge fund activist organizing the campaign will typically wind up holding a stock position of 6% to 10% as of the time of its Schedule 13D filing.[65] Much (but not the majority) of this stock will be acquired in the ten-day

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[65] Bebchuck, Brav, Jackson and Jiang find that "hedge fund activists typically disclose substantially less than 10% ownership with a median stake of 6.3%." See Lucian A. Bebchuk, Alon Brav, Robert J. Jackson and Wei Jiang, <u>Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy</u>, 39 Iowa J. Corp. Law 1, 3 (2013). Of course, the stake so disclosed represents only the holdings of those making the Schedule 13D filing and not the total stake of the entire "wolf pack." An earlier study of 52 activist "interventions" in 2005 and 2006 found that in twenty-six (or

statutory window before a Schedule 13D must be filed after the investor crosses the 5% threshold. Generally, the typical activist will not cross the 10% threshold, probably because at that point it will become subject to Section 16(b) of the Securities Exchange Act, which may force it to surrender any "short swing" profits to the corporation on shares acquired in excess of 10%.[66] In sum, here again, there is a cost in becoming a "group," because if a half dozen hedge funds collectively owning 15% of the stock were deemed a "group," they might be required under some circumstances to forfeit their profits on the sale of shares over the 10% level. Such shares would also be illiquid until Sections 16(b)'s six month period ran.

A third problem with "group" formation involves the target's response to the filing of a Schedule 13D. The target may respond by adopting a "poison pill" (or "shareholder rights plan," as it is more formally known) that will effectively bar the "group" from acquiring more of the target's shares. Because of the opposition to poison pills by proxy advisors, most public corporations today do not have a "standing" poison pill in place, but rather adopt one only in

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50%) of these "interventions," the disclosed activists held a stake of at least 9.5% and only five held a stake of less than 4.9%. In three of these 52 cases the participating institutions held a majority of the shares. See Briggs, supra note 20, at 697. Although the broader "group" of institutions may thus exceed 10%, no individual institution will typically exceed that level, probably because of the impact of Section 16(b), as discussed in the next footnote.

[66] Section 16(b) of the Securities Exchange Act of 1934 entitles any shareholder to sue to recover "short swing" profits for the corporation (plus attorney's fees) that are based on a purchase and sale, or a sale and purchase, within six months, of the stock of a "reporting company." See 15 U.S.C. §78p(b). Although Section 16(a) requires a "group" to disclose its beneficial ownership, Rule 16a-1(a)(4) permits each member of the group to disclaim beneficial ownership of the other group members' equity securities. See 17 C.F.R. §240.16a-1(a)(4).

response to a specific, perceived control challenge.[67] Let us suppose then that the "wolf pack" leader buys 5.1% quietly and then another 3.9% more hurriedly during the ten-day window before it files (for a total of 9%). Simultaneously, some six to ten hedge fund allies (all of whom will deny forming a "group") buy another 12% to 15%, mainly in the same ten-day window period. This produces a grand total of 21% to 24% if we add the other funds' shares to the 9% of the "wolf pack" leader. If the leader and its allies were deemed a "group," two consequences would follow. First, they would have had to file a Schedule 13D at a much earlier point (as even the initial holdings of the group may already exceed 5% at the moment of group formation). Such an earlier filing would have made it more costly to acquire additional shares post-filing. Hence, the same group would probably have wound up holding a much lower aggregate amount than the 24% stake in this hypothetical.

Second, the response of the target to the Schedule 13D's filing will often be to adopt a poison pill that barred further acquisition of stock by any member of the group. Specifically, the poison pill might use a 10% ceiling (as has been upheld in a recent case).[68] But if no group is

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[67]As recently as 2005, 35% of public companies still had a poison pill in place. See Victor L. Lewkow and Sharah G. ten Siethoff, "The Embattled Poison Pill," Insights, April 2005, at 13. That number has since dropped markedly, probably because of the opposition to poison pills of ISS and other proxy advisors (and the fact that companies, once made the subject of a corporate control contest, can then adopt a poison pill). One recent survey finds that some 471 companies have "traditional" poison pills in place, while another 25 have "two-tier" poison pills (which impose a lower threshold on "activist" investors). See Ronald Orol, "Five Developments to Watch As Activism Gains Steam," The Deal Pipeline, January 9, 2015 (citing FactSet Shark Watch data).

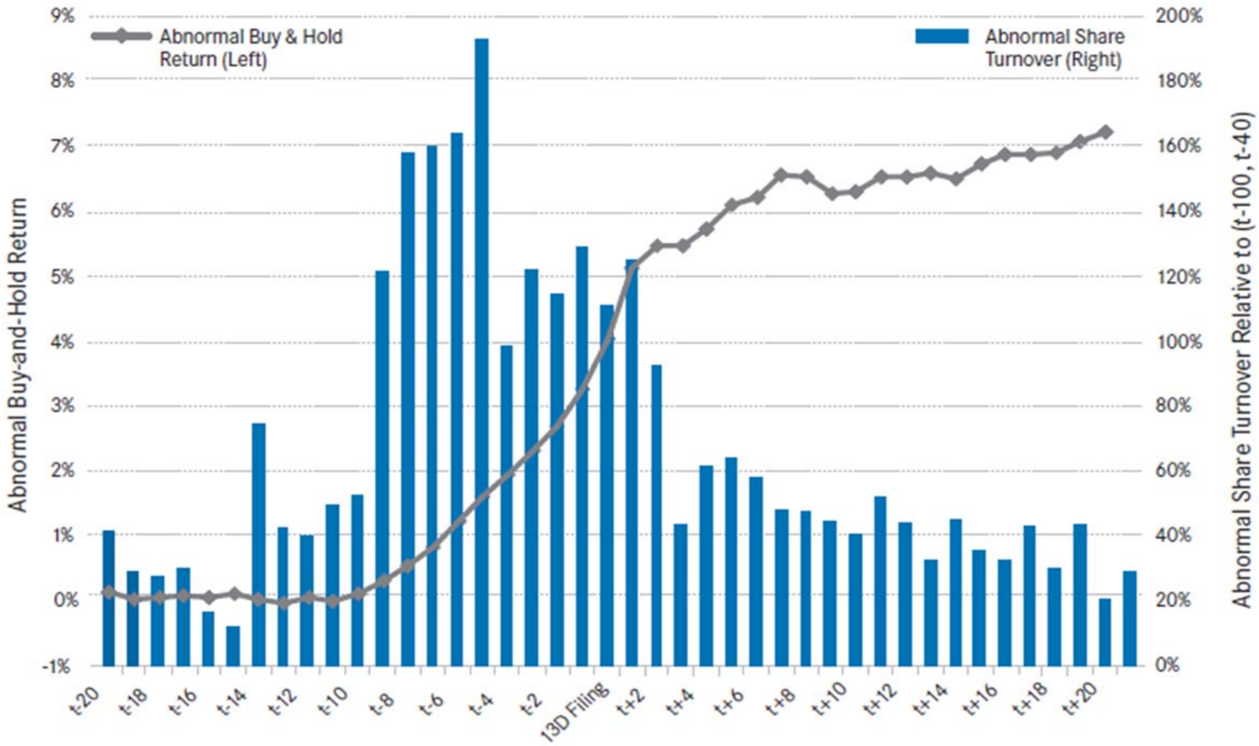
[68] In the 2014 proxy contest over the board of Sotheby's, Sotheby's adopted a poison pill with a 10% ceiling for "activist" investors, but only a 20% for "passive" investors. "Activist" investors were those who filed a Schedule

formed, the only restraint imposed by such a poison pill adopted on the Schedule 13D's filing will be to bar the "wolf pack" leader and other individual shareholders from crossing 10%. Although the poison pill may purport to apply to those who act in concert with this "wolf pack" leader, their identities will remain unknown to the target company, and each of these allies will carefully keep its distance from the "wolf pack" leader. The bottom line then is that the "wolf pack" technique enables activists to largely outflank the poison pill and assemble a larger stock position before the bidder learns of their existence.

Empirically, it is important to understand that most of the stock price appreciation and most of the high trading volume that surrounds the "wolf pack's" formation occurs just before the filing of the Schedule 13D during the ten-day window permitted by Section 13(d). The following chart shows this relationship:[69]

13D, and "passive" investors were those who filed a Schedule 13G. See Third Point LLC. v. Ruprecht, 2014 Del. Ch. LEXIS 64 (May 2, 2014).

[69] See Brav, Jiang, Partnoy and Thomas, supra note 14, at 1756. For a similar, consistent and more recent finding, see Bebchuk, Brav and Jiang, supra note 10, at 1122 (Figure 2) (finding a 6% abnormal gain around the Schedule 13D filing, with most of the stock price gain preceding the filing). Others have reported that the trading volume of stocks targeted by activist investors jumps by an average of 40% on the day when a Schedule 13D is filed. See Susan Pullian and Juliet Chung, "Investors Quietly Paying for Ideas," The Wall Street Journal, October 3, 2014, at C-1 (citing study by S&P Capital IQ).



Source: Alon Brav, Wei Jiang, Frank Partnoy and Randall S. Thomas, "Hedge Fund Activism, Corporate Governance, and Firm Performance," *Journal of Finance*, 63, no. 4, August 2008, p. 1756

After the Schedule 13D's filing, the stock may still appreciate further, but not at the same hyperbolic rate that it rose in the period just before the filing. Because the abnormal trading volume drops sharply within two days after the Schedule 13D's filing, this suggest that many other institutional investors have bought during this window period and not after it. Indeed, another, more recent study finds that most of the buying by those who file a Schedule 13D is "concentrated on the day they cross the threshold as well as the following day."[70] If so, this means that the high volume of trading that is evident on the above chart on the last eight days preceding the Schedule 13D's filing is attributable to others (who most likely have been informed by those filing the Schedule 13D of their intentions). The inference then seems

[70] See Bebchuk, Brav, Jackson and Jiang, supra note 23, at 6.

obvious: tipping and informed trading appears to characterize both the formation of the "wolf pack" and transactions during the window period preceding the filing of the Schedule 13D.

This pattern should not surprise us. Those who learn of the incipient Schedule 13D filing face a nearly riskless opportunity for profitable trading, if they act quickly, as the Schedule 13D filing usually moves the market upward. Although the lead hedge fund organizing the "wolf pack" also typically buys during the ten-day window after it crosses 5%, it can buy cheaper earlier (as the above chart makes very clear). Because the lead hedge fund typically does not acquire more than a 10% position, it would buy at least half of its stake in the period before this ten-day window—and at a lower price. Rationally, its incentive is to tip others only after it has completed its own purchases (as otherwise it will be forced to buy in a rapidly rising market). Thus, much (and maybe most) of the buying during the ten-day window seems likely to be by other "wolf pack" members. From a tactical perspective, it is the interest of the "wolf pack" leader to tip such allies, as the larger the percentage of shares held by loosely affiliated hedge funds, the greater the likelihood of victory in any proxy contest brought by the lead hedge fund. Actual practices remain uncertain in some respects.

How much calculated tipping by the lead fund actually occurs is uncertain, as information could also leak out by way of gossip, veiled signals, and body language within the hedge fund community. But clear examples of such tipping by hedge funds have come to light in litigated cases.[71] Still, whether it tips or sends only veiled signals, the lead hedge fund has little need to insist on confidentiality, at least once it has largely completed its own purchases.

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[71] See CSX Corp. v. Children's Inv. Fund Mgmt., (UK), LLP, 562 F. Supp. 2d 511, 525 (S.D.N.Y. 2008) (noting that defendant hedge fund contacted other hedge funds about the target to develop allies). Empirical data also points to large purchases by tippees in the ten-day window. One recent study finds that 40% of hedge fund activists "take

Such tipping by the "wolf pack" leader to its allies of its intent to launch an activist campaign may seem to resemble insider trading, but legally it is not equivalent. Although the information may be material and non-public, there is no breach of a fiduciary or other duty.[72] Indeed, it is in the interests of the lead hedge fund's own investors that allies be assembled. In short, the information is not misappropriated, but freely given in order to gain leverage over the target company. Under existing law, such tipping would be unlawful only if a tender offer for the target is made by the "wolf pack" leader. Then, Rule 14e-3 makes it unlawful for the bidder (or others) to tip information relating to an approaching tender offer, once the bidder has taken a "substantial step" towards making such an offer.[73] This issue has arisen in connection with the

advantage of a large part of the ten-day window." See Bebchuk, Brav, Jackson and Jiang, supra note 23, at 3. If only 40% of hedge fund activists buy in this window period, this suggests that other "wolf pack" members who do not file a Schedule 13D are doing much of the buying in this ten-day window period. This study further finds that, to the extent the "wolf pack" leader does buy during the ten day window, it does so primarily on the day that it crosses the 5% threshold and the next day. Id. at 6. But as the above chart in the text indicates, the abnormal trading peaks several days later, implying that others in the "wolf pack" are responsible for it.

[72] Under Dirks v. SEC, 463 U.S. 646 (1983), a breach of some fiduciary-like duty is a necessary element before a defendant can violate the insider tradition prohibition. United States v. O'Hagan, 521 US. 642 (1997), does not change this result, but simply allows the requisite duty to be one owed to the source of the information, rather than the trading partner.

[73] See Rule 14e-3(a) begins by stating: "If any person has taken a substantial step or steps to commence…a tender offer…, it shall constitute a fraudulent, deceptive or manipulative act or practice…." See 17 C.F.R. §240.14e-3(a). What constitutes a "substantial step" will depend on the facts and circumstances, but steps such as arranging financing for the tender offer or hiring an investment banker for that purpose seem sufficient.

Valeant and Pershing Square Capital joint bid for Allergan, Inc.,[74] but, outside this rare context of a joint tender offer by a hedge fund, insider trading issues seem unlikely to arise.

The "wolf pack" so formed is a loosely knit organization, and some members may drop out well before the proxy contest is begun or comes to a vote. Most do not appear to hold for the long run. Indeed, one well-known study places the median duration for hedge funds from the first Schedule 13D filing to the investor's "exit" at 369 days (or roughly one year), but a more recent study by basically the same authors shortens the median period to 266 days.[75] Either way activists specialize in short-term interventions. In fact, if the proxy contest is about merely a corporate governance issue (where the impact on share price is likely to be modest), those who bought in the ten-day window period may have little incentive to remain as shareholders for any extended period after the Schedule 13D filing. Alternatively, if the Schedule 13D discloses that the "wolf pack" leader is seeking to sell the company, spin off significant assets, or otherwise

[74] For a skeptical review of whether the Valeant/Pershing Square proposed transaction for Allergan may have involved insider trading in violation of Rule 14e-3, see Andrew Ross Sorkin, "Perhaps Too Clever To Be Legal," N.Y. Times, August 4, 2014 at p. B1. No view is here expressed or implied on this question.

[75] For the 266 day period between Schedule 13D filing and divestment, see Alon Brav, Wei Jiang and Hyunseob Kim, Hedge Fund Activism: A Review, Foundations and Trends in Finance (available at http://ssrn.com/abstract=1551953) at p. 18 and Table 4.2 Panel C (February 2010). For the earlier 369 day figure, see Brav, Jiang, Partnoy and Thomas, supra note 14, at 1769. The 25th and 75th percentile figures in this earlier study were 169 and 647 days, respectively. Id. In the case of "hostile" transactions, the median duration is even shorter—319 days (or a little over 10 months). Id. Of course, as the pace of activism has accelerated, the median duration may have become even briefer today than either study shows. Also, these reported figures are for those hedge funds that file a Schedule 13D. Other funds that simply join the "wolf pack," before or after the Schedule 13D filing, may hold for an even shorter duration.

trigger a corporate control contest, then the other members of the "wolf pack" may sense a future takeover premium and hold their shares to reap a possible arbitrageur's profit. In any event, a leading study finds an average 7% positive abnormal stock price reaction to the Schedule 13D's filing, and this seems sufficient to attract hedge funds who learn in advance of the filing, particularly when they know that they do not have to face potential legal liability for trading on such information.

How large can the "wolf pack" get? Here, it is difficult to gain precise information because neither the "wolf pack" leader nor the target will necessarily know how many silent allies have joined with it. But proxy solicitors can gain an estimate. In the 2014 proxy contest for the Sotheby's board (where the insurgents had publicly called for the firing of Sotheby's CEO), the lead hedge fund (Third Point LLC) had, itself, acquired a 9.62% stake in Sotheby's, but Sotheby's expert witness in the Delaware Chancery Court litigation (the CEO of Mackenzie Partners, Inc., a prominent proxy solicitor) testified that by his estimate 32.86% of Sotheby's stock was held (at the time of the vote) by hedge funds (including Third Point).[76] This was in no respect a record level, and instances have been reported where a majority of the stock was acquired by insurgents.[77]

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[76] See Expert Report of Daniel H. Burch, Chief Executive Officer of Mackenzie Partners, Inc. This report was filed in Third Point LLC v. Ruprecht, supra note 68. Professor Coffee also served as an expert witness in this case for Sotheby's. Based on this level of hedge fund ownership (i.e., 32.86%), Mr. Burch concluded that "a holder of between 5% and 9.99% of the outstanding voting shares has a good chance of winning a minority-slate campaign."

