Raiders, Activists, and the Risk of Mistargeting

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Abstract

This Article argues that the conventional wisdom about corporate raiders and activist hedge funds—raiders break things, and activists fix them—is wrong. Because activists have a higher risk of mistargeting— mistakenly shaking things up at firms that only appear to be underperforming—they are much more likely than raiders to destroy value and, ultimately, social wealth.

As corporate outsiders who challenge the incompetence or disloyalty of incumbent management, raiders and activists play similar roles in reducing "agency costs" at target firms. The difference between them comes down to a simple observation about their business models: raiders buy entire companies, while activists take minority stakes. This means that raiders are less likely to mistarget firms underperforming by only a slight margin, and they are less able to shift the costs of their mistakes onto other shareholders. The differences in incentives between raiders and activists only increase after the acquisition of their stake. Raiders have unrestricted access to nonpublic information after acquiring ownership of a target company, which allows them to look under the hood to determine whether changing the target's business strategy is truly warranted. Activists, by contrast, have limited information and face structural conflicts of interest that impair their ability to objectively evaluate what's best for the target company.

This insight has profound implications for corporate law and policy. Delaware and federal law alike have focused on building walls to keep raiders outside the gates, but they ignore the real threat—shareholder activists—that are already inside. We propose reforms to both state and federal law that would equalize the regulation of raiders and activists.

Keywords: Corporate Law, Securities Regulations, Corporate Governance, Delaware Courts, Institutional Investors, Hedge Fund Activism, Principal Costs, Agency Costs

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INTRODUCTION

Activist investor Bill Ackman was supposed to save J.C. Penney. His handpicked CEO Ron Johnson, the architect of Target's turnaround, announced a bold new strategy: "fair and square pricing."[1] No more discounts or clearance, just great prices every day of the year.[2] The results were disastrous and almost immediate. Revenue fell by a quarter, the stock price cratered by sixty percent, and thousands of employees lost their jobs.[3] "Penney had been run into a ditch when he took it over," Columbia Business School Professor Mark Cohen said of Johnson. "But, rather than getting it back on the road, he's essentially set it on fire."[4] Nor is that the only high-profile failure by an activist investor in recent years. After spending more than a decade trying to turn around Sears, Eddie Lampert, once hailed as "the Next Warren Buffet,"[5] left in disgrace and was sued by the company for allegedly stripping it of billions of dollars in assets.[6] And after nagging Sony for years to spin off entire divisions,[7] Dan Loeb of Third Point finally threw up his hands and sold out last year.[8] These stories cut against the conventional view of shareholder activists as scrappy visionaries with the pluck and acumen to turn around ailing corporate giants.[9]

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[1] James Surowiecki, *The Turnaround Trap*, NEW YORKER (March 18, 2013), https://www.newyorker.com/magazine/2013/03/25/the-turnaround-trap [hereinafter, Surowiecki, Turnaround; James Surowiecki, *When Shareholder Activism Goes Too Far*, NEW YORKER (Aug. 14, 2013), https://www.newyorker.com/business/currency/when-shareholder-activism-goes-too-far [hereinafter, Surowiecki, *Too Far*].

[2] Surowiecki, *Turnaround*, *supra* note 1.

[3] Surowiecki, *Turnaround*. *supra* note 1

[4] *Id.* Penney arguably never recovered from the Johnson disaster, filing for bankruptcy in 2020. *J.C. Penney Rescue Deal Approved in Bankruptcy Court, Saving Close to 60,000 Jobs*, REUTERS (Nov. 10, 2020), https://www.cnbc.com/2020/11/10/jc-penney-rescue-deal-approved-in-bankruptcy-court-saving-close-to-60000-jobs.html

[5] Michelle Celarier, *Eddie Lampert Shattered Sears, Sullied His Reputation, and Lost Billions of Dollars. Or Did He?*, INSTITUTIONAL INVESTOR (Dec. 3, 2018) https://www.institutionalinvestor.com/article/b1c33fqdnhf21s/Eddie-Lampert-Shattered-Sears-Sullied-His-Reputation-and-Lost-Billions-of-Dollars-Or-Did-He.

[6] Lauren Hirsch, *Sears Sues Former CEO Eddie Lampert, Treasury Secretary Mnuchin and Others for Alleged "Thefts" of Billions from Retailer*, CNBC (Apr. 18, 2019), https://www.cnbc.com/2019/04/18/sears-sues-eddie-lampert-steven-mnuchin-others-for-alleged-thefts.html

[7] Alex Weprin, *Dan Loeb Renews Push to Break Up Sony, Yet Praises Leadership*, HOLLYWOOD REPORTER (Jan. 30, 2020), https://www.hollywoodreporter.com/news/dan-loeb-renews-sony-break-up-push-praises-leadership-1275238; Surowiecki, *Too Far*, *supra* note 1.

[8] Svea Herbst-Bayliss & Makiko Yamazaki, *Hedge Fund Third Point Sells ADRs in Sony: SEC Filings*, REUTERS (Aug. 18, 2020), https://www.reuters.com/article/us-thirdpoint-sony/third-point-sells-sony-adrs-still-owns-large-amount-of-tokyo-stock-idUSKCN25F03T?il=0

[9] *See, e.g.*, Frank Partnoy & Steven Davidoff Solomon, *What CEOs Get Wrong About Activist Investors*, HARVARD BUSINESS REVIEW (May 1, 2018), https://hbr.org/2018/05/what-ceos-get-wrong-about-activist-investors (arguing that managers should view activists "as a source of potential value").

What these cases have in common are shareholder activists entering the corporate scene with a plan to make things better, and instead making things much worse. The very name—*shareholder activists*—evokes the image of faithful foot soldiers in the battle for efficiency and shareholder value. By contrast, their ugly cousins—*corporate raiders*—evoke greedy Wall Street fat cats: Gordon Gecko screaming into a phone and ruining somebody's life. But as the examples of J.C. Penney, Sears, and Sony show, sometimes the image fails to match the reality.

This Article argues that the conventional wisdom—corporate raiders break things and shareholder activists fix them—is wrong. Activists are no better than raiders, and if anything, they are likely worse. Because shareholder activists have a higher risk of *mistargeting*—mistakenly shaking things up at firms that only *appear to be* underperforming—they are much more likely than corporate raiders to destroy value and, ultimately, social wealth.[10] This insight has important implications for the law and policy of control contests: Delaware and federal law alike have focused on building walls to keep raiders outside the gates, but they ignore the real threat—shareholder activists—that are already inside. We thus propose equalizing the regulation of raiders and activists.

The difference between raiders and activists comes down to a simple observation about their differing business models. Raiders typically acquire 100 percent of the target's stock at a significant premium above market. By contrast, activists need only buy a small block of shares to push their reforms through via the proxy-voting process.[11] As a result, raiders have a much higher hurdle rate—the rate of return they need to make a target worth their substantial investment. Moreover, raiders are unable to shift risk onto other parties, since they end up owning 100 percent of the target's stock, further incentivizing them to invest more in information and take only prudent risks. Activists, on the other hand, buy smaller blocks, giving them a much lower hurdle rate, and

[10] There are no direct empirical studies measuring what we describe as mistargeting. However, there are conflicting studies on whether hedge fund activists increase firms' value in the long run. For instance, one study finds that "[f]ewer than half of all activist targets experience positive long-term returns," Ed deHaan, David F. Larcker & Charles McClure, *Long-Term Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUDS. 536, 539 (2019), while another study finds that, on average, targeted firms improve in value, Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 53 J. FIN. 1729, 1749 (2008). That is, the studies finding value destruction suggest less than 50% accuracy, while other studies finding long term improvement seem to suggest higher accuracy.

[11] *See* April Klein & Emanuel Zur, *Hedge Fund Activism* 31–32 (NYU Working Paper No. CLB-06-017, 2008), https://papers.ssrn.com/abstract_id=1291605 (defining hedge fund activism as a hedge fund purchasing an initial stake of five or more percent with the purpose of influencing management decisions) [hereinafter Klein & Kur, *Hedge Fund*].

they can shift some of the cost of mistakes onto other shareholders. They are thus much more likely to try to shake things up at corporations that are underperforming by only a slight margin.

The differences in the incentives of raiders and activists only increase after the acquisition of their stake. Raiders have unrestricted access to nonpublic information once they acquire 100 percent ownership, whereas activists have restricted access due to the securities laws and other restrictions.[12] After completing an acquisition and looking under the hood, a raider can always decide to maintain the company's existing business strategy, thereby preserving social wealth that an activist would have destroyed. Moreover, as repeat players whose success in future campaigns depends on their credibility and reputation,[13] activists face structural conflicts that impede their ability to objectively evaluate a target company's business even when they can obtain confidential information. For these reasons, activists are much more likely to try to "fix" something that is not broken.

The mistargeting risk rests on the idea that investors cannot always accurately identify the true value of the firms they buy into, and when they mistakenly undervalue these firms, they create an opportunity for raiders and activists to (mis)target these firms. There are at least two reasons why outsiders might fail to perceive the true value of a publicly-traded firm. The first is market mispricing. A company that lags behind its peers may be poorly run, or it may be engaged in an innovative business plan that is hard for investors to understand and value.[14] Investors may also systemically undervalue long-term gains over short-term ones, or else might simply be impatient—the "short-termism" problem.[15] Investors who desire immediate returns may not mind sacrificing

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[12] *See infra* note 103.
[13] *See*, C.N.V. Krishnan, *et al*., *The Second Wave of Hedge Fund Activism: The Importance of Reputation, Clout, And Expertise*, 40 J. Corp. Fin. 296 (2016); Travis L. Johnson and Nathan Swem, *Reputation and Investor Activism: A Structural Approach,* 139 J. Fin. Econ. 29 (2021).
[14] Zohar Goshen & Assaf Hamdani, *Corporate Control and Idiosyncratic Vision*, 125 YALE L.J. 560, 565–66 (2016); Mustafa Ciftci, *Do Analysts Underestimate Future Benefits of R&D?*, 5 INT'L BUS. RES., Sept. 2012, at 26, 35 (finding that "analysts underestimate earnings long term growth for R&D-intensive firms"); Mark Humphery-Jenner, *Takeover Defenses, Innovation, And Value Creation: Evidence from Acquisition Decisions,* 35 STRAT. MGMT. J. 668 (2014) (finding that hard-to-value firms that have antitakeover provisions make acquisitions that generate more shareholder wealth and are more likely to increase corporate innovation); Thomas Chemmanur & Xuan Tian, *Do Anti-Takeover Provisions Spur Corporate Innovation? A Regression Discontinuity Analysis*, 53 J. Fin. & Quant. Anal. 1163 (2018) ("The evidence suggests that antitakeover provisions help nurture innovation by insulating managers from short-term pressures arising from equity markets.").
[15] *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1084 (2007) [hereinafter Kahan & Rock, *Hedge Funds*]; DEAN KREHMEYER, MATTHEW ORSAGH & KURT N. SCHACHT, CFA CENTER FOR FIN. INTEGRITY & BUS. ROUNDTABLE INST. FOR CORPORATE ETHICS, BREAKING THE SHORT-TERM CYCLE: DISCUSSION AND RECOMMENDATIONS ON HOW CORPORATE LEADERS, ASSET

greater long-term ones. Or, investors might overreact (or underreact) to new information, leading to temporary mispricing until the market corrects itself.[16] The second reason why investors might misperceive the value of their companies is asymmetric information. A company may possess trade secrets or other confidential information it cannot share with the market, causing its stock price to fall short of its true value.[17]

Notably, the mistargeting is a mistake only from the perspective of the long-term diversified shareholders, who are either selling their firm to a raider for too low a price or replacing a successful business strategy with a mediocre one upon a campaign of an activist. Whether the reason for the undervaluation is mismanagement or the market's underappreciation of a high-quality company, it is a bargain for a raider and an opportunity to make a profit for an activist.

Because of their all-in business model, corporate raiders are less likely on all fronts to inflict costly mistakes on long-term shareholders. A short illustration shows how activists might destroy shareholder value to a greater extent than raiders. Suppose an economy is made up of high-quality companies, low-quality companies, and average companies. The low-quality firms underperform because of poor management, while the high-quality firms underperform because they are engaged in long-term, innovative strategies that will produce gangbuster profits in future periods. For the reasons mentioned above, it is difficult for activists to tell low-quality from high-quality companies. When activists target low-quality companies and turn them into average companies by improving management quality, they add value to shareholders and the economy.[18] But when they target high-quality companies and turn them into average companies by shutting down innovation, they *destroy* value. Raiders, by contrast, are less likely to *either* move companies

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MANAGERS, INVESTORS AND ANALYSTS CAN REFOCUS ON LONG-TERM VALUE 3 (2006) (defining short-termism as "the excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation").