[77] See Briggs, supra note 20, at 697 (finding three cases in his survey of hedge fund activism in 2005-2006 in which the institutions participating in the proxy campaign held a majority of the shares). Activists are currently targeting Hertz Global Holdings, Inc. ("Hertz"), and the press has reported that hedge funds own more than half of Hertz's stock. See "Nomination Windows Open at Activist Targets, Hertz, Amgen-Market Talk," Dow Jones Institutional

In any event, because art auction houses (such as Sotheby's) are low-tech companies that are not usually attractive to hedge funds, this suggests that the Sotheby's contest provides a good illustration of "wolf pack" formation (as the Delaware Vice Chancellor explicitly noted in upholding Sotheby's use of its poison pill).[78] To put this ownership level in perspective, it needs to be recognized that, in most proxy contests, some percentage of the shares (probably 15% to 20%) simply do not vote. If so, and if the "wolf pack" can assemble one third of the target's outstanding stock, then it only has to win another 7% to 10% of the remaining votes to obtain a *de facto* majority. Moreover, because the remaining shares will typically be held primarily by institutional investors (who may not be activists, but who do tend to follow the voting recommendations of their proxy advisors), the lead hedge fund can expect the support of shareholders outside the "wolf pack." Although ISS's and Glass Lewis's recommendations do not invariably favor the insurgents, they do support the insurgents much of the time. When they do so, the insurgents generally win.[79] These facts may explain why insurgents enjoyed a success rate approaching 80% in proxy contests last year.[80] Facing this prospect and aware that the vote

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News, January 14, 2015 (citing FactSet Shark Watch). Much attention earlier focused on the acquisition of 26.7% in J.C. Penney by Pershing Square and Vornado Realty Trust, most of which occurred during the ten-day window period after they crossed 5%. See Joshua Mitts, <u>A Private Ordering Solution to Blockholder Disclosure</u>, 35 N.C. Cent. L. Rev. 203, 204 (2013). This was not a "wolf pack," however, but two large "wolves," arguably acting in concert. Still, it shows just how much can be acquired in the ten-day window under Section 13(d)(1).

[78] See <u>Third Point LLC. v. Ruprecht</u>, supra note 68, at *58 to *59. Based on what he saw as the board's objectively reasonable perception of a threat, Vice Chancellor Parsons upheld the use of a poison pill with a 10% ceiling for activist investors.

[79] See Briggs, supra note 20, at 698.

[80] See text and notes supra at notes 32 to 35.

was going against it, the Sotheby's board opted to settle and gave Third Point the seats it was seeking on the Sotheby's board. This pattern seems likely to play out similarly in future cases.

F. The Shrinking Concept of "Group." At the heart of the foregoing "wolf pack" tactic is the fact that parallel action by like-minded activist investors, even when accompanied by discussions among them, does not, without more, give rise to a "group" for purposes of Section 13(d)(3).[81] This outcome is not apparent from the face of the statute, and the SEC's rules go even further by recognizing that a "group" that must be disclosed can be formed for the purpose of voting shares (as well as for the purposes of buying, holding, or disposing of shares).[82] Still, recent judicial interpretation of the "group" concept has been conservative. For example, in Hallwood Realty Partners L.P. v. Gotham Partners, L.P.,[83] the Second Circuit decided that two Schedule 13D filers and a Schedule 13G filer were not a "group, even though one was a well-known raider and all three discussed among themselves how to improve the value of the target company". In a later Southern District case, even a joint slate of directors proposed by the investors was not sufficient to make them a "group."[84]

[81] Virtually all commentators agree that parallel actions by, and communications among, hedge funds do not make them a group.

[82] See Rule 13d-4(b)(1), 17 C.F.R. §240.13d-4(b)(1). This rule adds "voting" to the statutory terms in Section 13(d)(3), which section refers only to "acquiring, holding and disposing" of equity securities. Hence, based on this rule, a "voting group" must also file a Schedule 13D.

[83] 286 F.3d 613 (2d Cir. 2002).

[84] See meVC Draper Fisher Juvetson Fund I, Inc. v. Millenium Partners, L.P., 260 F. Supp. 2d 616, 631-633 (S.D.N.Y. 2003).

In contrast, earlier cases were more prepared to find a "group." Thus, in both GAF Corp v. Milstein,[85] and Wellman v. Dickinson,[86] the Second Circuit found that a "group" was formed for purposes of Section 13(d)(3). In GAF Corp, the group was a family that pooled its holdings, and the defining criterion identified by the Second Circuit was that this effort threatened "the stability of the corporate structure."[87] Similarly, in Wellman v. Dickinson, the Second Circuit found that a fired CEO of a company and a number of friends constituted a selling "group" where they "reached an understanding to act in concert in disposing of their shares."[88] What made this association a "group"? The key fact to the Second Circuit may have been that the defendants "were linked by a desire to profit from a shift in the corporate control of Becton" (the target company).[89] But if that were the test, it applies broadly, as many hedge funds join in proxy control contests, hoping that a corporate acquirer will materialize and make a merger proposal or a tender offer for control. Under these tests, many loose associations of investors might be deemed "groups."

Differentiating Hallwood Realty from GAF Corp and Wellman appears to have been the fact that each of the institutional investors in Hallwood Realty "made an independent decision to purchase units, based on due diligence and a common understanding among knowledgeable investors that Hallwood units were undervalued."[90] This test places great emphasis on

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[85] 453 F.2d 709, 712 (2d Cir. 1971).

[86] 682 F.2d 355 (2d Cir. 1982).

[87] See GAF Corp v. Milstein, 453 F.2d 709, at 717-718 (2d Cir. 1971).

[88] 682 F.2d 355, at 363.

[89] Id at 365.

[90] 286 F.3d 613, at 616-618 (2d Cir. 2002).

sophistication. Apparently, if sophisticated parties independently reach the same investment strategy, no group arises, even if they actively discuss their investment strategy for the company among themselves.

Decisions must be understood in their context. Hallwood Realty did not involve a proxy contest. Hence, its focus on independent decision-making makes more sense. Conversely, when a proxy contest is foreseeable, collective action becomes the critical issue, and independent decision-making is less relevant when the objective is to assemble a voting majority. Because there is strength in numbers, even sophisticated investors know that they need allies and that independent voting decisions have little impact. Arguably then, Hallwood Realty's test should be confined to its context, and ongoing discussions among investors should play a larger role in the proxy contest context in the determination of whether a "group" exists. Conscious parallelism in efforts to persuade or induce others to vote in a specific way could logically be viewed as demonstrating the existence of a "voting" group on the part of those soliciting. But that is not the current law.

Overshadowing even the formalistic definition of "group" as a cause of aggressive behavior by the "wolf pack's" leaders is the absence of any meaningful remedy if a "group" is formed but not reported. Suppose two hedge funds form a "group" that as of its formation holds 5.1% of the target's shares. Although are required to file a Schedule 13D within ten days, they do not. Rather, after the expiration of ten days, they each buy up to just below 5% and thus collectively hold just under 10%. Although the issuer may sue for corrective disclosure, this remedy only closes the barn door after the horse has been stolen. Under the current case law, the issuer has no realistic chance of obtaining an injunction that "sterilizes" (i.e., bars the voting of) the shares acquired in violation of the Williams Act's rules.[91] As a result, activists have every incentive to play fast and loose with the "group" concept, because, even if their violation is detected, all that will happen as a practical matter is that they will be forced to disclose their unlawful acquisition of shares. Such a painless remedy is hardly a deterrent. Meanwhile, the voting electorate will have been irrevocably changed, and some shareholders will have sold to the "group's" members at a discount off the price that would have prevailed had timely disclosure been made.

G. Proxy Access. Traditionally, insurgent shareholders who wished to challenge management had to conduct a proxy contest to elect their own nominees to the corporation's board. Although hedge funds do wage proxy contests, they are an expensive proposition whose cost deters most shareholders, including particularly institutional shareholders, who, even if they might desire to change corporate policies, do not themselves want to control (or risk being deemed to control) the target corporation.[92] The Dodd-Frank Act sought to empower

[91] In CSX Corp. v. Children's Inv. Fund Mgmt. (UK) LLP, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), the district court found that a "group" had been formed by two hedge funds, which had acquired over 8% of the target's stock in violation of Section 13(d), but still concluded that it was powerless under the case law to order sterilization of the shares purchased in violation of the Williams Act's rules because "irreparable harm" could not be shown once corrective disclosure was made. Id at 567-571. Although the court said that it would have granted such an injunction to deter future violations, it found that it was barred by Treadway Cos v. Care Corp., 638 F. 2d 357, 380 (2d Cir. 1980), in which case the "group" members acquired a 31% block but still escaped sterilization.

[92] The costs of a proxy contest may make sense for those who acquire a significant percentage stake and expect to profit from a change in corporate policy, but less so for indexed institutional investors who do not want to exceed a low percentage (probably between 1% and 5%) of the stock of the companies in their portfolio. In addition, if the investor were to be deemed to hold "control," the investor would become subject to potential "controlling person"

institutional investors by authorizing a new system of "proxy access" under which a group of shareholders who had held a defined percentage of the company's stock for a defined period could add their own nominees to the corporation's own proxy statement and thus seek to elect a minority of the board at low cost.[93] Responding to this new authority, the SEC adopted Rule 14a-11 in 2011, which would have permitted shareholders to nominate up to (at most) three directors to the corporation's board.[94] But this rule was challenged by the Business Roundtable and promptly struck down by the D.C. Circuit Court of Appeals in 2011 on the ground that the SEC had not conducted an adequate cost/benefit analysis in adopting the rule.[95]

That defeat did not, however, end matters. Institutional investors and proxy advisors began to pressure corporations to change their own bylaws to permit some defined percentage of the shareholders to nominate a minority slate of directors by means of the corporation's own proxy statement. In particular, their goal became achieving a "universal proxy"—that is, a proxy card on which the corporation's nominees and any insurgent nominees would be listed side-by-side. Predictably, corporations resisted, and for a time the SEC sided with them, allowing

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liability under Section 20(a) of the Securities Exchange Act of 1934. See 15. U.S.C. §78t(a). Avoiding this characterization has traditionally been a concern for institutional investors.

[93] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §971, 124 Stat. 1376, 1915 (2010)(codified as amended at 15 U.S.C. §78n(a)(2)). This provision authorized (but did not require) the SEC to adopt rules under which shareholders could nominate between one and three directors (depending on the size of the board), using the company's own proxy statement.

[94] See Securities Act Release No. 9136, ("Facilitating Shareholder Director Nominations"), 75 Fed. Reg. 56,668, 56,773-93 (Sept. 16, 2010).

[95] See Business Roundtable Inc. v. SEC, 647 F. 3d 1144 (D.C. Cir. 2011). This controversial decision has been much debated, but those issues are beyond the scope of this article.

managements to use tactics that excluded shareholder proposals for proxy access from their proxy statements.[96] Then, in early 2015, SEC Chair Mary Jo White announced that the SEC would reconsider its policy on proxy access.[97] Equally significantly, some major corporations—most notably, General Electric—agreed to a compromise under which a 3% ownership block that had been held for at least three years could nominate up to 25% of the directors to be elected at an annual meeting.[98] At present, this procedure is gaining adherents and may soon become a widely accepted "best practice." Finally, in mid-2015, the SEC indicated that it was planning to

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[96] Shareholders seeking to change, or request a change, in the corporation's bylaws generally must rely on the SEC's shareholder proposal rule, Rule 14a-8, 17 C.F.R. §240.14a-8. However, this rule permits the corporation to exclude a proposal that "directly conflicts with one of the company's own proposals." See Rule 14a-8(i)(9). Exploiting this exemption, some companies proposed weak substitutes for "proxy access" and then omitted the stronger proposal made by insurgent shareholders. For a time the SEC's Staff permitted this technique by granting "no action" letters to corporations that made "conflicting" proposals on proxy access in their proxy statements. In late 2014, such a "no action" letter granted to Whole Foods Markets provoked angry responses from major institutional investors and eventually prompted an SEC re-examination of this policy. See Andrew Ackerman & Joann S. Lublin," Whole Foods Dispute Prompts SEC Review of Corporate Ballots," The Wall Street Journal Online, January 19, 2015.

[97] See Andrew Ackerman, "SEC Shift on 'Conflicting' Shareholder Proposals Sparked by Abuse Concerns; staff are reviewing when a shareholder proposal truly conflicts with a management proposal, SEC Chairman White said," The Wall Street Journal Online, March 19, 2015. SEC Chairman Mary Jo White explained this change in policy in a speech delivered at Tulane University Law School on March 19, 2015. See Mary Jo White, "A Few Observations on Shareholders in 2015, Remarks At Tulane University Law School 27th Annual Corporate Law Institute."

[98] The General Electric version of proxy access under which an individual or group holding at least 3% for at least three years can nominate up to 25% of the seats to be elected has also been adopted by Citigroup and Bank of America, all in 2015. See Gretchen Morgenson, FAIR GAME: Time to coax the Directors Into Talking," N.Y. times, March 29, 2015 at D-1.

implement a “universal” proxy card which would list all candidates for director on a single ballot.[99] This would significantly simplify the task for insurgents by giving them equal standing before shareholders with management’s own nominees.[100]

What does it mean for hedge fund activism? Few activist hedge funds have held their stock for anything approaching three years (because their business model is to buy stock in a target only after they decide upon an intervention strategy). Thus, they will need allies among traditional institutional investors, who are largely indexed and have held their investments in most companies for multiple years. By partnering up with pension funds and mutual funds, hedge fund appear today to be on the verge of acquiring increased influence over the composition of the target board at greatly reduced cost. At the same time, however, they will need to sell their proposals to traditional diversified institutional investors, and this will likely serve as a moderating influence on some activists.

[99] See Andrew Ackerman and David Benoit, “SEC Chief Tilts Again to Activists,” Wall Street Journal, June 28, 2005 at C-1 (describing “universal” ballot proposal).

[100] Another advantage of a universal proxy card is that it would permit shareholders to pick and choose among all candidates. Today, when rival ballots are circulated by the proxy contestants, shareholders must make an either/or choice. For example, if management nominates ten directors for a ten person board and the insurgent nominates a “short slate” of four nominees, the insurgent will also list on its ballot the six management nominees that it least objects to, in order that ten directors will be elected. Thus, because the insurgent will omit the name of four incumbents (in favor of its four nominees), there is no way that a hypothetical shareholder can vote for some of the insurgent’s nominees and one or more of the omitted management nominees. Such a hypothetical shareholder might wish to vote for two insurgents and eight of the incumbent directors, but under the current system, the shareholder cannot do this because it must sign and submit one of the two alternative ballots. On a “universal” proxy card, the shareholder can pick and choose as the shareholder wishes.

All in all, the leverage possessed by activist hedge funds seems likely to increase even further in the near future.

H. Tactics: The Game Plans for Each Side. In theory, activism and proxy fights are about insurgents seeking to convince shareholders that they have a better business plan than the incumbent management team. However, that explanation does not quite fit the data. One well-known study found no difference in abnormal returns between proxy contests in which the insurgents win a board seat and contests in which they lose.[101] In effect, the outcome is irrelevant. Why then does the market welcome such contests? In the foregoing study, the authors generalize that the gains come not from the identity of the victor, but from the predictable tendency of the incumbent management to implement the specific changes sought by the insurgents. These changes typically involve "liquidity events"—special dividends, stock buybacks, spinoff of assets, etc.

Revealingly, some studies find that the average abnormal returns in proxy contests are higher when the incumbent management wins,[102] and at least one study finds negative abnormal returns following a proxy contest in which the insurgent wins seats.[103] Why? Possibly, shareholders want the increased payout through dividends or stock buybacks that the activists are demanding, but feel more comfortable when the incumbent management oversees this process.

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[101] See J.H. Mulherin and A.B. Poulsen, Proxy Contests and Corporate Change: Change Implications for Shareholder Wealth, 47 J. Fin. Econ. 279, 300-302 (1998).

[102] See C.R. Alexander, M.A. Chen, D.J. Seppi and C.S. Spatt, Interim News and the Role of Proxy Voting Advice, 23 R. Fin. Stud. 4419, 4435 (2010).

[103] See D. Ikenberry and J. Lakonishok, Corporate Governance Through the Proxy Contest: Evidence and Implications, 66 J. Bus. 465 (1993).

Shareholders may not trust amateurs (or at least newcomers) to run their business. Of course, such an increased payout may come at the expense of bondholders and other creditors, but that is not the shareholders' concern. The bottom line is that these outcomes are consistent with the view that the gains from this type of activism come from either (1) expected turnover premiums, or (2) liquidity events that transfer wealth from bondholders and creditors.