[16] *See, e.g.*, Werner De Bondt, *Investor and Market Overreaction: A Retrospective*, 12 REV. BEHAVIORAL FIN. 11 (2020); Aydoğan Alti & Paul C. Tetlock, *Biased Beliefs, Asset Prices, and Investment: A Structural Approach*, 69 J. Fin. 325, 326 (2014); Werner F. M. de Bondt & Richard Thaler, *Does the Stock Market Overreact?,* 40 J. FIN. 793 (1985) [hereinafter De Bondt & Thaler, *Does the Stock Market Overreact?*]; Werner F. M. de Bondt & Richard Thaler, *Further Evidence on Investor Overreaction and Stock Market Seasonality*, 42 J. FIN. 557 (1987) [hereinafter De Bondt & Thaler, *Further Evidence*]; Kent Daniel, David Hirshleifer & Avanidhar Subrahmanyam, *Investor Psychology and Security Market Under- and Overreactions*, 53 J. FIN. 1839 (1998).

[17] *See*, Bernard Black & Reinier Kraakman, *Delaware's Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 529-33 (2002).

[18] This Article does not address the role of a new type of activist facilitating environmental and social changes, as exemplified by the activist fund Engine One's proxy fight with Exxon Mobil pushing Exxon to reduce its carbon footprint. *See* Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021). Instead, we focus on the more "traditional" types of activist hedge funds focused on financial returns.

from low-quality to average *or* high-quality to average. For example, if both high- and low-quality firms underperform relative to their peers by ten, twenty, or even fifty percent, a raider that needs sixty percent upside to turn a profit will pass.[19] Moreover, in the cases that the raider buys the target, the 100 percent ownership makes it more likely that the mistargeting is discovered and avoided. For this reason, raiders are less likely to destroy shareholder value *or* create it.

That shareholder activists and corporate raiders add value, at least in some cases, is beyond dispute. In particular, activists reduce agency costs (or "agent costs"), the value lost to unfaithful managers who take liberties and expropriate the private benefits of control.[20] Imagine a firm whose CEO mismanages the company for private benefits, so that the corporation underperforms relative to its peers by ten percent. A raider with a sixty-percent hurdle rate will not go anywhere near this company. But an activist who needs, say, a seven- or eight-percent return stands to make a buck by firing the CEO, replacing them with a loyal agent, and selling. In a world with only raiders, this CEO will get away with their expropriation, but in a world with activists *and* raiders, they will get the boot.

Moreover, both the positive and negative effects of activists and raiders have ripple effects across the market. On the one hand, where an activist or a raider can make a buck by firing lazy CEOs who take long afternoon naps and use the company jet for leisure travel, managers across the board are *ex ante* less likely to do those things.[21] This is a positive externality of shareholder activism.[22] On the other hand, where activists are likely to mistarget firms engaged in profitable but long-term business strategies, CEOs are less likely to take bold positions or invest in projects that fail to yield immediate returns. This is a negative externality of shareholder activism.[23] While

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[19] For a numerical illustration, *see infra*, note 50.

[20] *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,* 3 J. FIN. ECON. 305, 308 (1976). Jensen and Meckling broke down agency costs into the sum of monitoring costs, bonding costs, and residual loss. Monitoring costs represent the cost to the principal of monitoring agents to prevent misbehavior; bonding costs represent the cost of aligning agents' incentives with those of their principals; and residual loss is the result of unavoidable divergence in principals' and agents' incentives. *Id.* We use the term "agent costs" to refer to the costs that arise when agents exercise control, as distinguished from "principal costs," which are the costs that arise when principals exercise control. *See infra* note 25 and accompanying text.

[21] As one raider observed, managers were less likely to misbehave because "[t]hey knew guys like me would buy the company and throw them out." Nell Mackenzie, *Bosses Are Wary of the Return of the Corporate Raider*, BBC (Jan. 8, 2020), https://www.bbc.com/news/business-50609165.

[22] Nickolay Gantchev et al., *Governance Under the Gun: Spillover Effects of Hedge Fund Activism,* 23 REV. FIN. 1031 (2019) (finding that "these positive effects of activism reach beyond the targets, as non-targeted peers make similar improvements under the threat of activism").

[23] *See* John C. Coffee, Jr. & Darius Palia, *The Wolf at the Door: The Impact of Hedge Fund Activism on Corporate Governance*, 41 J. CORP. L. 545, 552 (2016) ("Our primary concern is . . . with the possibility that the increasing rate

raiders are likely to produce similar externalities, the model presented here suggests these externalities will be significantly lower than the externalities generated by activists.

The critical question is whether activists—as opposed to raiders—create more value by sacking unfaithful managers than they destroy by firing good ones.[24] The latter sum—the value destroyed by mistakenly firing good managers—can be deemed "principal costs" because they originate with the principal (the shareholder) rather than the agent.[25] Compared with raiders, which are greater: the principal costs that activists create or the agent costs they avoid? And if it is the former, should we be more on our guard about activists than corporate raiders, conventional wisdom be damned? There are no easy answers to these questions, but the long-term course of the market provides some hints.

In particular, market trends suggest that the cost of mistargeting might be higher than the benefits that activists provide, at least under the current regulatory regime. While empirical studies assessing whether activists reduce agent costs are equivocal,[26] activists' effects on principal costs are concerning. Start with the empirical observation that the returns in the stock market are not normally distributed—they are positively skewed.[27] A small number of firms account for most of the return in the stock market. Much like a venture capital fund portfolio where one successful startup compensates for the failure of nine other startups (one in ten),[28] it is one successful firm

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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."). Moreover, while the Gantchev et al. study exploring hedge funds' externalities interpret its result as reducing agent cost, it can as well be interpreted as increasing principal costs, as they find that "[p]eers with higher threat perception, as measured by director connections to past targets, are more likely to increase leverage and payout, decrease capital expenditures and cash, and improve return on assets and asset turnover." Gantchev et al., *supra* note 22. These are typical actions that can frustrate idiosyncratic vision, long-term, or complex business strategies.

[24] *See. e.g.*, Huasheng Gao, Jarrad Harford, and Kai Li, *Investor Myopia and CEO Turnover: Evidence from Private Firms* (working paper draft) (2013) ("We conclude that, contrary to the arguments that there is too little turnover risk for CEOs in public firms, public firm CEOs are fired too frequently, possibly due to investor myopia creating pressure on public firm boards"); Huasheng Gao, Jarrad Harford, and Kai Li, *CEO Turnover-Performance Sensitivities in Private* Firms, NTU 3 (2015) ("Given well-documented concern about public firm CEO entrenchment, it may at first seem surprising that public firm CEOs are actually more likely than private firm CEOs to be fired.").

[25] Zohar Goshen & Richard Squire, *Principal Costs: A New Theory for Corporate Law and Governance*, 117 COLUM. L. REV. 767, 770 (2017) ("Principal costs occur when investors exercise control, and agent costs occur when managers exercise control.").

[26] *See infra* section III.B.1.

[27] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills*, 129 J. FIN. ECON. 440 (2018).

[28] *See* Patrick Ward, *Is It True That 90% of Startups Fail?*, NANOGLOBALS https://nanoglobals.com/startup-failure-rate-myths-origin/ (June 9, 2021) (confirming one in ten rate); WSJ, Deborah Gage, *The Venture Capital Secret: 3 Out of 4 Start-Ups Fail,* available at:

out of four in the stock market.[29] This finding suggests that the cost of breaking a high-quality firm is greater than the benefit of fixing three low-quality firms.

Additionally, one study found that some four percent of companies have generated all the equity premium in the stock market over the past ninety years.[30] This finding suggests that the ratio is one successful firm out of twenty for the top performers in the stock market. Suppose that even just a quarter of those growth-driving companies (i.e., one percent of all companies) have at some point fit the mold of underperforming companies whose long-term vision would eventually lead to explosive growth. If activists had nipped these firms in the bud because they were not generating optimal short-term results, they would have destroyed a quarter of all economic growth. Moreover, there is no telling how many companies *would have been* among the four-percenters were it not for mistargeting by activists. Whatever the sum total of agent costs that activists avoid, it seems unlikely that it adds up to the amount lost to principal costs.

These observations suggest that the law's efforts to lock the gates against corporate raiders while letting shareholder activism go relatively unchecked should be adjusted.[31] If shareholder activists are no better than corporate raiders—and potentially even more harmful—it would seem the barbarians are already *inside* the gates. The insight that activists are more likely to mistarget companies than their ugly cousins has profound implications for corporate law, which we argue should equalize the regulation of raiders and activists. In fact, the main value of hedge fund activists is not in fixing targets' operations, financing, or governance, but rather in overcoming the barriers created by Delaware's takeover jurisprudence—side-stepping targets' legally allowed defensive measures and facilitating mergers and acquisitions. Our analysis has timely implications for debates currently taking place in the courts about how to evaluate corporate efforts to guard

https://www.wsj.com/articles/SB10000872396390443720204578004980476429190 (finding the rate is in fact one in four).

[29] *See* Blackstar Funds, *The Capitalism Distribution*, https://invertiryespecular.com/wp-content/uploads/2015/11/thecapitalismdistribution.pdf (last visited Oct. 5, 2021) [hereinafter: *The Capitalism Distribution*].

[30] Hendrik Bessembinder, *Do Stocks Outperform Treasury Bills*, 129 J. FIN. ECON. 440, 441 (2018).

[31] *See generally* John Armour et al., *The Evolution of Takeover Regimes in Developed and Emerging Markets: An Analytical Framework*, 52 HARV. INT'L L.J. 219, 244–247 (2011) (outlining the development of Delaware antitakeover doctrine and concluding this development forced would-be acquirers "to resurrect the proxy contest" as a means of effectuating a hostile takeover).

against shareholder activism, including a recent Delaware Court of Chancery decision that is currently on appeal before the Delaware Supreme Court.[32]

This Article proceeds in four parts. Part I provides background about how raiders and activists operate and introduces the concepts of principal and agent costs. Part II explains the mistargeting hazard and introduces an informal model that shows how the presence of control challenges may either decrease or increase the net sum of principal and agent costs. Part III analyzes the relative effects of activists and raiders on principal and agent costs in light of our model and the available empirical evidence and concludes that activists are likely to impose greater costs than raiders. Part IV examines implications for law and policy. The model presented in this Article suggests that, contrary to conventional wisdom, lawmakers and courts should be more skeptical of shareholder activists and avoid providing them with preferential treatment relative to raiders.

I. THE PROMISE (AND THREAT) OF CONTROL CONTESTS

The impact of activists and raiders on agency costs has been widely studied: Corporate control contests keep corporate boards and officers honest and hard-working by rewarding malfeasance with a coup.[33] The drawbacks of corporate control contests have received less attention.[34] The term "principal costs" can provide a template to understand the downsides of control contests. Just as missteps by agents can produce costs, so too can missteps by principals—in this case, activist hedge funds and corporate raiders—burden corporations and shareholders with unnecessary costs.[35] Control challengers in general—and different types of challengers in

[32] In re Williams Stockholder Litig., C.A. No. 2020-0707-KSJM, 2021 WL 754593, at *4 (Del. Ch. Feb. 26, 2021); Opening Br., Williams Cos. v. Wolosky, No. 139, 2021 (Del. June 25, 2021).
[33] *See, e.g.*, Paul Rose & Bernard S. Sharfman, *Shareholder Activism as a Corrective Mechanism in Corporate Governance*, 5 BRIGHAM YOUNG UNIV. L. REV. 1015, 1037 (2014) ("The traditional understanding of shareholder activism is that it is a tool of accountability used to minimize agency costs. For example, activism may reduce agency costs that result from management shirking or rent seeking . . . ."); Michael C. Jensen, *Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. 323, 328–29 (1986) (arguing that takeovers are "a solution to the problem" of "conflicts of interests between shareholders and managers"); Henry G. Manne, *Cash Tender Offers for Shares—A Reply to Chairman Cohen*, 1967 DUKE L.J. 231, 236–37 (arguing that the threat of raiders encourages managers to manage their companies as efficiently as possible).
[34] *But see* Matin Lipton, *Takeover Bids in the Target's Boardroom*, 35 BUS. LAW. 101 (1979); Leo E. Strine, Jr., *Who Bleeds When the Wolves Bite?: A Flesh-and-Blood Perspective on Hedge Fund Activism and Our Strange Corporate Governance System*, 126 YALE L.J. 1870 (2017); John C. Coffee et al., *Activist Directors and Agency Costs: What Happens When an Activist Director Goes on the Board*, 104 CORNELL L. REV. 381 (2019).
[35] *See* Goshen & Squire, *supra* note 25, at 770.

particular—create a fundamental tradeoff between agent and principal costs. In turn, this finer-grained understanding allows courts and scholars to judge different types of control challenges by the particular costs and benefits they are likely to impose.[36]

While activists and raiders pursue the same ends—shifting corporate control—they employ different means and incur different costs in doing so, resulting in a different tradeoff between principal and agent costs. Armed revolution and democratic elections both produce a change in government, but no doubt have different impacts on the populace. Without assigning the stigma of revolt or republicanism to either side, analyzing the means employed by raider and activists helps to clarify their likely impact on agent and principal costs. Before comparing different types of control challenges, it is necessary to first understand the costs they themselves incur, and next to lay out a vocabulary to analyze the costs they impose on firms.

This Part provides background on the promise and threat of control contests. Section I.A describes the roles of activists and raiders in corporate control contests, explaining how the different means they use results in activists incurring lower costs than raiders when contesting control. Section I.B introduces the vocabulary of principal and agent costs, explaining how the exercise of control by either principals or agents can generate costs.

A. Raiders and Activists in Corporate Control Contests

An investor who wishes to change the direction of a widely held corporation can win a control contest in either of two ways. One way, the strategy pursued by hostile raiders, is to assemble a control block. Traditionally, raiders have started a raid by buying a toehold stake in the target—typically about ten percent of the outstanding shares—on the open market.[37] Then, to build

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[36] There is literature in corporate law debating the relative efficiency of using *voting* to aggregate shareholder preferences and information (the activists' method relying on "voice") compared with *markets* allowing shareholders to sell their shares (the raiders' method relying on "exit"). The studies are equivocal. *See, e.g.*, Doron Levit, *Soft Shareholder Activism*, 32 REV. FIN. STUD. 2775 (2019); Yair Listokin, *Corporate Voting versus Market Price Setting*, 11 AM. L. & ECON. REV. 608 (2009); Ronald J. Gilson & Alan Schwartz, *Sales and Elections as Methods for Transferring Corporate Control*, 2 THEOR. INQUIR. LAW 1 (2001); Lucian Bebchuk & Oliver Hart, Takeover Bids, Proxy Fights and Corporate Voting (Mimeo, Harvard Law Sch., 1999); Bilge Yilmaz, Strategic Voting and Proxy Contests (Mimeo, Rodney L. White Ctr. for Fin. Research, Wharton, 1999), available at: https://rodneywhitecenter.wharton.upenn.edu/wp-content/uploads/2014/04/0005.pdf.

[37] *See, e.g.*, Ronald Gilson, *Seeking Competitive Bids Versus Pure Passivity in Tender Offer Defense*, 35 STAN. L. REV. 51 (1982). Toeholds are less prevalent today. *See* Eitan Goldman & Jun Qian, *Optimal Toeholds in Takeover Contests*, 77 J. FIN. ECON. 321, 326-27 (2005). Also, hostile takeovers are now frequently dressed up as friendly acquisitions. *See* Tingting Liua and J. Harold Mulherin, *How Has Takeover Competition Changed Over Time?*, 49 J. CORP. FIN. 104 (2018) (finding that "takeover competition across the entire auction process between deal initiation

that stake into a majority of shares, the raider makes a tender offer.[38] If the offer is successful, the raider will take steps to buy 100% of the shares, and then use its voting power to replace the board and implement the raider's own business vision. Alternatively, the raider can decide that the incumbent managers' business vision is fundamentally sound, in which case the raider could leave the managers in place and simply reap the resulting profits.

The second strategy that control challengers follow is to try to persuade a sufficient number of shareholders to support the challenger's proposal in a proxy contest. This is the strategy favored by activist hedge funds.[39] Once an activist fund identifies a suitable target, it typically builds up a five to ten percent equity stake through stock-market purchases.[40] But instead of then making a tender offer, the activist initiates, or threatens to initiate, a proxy contest.[41] When it runs a proxy contest, it asks other shareholders to support its proposal to replace incumbent directors, increase dividends, or force a change in the firm's capital or governance structure.[42] Regardless of the substance of its proposal, the activist operates through the mechanism of shareholder voting.

To contest control successfully, a challenger must incur shifting costs: the costs of shifting a target firm from one business strategy to another. A hostile raider's shifting costs commonly include research to identify a target, execution costs (such as hiring advisers and arranging the financing for the acquisition), and the large premium that the raider must offer other shareholders to induce them to tender. The latter two costs will usually increase with the size of a target. Empirical studies indicate that a raider's total shifting costs have generally exceeded thirty percent—and often more than fifty percent—of the target's pre-raid market capitalization.[43]

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and completion has not declined. In effect, takeover competition via auctions has gone underground"). For reasons that will become apparent in Part IV, we nevertheless discuss raiders in traditional terms.

[38] Rajdeep Singh, *Takeover Bidding with Toeholds: The Case of the Owner's Curse*, 11 REV. FIN. STUDS. 679, 679–80 (1998) (describing and evaluating the "toehold" strategy).

[39] *See, e.g.*, Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PA. L. REV. 1021, 1088 (2007) [hereinafter Kahan & Rock, *Hedge Funds*].

[40] *Id;* Brian Cheffins & John Armour, *The Past, Present and Future of Shareholder Activism by Hedge Funds*, 37 IOWA. J. CORP. L. 51 (2011).

[41] Klein & Zur, *Hedge Fund, supra* note 11, at 5.

[42] SULLIVAN & CROMWELL, REVIEW AND ANALYSIS OF 2018 U.S. SHAREHOLDER ACTIVISM 27 (2018) ("Although board representation remains the most common objective in activist campaigns, it is almost always sought in conjunction with other underlying objectives.").

[43] *See* Michael C. Jensen, *Takeovers: Their Causes and Consequences,* 2 J. ECON. PERSPECTIVES 21, 22 (1988) (average takeover premium paid to target shareholders was historically about thirty percent and about fifty percent in recent years); Shaojie Lai & Xialing Pu, *Mispricing or Growth? An Empirical Analysis of Acquisition Premium*, FIN. RES. LETTERS, vol. 37, at 2 (2020) (finding an average acquisition offer premium of 41.24% for U.S. public company

Notably, these high costs mean that a raid is worthwhile only if the raider can effect a very large increase in the target's value.

An activist hedge fund's shifting costs tend to be much lower, consisting of research to select a target, developing an alternative business strategy, buying the five-to-ten-percent block of shares at market prices, and the expenses of a proxy fight. One empirical study estimates that the activist's average expenses for a campaign ending in a proxy fight are about $11 million, a price tag that does not vary much with target size.[44] If it is successful, the activist may even be able to get the corporation to reimburse those expenses.[45] Moreover, the activist can incur even lower expenses if it settles with the company—the same empirical study estimates that the "demand negotiations" and "board representation" stages of an activist campaign incur average costs of about $3 million and $2 million, respectively[46]—which happens more often than a full-fledged proxy contest.[47] And as with a successful proxy contest, a settlement may provide for partial or full reimbursement of the activist's costs.[48] Therefore, an activist's shifting costs tend to be lower than a raider's, with the difference widening as target size increases.

This differential cost implies that activists have a much lower "hurdle rate": the minimum percentage improvement in the target's share price necessary to make targeting profitable.[49] And, because they have lower hurdle rates than raiders, activists can target a wider range of firms.[50] Put

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targets in cash deals). These acquisition premia do not include research and execution costs, which bring total shifting costs even higher.

[44] Nickolay Gantchev, *The Costs of Shareholder Activism: Evidence from a Sequential Decision Model*, 107 J. FIN. ECON. 610, 611 (2013).

[45] *See* DEL. CODE tit. 8, § 113 (allowing the corporation's bylaws to "provide for the reimbursement by the corporation of expenses incurred by a stockholder in soliciting proxies in connection with an election of directors"); Joseph E. Gilligan et al., *Preparing for Proxy Contests: Practical Steps Every Company Should Consider*, BLOOMBERG BNA (Feb. 24, 2014), https://www.hoganlovells.com/~/media/hogan-lovells/pdf/publication/q00281-bna-article-04cm_pdf.ashx ("[A]ctivist stockholders who succeed in having one or more of their nominees elected to the board of directors can and often do seek reimbursement of the expenses they incurred in mounting the proxy contest; while results are mixed in 'short slate' proxy contests (in which an activist stockholder seeks to replace less than the entire board of directors), in cases where the entire board is elected by an activist stockholder, reimbursement of its expenses is commonplace.").

[46] Gantchev, *supra* note 44, at 612.

[47] *See* Lucian A. Bebchuk, Alon Brav & Wei Jiang, *Dancing with Activists*, 137 J. FIN. ECON. 1 tbl.1 (2020) (analyzing 3,012 activism campaigns between 2000 and 2013 and finding that settlements were more than twice as common as voted proxy contests).

[48] *Id.* at 7 n.11 ("While the dissident might already have incurred part of these costs at the time when the settlement is negotiated, many settlements specify that the activist is reimbursed part or all of its contest-related expenses.").

[49] Will Kenton & Michael J. Boyle, *Hurdle Rate*, INVESTOPEDIA (Oct. 23, 2020), https://www.investopedia.com/terms/h/hurdlerate.asp.

[50] As an illustration, consider a target firm whose total market capitalization is $1 billion. Assume that an activist hedge fund can successfully target the firm by acquiring a 10% share block at unaffected, pre-announcement market

another way, agent costs must reach a minimum level at a firm before targeting the firm is worthwhile, and that threshold is higher for raiders than for activists. Moreover, the advantage that activists have over raiders in policing agent costs will generally increase with the size of the target.

B. Agent and Principal Costs in Corporate Control Contests

The effects that activists and raiders have on principal costs is not as well studied as the agent cost effects. When activists and raiders mistarget firms—selecting targets whose business strategies are ultimately profitable but entail delay or complexity—they destroy shareholder value. Corporate control challenges therefore produce countervailing effects: reducing agent costs while increasing principal costs. To understand the fundamental tradeoff posed by corporate control challengers, it is crucial to first understand the reasons for mistargeting.

By delegating control to agents, investors expose themselves to agent costs, defined as the costs generated by the divergent goals of agents and principals.[51] Principals hope to maximize profits, while agents hope to maximize their personal gain to the greatest extent possible without being fired. Because the agent captures only a small portion of the firm's cash flows, they may not work as hard as they would otherwise (this is known as "shirking"), and may consume more of the firm's resources in the form of perquisites than they would otherwise (this can be called "diverting").[52] Shirking and diverting reduce the cash flows the firm generates and thus its total value. Together, these can be understood as *conflict costs*—the cost arising from *conflict* between the goals of shareholders and the goals of managers.[53] We use the term agent costs—as opposed to the more conventional "agency costs"—to encompass another category as well: *competence costs*.[54] These are the costs an honest decisionmaker will incur in trying to do her best to avoid

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prices and then spending $5 million dollars to win a proxy fight. On these assumptions, the overall value of the target needs to improve by at least $50 million, or 5%, for the activist to turn a profit (assuming the market prices the firm's shares accurately). By contrast, a hostile raider who pays a 50% premium will have to spend $500 million in addition to the unaffected market price of $1 billion to buy 100% of the shares in a tender offer. Therefore, the raider will have to expect to increase the value of the target by more than $500 million, or 50%, to turn a profit and make the raid worthwhile. If we assume an even larger target, the activist's hurdle rate falls further, but the raider's does not, on the assumption that the activist's shifting costs vary less with the target size's than the raider's do.

[51] *See* Jensen & Meckling, *supra* note 20 (developing the formal analysis of agency costs); Goshen & Squire, *supra* note 25 (developing a theory of "principal" and "agent" costs).

[52] *See* Jensen & Meckling, *supra* note 51, at 12.

[53] *See* Goshen & Squire, *supra* note 25, at 784.

[54] *Id.*

mistakes and maximize firm value.[55] Competence costs will include the cost of acquiring the necessary expertise, the information needed to make optimal decisions, and the residual cost of mistakes.[56] So, for example, when Ron Johnson decided to switch to fair-and-square pricing and caused J.C. Penney's revenue to collapse, he inflicted competence costs on Penney's shareholders.[57]

Control challengers reduce agent costs—both conflict and competence costs—by solving the collective-action problem of multiple diversified investors.[58] Institutional shareholders that dominate the public equity markets may be "rationally reticent" to invest in policing managerial misbehavior because they capture a relatively small portion of the gains from such activity.[59] Thus, no one shareholder will act because most of the gains from policing management go to free riders who benefit from increased stock prices without contributing to the cost of investing in information and engaging with managers.[60] Activists solve this problem by taking on the burden of disciplining or replacing lazy or incompetent managers.

But competence and conflict costs are not the sole prerogative of agents. When principals rather than agents generate these costs, they can be deemed *principal costs*.[61] Perhaps the most common way principals can generate these costs is by firing managers they misperceive as disloyal or incompetent, who are actually loyal and able.[62] By removing these managers and preventing them from carrying out their business strategies, or selecting incompetent managers, principals act incompetently and inflict costs on the firm.[63] To return to the unfortunate example of J.C. Penney, the fair-and-square-pricing disaster can be understood through the lens of principal costs.[64] Rather than pinning the failure on the CEO, replacing Penney's leadership and installing Johnson in the

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[55] *Id.* at 785–86.
[56] *Id.* at 770.
[57] *See supra* notes 1–4 and accompanying text.
[58] *See* Klein & Zur, *Hedge Fund*, *supra* note 11, at 2.
[59] 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, 870–71 (2013).
[60] Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 453–54 (1991).
[61] *See* Goshen & Squire, *supra* note 25, at 771.
[62] *See id.* at 786–88. These costs can properly be termed "principal competence costs" since they arise not from conflicting motives but from the principal's lack of competence in policing manager behavior. *Id;* Laurent Bach & Daniel Metzger, *The Dark Side of Shareholder Activism: Evidence from CEO Turnovers,* Stockholm School of Economics working paper (2013), available at: https://www.eurofidai.org/Bach_2013.pdf (finding that strong corporate governance inflicts costs on shareholders as it sometimes leads to the departure of value-enhancing CEOs).
[63] *See* Goshen & Squire, *supra* note 25, at 786-88.
[64] *See supra* notes 1–4 and accompanying text.

first place can be understood as incompetence on the part of Bill Ackman, the hedge fund manager. Ackman—a principal—inflicted costs on the firm and thus on other shareholders by firing Penney's management, or at least by replacing them with Johnson instead of someone else.