III. Are Hedge Funds Shortening the Investment Horizon of Corporate Managers?: Framing the Issue.

One of the most frequently voiced concerns about hedge fund activism is that it will lead to "short-termism"—a term that is seldom well defined and may depend on the eye of the beholder. We will use this term to mean a tendency to discount future earnings at a higher discount rate than traditional institutional investors. Consistent with this tendency, the "short-term" investor usually favors a managerial strategy that seeks to increase shareholder distributions by way of dividends and/or stock buybacks, typically by taking on increased leverage, which in turn necessitates reduced long-term investments (particularly in R&D). This claim is sometimes made by corporate lobbying groups, and it attracts the scorn of many academics.[104] Others accept that "short-termism" is associated with institutional activism, but defend it as economically desirable.[105] We think, however, this claim deserves a more careful analysis that recognizes that investors do not all share the same investment horizon.

[104] For the view that "short-termism" is merely a "debater's weapon" without any legitimate meaning, see Mark J. Roe, Strong Managers, Weak Owners: The Political Roots of American Corporate Finance at 242-43 (1994).

[105] This appears to be the position of Professor Bebchuk and his colleagues: namely, that "investment-limiting" interventions are efficient and desirable. See Bebchuk, Brav, and Jiang, supra note 10, at 59 to 61.

The evidence for why activist hedge funds might be more short-term oriented starts with the standard compensation structure for hedge fund managers. Under the typical formula, hedge fund managers charge annually 2% of the assets under management plus a performance fee of 20%.[106] In return for these generous fees, hedge fund investors expect quick returns that outperform the market: But outperforming the market is hard (or even impossible) to do consistently. Knowing this and knowing that their investors are likely to move their investments to the recent winners in the intense competition among hedge funds, hedge fund managers needed to find a business strategy that did not require them to achieve the impossible. They found that strategy in activism, which did not necessitate their outperforming the market consistently as passive stock-pickers. Instead, they became proactive and focused on underperforming companies. Even with this revised approach, hedge fund managers remained subject to short-term time constraints: because if they did not earn above-market returns as activists, their investors were again likely to switch to other managers who had recently done so. All in all, investors in hedge funds can withdraw their funds at regular intervals, are likely diversified, and probably have put much of their wealth in lower-risk investments. Thus, they can tolerate risk, and they correspondingly expect hedge funds to assume risk in pursuit of short-term gains. Investing for the short-term, these investors have little reason to object to a short-term focus on the part of their agents.

More generally, some empirical evidence strongly suggests that the composition of the firm's shareholders determines its investment horizon and that a strong correlation exists between "short-termism" within firms and a high ownership level on the part of "activist" hedge

[106] See Thomsen, Hawke and Calande, supra note 3, at 558. The performance fee is computed on realized and unrealized gains.

funds and certain other institutional investors.[107] In research dating back to 1998, Wharton Professor Brian Bushee has found that "predominant ownership by transient institutions—which have high portfolio turnover and use momentum trading strategies…significantly increases the likelihood that managers cut R&D to manage earnings."[108] In a later study, he concluded that "high levels of ownership by transient institutions are associated with overweighting of the near-term earnings component and underweighting of the long-term earnings component."[109] The archetypal "transient investor" is probably the hedge fund (although many mutual hedge funds would qualify also). From this perspective, the more stock that the "wolf pack" of hedge funds acquires in a firm, the greater the likely underweighting of the firm's longer-term investments in research and development and the more the pressure to reduce those investments. Other studies have agreed and suggest both that a high percentage of short-term investors leads to weaker monitoring[110] and a strong preference for near-term earnings at the expense of the longer term[111].

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[107] See Brian Bushee, The Influence of Institutional Investors on Myopic R&D Investment Behavior, 73 Acc. Rev. 305, 330 (1998).

[108] Id at 307.

[109] See Brian Bushee, Do Institutional Investors Prefer Near-Term Earnings Over Long Run Value?, 18 Contemp. Acct. Res. 207, 213 (2001); see also Kevin J. Laverty, Economic "Short-Termism": The Debate, The Unresolved Issues, and the Implications for Management Practice and Research, 21 Acad. of Mgmt. Rev. 825 (1996).

[110] See, e.g., Yia Chen, Jarrad Harford, and Kui Li, Monitoring: Which Institutions Matter?, 86 J. Fin. Econ. 279 (2007) (arguing that traditional institutional investors with long-term horizons specialize in monitoring, while shorter-term holders focus on trading); Jose-Miguel Gaspar, Massimo Massa, and Pedro Matos, Shareholder Investment Horizons and the Market for Corporate Control, 76 J. Fin. Econ. 135 (2005); Francois Derrien, David Thesmar, and Ambrus Kecskes, Investor Horizons and Corporate Policies, Working Paper (available at http://ssrn.com/abstract=1491638) (June 27, 2012) (forthcoming in Journal of Financial and Quantitative Analyses)

A. The Evidence on Activism's Impact on R&D Expenditures:

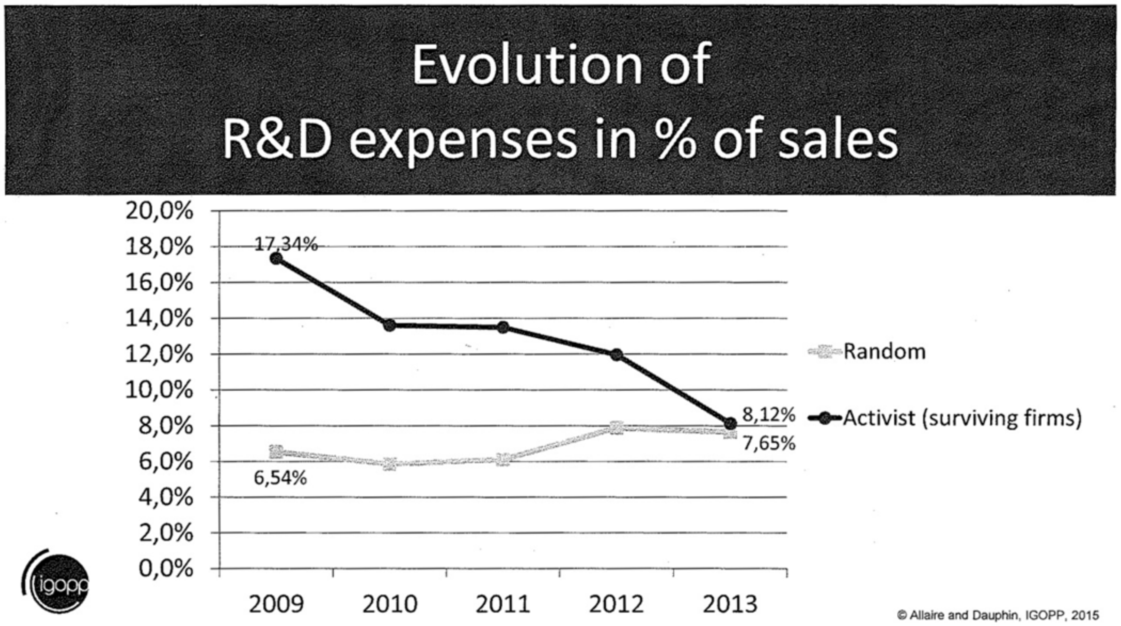
Recently, researchers have focused on the targets of hedge fund activism to see whether the investments by these targets in research and development increased or decreased in the aftermath of a hedge fund engagement. In common, they have found a sharp decline. A 2015 study used a sample of firms targeted in 2009 and found that the "surviving" firms (i.e., those not taken over) decreased their investment in R&D (measured as a percentage of sales) by over 50%.[112] The following chart shows the decrease from 17.34% to 8.12% over the four year period from 2009 to 2013:[113]

(longer investor horizons attenuate effect of stock mispricing and are associated with more investment and lower payout to shareholders).

111 See Katherine Guthrie and Jan Sokolowsky, Large Shareholders and the Pressure to Manage Earnings, 16 J. Corp. Fin. 302 (2010); Victor L. Bernard & Jacob K. Thomas, Evidence That Stock Prices Do Not Fully Reflect The Implications of Current Earnings for Future Earnings, 13 J. Acct. & Econ. 305 (1990).

112 See Yvon Allaire and Francois Dauphin, "Hedge Fund Activism: Preliminary Results and Some New Empirical Evidence" (Institute for the Governance of Public and Private organizations, April 1, 2015). The sample of firms was taken from a dataset developed by FactSet, a consulting firm that follows shareholder activists, with the researchers then eliminating those activist campaigns not commenced by hedge funds.

113 Id at 24.



Nor was this the result of any broad market-wide decline in R&D because a random control group modestly increased its R&D expenditures over the same period.[114] Also, because this study could tabulate the R&D investments only of firms that were not taken over, the actual decline in R&D investment was likely even greater, as acquiring firms probably cut back even more on the R&D budgets of acquired firms.

Proponents of hedge fund activism, however, have a rebuttal. Although studies concede that investments in R&D decline significantly in the wake of hedge fund engagements,[115] one

[114] Id. The increase for the control group over the same period was from 6.5% to 7.65%—modest but a change in the opposite direction.

[115] See Alon Brav, Wei Jiang, Song Ma, and Xuan Tian, "Shareholder Power and Corporation Innovation: Evidence from Hedge Fund Activism" (available at http://ssrn.com/abstract=2409404)(December 2014) at p. 3 ("Consistent with previous findings that target firms reduce investment following intervention, we find that R&D spending drops

recent study reports that the firms targeted by hedge funds thereafter file more patent applications compared to matched firms.[116] In their view, this shows an increase in "innovation output."

This assertion that less "innovation input" can produce greater "innovation output" under hedge fund guidance is, to say the least, counter-intuitive. Although it is plausible that activists could force the cancellation of marginal or long-term research projects, thus increasing at least short-term profit, the claim that total "innovation output" could increase in the face of major cutbacks is less credible, and it hinges entirely on the premise that proof of greater output lies in patent and patent citations counts over a relatively short subsequent period. Here, there are sufficient methodological issues surrounding this approach to make one skeptical of so strong a conclusion, particularly in the absence of needed controls[117] At this point, it seems premature to

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significantly during the five year window subsequent to hedge fund activism"). Specifically, they find a $20.58 million post-intervention decrease in R&D expenditures "relative to changes incurred by matched firms." Id. at 14.

[116] Id at 14 (finding about 15.3% more patent applications compared to matched firms). "Innovation output" should be measured in this view by patent counts, citation counts per patent, and patent originality. They find that "most of these measures actually improve significantly." Id at 4.

[117] Other scholars have found that attempts to use patent citations to measure innovation have regularly produced dubious findings because of serious methodological problems. See Josh Lerner and Amit Seru, "The Use and Misuse of Patent Data: Issues for corporate finance and beyond" (Harvard Economics Department Working Paper March 2015). For example, some studies have sought to measure the impact of bank deregulation or antitakeover legislation on the rate of innovation (as measured by patents and patent citations). Professors Lerner and Seru incisively explain the errors that confound this research. See also Daniel Abrams, Ukuk Akeigit, Jillian Popadak, "Understanding the Link Between Patent Value and Citations: Creative Destruction or Defensive Disruption?" NBER Working Paper No 219647 (available at http://ssrn.com/abstract=2355663) (April 18, 2013) (finding a nonlinear relationship between value of patents and their number of citations with the most valuable patents being

accept at face value any conclusion that innovation output can increase, even as investment in research and development declines. Rather, it seems safe to conclude only: (1) most studies find that research and development expenditures decline significantly in the wake of hedge fund pressure; and (2) at least one study finds that patent applications do increase at targeted firms.[118]

Still, even if it could be shown that firms targeted by activists thereafter increase the profitability of their R&D investments, this would not resolve the public policy issues surrounding reduced R&D expenditures for two distinct reasons. First, one needs to look beyond

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frequently less cited); Adita Mehta, Mark Ryeman, and Tim Simcoe, Identifying the Age Profile of Patent Citations: New Estimates of Knowledge Diffusion (September 30, 2008)(discussing need to control for age of patent). The Brav, Jiang, Ma and Tian article, supra note 115, does not appear to control for any of these variables. Lerner and Seru, supra, show that failure to employ such controls can result in serious mistakes. They use one well-known article, published in the Journal of Finance, that sought to show that the passage of state anti- takeover legislation resulted in a decline in innovation at corporations incorporated in such states. This conclusion was biased by the fact that California never passed such legislation but was the home to Silicon Valley. As a result, the rate of innovation at corporations incorporated in states with antitakeover statutes were being compared to the rate of innovation in Silicon Valley.

Additionally, the Brav, Jiang, Ma and Tian study focuses on the relationship between R&D expenditures and a firm's assets. They do not scale R&D expenditures against sales, which we believe is the more important and logical relationship. In any event, they do not find any significant relationship between R&D expenditures and firm assets, but do find a marginally significant relationship (at the 10% level) in terms of the decline of R&D expenditures measured in dollars. See Brav, Jiang, Ma and Tian, supra note 115, at 14.

[118] This could be a consequence of managers seeking to justify their R&D programs by filing more patent applications to demonstrate its value. We do recognize that it is certainly plausible that hedge fund pressure may cause target firms to curtail or discontinue their least successful or most long-term research projects, thus producing a short-term gain in earnings. We question only whether firms, after significant cuts in research, can still produce the same or greater output in terms of innovation.

the targeted firms and consider the general deterrent impact of hedge fund activism on R&D expenditures across the broader landscape. For every firm targeted, several more are likely to reduce R&D expenditures in order to avoid becoming a target. Second, it is critical here to distinguish between the private and public benefits of research. Research and development expenditures typically produce positive externalities. No single entrepreneur can capture all the gains or benefits from an innovation or a scientific advance. If pharmaceutical company XYZ discovers a new wonder drug or treatment, it is likely that its competitors will over time profit as well, either by finding ways to duplicate the drug with slightly different products or procedures or by finding additional applications or uses for the new product. One discovery leads to others, and a research breakthrough may generate a host of new products or drugs that were often unforeseen by the original researchers. As a result, even if reducing investment in R&D makes sense for an individual company (because it increases its profitability), this reduction in investment likely involves a social cost (as fewer new drugs and products are introduced).

B. Case Studies:

Economic studies have their limitations, and a closer-angled examination of hedge fund engagements and their impact on long-term investment can provide additional insight. We thus look briefly at two recent engagements.

1. The Allergan Takeover Battle: In 2014, Pershing Square Capital Management ("Pershing Square") teamed with Valeant Pharmaceuticals International ("Valeant") to seek to acquire Allergan, Inc. ("Allergan"), a major pharmaceutical company, in an over $50 billion transaction. Pershing Square created an entity, PS Fund I, LLC., a Delaware limited liability company ("PS Fund"), to acquire shares in Allergan and certain derivatives referencing Allergan common stock. Pershing Square began buying Allergan's shares quietly on February 25, 2014;

then, as it approached the 5% level, PS Fund's LLC agreement was amended to add Valeant as a member on April 6, 2014. Thereafter, the 5% level was quickly reached on or about April 11, 2014, and then PS Fund picked up the pace of its purchases.[119]

Ten days later, at the end of the ten-day window under Section 13(d)(1), Pershing Square and Valeant each filed on April 21, 2014 a Schedule 13D disclosing that PS Fund had acquired 9.7% of the outstanding shares of Allergan (with roughly 97% of the funds supplied by Pershing Square). The next day (April 22), Valeant made public its offer to acquire Allergan for a combination of cash and shares totaling over $50 billion (subsequently increased to $53 billion). Two months later, on June 18, 2014, Valeant announced a formal tender offer. Valeant described Pershing Square as a co-bidder, but Pershing Square offered nothing to Allergan's shareholders. Pershing Square clearly did not intend to become a long-term owner of Allergan stock (beyond a one year period during which it was contractually committed by Valeant to hold the Valeant stock received in the prospective merger). Thus, it had the best of both worlds: advance knowledge of a tender offer without any obligation to make any portion of the back-end merger itself.

For immediate purposes, the motivation of Valeant is particularly relevant. The product of a series of mergers and acquisitions, itself, Valeant is known for its business model under which, as a "serial acquirer," it buys pharmaceutical companies with established products and

[119] These facts are taken from (i) Allergan, Inc. v. Valeant Pharms. Int'l, Inc., 2014 U.S. Dist. LEXIS 156227 (C.D. Cal. November 4, 2014), (ii) the Schedule 14A preliminary proxy statement filed by Pershing Square with respect to Allergan, dated May 16, 2014, (iii) the Amendment No. 1 to Form S-4 Registration Statement filed by Valeant Pharmaceuticals International Inc. on July 22, 2014, and (iv) the Schedule 13D filed by Pershing Square with respect to its acquisition of stock in Allergan on April 21, 2014.

cuts back on, or ceases, their research and development efforts in order to maximize the cash flow from their established products.[120] According to a Wall Street Journal report on Valeant, "large pharmaceutical companies often spend as much as 20% of their sales on R&D."[121] In sharp contrast, in 2013, Valeant spent only 2.7% of its $5.77 billion in revenues on R&D.[122] Disinclined to invest in R&D, Valeant valued Allergan for one product: Botox, a drug with an expanding number of uses, but internationally known as a wrinkle-erasing medication.

Valeant's CEO did not attempt to hide his plans to cut both R&D and Allergan's employees if Valeant could take control. Specifically, in April, 2014, when he announced his merger proposal, Valeant's CEO estimated that about 20% of the combined company's 28,000 employees would lose their jobs.[123] Valeant similarly estimated that, on a merger with Allergan, "it would reduce the combined company R&D spending by 69%."[124] In short, it would strip Allergan of R&D not related to Botox, but would seek to expand the uses for that product.