This dynamic also produces second-order effects. When the fear of a control contest dissuades other managers from generating agent costs through disloyalty or incompetence—lest they too find themselves on the business end of a proxy fight or hostile takeover—that effect extends to even those firms that activists and raiders have not targeted. To avoid the possibility of a control contest, managers will shirk and divert less than they would without such a threat looming, thereby reducing agent costs even at untargeted firms. This effect is a positive externality created by activists and raiders.[65] By contrast, when the fear of a control contest dissuades other competent and loyal managers from pursuing idiosyncratic, long-term, or complex business strategies—again, lest they too find themselves on the business end of a proxy battle or hostile takeover—that effect also extends to untargeted firms. The threat of a control contest can strike fear into the hearts of even competent and otherwise loyal managers, who—understandably—want to keep their jobs, and dissuade them from pursuing strategies that may make them the target of a proxy battle or takeover. Principal costs can therefore manifest even at firms without an active control contest. This effect is a negative externality created by activists and raiders.[66]

The foregoing analysis suggests that raiders and activists increase principal costs by introducing a risk of mistargeting. The next Part explores this mistargeting hazard in greater detail, setting the stage for an analysis of the different propensities of raiders and activists to mistarget.

II. THE MISTARGETING HAZARD

When Dan Loeb attempted to disrupt a business strategy at Sony that turned out to be profitable, he was engaged in mistargeting.[67] Mistargeting refers to corporate control challenges initiated against firms that are not underperforming, but only appear to be underperforming. It is important to emphasize, however, that the mistargeting is a mistaken targeting only from the perspective of the long-term diversified shareholders, who either sell their firm at a discount or exchange a successful business strategy for an average one. From the perspective of a raider,

[65] *See* Nickolay Gantchev *et al.*, *supra* note 22.
[66] *See supra* note 23.
[67] *See supra* note 7 and accompanying text.

market mispricing leading to undervaluation of a firm, represents a bargain not a mistake.[68] Similarly, from the perspective of an activist, it does not matter if the activist campaign increased the share price as a result of destroying idiosyncratic vision or fixing agency costs. The mistargeting risk represents a salient category of principal costs that control challengers introduce. This Part explains this mistargeting hazard and its potential effects on principal and agent costs. Section II.A describes two key potential causes of mistargeting: market mispricing and asymmetric information. Section II.B introduces an informal model that shows how mistargeting could cause the presence of control challengers to increase the net sum of principal and agent costs.

A. Causes of Mistargeting

There are at least two reasons why control challengers might mistake high-quality firms for low-quality ones. The first has to do with market mispricing. Corporate leaders may simply see something that the market does not ("differences of opinion"), perhaps because the leader has an idiosyncratic vision that others fail to recognize. While these firms underperform now—because it is hard for the market to evaluate their vision—their investments will eventually pay off handsomely. Alternatively, myopic markets might not perceive or properly reward value that will be realized far in the future ("short-termism"), or the market might under- or overreact to new information ("inefficient markets"). The second reason for mistargeting is a lack of information ("asymmetric information"). Corporate managers may be unable to reveal to potential control challengers the reason that their stock price is sagging.

1. Market Mispricing

The first reason for mistargeting relates to market mispricing, which occurs when the market fails to accurately price the company's stock based on public information. This can occur for several reasons, including a failure to recognize the leader's idiosyncratic vision, short-termism, or over- or underreaction.

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[68] *See* Karen Simonyan, *What Determines Takeover Premia: An Empirical Analysis,* 75 J. ECON. & BUS. 93 (2014) (finding that "takeover premia were affected by market misvaluation: they were higher during periods of investor pessimism and market undervaluation and were lower during periods of investor optimism and market overvaluation"); Alex Edmans et al, *The Real Effects of Financial Markets: The Impact of Prices On Takeovers*, 67 J. FIN. 933 (2012) (showing a strong relation between a firm being valued below its potential and the probability of it being a takeover target); Ming Dong et al, *Does Investor Misvaluation Drive the Takeover Market*? 61 J. FIN. 725 (2006) (finding that "bidders for undervalued targets have an incentive to profit by bidding below true target value").

Idiosyncratic Vision. Intuitively, it is not hard to imagine that the stock markets might undervalue bold, long-term visions.[69] Suppose a firm invests 7% of its cash flows in research and development (R&D) while its peers in the industry only invest 3%. Are the managers of this outlier firm engaged in a "pet" project wasting corporate resources (agent costs)[70] or in developing a path breaking innovation that would transform the industry (idiosyncratic vision)[71]? It is hard to know. And if the market believes that the managers are investing in a "pet" project the stock price will decline.[72] Depending on the true reality behind the R&D budget, when an activist's campaign to slash R&D expense is successful, it might have reduced agent costs or inflicted principal costs. It is hard to know because it is only rarely that we get to see the counterfactual.

Of these rare cases, the best illustration of the complexity a business vision presents to determining the reasons for suboptimal performance is probably the story of Henry Ford. Ford did not invent the automobile, nor did he own any valuable intellectual property in the technology. He was competing with hundreds of other entrepreneurs attempting to create a "horseless carriage." Ford, however, had a unique vision regarding car production. Investors controlled the first firm he founded, the Detroit Automobile Company. While the Detroit Auto Company's investors demanded that cars be immediately produced and sold, Ford insisted on perfecting the design prior to production, leading to delays, frustration on both sides, and the eventual shutdown of the firm by the investors.[73] Investors also controlled the Henry Ford Company, Ford's second attempt. Again, after designing a car, Ford resisted investors' pressure and interference, and he did not move directly into production. Eventually, his obstinacy led the investors to replace Ford with Henry Leland, change the company name to the Cadillac Automobile Company, and produce the car designed by Ford with great success.[74] This sounds like the classic success story of shareholder

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[69] *See generally* Goshen & Hamdani, *supra* note 14 (setting forth a theory of corporate control and idiosyncratic vision).

[70] *See* Volker Laux and Brian Mittendorf*, Board Independence, Executive Pay, and the Adoption of Pet Projects,* 28 CONTEMP. ACCOUN. RES. 1467 (2011); Michael Jensen, *Agency Costs of Free Cash Flow, Corporate Finance and Takeovers*, 76 AM. ECON. REV. 323 (1986) (introducing the problem of management overinvestment); Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217 (1989) (offering evidence in support of the empire-building hypothesis); Scott Richardson, *Over-Investment of Free Cash Flow*, 11 REV. ACC. STUDS. 159 (2006) (finding that strong governance reduces overinvestment).

[71] *See* Chemmanur & Tian, *supra* note 14 (finding that "antitakeover provisions help nurture innovation by insulating managers from short-term pressures arising from equity markets").

[72] *See* Ciftci, *supra* note 14 ("analysts underestimate earnings long term growth for R&D-intensive firms").

[73] M. Todd Henderson, *The Story of Dodge v. Ford Motor Company: Everything Old is New Again*, in CORPORATE LAW STORIES 40 (Mark Ramseyer, ed. 2009).

[74] *Id.* at 45.

activism reducing agency costs. Although we usually do not get the counterfactual, history gave it to us this time, and it tells a different story. In his third attempt—the Ford Motor Company—Ford insisted on retaining control. This time, with no outside investor interference, Ford transformed his ideas for car design and production (his business vision) into one of the great corporate success stories of all time.[75] Although investors made money from firing Ford and appointing Leland, they would have made much more had they been patient and stayed with him. The Ford story illustrates that principal costs—in this case mistargeting—could be very high even when performance apparently improves.

Similarly, the story of Apple's firing of Steve Jobs immediately comes to mind.[76] Apple's board authorized then-CEO John Sculley to fire Steve Jobs in 1985 largely because of Macintosh Office's commercial failure. Jobs proposed the company cut the price of its struggling computer and shift its advertising resources to support the Macintosh Office. Sculley did not trust Jobs' instinct and went to the board, which, after contemplating Jobs' proposal versus Sculley's, ultimately forced the one-day savior of Apple to step down. Sculley eventually admitted that at the time he had not realized the power of Jobs' passion and vision and could not appreciate Jobs' leadership as a founder. After he was forced out of Apple, Jobs founded NeXT Computer and Pixar before returning to Apple to lead it from the brink of failure to being the largest publicly traded corporation in the world by market capitalization.

There are, however, other examples.[77] For one recent example, look at Tesla, the electric automaker. In October 2018, when Tesla's price was about $50, the Hedge Fund manager David Einhorn of Greenlight Capital wrote to his investors that right now Tesla bears a grim resemblance to Lehman Brothers before its 2008 bankruptcy (a collapse that Einhorn predicted months

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[75] *Id.* at 47.

[76] *See* Randall Lane, *John Sculley Just Gave His Most Detailed Account Ever Of How Steve Jobs Got Fired From Apple*, FORBES, http://onforb.es/1akpdJU (Sept. 9, 2013).

[77] Similar stories to Steve Jobs' are about Jack Bogle who was fired from managing the Wellington Management Company and returned to transform Vanguard into the largest mutual fund company in America, and Jon Luther whose investors closed a food chain he managed, Benchmark, only for him to become the turn-around CEO of Popeye's and Dunkin Donuts, are part of a book by Rick Newman, REBOUNDERS: HOW WINNERS PIVOT FROM SETBACK TO SUCCESS, Chpts. 3 & 4 (2012).

earlier).[78] And some indeed blatantly predicted Tesla's bankruptcy in 2019,[79] while others speculated on who should replace Elon Musk.[80] A year later, in October 2019, as Tesla delivered a rare third-quarter profit, experts remained "concerned on 2020 momentum/profitability."[81] By the end of 2020, its stock price was well above $600.[82] The unexpected stock jump minted a new class of millionaires.[83] The market, it seemed, had undervalued Tesla and the investment strategy of its quixotic leader. Those who had perceived Tesla's true value made off handsomely. Had an activist (like Einhorn) or a raider mistargeted Tesla and sold it for scrap, investors would never have enjoyed those profits. Elon Musk's idiosyncratic vision would have remained unrealized. While the future of the electric vehicle is now understood, other path-breaking technologies such as artificial intelligence and gene editing may still face market skepticism.[84]

Short-termism. Relatedly, the classic theory of short-termism asserts that stock markets often suffer from myopia: Their focus on short-term returns impairs their ability to properly analyze long-term business plans.[85] Under this theory, markets undervalue the profits that long-term investments generate.[86] Such myopia might occur because stock-market investors systematically underestimate the likelihood that long-term business projects will succeed, or apply

[78] Tae Kim, *Einhorn On Tesla: 'Like Lehman, We Think The Deception Is About To Catch Up'*, CNBC (Oct. 5, 2018), https://www.cnbc.com/2018/10/05/einhorn-on-tesla-like-lehman-we-think-the-deception-is-about-to-catch-up-to-tsla.html.
[79] Mike Guy, *Here's Why Tesla Will Go Bankrupt in 2019*, THE DRIVE (https://www.thedrive.com/tech/24261/elon-musk-and-10-billion-of-debt-why-tesla-will-go-bankrupt-in-2019 (Oct. 19, 2018).
[80] Sam Abuelsamid, *Who Should Replace Elon Musk As Tesla CEO?* , FORBES (Oct. 1, 2018), https://www.forbes.com/sites/samabuelsamid/2018/10/01/who-should-replace-elon-musk-as-tesla-ceo/?sh=578c544b53d1
[81] Paul A. Eisenstein, *Tesla Reported A Surprise Profit — But How Long Can CEO Elon Musk Stay Ahead?*, CNBC (Oct. 24, 2019), https://www.nbcnews.com/business/autos/tesla-reported-surprise-profit-how-long-can-ceo-elon-musk-n1071296
[82] Tesla Inc., GOOGLE FINANCE, https://www.google.com/finance/quote/TSLA:NASDAQ (last visited July 1, 2021).
[83] Justin Harper, *Tesla: Soaring Share Price Creates Army of 'Teslanaires'*, BBC NEWS (Dec. 29, 2020), https://finance.yahoo.com/news/soaring-share-price-creates-army-111918373.html.
[84] This can be seen by the broad skepticism over Cathie Wood's innovation fund, ARKK. *See* Abhishek Vishnoi, *Cathie Wood's Strategy Draws More Skeptics As Returns Wane*, BLOOMBERG (Aug. 8, 2018), https://www.bloomberg.com/news/articles/2021-08-18/detractors-of-cathie-wood-s-strategy-seem-to-be-growing-each-day
[85] Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 985–87 (2013) [hereinafter Roe, *Corporate Short-Termism*] (summarizing the arguments and relevant literature). *See also* Patrick Bolton, Jose Schneinkman & Wei Xiong, *Executive Compensation and Short-Termist Behavior in Speculative Markets*, 73 REV. ECON. STUDS. 577 (2006); Jeremy C. Stein, *Efficient Capital Market, Inefficient Firm: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655 (1989) [hereinafter Stein, *Myopic Corporate Behavior*]; Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61 (1988).
[86] *E.g.*, Roe, *Corporate Short-Termism*, *supra* note 85, at 985.

too high a risk premium because they overestimate the volatility of returns from such projects.[87] The resulting mispricing might persist because investors face limits on arbitrage that prevent the correction of mispricing.[88] That is, good ideas might take too long to pan out for investors who expect a certain short-term return. In any case, myopic markets might underprice the shares of firms that will generate most of their profits later rather than sooner. Thus, corporate leaders who pursue long-term visions may be replaced before that vision can pan out.[89]

To be sure, if the market valued long-term investments correctly, actions that harmed a corporation in the long term would immediately reduce its stock price. The theory of short-termism thus assumes inefficient markets.[90] Critics of the myopic-markets theory doubt that markets systemically undervalue long-term investments or can easily be fooled by such "tricks." But the theory's proponents find support in theoretical models showing that market myopia is possible,[91] and in empirical evidence that either challenges the efficiency of markets[92] or correlates the

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[87] *E.g.*, *id*.