Allergan's next step was predictable. Faced with shareholder support for Valeant's lucrative offer, Allergan's management decided that if it could not beat Valeant's strategy, it

[120] See Steven Davidoff Solomon, "In Allergan Fight, A Focus on Clever Strategy Overshadows Goals," N.Y. Times, August 13, 2014, at B4 (describing Valeant as a "serial acquirer"). Valeant had recently acquired Biovail and Bausch & Lomb. Valeant has also attracted attention and criticism for its alleged inattention to safety issues. See Jesse Eisinger, "Valeant's Cost-Cutting Ethos May Yet Give Wall Street Indigestion," N.Y. Times, July 21, 2014 at B6.

[121] See Joseph Walker, "Botox Itself Aims Not to Age," The Wall Street Journal, May 19, 2014 at B-1.

[122] Id.

[123] See Joseph Walker and Liz Hoffman, "Allergan's Defense: Be Like Valeant," The Wall Street Journal, July 22 2014 at B-1.

[124] Id.

would mimic it. Thus, in July, 2014, Allergan announced that it would cut its work force by 13%—less than Valeant's 20% goal but still substantial.[125] Allergan similarly announced that it would reduce R&D spending to about 13% of annual sales, as compared with its historical rate of 16% to 17%.[126] This is the usual pattern, and Allergan probably had little choice. Although there has been little public disclosure concerning the size of the "wolf pack" backing Pershing Square and Valeant, Paulson & Co, a major hedge fund, disclosed in a Section 13(f) filing that it acquired 5.6 million shares of Allergan, valued at $948 million, sometime during the Second Quarter of 2014.[127] Other hedge funds had likely also joined the Pershing Square/Valeant team, giving the bidders a likely prospective victory in any proxy contest. Ultimately, a higher bidder prevailed, outbidding Valeant. But this only increased the profit to Pershing Square and suggests that this tactic of a joint bid may be used again.

Some evidence suggests that the pharmaceutical industry has become painfully aware of hedge fund's apparent distaste for long-term investment in research and development. A Financial Times survey in July, 2014, noted a "fundamental trend" in this industry: namely, that pharmaceutical and household consumer products companies were divesting their non-core

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[125] See Walker and Hoffman, supra note 123, at B-1.

[126] Id. at B-2.

[127] See Kelly Bit, "Paulson Wagers on Allergan Bid, as Ackman Defends Tactics," Bloomberg, August 15, 2014 (available at http://www.bloomberg.com/news/print/2014-08-15/paulson-wagers-on-Allergan-bid-as-Ackman-defends-tactics.html). This disclosure did not indicate when John Paulson made this investment (and specifically whether it was prior to Pershing Square's Schedule 13D filing). We do not suggest that Paulson & Co. formed a "group" with the two bidders; our point is only that the size of the "wolf pack" and its holdings are usually much larger than is disclosed in the Schedule 13D.

divisions and "reassessing their portfolios."[128] The most obvious example was Reckitt Benckiser's decision, announced in July, 2014, to spin off its pharmaceutical business[129], but that case does not stand alone. Just in 2014, Johnson & Johnson, Eli Lilly, Merck & Co. and Sanofi announced sales or spinoffs of significant pharmaceutical divisions.[130]

2. The DuPont Proxy Contest: Many of the elements in the Allergan battle are also evident in the nearly successful 2015 campaign by the Trian Fund to elect four of its nominees to the board of DuPont.[131] Although DuPont had regularly outperformed the S&P 500 index and other metrics of corporate profitability, the Trian Fund's apparent aim was to break DuPont into multiple parts and "shut down DuPont's central research labs."[132] Again, this fits the paradigm of the "investment limiting" campaign that hedge funds increasingly favor, but it was directed at an iconic firm with a long history of innovation and highly successful research. Under pressure from Trian, DuPont did agree to spin off a major division and to reorganize its approach to

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[128] See Scherazade Daneshku, Andrew Ward and Adam Thomson, "Drugmakers juggle non-core assets," Financial Times, July 25, 2014, at 13.

[129] Adam Sherman, "Reciktt Poised to Spin Off Pharma Business," Financial Times, July 29, 2014, at 1.

[130] Daneshkhu, Ward and Thomson, supra note 128, at 13.

[131] See Bill George, "Petlz's Attack on DuPont Threatens American's Research Edge," The New York Times Dealbook Online, April 9, 2015. Nelson Peltz is the founder and CEO of the Trian Fund. The proxy contest was to elect four Trian nominees, but the longer term goal to reduce investment in research was clearly evident.

[132] Id. In response, DuPont did undertake a significant stock buyback and agreed to spin off a large chemical division (now called Chemours) that made titanium oxide. See Bunge and Benoit, supra note 22, at 1. Thus, even in this rare loss, the activists achieved many of their goals, and DuPont's management will likely be more cautious in the future about long-term capital investments.

research and development. In particular, it agreed to return $9 billion in capital to shareholders.[133]

In short, as with Allergan, DuPont survived largely intact by preempting Trian's strategy—with the result that, whether management wins or loses in the proxy contest, R&D expenditures decline. Such a response is predictable (and only encourages more activism by hedge funds, who profit on their stock, even if they lose the vote). Corporate managers quickly recognize the common strategy behind hedge fund interventions and seek to steal its thunder. Even if not targeted, other firms in the same industry will understandably fear becoming the subject of a similar activist intervention and become more likely to take preemptive steps to cut research expenditures.

C. The Broader Pattern: From Investment to Consumption: The trend away from longer-term investments (particularly those in research and development) cannot be attributed exclusively to hedge fund activism. Viewed from a distance, hedge fund activism may only be the spearhead of shareholder activism, and the preferences of shareholders generally may be changing. Arguably, shareholders may want corporate management to disdain longer-term investment in favor of greater shareholder payouts. This could reflect a view (correct or incorrect) that managements have an innate tendency towards empire-building, which needs to be controlled by shareholder interventions.

The latest evidence does suggest that shareholders may have turned in this direction. A 2015 study by the Roosevelt Institute summarized:

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[133] See Jonathan Laing, "The Peltz Principle," Barron's, July 4, 2015 at p. 23. DuPont asserted that they had already planned such an enhanced payout, but its size may have still been influenced by pressure from Trian.

> "In the 1960s, an additional dollar of earnings or borrowing was associated with about a 40-cent increase in investment. In recent years, the same dollar is associated with less than 10 cents of additional investment."[134]

This same study reports that between the second half of 2009 through 2013, corporations borrowed nearly $900 billion, but paid out $740 billion to shareholders, while investing only $400 billion.[135] In effect, the implication here is that the lion's share of what corporations earn or borrow today goes to shareholders, not investment.

Other studies paint a similar picture. A study by S&P Capital IQ, done for the Wall Street Journal, found that "companies in the S&P 500 Index sharply increased their spending on dividends and buybacks to a median 38% of operating cash flow in 2013, up from 18% in 2003."[136] Meanwhile, it added "[o]ver the same decade, these companies cut spending on plants

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[134] See J.W. Mason, "Disgorge the Cash: The Disconnect Between Corporate Borrowing and Investment" at 19 (The Roosevelt Institute 2015).

[135] Id. at 3. The sum of $740 billion and $400 billion is $1,140 billion, and the difference between that number and $900 billion in debt presumably reflects payments funded by corporate earnings or retained capital.

[136] Vipal Monga, David Benoit, Theo Francis, "Firms Send Cash Back to Shareholders—activists push for returns, fueling worries about long-term investments," The Wall Street Journal, May 27, 2015 at A-1. Other studies agree. For example, another Wall Street Journal study finds that companies in the S&P 500 index "paid a record $93.4 billion in dividends" in 2014 and repurchased $148 billion in shares in the first quarter of 2015. See Maxwell Murphy and Mike Cherney, "CFO Journal: Bond-funded Buybacks Draw Skeptics," The Wall Street Journal, June 16, 2015 at B-6. Goldman Sachs predicts that index-wide stock buybacks "will hit a record above $600 billion this year and will represent 28% of companies' total cash spending." Id.

and equipment to 29% of operating cash flow, from 33% in 2003."[137] Revealingly, this study further found that:

> "At S&P 500 companies targeted by activists, the spending cuts were more dramatic. Targeted companies reduced capital expenditures in the five years after activists bought their shares to 29% of operating cash flow from 42% the year before." [138]

These same targeted companies "boosted spending on dividends and buybacks to 37% of operating cash flow in the first year after being approached from 22% in the year before.[139]

This seems a significant transition, but hedge fund activism may be only one factor in this preference for payout over investment. Alternatively, while activists target only a minority of firms, they may affect the majority because the majority wishes to avoid any engagement with activists. All that is clear is that if this trend were to continue, the ability of the American corporation to retain its capital or to fund long-term investment or expansion would be in question.

A critical uncertainty here is whether the majority of shareholders actually want to prioritize payout over investment. Or is that the preference only of those activists with a short-term perspective? Here, there is some evidence of a conflict among shareholders—in particular between diversified shareholders (e.g., pension funds and mutual funds) on the one hand and actively trading hedge funds and other "stock pickers" on the other hand. In the DuPont proxy battle described above, DuPont won ultimately because it received the support of its three largest

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[137] Id.

[138] Id.

[139] Id

shareholders: BlackRock Inc., State Street Global Advisors, and the Vanguard Group, which collectively held 16.7% of its stock.[140] Had they voted with the activists, DuPont would have lost decisively.

Why did these diversified investors disagree with hedge funds and side with management? Some, most notably, BlackRock (the nation's largest asset manager), have been outspoken, expressing their view that "activist" hedge fund strategies are excessively short-term oriented.[141] Underlying this divide is a basic difference: diversified investors (and particularly indexed investors) may be concerned about the impact of activism on their broader portfolio. A BlackRock invests in both equity and debt and thus may fear that activist gains on stocks will be offset by losses on bonds. Or, it may fear that a sector of the economy in which it is invested will cease to grow if long-term investments are chilled. These fears that the portfolio may lose more than the target stock gains do not trouble activists, who generally do not hold a diversified portfolio and can focus on only one stock at a time. This is an important division to which we will return, because it implies that tactics (such as the "wolf pack") that give hedge funds a short-term majority do not necessarily demonstrate the preferences of all shareholders (or the long-term majority of shareholders).

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[140] See "Heard on the Street: Why Peltz Doesn't Have Icahn's Apple Touch?," The Wall Street Journal, May 23, 2015 at B-14; see also Laing, supra note 133.

[141] In April 2015, BlackRock's CEO Lawrence D. Fink wrote a much publicized letter to the C.E.O.s of 500 of the nation's largest companies, criticizing the short-term orientation of activist investors. Specifically, he stated: "The effects of the short-termist phenomenon are troubling both to those seeking to save for long-term goals such as retirement and for our broader economy." See Andrew Ross Sorkin, "Dealbook: BlackRock's Chief, Lawrence Fink, Urges Other C.E.O.s to Stop Being So Nice to Investors," N.Y. Times, April 12, 2015.

IV. A Survey of the Evidence.

Academic studies of the effect of hedge fund activism have found mixed evidence, both as to their efficacy in generating value for shareholders, bondholders and other corporate claimants, and as to their impact on research and development, leverage and long-term investment. We survey this evidence below, noting some important methodological shortcomings in the case of a number of studies. We are also mindful that all of these studies end generally no later than hedge fund interventions initiated in 2007. Since that time, hedge fund activism has accelerated substantially and altered its targets, thus having impacts that these studies may not capture.

A. Who are the Targets of Hedge Fund Activism? Although the studies do not fully agree, many report that the typical target firm of activist investors is smaller, more profitable, has a large institutional ownership level, and has more of a "value" orientation (namely, a higher book-to-market ratio) than a control sample of firms.[142] But these targets are not simply

[142] See Brav, Jiang, Partnoy and Thomas, supra note 14 (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and industry); Christopher P. Clifford, Value Creation or Value Destruction? Hedge Funds as Shareholder Activists, 14 J. Corp. Fin. 323 (2008) (here, the control sample consists of firms who face a 13G filing rather than the activist investor's 13D filing); April Klein and Emanuel Zur, Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors, 64 J. Fin. 187 (2009) (here, the control sample consists of firms not targeted by activist hedge funds but otherwise similar in size, book-to-market and industry); Y. Hamao, K. Kutsuna, and P. Matos, Investor Activism in Japan: The First 100 Years, Working Paper, Columbia Business School (2010) (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and industry); Nicole M. Boyson and Robert Mooradian, Corporate Governance and Hedge Fund Activism, 14 Rev. Deriv. Res. 169 (2011) (here, the control sample consists of firms not targeted by activist hedge funds but are otherwise similar in size, book-to-market and

"losers." Indeed, Brav, Jiang, Partnoy and Thomas find that the probability of a firm being targeted by an activist hedge fund is positively related to its return-on-assets.[143] Khorana, Hoover, Shivdasani, Sigurdsson and Zhang find that over one third of the firms being targeted since 2006 actually experienced stock price overperformance prior to being targeted and this proportion is growing over time.[144] In general, we observe that target firms are often more profitable than the control sample, suggesting that these targets are not poorly performing firms as some advocates for hedge fund activism suggest. In fact one study finds that target firms of activist hedge funds have lower bankruptcy risk than a control sample of non-targeted firms that are matched by size, book-to-market and industry.[145]

One common argument made by proponents of hedge fund activism is that these interventions result from agency problems between corporate managers and their dispersed shareholders. Under this argument, managers exploit free cash flow by sub-optimally investing in negative net present value projects, rather than dispersing cash to shareholders via dividends or share repurchases.[146] From this perspective, cutting back on wasteful R&D and capital expenditure programs maximizes shareholder value. Similarly, increasing leverage substantially

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industry); and April Klein and Emanuel Zur, <u>The Impact of Hedge Fund on the Target Firm's Existing Bondholders</u>, 24 Rev. Fin. Stud. 1735 (2011) (here, the control sample consists of firms not targeted by activist hedge funds but otherwise similar in bond rating, liquidity, maturity and industry).

[143] See Brav, Jiang, Partnoy and Thomas, supra note 14, at 1753.

[144] A. Khorana, E. Hoover, A. Shivdasani, G. Sigurdsson, and M. Zhang, "Rising Tide of Global Shareholder Activism," Citi Corporate and Investment Banking (November 12, 2013) at 7.

[145] See Klein and Zur (2009) supra note 142, at 203-204.

[146] See Michael C. Jensen, <u>Agency Costs of Free Cash Flow, Corporate Finance and Takeovers</u>, 76. Amer. Eco. Rev. 323 (1986).

and forcing managers to focus on servicing this debt is one way to reduce free cash flow problems. If this managerial agency argument is valid and fairly characterizes the targets of activism, then one would expect to find that target firms would have higher capital expenditures, higher wasteful R&D expenditures, lower dividends and stock buybacks, and lower leverage than a control sample of firms not targeted by activists. Although some studies support this thesis, the majority do not report evidence of changes in real variables consistent with this free cash flow hypothesis. For example, some studies have found that target firms of activist hedge fund investors have less leverage,[147] whereas others have found similar or higher leverage[148] than the control sample. Similarly, one study found that target firms of activist hedge fund investors have lower dividend payouts,[149] whereas another found similar dividends,[150] in comparison to the control sample.

To sum up, although many generalizations have been advanced about the characteristics of target firms, the evidence consistently supports only the generalization that targets of activism often tend to have a lower Tobin's Q and a "value" orientation, but these characteristics are not, by themselves, proof of poor managerial performance or high agency costs.

B. Does Hedge Fund Activism Create Value? For ease of exposition, in this sub-section, we subdivide the evidence into two parts, based on whether the measurement period is the short run (a few days) or the long run (a few years).

[147] See Boyson and Mooradian, supra note 142, at 181; Hamao, Kutsuna, and Matos, supra note 142, at 18.

[148] See Clifford, supra note 142, at 330; Klein and Zur (2011), supra note 142, at 1751.

[149] See Klein and Zur (2011), supra note 142, at 1751.

[150] See Clifford, supra note 142, at 330.

1. Short-horizon event studies of stock returns: Many studies have examined what happens to targets firm's stock price when there is a Schedule 13D filing with the SEC. The date of filing is called the event date, and the studies examine whether a target firm earns abnormal returns (generally defined as actual returns less returns adjusted for market movements) in the few days before and after the event date (called the "event window"). Most studies have found that target firms of activist hedge funds earn *on average* positive abnormal returns in the event window, although differences exist in the studies in their definition of event windows and the economic magnitude of the abnormal returns earned.[151]

[151] For ease of exposition, let us define [-x, +y] to be x days before the 13D filing, to y days after the filing. On this basis, Brav, Jiang, Partnoy and Thomas, supra note 14, find that target firms of activist hedge funds earned on average 7.2% abnormal returns in [-10, +10], consisting of 3.2% abnormal returns in [-10,-1], 2% in [0,+1], and 2% in [+2,+10]; Klein and Zur (2009), supra note 142, find that target firms of activist hedge funds earned on average 7.2% abnormal returns in [-30, +30]; R. Greenwood and M. Schoar, Investor Activism and Takeovers, 92 J. Fin. Eco. 362 (2009), find that target firms of activist hedge funds earned on average 3.5% market, size and momentum-adjusted abnormal returns in [-10, +5]; Clifford, supra note 142, finds that target firms of activist hedge funds earned on average 3.4% abnormal returns in [-2, +2]; Boyson and Mooradian, supra note 142, find that target firms of activist hedge funds earned on average 8.1% abnormal returns in [-25, +25], and 2.45% abnormal returns in [0, +25]; Bebchuk, Brav and Jiang, supra note 10, find that target firms of activist hedge funds earned on average 6% abnormal returns in [-20, +20]; Stuart Gillian and L. Starks, Corporate Governance Proposals and Shareholder Activism: The Role of Institutional Investors, 57 J. Fin. Eco. 275 (2000), find that target firms of institutional investors earned zero abnormal returns in [-1,+7]; M. Becht, J. Franks, C. Mayer and S. Rossi, Returns to Shareholder Activism: Evidence form a Clinical Study of the Hermes UK Focus Fund, 22 Rev. Fin. Stud. 3093 (2009), find a 5.74% market-adjusted abnormal return in [-5, +5]; and Hamao, Kutsuna and Matos, supra note 142, find that target firms of activist hedge funds earned on average 2% abnormal returns in [-5, +1].

There are two interpretive issues with the above results. First, although it is generally true that the average stock return performance around the event date is positive, substantial differences exist in the distribution of abnormal returns earned by target firms. A significant proportion of firms actually earned *negative* abnormal returns in the above studies.[152] This finding implies a significant conflict between the goals of activists and corporations. Activists typically invest in many firms concurrently, resulting in superior fund performance even if only some of their targets earn substantial return performance. Corporations do not have this luxury of diversification, as they are invested only in themselves. Thus, the possibility of a negative return (particularly when the upside return may be only modest) may reasonably cause a board of directors to reject a strategy favored by a group of hedge funds.

Probably the best known example of such a financial disaster caused by aggressive intervention by hedge funds was the joint acquisition by Pershing Square and Vornado Realty Trust of over 26% of the stock of J.C. Penney. Most of this stock was purchased during the ten-day window under Section 13(d), and the two activists obtained board representation, forced the resignation of J.C. Penney's incumbent CEO, and announced a new marketing philosophy. Although J.C. Penney's stock rose initially, customers fled in droves, and J.C. Penney's stock

[152] Studies are cited supra at notes 142 and 151. For example, Brav, Jiang, Partnoy and Thomas, supra note 14, find that 38% of target firms of activist hedge funds earned negative abnormal returns. Consistent with this argument, the 25th percentile of their hedge fund targets earned -5.3% abnormal returns; Klein and Zur (2009), supra note 142, find that the 25th percentile of hedge fund targets earned -2.7% abnormal returns; Clifford, supra note 142, finds that 37.2% of target firms of activist hedge funds earned negative abnormal returns; and Becht, Franks, Mayer and Rossi, supra note 151, find that 28.3% of target firms earned negative abnormal returns.

price fell some 59.5% over the period between the initial Schedule 13D filing and Ackman's eventual resignation from the board.[153]

Beyond the distribution of returns (and the risk inherent in running an operating company without prior experience in the field), the second problem with much of the data on hedge fund activism is the missing evidence as to what causes the stock price gains that are observed. If the positive abnormal stock returns are attributable to actions by activists that reduce managerial agency problems, they should leave some trail. That is, there should be evidence about changed capital structure, reduced executive compensation, dividend payouts, or altered investments. Yet, most of the studies find that the positive abnormal returns are *not* statistically significantly related to changes in real variables that occur subsequently to the activists' intervention.[154]

[153] For a detailed review of Pershing Square's failure (and hubris), see James Surowiecki, "When Shareholder Activism Goes Too Far," The New Yorker, Aug. 15, 2013. Over the same period, the stock market soared, thus magnifying the loss.

[154] For example, Brav, Jiang, Partnoy and Thomas, supra note 14, find no statistically significant relationship between the target's abnormal returns and their governance and capital structure. But they find a positive relationship to business strategy and general purpose; Klein and Zur (2009), supra note 142, find no statistically significant relationship between the target's abnormal returns and replacing the CEO, cutting CEO pay, and other corporate governance issues; Greenwood and Schoar, supra note 151, find no statistically significant relationship between the target's abnormal returns and capital structure changes, corporate governance issues, corporate strategy reasons, or proposing a spinoff. Clifford, supra note 142, finds all activities other than selling part or whole of firm are not related to the target's abnormal returns; Boyson and Mooradian, supra note 142, find no statistically significant relationship between the target's abnormal returns and providing finance, changing capital structure, and changing the firm's operations; Gillian and Starks, supra note 151, find a statistically insignificant relationship between the target's abnormal returns and certain governance issues involving the board of directors, confidential

2. Long-horizon stock return studies: Two studies, each published in 2015, merit special attention. First, Bebchuk, Brav and Jiang find that buy and hold stock returns are on average positive in the three-years and five-years after the Schedule 13D filing.[155] In doing so, they control for the returns on the market portfolio and the returns on small size, value and momentum portfolios (often referred to as the four-factor model of stock returns). These positive average long-horizon abnormal returns have also been found in other studies.[156] However, when Bebchuk, Brav and Jiang examine the three-year and five-year calendar year returns before and after the filing date, they find them to be statistically insignificant from zero. This suggests that an activist investor cannot beat the performance of the four-factor stock return model.

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voting, repeal of poison pill, and others. In one study, Becht, Franks, Mayer and Rossi, supra note 151, find that target firm earned negative abnormal returns when the stated objective was to force restructuring, or replacing the Chairman or CEO.

[155] Bebchuk, Brav, and Jiang, supra note 10, at 4-5.

[156] Unless otherwise defined, let [-x, +y] be x months before the Schedule 13D filing, to y months after the filing. On this basis, Brav, Jiang, Partnoy and Thomas, supra note 14, find that the average annualized market-adjusted holding period return in the period [-1, day of activist exit] is 20.6%, and the average size-adjusted holding period returns during the same period is 14.3%; Greenwood and Schoar, supra note 151, find that the average market-, size- and momentum-adjusted holding period return in [-1, +18] is 10.3%; Clifford, supra note 142, finds that the average market-, size-, value- and momentum-adjusted holding period return in [-1, +36] is 1.3%; Khorana, Hoover, Shivdasani, Sigurdsson, and Zhang, supra note 144, find abnormal market-adjusted returns on [-1 month, 2 years] of 33.8%.

A second study by Becht, Franks, Grant and Wagner provides a significantly different perspective.[157] Going beyond simply reporting the impact of the announcement of a block's formation (which in the U.S. occurs on the filing of the Schedule 13D),[158] they uniquely focus on the outcome of the activists' intervention. Unsurprisingly, they find that a successful outcome counts,[159] but more surprisingly, they find that the market appears to value only a limited number of successful outcomes. When the outcome announced was a takeover, this announcement produced abnormal returns averaging 9.7%; similarly, announcement of restructuring produced abnormal returns of 5.6%; but changes in board composition yielded only a more modest average abnormal return of 4.5%.[160] Finally payout changes (whether achieved through dividends or stock buybacks) resulted in a <u>negative</u> abnormal return of -0.2%.[161]

Much depended on whether there was a successful outcome; in the case of North American activist engagements, the value-weighted annualized returns were 6.6% for engagements with successful outcomes but minus 1.2% for engagements without such

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[157] See Becht, Franks, Grant, and Wagner, supra note 12. This study examines a large sample of 1,740 activist interventions, of which 1,125 were with respect to U.S. firms and 165 were U.K. firms. This article will limit itself to the North American context, where the data sample is larger and practices appear more standardized.

[158] As with other studies, they find a positive abnormal return of 7% for U.S. firms over the twenty-day window around the filing of a Schedule 13D. Id at p. 2. This is consistent with other studies, including Brav, Jiang, Partnoy and Thomas, supra note 14.

[159] Abnormal returns around the announcement of successful outcome averaged 6.4% across all countries and 6.0% in North America. Id at p. 3.

[160] Id. at 3. "Restructuring" is a potentially vague word, but these authors define it to mean the "divestitures and spinoffs of non-core assets and blocking diversifying acquisitions." See Table 6 at p. 56.

[161] Id.

outcomes.[162] In short, even though the majority of North American engagements do produce a successful outcome, there is clearly a downside. Unless the activist is pursuing a takeover or a restructuring, even successful activist engagements appear to yield only modest, if any, value for shareholders.

Finally, in all these studies, focusing only on the average abnormal returns may miss much of the story. A significant fraction of target firms earn *negative* long-horizon abnormal returns. In fact, one study finds that a small majority of target firms (52%) earn negative abnormal returns in the one-month before to one-year after the filing period,[163] and another study (which has one author overlapping with the above Bebchuk study) corroborates this finding that a significant fraction of target firms earn negative abnormal returns.[164]

C. What Are the Sources of Gains From Activism? In this subsection, we survey the evidence on the sources of shareholder gains from activism. To what extent are they the result of wealth transfers?

1. Improvements in operating performance. The evidence on whether the operating performance of target companies has improved due to activist hedge fund intervention is again mixed, with the preponderance of the studies finding no improvement. Operating performance is defined as the firm's return on assets ("ROA"), and/or operating profits, and/or operating margins, and/or cash flows. Defining the year of the Schedule 13D filing as "year t," studies have compared the differences in the operating performance of target firms in the years after

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[162] Id. at p. 4.

[163] See Khorana, Hoover, Shivdasani, Sigurdsson, and Zhang, supra note 144, at 14.

[164] Brav, Jiang, Partnoy and Thomas, supra note 14, find that the 25th percentile of their hedge fund targets earned -19.7% in market-adjusted holding period returns and -25% for size-adjusted holding period returns.

filing to years before filing or the year of filing. Brav, Jiang, Partnoy and Thomas conduct two sorts of matches.[165] The first matching procedure, matches target firms by year to a similar industry, size and momentum firm. Interestingly, ROA and operating margins of target firms are better than the matched firm in year t-2, and then dip in the year of filing. By year t+2, the ROA and operating margins of target firms are once again better than the matched firm in similar fashion as in year t-2. This suggests that activist hedge funds target firms who were more profitable in years t-2, t+1, but that had short-term underperformance in year t. A similar pattern emerges when firms are matched by performance.[166] Bebchuk, Brav, and Jiang report that targeted firms have a higher ROA and Tobin's Q in the five years after intervention as compared to the year of intervention (or the previous year), but their data does not seem to clearly support their conclusions.[167] Additionally, we know that firms selected by activists are not random. Thus, Bebchuk, Brav, and Jiang need to control for a number of variables (for example,

[165] Brav, Jiang, Partnoy and Thomas, supra note 14, at 1751.

[166] Several studies do not control for differences with a sample of matched non-targeted firms, making their results difficult to interpret. For example, Becht, Franks, Grant and Wagner, supra note 12, does not control for industry or firm size.

[167] See Bebchuk, Brav and Jiang, supra note 10, at 1101 to 1110. Their Table 4, which reports ROA and Tobin's Q over the six years that begin with the event year, shows only five out of twenty regression coefficients in the post-event year (or 25%) to be positive at the standard 95% confidence level. Thus, the majority of coefficients are not positive, which is hardly supportive of their conclusion. Id. at 1109 to 1112. They also find that the third, fourth and fifth years after the activist intervention earn higher ROA and Tobin's Q than the year of, or prior to, intervention. But this test is inconclusive because we know that it is significantly affected by the firm's underperformance in the year of, or prior to, intervention. Additionally, in their Table 5, they repeat their analysis, using high dimensional fixed-effects of industry codes and year dummies as controls. This method does not adequately control for firm-level effects. Id. at 1109 to 1114.

institutional ownership levels, value, momentum, etc.), use matching methods (such as propensity score matching or neighborhood matching) and then use a regression discontinuity estimation method to test if activism has indeed a positive effect on firm performance.

Conversely, Klein and Zur find no evidence that target firms of activist hedge funds had better operating profits than a control sample of firms measured one-year before and after filing Schedule 13D.[168] Clifford finds, however, that firms targeted by activists do experience a median increase in ROA in comparison to firms targeted by passive institutional investors, but he attributes this difference to the fact that firms targeted by activists tend to shed assets (rather than improve cash flow).[169] Boyson and Mooradian find that target firms of active investors did not have a statistically different change in ROA (year after to year before filing) than control firms.[170] A similar insignificant result is found for changes in cash flows.[171] Although these studies differ slightly, all three—Klein and Zur, Clifford, and Boyson and Mooradian—find no significant improvement in cash flow at the targeted firm.

2. Increasing the Expected Takeover Premium. The Brecht, Franks, Grant and Wagner paper strongly implies that a successful takeover appears to be the outcome that most drives the abnormal long-term returns from activist engagements.[172] Although restructurings also produce positive long-term abnormal returns in this study, this may reflect the same control

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[168] See Klein and Zur, supra note 142, at 201.

[169] See Clifford, supra note 142, at 330-331. He concludes: "Thus, the improvements in operational efficiency are caused by a reduction in firm assets, more so than an improvement in cash flow." Id.

[170] See Boyson and Mooradian, supra note 142, at 191.

[171] Id. at 191.

[172] See Becht, Franks, Grant and Wagner, supra note 12, at 3 (noting that activist's engagements result in takeovers produce average abnormal gains of 9.7% while other outcomes produce much smaller returns).

premium source for the gains; that is, if a significant division is to be sold or spun off, it may produce an active auction that benefits shareholders by securing the highest premium that a control seeker will pay. Even in the case of short-term abnormal returns on the filing of a Schedule 13D, the simplest explanation may again be that activist firms are perceived to be putting the target "firm" in play and raising its expected takeover premium. Khorana, Hoover, Shivdasani, Sigurdsson and Zhang report that this is a common way for an activist firm to get higher value.[173] They find that following an activist campaign more than 7% of the targets that outperformed in the six month following the filing date were acquired or sold in the subsequent six months. Although 7% may seem a low percentage, this acquisition frequency is three times higher for targets that underperformed following the activist campaign. In short, the market is sensing who might become an acquisition target and bidding up their price incrementally.

Similarly, Brav, Jiang, Partnoy and Thomas find that the short-horizon abnormal stock returns are highest (8.54%) when the activist hedge funds stated objective is to sell the company.[174] Klein and Zur find short-horizon abnormal stock returns of 13.1% when the hedge fund is seeking a sale of the company;[175] Greenwood and Schoar find positive abnormal returns for targets that are ultimately acquired, and zero abnormal returns when targets remain independent;[176] and Clifford finds positive abnormal returns when the target firms sell themselves to another firm.[177] All told, this evidence suggests that changes in the expected

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[173] See Khorana, Hoover, Shivdasani, Sigurdsson and Zhang, supra note 144, at 14.

[174] See Brav, Jiang, Partnoy and Thomas, supra note 14, at 1758.

[175] See Klein and Zur (2009), supra note 142, at 210.

[176] See Greenwood and Schoar, supra note 151, at 368.

[177] See Clifford, supra note 142, at 328.

takeover premium, more than operating improvements, account for most of the stock price gain, both in short-term and long-term studies.

3. Wealth transfers. Definitionally, the value of the target firm is the sum of the value of its debt and equity. Can the higher stock returns found in the above studies be a transfer of wealth from bondholders to shareholders? Klein and Zur suggest that this may be the case.[178] They find that the average abnormal bond returns 10-days before and one-day after the filing date is negative (-3.9%). Furthermore, the average abnormal bond returns for one-year after the filing date is an additional -4.5%. Finally, the study finds that the abnormal stock returns are negatively related to the abnormal bond returns at both the short-term and long-term intervals. This last result convincingly shows that there is a wealth transfer from bondholders to shareholders.

It is also possible that there is wealth transfer from the target firm's employees to their shareholders. This could be from reduction in the employees promised pension payouts or salary reductions or layoffs. Brav, Jiang and Kim find that the workers of target firms do not benefit from hedge fund activism.[179] Although their productivity rises, there is stagnation in their wages and only insignificant changes in the hours worked.

4. Reduction in managerial agency problems. If positive abnormal stock returns occur because of the actions of hedge fund activists in reducing managerial agency problems, then there should be observable changes in real variables, including changes in corporate governance, reduction of excessive managerial compensation, movement away from non-optimal

[178] See Klein and Zur (2011), supra note 142, at 1735.

[179] See Alon Brav, Wei Jiang and Hyunseob Kim, The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation and Industry Concentration, (available at http://ssrn.com/abstract=2022904) at 3 (May 23, 2013).

capital structures, etc. However, most of the evidence shows that the positive abnormal returns are not statistically significantly related to such changes, even if they were stressed by the activist hedge fund in its Schedule 13D filing.[180]

D. Do the Targets of Hedge Fund Activism Experience Post-Announcement Changes in Real Variables? In this sub-section we summarize the evidence found in the various studies that examine whether the target firms experienced changes in real variables after filing Schedule 13Ds when compared to a control sample of non-target firms. In summary, we find neither a positive relationship between abnormal stock price returns and changes in real variables nor any consistent evidence of a directional change in the target's firm variables when compared to the control sample.