[88] Andrei Shleifer & Robert W. Vishny, *The Limits of Arbitrage*, 52 J. FIN. 35 (1997); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AMER. ECON. REV. 148 (1990) (explaining that it is less risky and less costly for asset managers to arbitrage a short-term asset for which mispricing will disappear in the short term than a long-term asset where there is more time for bad news or a wave of pessimism to hit).

[89] *See, e.g.*, Martin Lipton, *Bite the Apple; Poison the Apple; Paralyze the Company; Wreck the Economy*, HARVARD L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 26, 2013, 9:22 AM), http://blogs.law.harvard.edu/corpgov/2013/02/26/bite-the-apple-poison-the-apple-paralyze-the-company-wreck-the-economy/; Martin Lipton & William Savitt, *The Many Myths of Lucian Bebchuk*, 93 VA. L. REV. 733, 745–47, 756–57 (2007); Martin Lipton & Steven A. Rosenblum, *A New System of Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 205–13 (1991).

[90] Kahan & Rock, *Hedge Funds*, *supra* note 15, at 1084 ("For the short-term trading horizon of hedge funds to generate a short-term investment outlook for hedge fund managers, the stock market must suffer from myopia: that is, it must undervalue long-term investments relative to short-term investments. If the market does not itself suffer from such a bias, then the interests of investors with short-term trading horizons will not conflict with those of investors with long-term trading horizons.").

[91] *See* Stein, *Myopic Corporate Behavior*, *supra* note 85, at 655–56 (a game theory model according to which if markets infer positive values from certain observable managerial signals, and manipulation of those signals is not easily detected, managers have an incentive to manipulate these signals to enhance stock prices); Adam Brandenburger & Ben Polak, *When Managers Cover Their Posteriors: Making the Decisions the Market Wants to See*, 27 RAND J. ECON. 523, 526–27 (1996) (explaining myopia as a function of information asymmetries between managers and shareholders); Simon Grant et al., *Information Externalities, Share-Price Based Incentives and Managerial Behavior*, 10 J. ECON. SURVEYS 1 (1996); Natalie Mizik, *The Theory and Practice of Myopic Management*, 47 J. MARKETING RES. 594, 596 (2010); Andrei Shleifer & Robert W. Vishny, *Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV. 148 (1990) (explaining that it is less risky and less costly for asset managers to arbitrage a short-term asset for which mispricing will disappear in the short term than a long-term asset where there is more time for bad news or a wave of pessimism to hit).

[92] Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 653 (2003); 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).

adoption of short-term strategies with shareholder pressure.[93] Of course, the other side to the debate cites its own empirical studies showing that markets are efficient and that shareholder activism improves corporate value in the long run.[94] The empirical battle over short-termism has not yet produced a clear winner.[95] This Article does not take a position on the magnitude of the short-termism hazard. But the hazard likely exists.

Inefficient Markets. Finally, the market might misprice the target company's stock because the market has over- or underreacted to new information.[96] Prices might deviate from fundamental valuations due to fads, fashion, information bubbles or crashes.[97] For example, consider the market gyrations that occurred during the beginning of the COVID-19 pandemic. Between mid-February and mid-March 2020, the S&P 500 dropped over thirty percent amidst fears that the pandemic would devastate the economy.[98] Over the following months, however, the market rebounded, and

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[93] *See, e.g.*, Daniel Ferreira et al., *Shareholder Empowerment and Bank Bailouts* (2013) (showing that banks in which managers were more insulated from shareholders were roughly 18 to 26 percentage points less likely to be bailed out during the financial crisis); Leo E. Strine, Jr., *Can We Do Better by Ordinary Investors? A Pragmatic Reaction to the Dueling Ideological Mythologists of Corporate Law*, 114 COLUM. L. REV. 449, 463 n.41 (2014) [hereinafter Strine, *Can We Do Better*](citing empirical studies suggesting that direct shareholder democracy might harm long-term corporate value); Brian J. Bushee, *Do Institutional Investors Prefer Near-Term Earnings over Long-Run Value?*, 18 CONT. ACCT. RES. 207 (2001) (finding high levels of transient ownership are associated with an over-weighting of near-term expected earnings); Brian J. Bushee, *The Influence of Institutional Investors on Myopic Investment Behavior*, 73 ACCT. REV. 305 (1998) (arguing that high level of institutional ownership by institutions exhibiting high portfolio turnover, diversification, and momentum trading, significantly increases managerial incentives to pursue short-term projects); Tomislav Ladika & Zacharias Sautner, *The Effect of Managerial Short-Termism on Corporate Investment* (Feb. 2014) (finding that management with shortened timeframes for performance based compensation resulted in less real investment by corporations); Kevin J. Laherty, *Economic "Short-Termism": The Debate, the Unresolved Issues, and the Implications for Management Practice and Research*, 21 ACAD. MGMT. REV. 825, 832 (discussing short-termism as managerial opportunism).

[94] *See, e.g.*, Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 53 J. FIN. 1729, 1749 (2008) (finding that activist hedge funds generate long-term value); Lucian A. Bebchuk, Alan Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1138 (2015) (same); April Klein & Emanuel Zur, *Entrepreneurial Shareholder Activism: Hedge Funds and Other Private Investors*, 64 J. FIN. 187 (2009); Robin Greenwood & Michael Schor, *Investor Activism and Takeovers*, 92 J. FIN. ECON. 362 (2009); Mark J. Roe, *Corporate Short-Termism—In the Boardroom and in the Courtroom*, 68 BUS. LAW. 977, 1005 (2013) ("Overall, the evidence that financial markets are excessively short-term is widely believed but not proven, and there is much evidence pointing in the other direction."); Mark J. Roe, *Stock-Market Short-Termism's Impact*, 167 U. PA. L. REV. 71 (2018). For a perspective that "long-term bias" can also impose substantial costs on investors and be every bit as damaging as short-termism, see Michal Barzuza & Eric Talley, *Long-Term Bias*, 2020 COLUM. BUS. L. REV. 104.

[95] *Compare* Coffee & Palia, *supra* note 23, *with* Mark Roe & Roy Shapira, *The Power of Narrative in Corporate Lawmaking*, Harv. Pub. L. Res. Paper No. 20-21 (2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3703882.

[96] *See* De Bondt & Thaler, *Does the Stock Market Overreact?*, *supra* note 16; De Bondt & Thaler, *Further Evidence*, *supra* note 16; Daniel, Hirshleifer & Subrahmanyam, *supra* note 16; De Bondt, *supra* note 16.

[97] Colin Camerer, *Bubbles and Fads in Asset Prices*, 3 J. ECON. SURV. 3 (1989).

[98] S&P 500, GOOGLE FINANCE, https://www.google.com/finance/quote/.INX:INDEXSP?sa=X&ved=2ahUKEwiB7r7CtdfyAhXOTd8KHe0VCa4Q3ecFegQIJRAa&window=5Y (last visited Aug. 29, 2021).

the S&P 500 ended the year over ten percent higher than the earlier pre-pandemic peak.[99] These wild fluctuations, which plausibly reflect market overreaction to new information about the pandemic, provided control challengers with an opportunity to buy in cheap and potentially exploit temporary market fears when mounting a control contest.[100] In recognition of these risks, the two major proxy advisers—which advise institutional investors on how to vote in proxy contests and frequently support the challenger—modified their policies during the pandemic to give managers more freedom to stay the course during those unusual times.[101]

2. *Asymmetric Information*

Because market prices only reflect public information, the market will underprice the stock of a corporation whose board cannot disclose favorable inside information. During this period of undervaluation, a control contest could cause shareholders to forfeit the corporation's hidden value because they either tender their shares to a raider at too low a price[102] or lend their support to an inferior alternative business strategy proposed by an activist hedge fund in a proxy fight. Assume, for example, that a company knows that lands on which it holds an option sit atop vast and valuable mineral reserves. They may choose to withhold this information because they intend to buy up neighboring land. If an activist targets this company during this latency period, competent managers could well be mistakenly replaced. Managers may have a fiduciary duty *not* to disclose the information to the general public, even when facing a control contest, because divulging would be against the company's best interests. Meanwhile, federal securities law prohibits managers from

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[99] *Id.*

[100] *See* Ofer Eldar & Michael D. Wittry, *Crisis Poison Pills*, 10 REV. CORP. FIN. STUDS. 204 (2021) (finding that during the coronavirus pandemic, many firms adopted poison pills in response to declines in valuations, and stock prices increased upon their announcements).

[101] *See supra* notes 205–206 and accompanying text.

[102] This version of short-termism, called the "hidden value" theory, was analyzed by Professors Bernard Black and Reinier Kraakman in the context of the debate over hostile takeovers. They specified nine required assumptions for the hidden value claim to be valid: (1) the quality of the board's private information is very good; (2) the board's ability to communicate its private information to shareholders and potential acquirers is poor; (3) the magnitude of the board's private information is large; (4) hidden value can remain hidden for long periods of time; (5) most target boards are trustworthy, more so than shareholders believe; (6) an investment banker's opinion is a credible check on the target board's claim of hidden value; (7) hidden value often cannot be captured in the takeover market; (8) long-term shareholders and short-term shareholders have different interests, and long-term shareholder interests should control; and (9) the interests of undiversified investors count more than those of diversified investors. Black and Kraakman doubted that the required conditions are all likely to be true. "Under elementary principles of finance, even short-term investors have an incentive to maximize the firm's long-term value, because only by doing so can they maximize the price at which long-term investors will buy the shares that short-term investors will soon want to sell (the unity of long and short-term shareholder interests is known as Fisher separation)." Black & Kraakman, *supra* note 17.

selectively disclosing the information to just the control challenger, and control challengers may not want to receive nonpublic information because they wish to remain free to trade without risking insider trading liability.[103]

B. The Mistargeting Model

Imagine once more the stylized market described above with three types of firms: high-quality, low-quality, and average firms. The low-quality firms underperform because their managers are either incompetent or disloyal—that is, inept or greedy. However, the high-quality firms also underperform, either because they are pursuing innovative or long-term plans that are hard for the market to price, or because they are relying on confidential information that has not yet become public. To outsiders, high-quality and low-quality firms are indistinguishable, as both underperform by about the same margin—say, ten percent—relative to the average firms. By contrast, investors can largely tell the average firms from the high- and low-quality firms (because they perform about eleven percent better).

For example, assume the market has 100 firms and that half of them (fifty) are average. The others are split between twenty high-quality firms (twenty percent of the total) and thirty low-quality firms (thirty percent of the total). Assume that there are two time periods, T1 and T2. At T1, the average firms trade at $1 million, while the high- and low-quality firms both trade at $900,000. However, if time is allowed to run its course, the high-quality firms will be worth $1.1 million at T2, while the market capitalization of the average and low-quality firms remains unchanged.

[103] *See* 17 C.F.R. § 243.100(a) (prohibiting the selective disclosure of material nonpublic information); Salman v. United States, 137 S. Ct. 420, 427 (2016) (holding that gifting confidential information may violate insider trading laws). In a recent widely reported episode, the SEC brought an enforcement action charging that AT&T and three executives violated Regulation FD by selectively disclosing information to analysts, underscoring the risks associated with selective disclosure. Press Release, SEC Charges AT&T and Three Executives with Selectively Providing Information to Wall Street Analysts (Mar. 5, 2021), https://www.sec.gov/news/press-release/2021-43.

Table 1: No Activists or Raiders

	T1	T2
High-quality firms	20 x $900K = $18M	20 x $1.1M = $22M
Low-quality firms	30 x $900K = $27M	30 x $900K = $27M
Average firms	50 x $1M = $50M	50 x $1M = $50M
Total market capitalization	$95M	$99M

Now, however, assume that activists and raiders will target a certain subset of the high- and low-quality firms and turn them into average firms. We might first assume that they have perfect competence and no conflicts: they only target low-quality firms. Assume they will target twenty low-quality firms. In this case, we would see market value at T2 rise to $101 million instead of $99 million in the normal course, a $2 million improvement (twenty firms, each with $100,000 improvement). Control contests, assuming perfect competence and no conflicts, would be an unmitigated good.