1. Risk. Klein and Zur find that the target's idiosyncratic volatility of stock returns, or risk, goes up post-filing when compared to the target's pre-filing risk.[181]

2. Leverage. Some studies have found leverage to increase[182] after the Schedule 13D filing when compared to before the Schedule 13D filing, but other studies find no statistically significant increase or decrease in leverage.[183] Thus, although the evidence on leverage seems to be mixed, increases in leverage, which a number of studies find, is consistent with an explanation that hedge fund activism transfers wealth from bondholders to shareholders.

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[180] See studies cited supra at note 142.

[181] See Klein and Zur (2011), supra note 142, at 1751.

[182] See Brav, Jiang, Partnoy and Thomas, supra note 14, at 1772; Klein and Zur (2011), supra note 142, at 1751.

[183] See Clifford, supra note 142, at 330; Boyson and Mooradian, supra note 142, at 191.

3. Investment expenditures. Boyson and Mooradian and Klein and Zur both find no statistical change in capital expenditure and R&D expenses before and after the Schedule 13D filing as compared to a control sample.[184] In contrast, in a more recent study, Bebchuk, Brav and Jiang focus on a subsample of "investment-limiting" activist interventions that are followed by substantially increased leverage, higher payouts to shareholders, or reduced long-term investments over the two years following the year of intervention.[185] To identify these cases, they classify an activist intervention as "investment limiting" if it falls into one of the three following subcategories (each of which involves extreme departures from the norm): (a) the increase in R&D and capital expenditure from the base year (t-1) to year t, t+1 or t+2 falls within the bottom five-percent of all firms in that year; (b) the increase in payout yield (including therein both dividends and share buybacks) from the base year (t-1) to any of the three following years (t, t+1, and t+2) falls within the top 5% of payout increases among all public companies in that year; or (c) the increase in leverage from the base year to any of the three following years falls within the top 5% of leverage increases among all public companies in that year. In short, each of these subcategories involves not just a company cutting research and capital expenditures, or increasing leverage or payout to shareholders, but doing so by such a degree as to make it into the top (or bottom) 5% of all public companies in that year.

Given the extreme selectivity of their criteria (i.e., they are in effect defining the bull's eye of a broader target), their most important and eye-opening finding may be that 19% of all activist interventions fall into one of these extreme subcategories, and about 25% of these

[184] See Boyson and Mooradian, supra note 142, at 192; Klein and Zur (2009), supra note 142, at 201.

[185] See Bebchuk, Brav and Jiang, supra note 10, at 1136 to 1139 (noting that 19% of activist interventions qualify as "investment-limiting" interventions under their strict criteria).

interventions fall into two or more of these subcategories.[186] Had their categories been moderately expanded to include the top (or bottom) 10% of all public companies, one wonders how many more hedge fund interventions would have been captured. Even on their highly selective basis, the conclusion seems inescapable that activist interventions (or at least many of them) are associated with a decline in R&D and long-term investment. Our earlier Allergan example thus does not then stand alone as an idiosyncratic outlier.

These interventions may boost profits, but the evidence is less than clear. Bebchuk, Brav, and Jiang assert that ROA and Tobin's Q are positively related to year dummy variables year t through year t+5, and they suggest that this shows that so called "investment-limiting" proposals actually lift profits.[187] Their data, however, does not prove this claim for a number of reasons. First, only a small minority of their results are positively related to ROA.[188] Indeed, in the case of Tobin's Q, the coefficients are often negative and the positive coefficients are statistically insignificant, suggesting that when activist hedge funds increase leverage and shareholder payouts and decrease R&D, Tobin's Q actually falls. Second, we know that firms selected by activists are not random. Again, they need to control for a number of variables (for example, institutional ownership levels, value, momentum, etc.), use matching methods (such as

[186] Id. at 1137 to 1138 and note 103.

[187] Id. at 1138.

[188] Id. at 1140-1141. Their Table 13 shows only one out of 20 regression coefficients in the post-event period to be positive and statistically significant at the standard 95% confidence level. For additional shortcomings in their estimation methodology, see supra note167.

propensity score matching or neighborhood matching) and then use a regression discontinuity estimation method to test if activism has indeed a positive effect on firm performance.[189]

4. Growth. On the one hand, it is arguable that activist hedge funds can use their managerial and industry expertise and access to capital to accelerate the growth of target firms. On the other hand, the activists can sell assets and slow down the fast-growing target firms. Boyson and Mooradian find no statistical change in the growth of sales or asset size,[190] whereas Klein and Zur (2011) found the size of assets to decrease.[191]

5. Payouts. Clifford,[192]and Klein and Zur[193] find no statistical change in the level of payouts after the Schedule 13D filing when compared to before the Schedule 13D filing. In contrast to the above four studies, Brav, Jiang, Partnoy and Thomas find payouts to increase after the Schedule 13D filing as compared to before the Schedule 13D filing. [194]

6. Cash. Clifford finds no statistical change in the level of payouts after the Schedule 13D filing when compared to before the Schedule 13D filing,[195] but Klein and Zur[196] find cash levels to go down.

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[189] Bebchuck, Brav, and Jiang use high dimensional fixed-effects of industry codes and year dummies as controls. This method does not adequately control for firm-level effects.

[190] Boyson and Mooradian, supra note 142, at 191.

[191] See Klein and Zur (2011), supra note 142, at 1751.

[192] Clifford, supra note 142, at 330.

[193] Klein and Zur (2009), supra note 142, at 201; Klein and Zur (2011), supra note 142, at 1759.

[194] Brav, Jiang, Partnoy and Thomas, supra note 14, at 1771.

[195] Clifford, supra note 142, at 330.

[196] Klein and Zur (2011), supra note 142, at 1751.

E. An Initial Evaluation. Some of the inconsistencies among these studies may be the result of timing differences. More recent studies (such as both Bebchuk, Brav and Jiang and Allaire and Dauphin) find leverage increases and reductions in R&D and long-term investment, while earlier studies did not.

Overall, the evidence is (1) clear that there is a short-term positive stock price reaction to a Schedule 13D's filing; (2) unclear that there is any significant positive long-term price reaction (except when a takeover or restructuring followed); and (3) doubtful that operating performance improves after activist interventions.

The question of who is targeted also produces generally consistent findings: namely, companies with a low Tobin's Q and a "value" orientation. But little evidence suggests that these firms are industry laggards. Finally, even if we use severe and demanding criteria (as Bebchuk, Brav and Jiang do), it appears that many (and possibly a plurality of) activist interventions increase leverage and shareholder payout, while reducing R&D and long-term investment.

V. Implications

The appearance of the "wolf pack" has fundamentally changed corporate governance and the nature of shareholder activism. The data shows this in three ways: (1) "wolf packs" acquire significantly higher stakes than other shareholder activists;[197] (2) the announcement of a "wolf pack" engagement produces a significantly higher return over the window period around

[197] In the most recent study, "wolf packs" appear to acquire 13.4% as compared to 8.3% by other activists. See Becht, Franks, Grant and Wagner, supra note 12, at 32.

this disclosure;[198] and (3) the probability of a "wolf pack" achieving at least one of its intended outcomes is also much higher than in the case of individual activists.[199]

Much of the success of the "wolf pack" as a tactic may derive from its ability to escape transparency and managerial defensive tactics (such as the poison pill) because the "wolf pack" today enjoys apparent freedom to: (i) delay disclosure of material share acquisitions; (ii) form de facto "groups" without any disclosure; and (iii) enter into specially designed partnerships with strategic bidders that essentially tip the forthcoming bid to the hedge fund investor (who still accepts no responsibility to join in the bid).[200] Nonetheless, whether American corporate and securities law should facilitate and encourage activists seeking in this fashion to increase leverage and reduce R&D remains open to debate. Beyond question, a formidable "wolf pack" of activist hedge funds can today be assembled more quickly and with less disclosure in the United States than may be possible in the other major capital markets.

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[198] During the event window (-20,20) around the disclosure of the "wolf pack" (i.e., on the filing of the Schedule 13D in the U.S.), the abnormal returns are roughly 14% in the case of a "wolf pack" as opposed to 6% for other activists. Id at 32.

[199] Becht, Franks, Grant and Wagner, supra note 12, find that the probability of achieving at least one successful outcome is 78% for the "wolf pack" versus 46% for other activists. Id. at 32. Allaire and Dauphin, supra note 12, place the probability of success at 75.7% in their sample of hedge fund activists. See Allaire and Dauphin, supra note 12. Both reinforce each other and the conclusion that the "wolf pack" is nearly unstoppable.

[200] One decision has questioned the legitimacy of such a partnership, but did not enjoin it. See Allergan, Inc. v. Valeant Pharms. Int'l. Inc., 2014 U.S. Dist. LEXIS 156227 (C.D. Cal. November 4, 2014). Although there is some legal uncertainty surrounding these strategic partnerships, they will predictably evolve further, as transaction planners seek to reduce legal exposure and design refinements on the structure used in that case.

This gives rise to three different sets of concerns: First, the “wolf pack” can be used to effect a “creeping control” acquisition in which ordinary shareholders receive little or no control premium, as they sell out during the window period to informed purchasers. Second, activists do not always need to have a superior strategy; indeed, some may seek to launch an activist campaign largely to roil the waters on the premise that noisy activism will be read by the market as signaling a possible takeover or restructuring. Even when the proposed change is flawed, those who purchase shares in the target firm before the filing of a Schedule 13D and exit at an early point will likely profit handsomely. This possibility of a relatively riskless profit that is divorced from the merits of the policy proposal concerns us because it may encourage ill-considered or even pretextual corporate governance campaigns, based on the premise that noise generates profit.

These first two concerns pale in importance in comparison to our third concern: namely, that hedge fund activism may be leading to a broad and systemic shift by American corporations from investment to payout, and particularly toward avoidance of investments in R&D. Studies vary, but all find significant declines in such investment in the years following an activist engagement.[201] Of course, the significance of this decline can be debated, and some financial economists (including Professor Bebchuk) appear to view this as evidence that management’s bias towards inefficient expansion and empire building is being successfully curbed by the “investment limiting” proposals of activists. In our view, however, this is a doctrinaire and outdated position that ignores basic changes in corporate governance, including most notably the shift in senior executive compensation from cash to equity. Once, management was compensated primarily in cash, and this did create an incentive to expand the firm

[201] See Allaire and Dauphin, supra note 12. This is a fall in R&D investment, measured as a percentage of sales.

inefficiently, because a larger firm size was deemed by compensation committees, operating on a comparative basis, to justify a higher salary.[202] But today, and for some time now, senior executives are compensated primarily with stock options and restricted stock grants.[203] Such equity-based compensation incentivizes management to maximize the firm's stock price

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[202] As a number of commentators have argued, a system of primarily cash compensation created a perverse incentive to "pay-for-size." See Brian Cheffins, "Corporate Governance Since the Managerial Capitalism Era, in Business History Review" (2016)(forthcoming). Leading business theorists of this time, such as Robin Marris and Oliver Williamson, argued that corporate firms during this era "profit-satisfied" (rather than profit-maximized), avoided risk, and pursued empire-building policies. See Robin Marris, THE ECONONOMIC THEORY OF MANAGERIAL CAPITALISM (1967); Oliver E. Williamson, Managerial Discretion and Business Behavior, 53 Am. Econ. Rev. 1032, 1055 (1963). This literature on managerial capitalism appears to be the theory and evidence that Professor Bebchuk and his colleagues are relying upon. Eventually, however, institutional investors rebelled and demanded greater use of incentive compensation and "pay for performance." See Cheffins, supra, at 28-30. The era of managerial capitalism is now over.

[203] For a more detailed history of this transition in the late 1980s and 1990s, see John C. Coffee, What Caused Enron?: A Capsule Social and Economic History of the 1990s, 89 Cornell L. Rev. 269, 272-275 (2003)(noting that between 1990 and 1999, equity-based compensation for the chief executive rose from 5% to 60% of total compensation). Indeed, in the wake of the 2008 financial crisis, it was evident to Congress that incentive compensation had reached the point that it was encouraging excessive risk-taking at many financial institutions. As a result, Section 956 of the Dodd-Frank Act authorized financial regulators to restrict incentive compensation at covered financial institutions. See John C. Coffee, The Political Economy of Dodd-Frank: Why Financial Reform Tends to Be Frustrated and Systemic Risk Perpetuated, 97 Cornell L. Rev. 1019, 1067-1072 (2012). The industry has, however, pushed back, and the rules authorized by the Dodd-Frank Act have yet to be adopted. See Victoria McGrave and Andrew Ackerman, "Work on Incentive-Pay Rules Revs Up," The Wall Street Journal, Februrary 16, 2015 at C1. The bottom line is that incentive compensation today aligns managerial and shareholder preferences, unlike in the past.

(although more for the long-term because management cannot exit the firm as quickly as a short-term investor).

If management is in fact motivated today to maximize the firm's stock price, attempts to limit its discretion through sudden and concealed activist campaigns would not necessarily lead to optimal outcomes. Indeed, because management generally has better information than outsiders, coupled with a strong incentive to maximize the firm's stock price, one can no longer begin from the premise that investment projects favored by management are the product of an inefficient preference for "empire-building." If that premise was justified in its time, that time is now past. Moreover, the closer we look at these activist campaigns (for example, the recent Allergan or DuPont battles), the more we see activists attempting to cut back R&D, not with a scalpel, but a chainsaw. Finally, even if Professor Bebchuk and his co-authors are correct in their highly qualified claim that activists improve the operating performance of targets,[204] they are still ignoring the impact of such campaigns on the silent majority of firms not targeted. The threat of an activist engagement pressures these firms to cut back on long-term investments and increase shareholder payout. Bebchuk, Brav and Jiang make no attempt to measure the impact of activism on untargeted firms, but others have found a contemporary shift from investment to

[204] Despite some broader statements in their article, Bebchuk, Brav and Jiang actually state their critical finding on this point in a very equivocal and tentative fashion. Revealingly, they phrase their most relevant conclusion only in negative terms, writing: "Overall the analysis of stock returns carried out in this Part provides no support for the claim that activist intervention makes shareholders of targets worse off in the long-term." 115 Colum. L. Rev. at 1130. That is a very modest conclusion (which we do not necessarily dispute). Our concern lies more with shareholders generally (and not just at the target firm) and with the American economy.

payout at the average firm.[205] Given that the number of untargeted firms dwarfs the number of firms actually targeted, this latter impact is logically more significant.

So, what can be done without insulating managements from shareholder accountability? Probably the best solution would be the use of the tax laws to encourage longer-term holdings and to deter the "hit-and-run" activist. If activists had to hold their shares for multiple years (as Hillary Clinton has proposed),[206] the current average activist holding period of less than one year would predictably lengthen.[207]

But changing the tax laws is hard to accomplish, and even Presidents are seldom successful. Nor is it wise to rely on only one weapon whose impact has not yet been tested. Thus, we will begin with those reforms that either do not require legislation or need only a very modest legislative fix; then we will turn to private action. We consider the following options (or variants on them) to be both feasible and relatively easy to implement:

A. <u>Closing the Section 13(d) Window.</u> In the United Kingdom (and elsewhere), the activist does not have the same ten-day window provided by Section 13(d)(1) before it must disclose its acquisition of a greater than 5% stake.[208] Disclosure may be required within two

[205] See text and notes infra at notes 138 to 139.

[206] See text and note supra at note 4.

[207] See text and note supra at note 74.

[208] Disclosure of beneficial ownership must be filed within two trading days after crossing the 3% ownership level in the United Kingdom. See David Katz and Laura A. McIntosh, "Corporate Governance Update: Section 13(d) Reporting Requirements Need Updating," N.Y.L.J., March 22, 2014, at 4. In Australia, Germany and Hong Kong, the requirements range between two and four trading days. Canada requires "prompt disclosure" and limits additional share purchases until one business day after the required disclosure is made. Id. at 4-5. Although the U.S.

business days. The shorter the window, the smaller the position that can be assembled. In 2010, the Dodd-Frank Act authorized the SEC to shorten the Williams Act's ten-day window,[209] and, unsurprisingly, the Wachtell Lipton firm promptly petitioned the SEC to exercise this authority.[210] Their request was met by an outpouring of academic writing, advising the SEC not to do so.[211] Among the reasons given were the following:

First, because hedge fund activists rarely acquire all (or even most of) the stock of the target, they cannot capture all the gains from their governance strategy and must share the gains with other shareholders.[212] Closing the ten-day window, it was argued, would thus deny hedge fund activists the opportunity to make a sufficient profit from their campaign to motivate them to maximize shareholder value.

Second, the empirical evidence does not show any new trend toward increased accumulations by hedge fund activists (or anyone else) during the ten-day window. Rather, one

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was ahead of other countries in requiring beneficial ownership disclosure, they have surpassed us in the rigor of their current requirements.