However, a more interesting (and realistic) model is a world with mixed competence. Sometimes activists and raiders will correctly target low-quality firms, and sometimes they will mistakenly target high-quality firms. Suppose that their "accuracy rate" is sixty percent, meaning that challengers correctly choose low-quality firms sixty percent of the time, out of the total firms they target. Assume they target twenty-five firms in total. In this scenario, challengers will target ten high-quality firms and fifteen low-quality firms and transform them all into an average-quality firms. For every two high-quality firms that become average, three low-quality firms also become average. Under the assumptions of this example, these effects roughly cancel one another out in terms of market capitalization (and taking into account the costs of activists and raiders): $99.5 million market capitalization instead of the $99 million without control challengers.

Table 2: Sixty Percent Accuracy

	T1	T2
High-quality firms	20 x $900K = $18M	10 x $1.1M = $11M
Low-quality firms	30 x $900K = $27M	15 x $900K = $13.5M
Average firms	50 x $1M = $50M	75 x $1M = $75M
Total market capitalization	$95M	$99.5M

From this point, we can imagine at least two changes to the model: a change in the relative returns of high- and low-quality firms and a change in the rate of accuracy. First, assume that high-quality firms are fewer in number (with only ten firms), but are actually much *higher* quality then before. Now, high-quality firms are growth machines. They underperform now, at T1, but at T2 they really take off, becoming 400 percent more valuable than their average peers. That is, at T2, they are worth $5 million. Table 3 shows the outcomes when there are no control challengers.

Table 3: Growth Machine Model

	T1	T2
High-quality firms	10 x $900K = $9M	10 x $5M = $50M
Low-quality firms	30 x $900K = $27M	30 x $900K = $27M
Average firms	60 x $1M = $60M	60 x $1M = $60M
Total market capitalization	$96M	$137M

Assume, however, that activists and raiders are at work. Suppose they have an eighty-percent accuracy rate, meaning about one-fifth of the companies they target, on average, are high-quality ones, and they target 25 firms in total. That is, control challengers are even more accurate than before—they will mistarget five high-quality firms and properly target twenty low-quality firms. In this world, however, we can expect activists and raiders to do much more damage than before, even though they usually target the right firms, because the high-quality firms are worth so much more than the average-quality firms. Mistargeting is, therefore, a much more pressing risk.

Table 4: Principal Costs Illustrated (Growth Machine with Control Contests)

	T1	T2
High-quality firms	10 x $900K = $9M	5 x $5M = $25M
Low-quality firms	30 x $900K = $27M	10 x $900K = $9M
Average firms	60 x $1M = $60M	85 x $1M = $85M
Total market capitalization	$96M	$119M

In this world, corporate control contests do more harm than good. Without corporate raiders and shareholder activists, the market would have been worth $137 million, as shown in Table 3. But because control contests create more principal costs than they avert in agent costs, it turned out to be worth $119 million, as shown in Table 4. That $18 million difference represents the principal costs of control contests.

This effect can become even more pronounced with externalities. In the previous scenarios, control challengers targeted only a subset of the high- and low-quality firms, contesting control for only part of these firms. The other part continued doing business without interference. Now suppose that corporate boards and managers of high- and low-quality firms that have not been targeted realize they could nevertheless soon become the target of a control contest. To avoid such a control contest—and potentially losing their jobs if the challenger is successful—these incumbents change their companies' business strategies to make them less attractive targets to activists or raiders, such as by cutting R&D, taking on additional debt, and increasing share buybacks. Here, all high- and low-quality firms become average at T2, even though control challengers have targeted only a subset of the firms.

Table 5: Growth Machine with Control Contests and Externalities

	T1	T2
High-quality firms	10 x $900K = $9M	0 x $5M = $0
Low-quality firms	30 x $900K = $27M	0 x $900K = $0
Average firms	60 x $1M = $60M	100 x $1M = $100M
Total market capitalization	$96M	$100M

In this scenario, control contests destroy even more value. Without activists and raiders in the picture, the market would have grown from $96 million to $137 million. With activists and raiders intervening—but without externalities—the market grows from $96 million to $119 million. Add externalities into the model, and control contests even more dramatically dampen economic growth, with the market growing from $96 million to only $100 million.

Depending on the assumptions one makes about which firms generate outsized returns, and how likely raiders and activists are to destroy social wealth by mistakenly targeting high-quality firms, control contests can either be a net good or a net evil. More particularly, certain kinds of control contests may be—and indeed, this Article argues, *are*—more likely to result in mistargeting.

This Part has analyzed one of the key risks of corporate control contests: the mistargeting hazard. When the challenger gets things right, control contests reduce agent costs by getting rid of bad managers. But control contests can also create principal costs when the challenger gets rid of a good manager who is pursuing mispriced or confidential business strategies. Moving from the general into the particular, the next Part examines how activists and raiders are likely to differ in the extent to which they avoid agent costs and create principal costs. The mistargeting model presented in this Part lays the groundwork for understanding the profound differences between the two different types of control contestants.

III. The Costs of Raiders and Activists

The question of how raiders and activists make a buck at first seems purely theoretical: After all, both seek to change corporate business strategy by shifting control, and profit when those changes prove beneficial. But the differences in how raiders and activists pursue this goal influence both the types of firms they are likely to target and what happens after the challenger succeeds, and thus the benefits and costs they provide to shareholders and the market. Compared with corporate raiders who purchase the entirety of their targets' stock at a premium, hedge-fund activists have a relative hair-trigger for getting involved. This hair-trigger means they are more likely to correct managerial malfeasance before it rises to a staggering level. But it also means they are more likely to mistarget companies that would be better off left alone. In short, activists are more likely to both fix things that are broken and break things that never needed fixing.

The differences between raiders and activists do not end there. A close analysis of the different features of activists and raiders shows that activists are more likely than raiders to destroy social wealth after engaging in mistargeting, even controlling for each control challenger's willingness to intervene. This means that activists are more likely to both get involved and wrongly cause their targets to abandon sound business strategies when they do get involved.

This Part explores the relative costs of raiders and activists in light of the mistargeting hazard. Section III.A argues that activists are likely to impose greater principal costs than raiders because activists are more likely to engage in mistargeting and ultimately destroy social wealth. Section III.B turns to the available empirical evidence. Empirical studies offer equivocal evidence for the claim that activists increase shareholder value, and they suggest that any value created by activists is driven primarily by those activist efforts that eventually result in the target company's acquisition. In short, activists create value mainly by opening the door for raiders. As explained in the following Part, this has important implications for law and policy.

A. Raiders and Activists Compared

The key difference between the business models of activists and raiders is that an activist acquires a relatively small stake in the target company—generally less than ten percent—whereas a raider acquires the entire company. This difference leads to two important results. First, activists are simply more likely than raiders to engage in corporate control contests, including both warranted and unwarranted ones. This means that the presence of activists is likely to lead to both lower agent costs and higher principal costs than the presence of raiders alone. Second, activists are more likely than raiders to destroy social wealth after engaging in mistargeting, even controlling for their willingness to intervene. This suggests that activists impose greater principal costs than raiders, independent of the greater propensity of activists to engage in control contests.

1. Propensity to Intervene

Activists have a greater potential than raiders to both reduce agent costs and increase principal costs due to activists' greater propensity to engage in control contests. As previously explained, activist hedge funds have a lower hurdle rate than corporate raiders.[104] As a result, activists will be willing to target a wider range of firms, even when the firm's apparent underperformance is relatively modest. That means that activists will engage in control contests

[104] *See supra* section I.A.

where raiders would sit on the sidelines. When activists target the right companies—and correct actual managerial incompetence or disloyalty—that additional engagement will translate into lower agent costs for shareholders and the market. When they target the wrong companies—undervalued because of idiosyncratic vision, short-termism, market mispricing, or lack of confidential information—that additional engagement will translate into higher principal costs for shareholders and the market. Thus, the presence of activists can be expected to both reduce agent costs and increase principal costs to a greater extent than would the presence of raiders alone.

Externalities amplify these effects. As previously noted, the presence of activists and raiders in the market can dissuade managers from pursuing strategies that they believe may make them the target of a control contest, even at firms that activists and raiders have not targeted.[105] To the extent managers are dissuaded from generating agent costs through disloyalty or incompetence, that is a positive externality.[106] To the extent managers are dissuaded from pursuing idiosyncratic, long-term, or confidential business strategies that would create value, that is a negative externality.[107] Because activists are willing to target a wider range of firms, the presence of activists in the market will increase both positive and negative externalities more than would the presence of raiders alone.

2. Likelihood of Destroying Social Wealth

So far, we have shown that activists are more likely than raiders to engage in control contests because activists have lower hurdle rates. If the contestant's hurdle rate were the only factor that distinguished activists from raiders, the relative impacts of activists and raiders on firm value would depend solely on whether control contests generally increase or decrease the net sum of principal and agent costs. If control contests decreased the net sum of principal and agent costs, then activists would do more to improve firm value than would raiders alone. If control contests increased the net sum of principal and agent costs, by contrast, then activists would reduce firm value more than would raiders alone.

But a careful examination of the different features of activists and raiders suggests that raiders are likely to impose lower principal costs than activists, even controlling for each contestant's hurdle rate, because raiders are less likely to mistakenly destroy social wealth after

[105] *See supra* section I.B.
[106] *See* Gantchev *supra* note 22
[107] *See supra* note 23.

mistargeting has occurred. While activists must execute their competing business strategies to achieve their goals of increasing firm value within the time horizon of their investments, raiders are not so bound. As investors who buy the entire company, raiders can effectively look under the hood to determine whether changes are necessary after all, reducing the likelihood that they will make the wrong decision based on market mispricing or asymmetric information. Thus, when they recognize that they have mistargeted, raiders are less likely to mistakenly cause the newly acquired company to abandon a profitable business strategy, thereby destroying social wealth. Instead, the raider can elect to allow the firm to continue its existing business strategy, thereby preserving social wealth.

i. Market Mispricing

Returning to our mistargeting model, the first salient difference between raiders and activists relates to market mispricing. Raiders are less likely than activists to mistakenly destroy idiosyncratic vision or long-term investments, or because the market has temporarily misinterpreted the significance of new information. Two factors explain this result. First, because they buy 100 percent of the corporation, raiders will receive more in information after targeting a firm, meaning they are more likely to understand when a firm is engaged in an innovative, long-term, or hard-to-value business plans, as opposed to underperforming for other reasons.[108] Second, when the dust settles on a corporate raid, the raider ends up with 100% of the target stock, meaning what is good for the target is good for the raider. If the raider can be convinced that the business plan will be more profitable over the long term than a strategy of spinoffs or dividends, it will naturally allow the plan to proceed either with the existing board or with its own board.[109]

Activists are unlikely to have the luxury of waiting for an idiosyncratic vision or long-term business plan to pay off. Generous estimates of hedge fund involvement put their median time horizon between one and two years.[110] Moreover, when successful, their methods tend to involve

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[108] *See*, Julian Franks and Colin Mayer, *Hostile Takeovers and The Correction of Managerial Failure*, 40 J. FIN. ECON. 163 (1996) ("the high board turnover does not derive from past managerial failure").

[109] *See* Julian Franks, *et al.*, *Who Disciplines Management in Poorly Performing Companies?* 10 J. FIN. INTERM. 209 (2001) ("Bidders replace a high proportion of management of companies acquired in takeovers but do not target poorly performing management").

[110] Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729, 1749 (2008) (identifying 369 days for the period between Schedule 13D filing and divestment, and 319 as the median duration in the case of hostile transactions); Alon Brav, Wei Jiang & Hyunseob Kim, *Hedge Fund Activism: A Review*, 4 FOUNDATIONS AND TRENDS IN FIN. 1, 18, tbl. 4.2 (2010) (identifying 266 day period between Schedule 13D filing and divestment)

increasing a company's debt load and distributing its cash.[111] Predictably, these interventions result in a spike in short-term value but often scuttle long-term growth.[112] High debt loads and low cash reserves are likely to hamper innovative business plans requiring substantial investments to carry out. And realizing the gains of complex business plans that distinguish a firm from its peers is incompatible with the strategy of increasing debt load, distributing cash, and moving on. Thus, even if convinced the payout would be greater in the long run, the activist may be ready to sacrifice that long-term gain for short-term profits. Indeed, the business model of activist hedge funds requires them to generate consistent abnormal short-term returns or risk their investors fleeing to other funds that are generating such returns.[113] Moreover, even if the activist learns new information after obtaining a seat on the company's board, the activist will face structural conflicts that impede it from objectively assessing whether to change the company's business. If the activist backs off, it is effectively conceding to the market that it was wrong, which will cause the activist to lose credibility in future campaigns.[114] As repeat players, activists have strong incentives to avoid such a result.[115] Activists are thus more likely than raiders to introduce principal costs by scuttling innovative or long-term business plans that are hard for the market to value.

ii. Asymmetric Information

The second difference between raiders and activists relates to asymmetric information. In short, raiders are less likely than activists to mistarget a firm because of asymmetric information and change the company's business strategy for the worse. Activists that buy into a firm that only *appears* to be underperforming because undisclosed information puts the true value well above the stock price have no means of discovering this undisclosed information. Indeed, securities

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[111] Klein & Zur, *Hedge Fund*, *supra* note 11, at 5.
[112] Mark R. DesJardine & Rodolphe Durand, *Disentangling the Effects of Hedge Fund Activism on Firm Financial and Social Performance*, 41 STRAT. MGMT. J. 1054, 1078–79 (2020).
[113] *See* Coffee & Palia, supra note 23, at 48.
[114] *See supra*, note 13.
[115] Although it is theoretically possible that activists could try to develop a reputation for being fair-minded by adjusting their views based on nonpublic information learned after joining the board, we doubt that this is widespread as an empirical matter. To the contrary, anecdotal evidence suggests that activists generally do not approach things with an open mind after obtaining board representation, as highlighted by the Delaware Court of Chancery's finding that an activist hedge fund manager who obtained a board seat breached his fiduciary duties as a director by continuing to single-mindedly pursue the announced objective of his activist campaign after joining the board. In re PLX Tech. Inc. Stockholder Litig., Consol. C.A. No. 9880-VCL, 2018 WL 5018535 (Oct. 16, 2018). In any event, even if activists may adjust their views in certain situations, they seem less likely than raiders to do so.

regulation and directors' fiduciary duties may affirmatively prevent the company from sharing confidential information with an activist—even though sharing that information could avert a proxy contest—and the activist may not want to receive such information because it wishes to remain free to trade without risking insider trading liability.[116] Here too, even if the activist learns new information after obtaining a seat on the company's board, the activist, as a repeat player who needs to guard its reputation,[117] will face structural conflicts that impede it from objectively assessing whether to change the company's business. Meanwhile, the impact of that proxy contest could thwart the company from realizing the value of its trade secrets and other confidential information. To return to the example of the minerals company sitting on a secret discovery, an activist might target this company during the latency period between discovering the reserves and revealing them to the market. If the activist succeeds, the increased debt load and decreased cash reserve may prevent the company from capitalizing on its discovery by buying nearby land.