[209] Section 929R of the Dodd-Frank Act of 2010 amended Section 13(d)(1) of the Securities Exchange Act of 1934 to authorize shortening its ten-day window to "such shorter time as the Commission may establish by rule." For a discussion of the events leading to this change, see Mitts, supra note 77, at 214-215.

[210] See Letter from Wachtell Lipton Rosen & Katz to Elizabeth M. Murray, Sec'y, U.S. Securities & Exchange Commission (May 7, 2011), available at http://www.sec.gov/rules/petition/2011/petn4-624.pdf. For a further statement by the Wachtell firm, see Adam O. Emmerich, Theodore N. Mirvis, Eric S. Robinson & William Savitt, Fair Markets and Fair Disclosure: Some Thoughts on the Law and Economics of Blockholder Disclosure and the Use and Abuse of Shareholder Power, 3 Harv Bus. L. J. 135 (2013).

[211] Lucian A. Bebchuk and Robert J. Jackson, Jr., The Law and Economics of Blockholder Disclosure, 2 Harv. Bus. L. Rev. 39 (2012); Bebchuk, Brav, Jackson and Jiang, supra note 63; Gilson and Gordon, supra note 2.

[212] See Bebchuk and Jackson, supra note 211, at 49-50.

well-known study reports that the size of pre-disclosure accumulations by those filing the Schedule 13D "has remained relatively stable throughout the 14-year period" that they study.[213] In fact, most of the stock acquired by the activists who file a Schedule 13D at the end of the ten-day window is "concentrated on the day they cross the threshold as well as the following day."[214]

Third, given the "proliferation of low-threshold poison pills in the United States" (i.e., poison pills with a threshold of 15% or lower), shortening the ten-day window would subject activists to defensive tactics that locked them into no more than a 10% to 15% stake, possibly making it more difficult to win a proxy contest from such a reduced base.[215]

Fourth, a shortened window for the purposes of Williams Act reporting would also be costly to non-activist investors, who may greatly outnumber hedge fund activists.[216]

Although none of these arguments can be ignored, each seems overstated. First, although it is true that a hedge fund cannot capture all the gains from a corporate governance campaign, such an activist also avoids taking all of the risk. Instead, a hedge fund that stops below 10% (as most do) maintains a portfolio that has at least some diversification. If the median stake of the activist hedge fund under the current ten-day window is only 6.3% (as these scholars find[217]), and if the lead activist concentrates its purchases on the day that it crosses the

[213] See Bebchuk, Brav, Jackson and Jiang, supra note 23, at 5.

[214] Id. at *6.

[215] Id.

[216] Id. at *5.

[217] Id. at *4-5.

5% threshold and the next day (as they apparently do[218]), this failure to exploit the full ten-day period was a voluntary choice that shows that activists did not want to assume the risk of a larger position. In short, even under the current and permissive ten-day window, individual hedge fund activists generally stay below the 10% level, and thus it appears that economic, legal and financial considerations constrain them independent of the length of the statutory window for SEC reporting.[219] Even a high-risk hedge fund may feel compelled to stop short of risking all (or most of) its portfolio on one transaction (and thus one roll of the proverbial dice).

The bottom line then is that the Williams Act (and its statutory window) are not today placing the operative legal ceiling on the maximum stake that an individual hedge fund activist can acquire; rather other factors—legal and economic—do this. For prudential reasons, hedge funds may prefer to share the gains among themselves by using an organizational structure that unites a number of funds into a loosely knit organization (i.e., the "wolf pack") that may acquire 25% or more of the target. Although the lead hedge fund that does not fully capture all the gains obtainable in the transaction it leads, it reduces its risk and may receive reciprocal treatment from other hedge funds that later invite it to join it to their "wolf packs."[220]

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[218] Id. at *6 ("Their purchases are likely concentrated on the day they cross the threshold as well as the following day").

[219] As previously discussed, Section 16(b) is one such factor. Fear of illiquidity may be another. We, of course, acknowledge that large blocks (such as the 26.7% acquired in the J.C. Penney's battle) can be acquired during the ten-day window. See discussion supra at note 76. But these are the exception, not the rule.

[220] This is an unexplored area, and we express no firm conclusion. But norms of reciprocity characterize many areas of commercial life. Thus, before we accept the thesis advanced by Bebchuk and Jackson that the activist "hedge fund" is undercompensated for its efforts to increase shareholder value, we would want to know more about the possibility of reciprocity within the hedge fund community.

Second, if the principal hedge fund activists buy mainly on the day they cross the 5% threshold and the next day (as these scholars find[221]), shortening the ten-day window to two business days would not prejudice them to any significant degree. Seemingly, they could do the same even under a two business day window. More importantly, however, the finding announced by these scholars that pre-disclosure accumulations have not increased is incomplete, and they simply miss the forest for the trees. Although the lead hedge fund may usually stop short of 10%, the rest of the "wolf pack" on a collective basis does not. Because these other and allied activists never concede being a "group," they never disclose publicly their holdings. Hence, the reported finding that pre-announcement purchases have not increased focuses only (and myopically) on those who report in the Schedule 13D and ignores the rest of the "wolf pack." This is akin to measuring the size of an iceberg by examining only that portion that floats above the water and ignoring the much greater magnitude below. In the Sotheby's litigation, the rest of the "wolf pack" brought the total ownership in Sotheby's up from 9.6% to nearly 33%.[222] In short, empirical research that focuses only on the disclosed ownership ignores the reality of the "wolf pack's" aggregate stake, which remains out of sight—but may tip the balance in a proxy contest. To be sure, if the ten-day window were shortened to two business days (i.e., the British approach), these hidden allies would still not be disclosed under the existing definition of "grouphood." Still, the "wolf pack" leader would have much less time to assemble them or to tip other expected allies of its plans. Hence, the "wolf pack" might be smaller.

Finally, while shortening the ten-day window might impact some non-activist investors, these investors have the option of filing a Schedule 13G (which is filed on an annual

[221] See Bebchuk, Brav, Jackson and Jiang, supra note 23, at *6.

[222] See text and notes supra at notes 74 to 75.

basis) so long as they do not attempt to seek to "change or influence" control.[223] As a result, non-activist investors have little to fear from a partial closing of the ten-day window.

To sum up, the arguments against "closing the window" work only if one assumes both that activists are the hero of the story and that they generate value for all shareholders. Neither assumption seems sound, at least without substantial qualification. Nor does the fear that closing the window will chill activism sound convincing. Activists are reaping record returns at present; the number of such campaigns is accelerating; and fears for their future seem premature.

Even the alleged gains from activism are debatable because the gains that activists make in trading on asymmetric information (before the Schedule 13D's filing) come at the expense of selling shareholders. This behavior may be lawful, but it represents another wealth transfer. Disclosure that is delayed ten days enables activists to profit from trading on asymmetric information over that period, and the abnormal share turnover over this window period suggests that this is occurring.[224] For example, others have estimated that Pershing Square and Vornado made a $230 million gain based on buying 26.7% of J.C. Penney at a discount to the price Penney's stock rose to on disclosure of their ownership.[225] Furthermore, evidence suggests that such asymmetric trading harms other investors (not just the sellers), both

[223] Under SEC Rule 13d-1(b)(1), a person otherwise obligated to file a Schedule 13D may instead file a shorter Schedule 13G if "such person has acquired such securities in the ordinary course of business and not with the purpose nor with the effect of changing or influencing the control of the issuer." See 17 C.F.R. § 290.13d-1(b)(1)(i). A Schedule G need only be filed within 45 days after the end of the calendar in which the person became obligated to file.

[224] See the chart supra in the text at note 69.

[225] See Mitts, supra note 77, at 204.

by reducing liquidity and widening the bid-ask spread.[226] Closing or shortening the ten-day window is the simplest, most feasible means of restricting such trading (and primarily by parties—i.e., the tippees of the lead hedge fund—who were not responsible for the original idea). By shortening the ten-day window, new rules would primarily impact and chill not trading by the lead hedge fund (whose trading seems to culminate on the first day after it crosses the 5% threshold[227]), but trading by its allies and tippees in the "wolf pack." These may be exactly the parties that public policy most wants to deter.[228]

At present, the SEC seems to have backed off of its original intent to shorten the Williams Act's ten-day window.[229] This may be because the SEC has been overwhelmed by the task of implementing the Dodd-Frank Act or because it wanted to avoid an unexpectedly controversial issue. Various compromises have been suggested, but none seem likely to be adopted.[230] Still, if the SEC is reluctant to act, this does not mean that the same outcome cannot

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[226] For an overview, see Kimberly D. Krawiec, Fairness, Efficiency and Insider Trading: Deconstructing the Coin of the Realm in the Information Age, 95 Nw. U. L. Rev. 443, 469-470 (2001) (citing studies).

[227] See text and note supra at note 67 (citing Brav, Jiang, Partnoy and Thomas, supra note 14, at 6).

[228] More than the "wolf pack" leader, these silent allies are essentially "free riders" who do not need to receive an attractive return in order to encourage efficient monitoring.

[229] In the Fall of 2013, the SEC indicated that it was "withdrawing this item from the Unified Agenda because it does not expect to consider this item in the next 12 months, but the Commission may consider the item at a future date." See Bebchuk, Brav, Jackson and Jiang, supra note 23, at *3 n.3 (quoting the Commission's website).

[230] One such proposal is that the length of the Schedule 13D window should be left to the target company's shareholders to determine. See Mitts, supra note 77, for this proposal. Of course, once shareholder choice is legitimized, some may argue that shareholders should be able to opt out entirely from any disclosure of beneficial ownership or to specify a lengthy (say, six months) window that would make disclosure meaningless. Nonetheless,

be achieved by private ordering. Shortly, we will propose what we call a "window closing" poison pill and suggest that courts should accept it under certain circumstances.

B. Expanding the Definition of Insider Trading. If a hedge fund's tipping to its prospective allies of its prospective Schedule 13D filing and/or its proxy campaign permits the exploitation of asymmetric information (as the law today seemingly does), a logical response might be to expand the definition of insider trading, either by statute or by SEC rule, to reach it. Some have urged this. Nonetheless, of the various possible reforms, we believe this would be the worst option to pursue. In our judgment, it would vastly overextend the reach of the insider trading prohibition.

At present, insider trading generally requires a breach of some duty. Either an insider has breached a fiduciary duty to shareholders or an outsider has misappropriated information belonging to another. Eliminating this requirement extends enormously the reach of the insider trading prohibition. Indeed, the term "insider trading" would become a misnomer, because the law would actually prohibit "outsider trading." Merely the use of material, nonpublic information would become criminal.

All that said, there remains one important respect in which insider trading law could be safely expanded. This is the context addressed by Rule 14e-3, which applies only to tender offers and uniquely does not require proof of a fiduciary breach.[231] Its currently uncertain reach

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if the default rule were two business days (i.e., the British rule) and if shareholders could vote to extend this period to up to ten days (the current period), the net effect would probably chill "wolf pack" formation.

[231] See C.F.R. § 240.14e-3. The lack of need to prove a fiduciary breach was discussed and upheld in United States v. O'Hagan, 5221 U.S. 642 (1997).

is illustrated in the Allergan litigation.[232] Although the Allergan court found "serious questions" in that case about Valeant's tipping to Pershing Square of its proposed bid for Allergan,[233] no ultimate decision was reached. Transaction planners may attempt to respond to Allergan by tinkering with the relationship between the bidder and the hedge fund, increasing marginally the investment by the hedge fund in the bid to make it resemble more a "co-offering person." With each twist of the legal kaleidoscope, transaction planners can try to outflank Allergan and thereby create new ambiguities about whether the hedge fund/tippee should be exempt from Rule 14e-3, either because (1) it was a "co-offering person" with the strategic bidder, or (2) the bidder had not yet taken a "substantial step" toward launching a tender offer.[234]

These ambiguities could, and should, be cured by either a modified rule or by legislation.[235] On a policy level it has long been accepted that insider trading on mergers and tender offers is particularly tempting, pervasive, and unjustified.[236] But the line between

[232] See Allergan, Inc. v. Valeant Pharms. Int'l, Inc., supra note 119. See text and notes supra at notes 113 to 130.

[233] Id. at * 42.

[234] Rule 14e-3 is applicable and bars trading on material information only once the bidder has taken a "substantial step" to make the tender offer. See Rule 14e-3(a), 17 C.F.R 240.143-3(a).

[235] Legislation could simply expand § 14(e) to give the SEC authority to adopt rules relating to the use of material information about all forms of acquisitions (mergers as well as tender offers or "creeping control" acquisitions). An expanded SEC rule under § 14(e) of the Securities Exchange Act would probably need to require an ultimate tender offer to confer jurisdiction on the SEC, but could be phrased to require only a "substantial step" toward any form of acquisition at the time of the trade, if eventually a tender offer was made.

[236] The likelihood of gain to the buyer is much higher in this context than in the context of trading on information about future earnings (where the market may already have incorporated into price some or all of the projected increase in earnings).

acquisition by merger and acquisition by tender offer is both razor thin and normatively meaningless. Indeed, once an acquisition proposal is accepted, it usually is in the interests of both sides to turn a merger proposal into a friendly tender offer to accelerate the process and thereby discourage possible third party bids. Hence, Rule 14e-3 should be expanded to cover trading on material, non-public information about either a tender offer or any other form of acquisition by which control over the target company would pass.[237]

This still leaves open the question of who is the bidder. Here, the facts of the Valeant/Pershing Square alliance show how artfully the parties can attempt to exploit the ambiguities in current law by having the hedge fund make some investment in the bidder. In response, the best answer is a bright-line rule: a hedge fund or other investor should not be deemed a "co-offering person" (and thus exempt from insider trading rules) unless it joins fully in making the tender offer and has joint and several liability for its payment. This would preclude most hedge funds from making a modest contribution to the strategic bidder in return for advance knowledge of the bid—a tactic that is hard to distinguish from paying a bribe for a tip.

C. Redefining Group. To the extent that the "wolf pack" is the tactic that has most fueled proxy activism, its feasibility depends on the ability of the lead hedge fund to disclose to allies its prospective Schedule 13D filing and/or proxy campaign without such communication making them members of a "group" for purposes of Section 13(d)(3). Once alerted to a material development that will boost the target's stock price, other hedge funds have little reason to resist trading in this stock.

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[237] Legislation could simply authorize the SEC to adopt rules relating to trading on any form of acquisition based on material nonpublic information, whether or not the information was acquired by means of a fiduciary breach or a misappropriation from any person.

But what if the act of trading on such information made them a member of a §13(d) "group"? The consequence of using the fact of a tip (or gift of information) from the lead activist to another as at least a major criterion in the definition of "group" would be that the existence of the "wolf pack" would have to be disclosed at a much earlier stage (and the disclosure might have to be amended as each additional member "joined" the team). Some investors would not want to join the "group" (possibly for fear of liability) and may not invest. Also, any poison pill adopted by the target in response to this disclosure would restrict all the "group" members, holding them to their disclosed stake. In short, the "wolf pack" could less easily grow to the size it reached in the Sotheby's case. The proxy contest would thus be a closer battle.

The problem with this proposal is that it has little support in the case law. But this does not mean that the SEC could not adopt such a rule or—even more plausibly—that Congress could not so legislate. Unlike simply shortening the ten-day window, this approach directly addresses the perceived unfairness in passing material, non-public information to a selected few and brings the hidden allies out into the open. Still, it is by no means a "showstopper." The leader of the "wolf pack" could still buy the target's stock until it crossed the 5% threshold and then quickly tip its allies who could buy heavily during whatever period remained before the Schedule 13D filing disclosed their "group." Its impact would likely be only to reduce the size and ownership of the "wolf pack" before it was disclosed (and allow the target to take more effective defensive steps).

D. <u>Focusing on the Proxy Advisor</u>. In Staff Legal Bulletin No. 20, issued earlier this year, the SEC has at last focused on the phenomenon of near total deference given by some institutional investors to ISS.[238] But it has still done little, essentially requiring only some additional monitoring.

What more could it reasonably do? A number of steps are possible. For example, the SEC could require a mutual fund to disclose to its shareholders that the fund had automatically adopted ISS's voting recommendations (or at least disclose the actual percentage of all votes in which it followed its proxy advisor). This might embarrass some mutual funds, but it probably will have little effect on hedge funds, which hold smaller portfolios, behave very differently with respect to voting decisions, and may often be beyond the SEC's jurisdictional reach.[239] More intrusive attempts at restricting proxy advisors by means other than increased disclosure could raise constitutional issues and in any event will probably not affect the outcomes in many proxy contests.

Still, another sensible reform might be to require the proxy advisor to publish an annual scorecard showing its voting recommendations on specific issues. For example, how often had it recommended a vote for the insurgents in a contested director election?

E. Private Ordering. Although the antagonists in the debate over shortening the ten-day window under the Williams Act tend to present the issue as one critical to the fate of contemporary corporate governance, we doubt that that such a reform (or any of the other reforms proposed in this section) would truly have decisive impact. In the case of a tender offer for a target at a premium (such as the recent bid for Allergan), we expect these reforms would

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[238] See text and note supra at notes 44 to 45.

[239] Hedge funds will generally not be subject to the Investment Company Act, and their investment advisers may not be registered with the SEC.

not change the likely outcome. Shareholders will predictably vote for a lucrative takeover if given the chance, and the target's best hope is the "white knight."