A raider that acquires 100 percent of the target's share does not generate the same concern. Once a raider has 100 percent of the target's shares, the incumbent managers can divulge everything they know to the raider without running afoul of securities laws, fiduciary duties, or other concerns.[118] Therefore, if a firm has hidden value, the raider is likely to realize it. The activist is thus less likely than the raider to perceive that hidden value exists, and more likely to conclude that agent costs are the reason for the firm's low share price. It follows that activists are more likely than raiders to mistakenly push for changes to a company's business strategy that would appear unwise if the company's trade secrets or other hidden information were public knowledge.

The amount of time it takes to complete a hostile takeover relative to a proxy contest provides an additional reason that asymmetric information is more likely to be problematic in the activist context than the takeover context. As explained in greater detail in Part IV, courts have generally allowed target management to use defensive measures to slow down a hostile tender offer and force the raider to mount a proxy contest as a precursor to gaining control.[119] After the

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[116] *See supra* note 103 and accompanying text (describing the effect of Regulation FD and insider trading prohibitions).
[117] *See supra,* note 13
[118] The securities law prohibition on selective disclosure applies only to public companies, which is not a concern for a raider once it completes the acquisition. 17 C.F.R. § 243.101(b) (issuers subject to Regulation FD include those with a class of securities registered under Section 12 of the Securities Exchange Act of 1934 or required to file reports under Section 15(d) of the Exchange Act). Meanwhile, there is no risk of insider trading liability if the raider is the sole shareholder because there is no risk that the raider will engage in prohibited trading.
[119] *See infra* Section IV.A.1.

proxy contest, additional steps such as negotiating the deal and obtaining antitrust approval will be necessary.[120] This means that a hostile takeover usually takes longer than an activist challenge. To the extent there is asymmetric information, the information is more likely to be disclosed during this longer period than during the relatively short period it takes to mount an activist challenge.

3. Cost-Shifting

Another difference between raiders and activists is that activists can more easily shift their costs onto other shareholders, whereas raiders must buy those shareholders out at a premium. The target firm can be thought of as a car: Activists plan to lease the car and then give it back, while raiders intend to buy it and either keep it for its useful life or sell it for value. The buyer is more likely than the renter to do its best to protect the car. This is partly because the buyer (raider) has more at stake as an absolute matter, and partly because the renter (activist) can shift some costs onto other parties—the dealer and future owners—while the buyer cannot. Put another way, raiders have to eat their own cooking. Raiders, then, are more likely to avoid the social loss of a mistargeted firm.

This difference in the ability to shift costs has two relevant implications. First, the premium paid out to other shareholders offsets the cost of a mistake by the selling target shareholders. While the large premium that raiders must offer limits the range of underperforming firms they can target profitably, it also provides an offsetting benefit in that it compensates diversified shareholders for mistargeting risk. Thus, both raiders and activists might mistarget a firm, buying an undervalued firm at a discount (the raider) or replacing a high-quality strategy with a middling strategy (the activist). A raider, however, at least partly compensates diversified shareholders for this risk by paying them a premium for their shares. The compensation will be even greater if the announcement of a tender offer puts the target "in play," drawing other raiders into a bidding contest.[121] Activists offer no such compensation, suggesting that they impose higher principal costs on diversified shareholders than raiders do.[122]

[120] *See* Fed. Trade Comm'n, *Premerger Notification and the Merger Review Process*, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/mergers/premerger-notification-merger-review (last visited Aug. 29, 2021).
[121] *See* Gilson, *supra* note 37.
[122] That said, raiders may also take a greater portion of the profits when they successfully improve the performance of an underperforming company. The difference between the purchase price and the pro forma value that the raider realizes (minus the raider's other costs) is pure profit for the raider. In theory at least, activists may share a greater portion of those profits with other shareholders. In practice, the sharing of activists's profits with diversified

Second, the ability of activists to shift their costs onto other shareholders means that activists can benefit even when they mistarget and destroy value, while raiders will generally not destroy value when they engage in mistargeting. Suppose that an activist mistakenly targets a high-value firm that only appears to be underperforming and then causes it to abandon its high-value business strategy. Even though it has destroyed value, the activist may still benefit to the extent the market perceives the changes caused by the activist as increasing the firm's value—whether due to market mispricing or asymmetric information—and bids up the company's stock price. The activist would then sell its stock—which it bought before the market bid up the price—for a profit. By contrast, although raiders can also benefit from mistargeting, they are less likely to destroy value. Raiders cannot shift their costs onto others, so they will ultimately refrain from imposing changes in strategy that are likely to decrease shareholder value. While the raider's mistargeting may cause a wealth transfer from other shareholders to the raider, such a wealth transfer would not be socially inefficient. The overall size of the pie would remain the same, even if there is a change in the allocation of the slices of the pie.

4. Offsetting Effects of Shareholder Screening

Shareholders have an incentive to screen bad proposals and so might be expected to curb the risk of mistargeting. If an activist mistargets a shareholder's portfolio firm, the shareholder loses out because long-term returns would have been greater without the control contest. If a raider mistargets a firm, the shareholders may sell for a premium that—although above market—is less than what the firm ultimately turns out to be worth. Thus, in either case, shareholders have a reason to discern good control contests from bad ones. While the role of shareholders at first seems promising, however, capacity and competence limitations cast doubt on the ability of shareholders to screen control contests.

To begin, because activist hedge funds do not offer shareholders a premium, they give those shareholders even more reason to screen than in the case of raiders. And we can expect that recent market changes have made the screening of activists more effective. Institutional shareholders, who are considered sophisticated, now own a large proportion of the shares of public

shareholders decreases to the extent that activists (1) accumulate large stakes at the initial, unaffected market price before disclosing their involvement to the public; or (2) in an effort to form a "wolf pack," tip off other activist hedge funds who buy stock at that same initial, unaffected market price before the activist's involvement is disclosed.

corporations.[123] Moreover, securities regulation has increased the amount and quality of information disclosed to the market, and market efficiency has also increased over the years.[124] Despite these changes, there are several reasons to suspect that screening still does not prevent mistargeting by activist hedge funds.[125]

First, not all institutional investors invest in information. Most prominently, index funds[126] invest very little in being informed about the quality of the managers at their portfolio companies.[127] The exchange of information between activists and institutional investors is unlikely to remedy this problem. In mounting a control contest, an activist hedge fund tries to persuade shareholders that the company is mismanaged, not undervalued. Second, many informed institutions will not hold share blocks that are large enough to justify becoming more informed than the hedge-fund activist.[128] Indeed, it is only because the institutional investor is insufficiently informed, or is committed to an indexing strategy, that it might hold low-quality firms in its portfolio in the first place. Third, some activist funds pursue the "wolf pack" tactic, in which several funds target the same firm, thereby acquiring, in combination, a large share block.[129] Since the pack's members tend to vote together, the "lead wolf" (the fund that initiates the contest) can succeed by persuading a relatively small fraction of the other shareholders to grant their proxies.[130] In other words, even if most unaffiliated shareholders vote *against* the activist, a small number of mistaken shareholders could doom the rest. The bottom line is that the factors that lead diversified

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[123] *See* Gilson and Gordon, *supra* note 59.

[124] Jeffrey N. Gordon, *The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices*, 59 STAN. L. REV. 1465 (2007) (analyzing the relationship between improved market efficiency and the rise of independent directors).

[125] *See generally* Alessio M. Pacces, *Exit, Voice and Loyalty from the Perspective of Hedge Funds Activism in Corporate Governance*, 9 ERASMUS L. REV. 199, 207–11 (2016) (analyzing the capacity of institutional investors to screen activist proposals).

[126] Index funds are a passive investment vehicle aiming at replicating a given market index (e.g., S&P 500, NASDAQ 100) by purchasing the securities composing the given index.

[127] *See* Lucian Bebchuk & Scott Hirst, *Index Funds and the Future of Corporate Governance: Theory, Evidence, and Policy*, 119 COLUM. L. REV. 2029, 2050–59, 2075–84, 2095–97 (2019) (describing index fund managers' incentives to underinvest in stewardship and the evidence in support of this theory). And index funds is a passive investment vehicle aiming at replicating a given market index (e.g., S&P 500, NASDAQ 100) by purchasing the securities composing the given index. Anna Agapova, *Conventional Mutual Index Funds Versus Exchange-Traded Funds*, 14 J. FIN. MARKETS 323 (2011).

[128] *See* Gilson & Gordon, *supra* note 59.

[129] Thomas W. Briggs, *Corporate Governance and the New Hedge Fund Activism: An Empirical Analysis*, 32 J. CORP. L. 681, 685 (2007); Coffee & Palia, *supra* note 23; Tanja Artiga González & Paul Calluzzo, *Clustered Shareholder Activism*, 27 CORP. GOV. 210 (2019).

[130] Coffee & Palia *supra* note 23.

shareholders to delegate authority in the first place—insufficient information, conflicts of interest, and collective-action problems—also make them unlikely to be effective screeners of control contests. Finally, self-interested boards who want to avoid losing their seats in a proxy fight may agree to activist demands before other shareholders get a chance to give their views. Indeed, most activist campaigns are resolved before even reaching the proxy fight stage, with settlements being about twice as common as voted proxy contests.[131]

Notably, shareholder screening cannot improve through learning. After an activist campaign is done, it is unobservable whether the activist reduced agent costs or increased principal costs. Go back to our example of the outlier firm investing 7% of cash flows in R&D compared to the 3% of its peers. If the market undervalues the firm because investors mistakenly believe managers are overinvesting in a "pet" project, a successful activist's campaign slashing the R&D budget will increase the share price even if the managers were in fact developing path-breaking technology.

In addition, shareholders may be particularly poor screeners of activists as opposed to raiders. Activists ask shareholders to vote on a substantive *business question*—whether to replace the board or pursue a particular business strategy. Institutional investors, whose core function is selecting investments, do not specialize in making these business decisions. Raiders ask these investors to make an *investment choice*—whether to sell their shares at a particular price. This decision depends on the potential future value of a company, a question that institutional investors *are* supposed to be experts at predicting. At least, in theory, screening a corporate raid should be easier for these large-scale shareholders than screening an activist proxy contest.[132]

B. The Empirical Evidence

In the previous section, we considered the likely impacts of raiders and activists on firm value along two dimensions: (1) the relative propensity of raiders and activists to engage in control contests; and (2) the likelihood that each contestant will destroy social wealth after engaging in mistargeting, controlling for the propensity to intervene. We argued that, given their greater propensity to contest corporate control, activists are likely to both decrease agent costs and increase

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[131] *See supra* note 47 and accompanying text.
[132] *See*, Melvin Aron Eisenberg, *The Legal Roles of Shareholders and Management in Modern Corporate Decisionmaking*, 57 CAL. L. REV. 1 (1969) (discussing the different types of decisions).

principal costs more than would raiders alone. We also argued that, holding constant each contestant's propensity to intervene, raiders are less likely to engage in value-destructive mistargeting and are therefore likely to impose lower principal costs.

The foregoing analysis suggests that the relative impacts of raiders and activists on firm value depend on both the aggregate effect of control contests on the net sum of principal and agent costs and the channels through which raiders and activists create or destroy that value. This section turns to the relevant empirical evidence bearing on these issues.