What then could be achieved? These reforms might reduce the possibility of "creeping control" acquisitions and the incentive for a pretextual governance campaign that is grounded less on the value of the proposed governance change than on the hope that a "noisy" signal will produce a short-term gain based on the market's perception of an increased prospect of a takeover. But these reforms will not much affect a real takeover. So viewed, they may (a) reduce the incentive to create noise for its own sake, and (b) reduce the gains from trading on asymmetric information. But these will be marginal changes.

Private ordering responses might be more effective, but they also carry risks. Two illustrations merit consideration. First, corporations fearful of a "wolf pack" could adopt a "standing" poison pill that would preclude any shareholder (with some possible exemption for "passive" shareholders) from exceeding a specified level (either 15% or possibly 10%), and such a poison pill could broadly define its coverage so as to apply to any persons "acting in concert" or "in conscious parallelism" with the leader of the "wolf pack."[240] The goal here is to define "group" for purpose of the poison pill much more broadly than the case law under the Williams Act has done in order to include persons who receive advance information of a Schedule 13D filing from a party making that filing (or an agent thereof). Such a pill will create considerable uncertainty and place high demands on courts. Thus, we think a second alternative is preferable. A "window-closing" poison pill could be designed that would be triggered by ownership of as

[240] We have been advised by Charles Nathan, a leading expert in the M&A field, that such a poison pill has been designed by the law firm of Latham & Watkins LLP. Our suggestion is to focus less on an ineffable concept such as "conscious parallelism" and more on a concrete act, such as tipping.

little as 5.1% of the target's stock if the acquirer did not file a Schedule 13D before purchasing stock in excess of the specified threshold.[241] By exceeding 5.1% without a prior filing, the acquirer would face significant dilution.

These more sweeping poison pills would impede the wolf pack's formation, but would be subject to legal challenge and would anger the proxy advisors (who might recommend that institutions withhold their votes for the directors of this corporation). For this reason, some compromises might intelligently be struck in designing such a poison pill. For example, a "window-closing" poison pill that denied the bidder the ability to delay its Schedule 13D filing for the ten-day window period permitted by the Williams Act might compensate for its short fuse by allowing the bidder to accumulate a greater level of stock (say, 15 or 20%), so long as it filed with the SEC immediately after crossing 5%. Or, as in the Sotheby's case,[242] it might permit a 100% bid to be made. Either concession should lead the Delaware courts to accept such a pill, because neither pill is "preclusive."[243] The bottom line is that private initiatives by determined

[241] The point of this variant is to deny the acquirer the Williams Act's ten-day window, because the failure to file a Schedule 13D promptly after crossing 5% would trigger the pill. We have been advised that such a pill has been drafted by the law firm of Fried, Frank, Shriver & Jacobson LLP. We express no views on the validity of these pills in specific contexts, as each context needs to be analyzed on its own facts.

[242] See Third Point LLC. v. Ruprecht, supra note 7. Sotheby's used a two-tier poison pill, but exempted any 100% bid that was kept open for a specified period (so that management had some time to seek a white knight bidder). The pill was upheld by the Delaware Chancery Court as a non-preclusive response to a "threat."

[243] Under contemporary Delaware law, a defensive tactic will generally only be enjoined when it is "preclusive." See Unitrin Inc. v. American Gen. Corp., 615 A. 2d 1361 (Del. 1995)(indicating that a defensive tactic will be enjoined when it is either "coercive" or "preclusive"). A poison pill that allows the potential acquirer to buy up to 15% (after

targets could both "close" the current ten-day window and render irrelevant the inadequacies in the current case law's definition of "group." In short, most of what can be done by regulation can also be done by private ordering.

Once, a clear academic consensus existed that takeover defensive measures reduced shareholder value, but today fissures are appearing in that consensus. Some recent studies find defensive measures to increase value for some companies.[244] Even more ironically, the staggered board (long the target of universal academic scorn) has been cast in a new light by recent research. Employing Tobin's Q as a proxy for firm value, one study of the period 1978-2011 finds that de-staggering the board reduces firm value, while staggering the board results in increased value.[245] The authors surmise that staggered boards might be beneficial for some companies because they commit shareholders to longer-term horizons.[246] This association was strongest for firms with high R&D expenditures.[247] The bottom line is that serious academic

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appropriate disclosures) should not be viewed as "preclusive" because the acquirer can launch and win a proxy contest and then redeem the pill. Indeed, such a pill is less preclusive than the one upheld in the Sotheby's litigation.

[244] See, e.g., William C. Johnson, Johnathan Karpoff and Sangho Yi, The Bonding Hypothesis of Takeover Defenses: Evidence from IPO firms (available at http://ssrn.com/abstract=1923667)(September 2, 2014).

[245] See K. J. Martijn Cremers, Lubomir P. Litov and M. Sepe, Staggered Boards and Firm Value, Revisited (available at http://ssrn.com/abstract=2364165, (July 14, 2014)). Their findings depend upon viewing the data from a time series (rather than a cross-sectional) perspective.

[246] Id at 3, 4.

[247] Id at 7-8.

research now supports the view that staggered boards can provide stability and continuity that enhances shareholder value.[248]

To be sure, it is probably already too late to save the staggered board, as momentum has gathered to purge it in all cases. Generally, resisting hedge fund activism will bring the company into conflict with its proxy advisors. Companies thus face a difficult choice between lying low or confronting the proxy advisor.

VI. Conclusion

For better or for worse, two major transitions are now in progress. First, corporate governance is moving from a "board-centric" system toward a "shareholder-centric" system.[249] Second, public corporations are increasingly under pressure to incur debt and apply earnings to fund payouts to shareholders, rather than to make long-term investments. Neither transition is wholly the product of hedge fund activism, but that force is accelerating both transitions.

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[248] For another such study finding a negative stock price reaction to de-staggering votes, see David F. Larcker, Gaizka Omazabal and Daniel J. Taylor, The Market Reaction to Corporate Governance Regulation, 101 J. Fin. Econ. 431 (2011).

[249] That is, the balance of power is tilting towards shareholders and away from boards. As a by-product, this shift will mean more divided boards with different factions of shareholders electing their own representatives. In 2014, "activists gained board seats at a record 107 companies." See David Benoit and Kirsten Grant, supra note 34, at A-1. Adding the insurgents' nominees to the board typically results in a divided board at these companies and some tensions. For an insightful discussion of the strains this transition is already causing in Delaware corporate law (which was clearly "board-centric"), see J. Travis Laster and John Zebenkiewicz, The Rights and Duties of Blockholder Directors, 70 Bus. Law 33 (2015).

These transitions cannot simply be halted or prohibited. Nor do we propose to freeze activists in place. But we submit that greater transparency is needed. Tactics such as the "wolf pack" enable some to earn a low-risk, short-term gain by pushing an agenda of more leverage and higher payout, coupled with less long-term investment. In many respects, the recent ascendancy of the activist hedge fund takes us back in time to an earlier era when, at the end of the 1980s, "bust-up" takeovers became briefly dominant. Then too, there was the same concern that managements were being pushed excessively to focus on the short-term.[250] Both the "bust-up" takeovers of that era and the contemporary activist campaigns for restructurings are fueled by the same desire to realize "negative synergy," based on the expectation that the value of the target firm broken exceeds its value fully assembled. The "bust-up" takeover of that era was slowed by a variety of forces, of which judicial acceptance of the poison pill was the most effective.[251] But today, activists have outflanked that barrier through the "wolf pack," which makes possible the sudden assembly of a near controlling block.

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[250] A host of commentators today believe there is an excessive focus on the short-run. See The Kay Review of UK Equity Markets and Long-Term Decision Making, Final Report at 9 (July, 2012) (available at http://www.gov.uk/government/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf); The Aspen Institute, "Overcoming Short-Termism: A Call for a More Responsible Approach to Investment and Business Management" at 2-3 (2009) (available at http://www.aspeninstitute.org). For the opposite view that these changes are desirable, see sources cited supra at note 2.

[251] The most important such decision was <u>Paramount Communications, Inc. v. Time, Inc.</u>, 571 A. 2d 1040 (Del. 1990), which seemed at the time to imply that a board, armed with a poison pill, could "just say no" to a takeover bidder. Contemporaneously, the majority of the states passed anti-takeover statutes of various types, which impeded to various degrees a hostile takeover. Takeover financing also dried up at the end of the 1980s, as the junk bond

We acknowledge that the "wolf pack" tactic is but one means by which a more "shareholder-centric" system of governance is emerging. But, unlike other means, it essentially enables a majority of short-term shareholders to gain de facto control, only to exit on average within a year after their appearance.[252] At least sometimes, this temporary majority will view issues differently than a majority of indexed (or at least largely diversified) shareholders. This tactic may increase target firm value on the announcement of the wolf pack's appearance, but long-term gains (according to most studies) seem to depend upon the activists achieving one of two outcomes: a takeover or a restructuring.[253] Mere changes in corporate governance or payout practices produce little impact, and if a takeover or restructuring does not result, the expected takeover premium for the target firm will eventually erode.[254]

Activists may well gain from these tactics, but their gains may come at a considerable cost. The clearest of these costs is the reduction in R&D expenditures by targeted firms in

market declined in the wake of the Government's prosecution of Drexel Burnham and the Federal Reserve Board tightened credit. For all these reasons, the takeover movement that had peaked in the 1980s declined in the 1990s.

[252] For the typical holding periods of hedge fund activists, see text and note supra at note 75.

[253] Becht, Franks, Grant and Wagner find that "activism with outcomes generates value-weighted abnormal returns over the engagement period of 8.0 percent, compared with 2.3 percent for activism without outcomes." Becht, Franks, Grant and Wagner, supra note 12, at 4. When returns are equal-weighted, "activism with outcomes generates annualized abnormal returns of just 1.1 percent, compared with minus 9.8 percent without. Id. Outcomes involving a takeover generate the highest returns (9.5 percent and 16.2 percent in the case of North American engagements), but restructuring outcomes are also "positive and significant." Id at 28. In contrast, outcomes that merely increase the payout to shareholders (i.e., a dividend or stock buyback) generate returns of "roughly zero." Id.

[254] Becht, Franks, Grant and Wagner find that "in all engagements, the returns crucially depend on the activist achieving outcomes." Id at 4. In the case of North American engagements, they find that "engagements generate 6.6 percent with outcomes, and minus 1.2 percent without." Id.

subsequent years.[255] R&D is probably more efficiently conducted within larger firms because the directions in which basic research will lead are often unpredictable.[256] Thus, the larger firm is better positioned to exploit these opportunities than a smaller firm with a limited number of product lines. The policy issue then is whether the gains from realizing negative synergy in the short-run exceed the long-term losses from reduced investment in R&D. We do not assert that this question can be dispositively answered today, but it needs to be raised. Moreover, takeover

[255] For example, in a still preliminary study, Allaire and Dauphin conclude that, based on a sample of recent targets that "survived" a campaign by hedge fund activists (i.e., they were not acquired), R&D expenditures as a percentage of sales declined at these firms by more than 50% over the period between 2009 and 2013. In contrast, a random sample of firms with similar market capitalizations saw R&D expenses, expressed on the same basis, modestly rise over the same period. See Yvan Allaire and Francois Dauphin, supra note 12. These results likely understate the decline in R&D because targets that were acquired probably experienced an even greater decline in "R&D."

[256] This is an economies of scale argument, and it is subject to some necessary qualifications. A distinction is made in the literature on innovation between "exploratory" innovation and "exploitative" innovation, with the former relating to research that seeks to develop processes or products that are fundamentally distinct from prior processes or products and the latter referring to research that builds on pre-existing practices. See James G. March, Exploration and Exploitation in Organizational Learning, 2 Organizational Science 71 (1991). Some recent research suggests that smaller firms are more likely to engage in "exploratory" innovation, possibly because there are less returns to scale for such research. See Ufuk Akoigit and William R. Kerr, "Growth Through Heterogenous Innovations," National Bureau of Economic Research Working Paper 16442 (2010). But even if smaller firms are better at this particular type of research, their ability to obtain funding to conduct it is often limited (and they too might be deterred if they have public shareholders and need to fear attracting activists). The larger firm is likely able to apply more working capital to R&D, even if it is less likely to conduct "exploratory" R&D.

gains and bust-up premiums do not necessarily reflect economic efficiency, but may instead be the product of other factors, such as acquirers gaining market power or bidder overpayment.[257]

Some will respond that our preference for more transparency implies that we are rejecting shareholder democracy. Not so! Rather, we are only expressing doubt about a novel form of shareholder democracy that enables a temporary majority to take irrevocable action. Neo-classical finance theorists may doubt that different constituencies of shareholders have different investment horizons or may assert that arbitrage will mitigate any such differences, but growing evidence suggests both that the composition of the shareholders owning the firm much affects the firm's investment horizons and that there are significant limits to arbitrage.[258]

The appearance of a short-term majority is a distinctly new phenomenon. Traditionally, a majority of the shareholders meant a majority of the firm's long-term equity holders. Until very recently, few shareholders bought stock in order to initiate a proxy contest. Although takeover bidders might buy stock in advance of a tender offer, their purchases were constrained by the Williams Act's disclosure rules and the poison pill. That has now changed, as the "wolf pack" today can effectively outflank both the Williams Act and the poison pill (as currently drafted). As a result, the old equilibrium has been destabilized by the prospect of the sudden appearance

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[257] One common explanation for takeover premiums is "bidder overpayment." See Bernard S. Black, Bidder Overpayment in Takeovers, 41 Stan. L. Rev. 597 (1989). Another is that the bidder is acquiring market power. Both imply that, even if the gains to target shareholders are high, the transaction may not be efficiency enhancing.

[258] The work of Wharton Professor Brian Bushee is particularly relevant here. See Bushee, supra note 107; Bushee, supra note 109. Even within mainstream economics, there is an increased sense of the limits on arbitrage. See Andrei Shleifer and Lawrence H. Summers, The Noise Trader Approach to Finance, 4 Journal of Economic Perspectives 19 (1990).

of a 20% (or greater) block that hovers on the brink of possessing control for the short-run.[259] At its worst, such a short-term majority resembles giving voting control of the corporation to its option holders, as both constituencies have incentives to undervalue long-term outcomes.[260]

Proponents of activism in effect argue that the majority has the right to rule, even if it remains only for the short-term. Although we recognize that there is no alternative to shareholder democracy, it does not follow that accountability need be a daily process (or that elections should be held at the choice of insurgents). One can accept shareholder democracy, but still debate the appropriate time-frames and processes for elections. By analogy, the President of the United States can only be replaced by the voters every four years. That may or may not be the optimal period, but virtually no one would shorten this period to, say, six months. Any such change would result in a virtually constant election contest and much diversion of the President's time.

This article has argued for the desirability of moderating sudden transitions in corporate governance. Changing the tax laws to require a longer holding period for capital gains (as Hillary Clinton has proposed[261]) could achieve this purpose, but increased transparency is an alternative and complementary approach. Increased transparency will not preclude shareholder activism, but it will slow marginally the acquisition of de facto control (as the Williams Act originally intended).

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[259] With respect to this estimate, see text and note supra at note 76.

[260] We do not mean to imply that activist hedge funds necessarily behave like option holders. But it is likely that they have shorter term horizons. See Bushee, supra note 107, and Bushee, supra note 109.

[261] See text and note supra at note 4.

Finally, we must observe that the case for strengthening shareholder power on the premise that any such shift will always enhance economic efficiency is far from self-evident.[262] A generation of legal academics has too quickly equated optimal corporate governance with maximizing shareholder power.[263] Nonetheless, a basic and problematic tradeoff must be recognized. Even if one believes that management is biased in favor of inefficient growth and expansion, one must still recognize that management has better information than outsiders (including hedge funds). Curbing managerial discretion thus precludes at least some efficient investments that are based on management's superior knowledge. Exactly how this tradeoff between management's self-interest and its superior knowledge balances out remains a very open question. We offer no general theory on what is optimal, either in terms of shareholder power, corporate leverage, or when investments in R&D become excessive. Nonetheless, we do observe that strong incentives are today pushing us toward higher leverage and reduced long-term investment.

Over time, we predict that hedge fund activism will yield diminishing returns. Too many activists will eventually chase too few legitimate targets.[264] But in the interim, we also see the prospect of what we term a "hedge fund bubble," as major and successful firms are disrupted

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[262] For a largely unqualified endorsement of shifting the balance of power towards shareholders, see Lucian A. Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833 (2005)

[263] In a nutshell, this is why insider trading is unlawful—because management does have superior information that is not available to others.

[264] On this theme, see Liz Hoffman, "Too Many Activists, Not Enough Targets," The Wall Street Journal. August 11, 2015 at C-1. Alternatively hedge funds with large cash inflows from investors may increasingly stalk foreign targets, rather than return their capital to investors. Thus, the American experience may repeat itself globally.

and/or broken up. We do not endorse preclusive reforms to prevent such a bubble, but we do suggest that greater transparency is the least drastic reform. In this interim, we also submit that what can be done by regulatory reform can also be done by private ordering.