On the whole, the evidence that activists generally decrease agent costs more than they increase principal costs is equivocal. And to the extent that activists do create long-term value, the evidence suggests that this effect is driven primarily by those activist efforts that eventually result in the target's acquisition. In other words, activists primarily add value not by improving governance and cutting agent costs, but rather by acting as auctioneers and selling off the companies they target to raiders.

Meanwhile, studies show that the returns in the stock market are positively skewed—a small number of firms generate most of the returns in the stock market—making the loss from breaking a good firm greater than the benefit of fixing a bad one. Additionally, companies whose business strategies are particularly susceptible to mistargeting risk—companies with innovative, long-term business strategies that are difficult for the market to value and require substantial upfront investment—appear to drive the bulk of economic growth in the United States. These facts suggest that principal costs—and not agent costs—are the main threat to shareholder value and the broader economy. Given that raiders are likely to impose lower principal costs than activists, this provides an additional reason to question the value of activists relative to raiders. Overall, this analysis suggests that the conventional view that corporate raiders should be kept out while activists should be encouraged has it backward.

1. Agent Costs in Focus

If activists do more to decrease agent costs than increase principal costs, we would expect to see large and durable gains from shareholder activism. Indeed, the premise of most empirical studies on activism is that outperformance of targeted companies over non-targeted companies proves the social benefits of activism.

As a threshold matter, our model provides reason to question this premise because the stock price of a targeted company may increase even where social value is destroyed. When an activist transforms an "underperforming" high-quality firm into an average firm, the stock price will go up and the activist will show a profit. The social loss from the abandoned business strategy will fall on the long-term shareholders and will not necessarily be captured by the empirical study. Although certain studies employ "matching" techniques that try to overcome this difficulty by comparing the targeted firms to a control group of untargeted firms with similar characteristics,[133] unobserved differences between the targeted and matched firms may limit the effectiveness of this causal identification strategy.[134]

In any event, even accepting this premise, the evidence that activists positively affect shareholder value is equivocal. Empirical studies have indicated that shareholder gains are ephemeral and uncertain. Rather, evidence suggests that hedge-fund activists are generally successful in generating shareholder gains only when the activism ultimately results in a sale of the target company.[135] In other words, the proper role of hedge fund activists, if any, is to act as an auctioneer for corporate raiders. This insight should color our understanding of the social consequences of activists and raiders.

Studies of stock returns after the announcement that a company is the target of a hedge-fund activist seem to show an initial premium,[136] but are split as to whether targets exhibit abnormal long-term gains.[137] And one of the more recent studies suggests that the earlier studies

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[133] *See, e.g.*, K.J. Martijn Cremers et al., *Hedge-Fund Activism and Long-Term Value* (Dec. 13, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 (finding that targeted firms underperformed non-targeted firms).

[134] Pacces, *supra* note 125, at 206–07 & n.78. *See also* Alon Brav et al., *The Long-term Effects of Hedge Fund Activism: A Reply to Cremers, Giambona, Sepe, and Wang*, HARV. L. SCH. F. ON CORP. GOV. (Dec. 10, 2015), https://corpgov.law.harvard.edu/2015/12/10/the-long-term-effects-of-hedge-fund-activism-a-reply-to-cremers-giambona-sepe-and-wang (criticizing the Cremers et al. study, *id.*).

[135] *See* Greenwood & Schor, *supra* note 94, at 362–63.

[136] *See* Klein & Zur, *supra* note 11; Alon Brav et al., *Hedge Fund Activism, Corporate Governance, and Firm Performance*, 63 J. FIN. 1729 (2008).

[137] DesJardine & Durand, *supra* note 112, at 1055 ("While less disagreement surrounds the evident increases in firms' market value immediately after hedge fund campaigns, questions remain whether the benefits of such interventions by activist hedge funds extend beyond short-term shareholders to also advantage longer-term shareholders and other stakeholders." (citation omitted). *Compare* Lucian A. Bebchuk, Alan Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085 (2015) (presenting evidence that hedge-fund activism has produced long-term gains), *with* DesJardine & Durand, *supra* note 112 (finding evidence of short-term gains for shareholders that reversed in later years), *and* K.J. Martijn Cremers et al., *Hedge-Fund Activism and Long-Term Value* (Dec. 13, 2018) (unpublished manuscript), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2693231 (arguing that selection effects explain prior findings that hedge-activism improves firm value). *See also* Alon Brav et al., *The Long-term Effects of Hedge Fund Activism: A Reply to Cremers, Giambona, Sepe, and Wang*, HARV. L. SCH. F. ON CORP. GOV. (Dec. 10, 2015), https://corpgov.law.harvard.edu/2015/12/10/the-long-term-effects-of-hedge-fund-activism-a-reply-to-cremers-giambona-sepe-and-wang (criticizing the Cremers et al. study).

that purport to associate hedge-fund activism with long-term returns suffer from a faulty research design because they use equal-weighted returns instead of value-weighted returns.[138] This recent study shows that the equal-weighted returns are driven by the smallest twenty percent of firms; and on a value-weighted basis, which likely best reflects the effects on shareholder wealth and the economy, activism-related returns are statistically insignificant.[139] Meanwhile, certain studies are subject to differing interpretations. For example, one study from the international context finds that when the Korea Corporate Governance Fund announced the first activist campaign in Korea, other (non-target) companies experienced a stock price increase negatively related to governance measures (*i.e.*, the more insulated boards and managers are from shareholder control, the more the company's stock rose in response to the threat of activism).[140] Based on that finding, the authors concluded activism has a positive wealth effect. But the finding that the threat of activism caused stock prices to rise more for firms that are insulated from shareholder control could just as easily be interpreted to yield the opposite conclusion—insulated firms experienced positive abnormal returns because they were harder for activists to screw up with value-destructive intervention.

To the extent that activists do create long-term value among target corporations, this effect seems to be driven by those activist efforts that eventually result in the target's acquisition. A study of 980 instances of shareholder activism over thirteen years (most of them by hedge funds) showed that an activist's involvement increases the chance that a corporation will be acquired by eleven percent.[141] Of the 980 target firms, 226—nearly a quarter—were the subject of an acquisition or an acquisition announcement within eighteen months.[142] These firms far outperformed their peers that were not acquired, and indeed were responsible for abnormal returns following the announcement of shareholder activism.[143] Two recent studies come to similar conclusions, though one study concludes that activism still produces some (modest) positive returns even when the activist does not demand a sale.[144] This evidence suggests that the stock premium following the

[138] *See* Ed deHaan, David F. Larcker & Charles McClure, *Long-Term Consequences of Hedge Fund Activist Interventions*, 24 REV. ACCT. STUDS. 536 (2019).
[139] *Id.*
[140] *See* Dong Wook Lee & Kyung Suh Park, *Does Institutional Activism Increase Shareholder Wealth? Evidence from Spillovers on Non-target Companies*, 15 J. CORP. FIN. 488, 509 (2009).
[141] *See* Greenwood & Schor, *supra* note 94, at 364, 372.
[142] *Id.* at 368.
[143] *Id.* at 369–70.
[144] *See* deHaan, Larcker & McClure, *supra* note 138, at 541 (finding "little evidence that commonly discussed strategy and governance motivations for activist interventions have consistent associations with improvements in shareholder

announcement of an activist campaign primarily reflects the possibility that the campaign will result in a takeover, rather than any likely governance or operational changes.[145] As one private equity manager remarked, the role of activists is not stirring things up within their target companies but "teeing up deals," resulting in the target firm "being driven into some form of auction."[146]

This evidence suggests activists play a limited role in reducing agent costs at target firms. If they did play a meaningful role, activists would trigger large-scale governance and operational changes that result in statistically and economically significant changes in accounting metrics or stock price. This is not the case. Instead, activists generate value primarily by "teeing up deals" for potential acquirers.[147] Especially when compared with principal-cost effects, agent costs are a thin reed on which to rest scholarly and judicial justifications for the role of activists.

2. Principal Costs in Focus

How great is the risk (and cost) of mistargeting? If principal costs in the form of mistargeting are the greater threat to shareholder value, this would provide a reason to be more skeptical of activists than raiders, which are less likely to mistarget and destroy social wealth. Two strands of empirical studies suggest that we should expect principal costs to be a higher risk than agent costs. The first is the empirical observation that the returns in the stock market are not normally distributed—they are positively skewed.[148] A small number of firms account for most of the return in the stock market, making the cost of breaking a high-quality firm greater than the benefit of fixing a low-quality firm. The following graph shows how stocks, when sorted from

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wealth," and "nearly all the positive long-term returns to activist interventions are concentrated among firms that are subsequently acquired"); Edward P. Swanson, Glen M. Young & Christopher G. Yust, Are All Activists Created Equal? The Effect of Interventions by Hedge Funds and Other Private Activists on Long-Term Shareholder Value 3, 57 tbl.2 (Mays Bus. Sch. Res. Paper No. 2823067, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2823067 (finding that "[a]nnouncement returns are especially large at 17.36% when activists demand a sale of all, or part, of the company," while "abnormal returns for non-sale demands are" smaller at 3.91 percent but still "statistically and economically significant"). Swanson, Young, and Yust's finding that activism still produces modest positive returns even when the activist does not demand a sale would be consistent with market expectations that there is still a possibility, however slight, that the activist intervention will result in a sale.

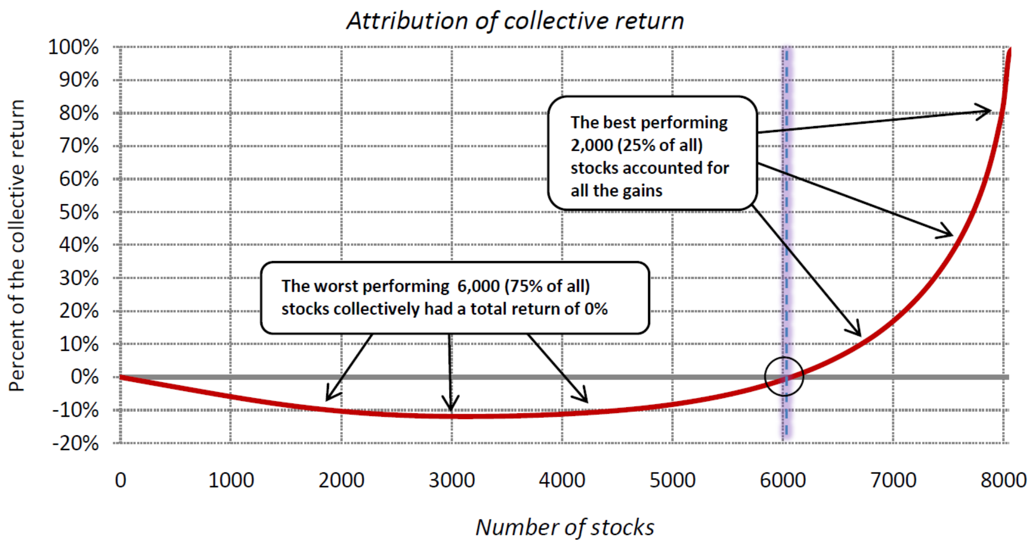
[145] Greenwood & Schor, *supra* note 94, at 363 ("Under this hypothesis, the high returns documented around the announcement of activism reflect investors' expectations that target firms will be acquired at a premium to the current stock price."); deHaan, Larcker & McClure, *supra* note 138, at 541.

[146] Andrew Ross Sorkin, *Will the Credit Crisis End the Activists' Run?*, N.Y. TIMES: DEALBOOK (Aug. 27, 2007), https://dealbook.nytimes.com/2007/08/27/will-credit-crisis-end-the-activists-run.

[147] *Id.*

[148] Bessembinder, *supra* note 27.

least profitable to most profitable, contributed to the total gains produced from all stocks from 1983 to 2007.[149]



A minority of stocks (25%) are responsible for the majority of the market's gains. In other words, according to the findings of this study, mistargeting one good firm will inflict costs higher than the benefits of fixing three bad firms.

Moreover, another study found that between 1926 and 2016, just four percent of publicly listed companies (1,100 firms out of the 25,332 firms in the study) accounted for *all* economic growth.[150] Beyond these best-performing firms, an additional 9,579 firms (37.81%) created positive wealth over their lifetimes, just offset by the wealth destruction of the remaining 14,661 (57.88%) firms. Stripped of these four percent of the top firms, the stock markets in aggregate failed to outperform U.S. Treasury bonds.

However, even disregarding the wealth creation of the top performers, overall, the study shows that only 30.8% of individual common stocks generated lifetime buy-and-hold returns that exceed the performance of the value-weighted portfolio of all common stocks over the matched time intervals, and only 26.1% outperformed the equal-weighted portfolio. In other words, one of three firms creates more value than the other two destroyed. Mistargeting, even a small subset of

[149] *See The Capitalism Distribution*, *supra* note 29.
[150] Bessembinder, *supra* note 30, at 441.

the top performers companies, will result in a substantial social loss, and more generally, mistargeting one good firm will inflict more damage than the benefits of fixing two bad ones.

The second strand provides evidence that activism indeed results in a decrease in R&D investment at firms, giving credence to the idea that control challenges can deter idiosyncratic vision and long-term investment strategies.[151] Together with the insight that firms engaged in innovative investment projects drive most economic growth, these results suggest that activists may inflict more principal costs than they avert in agent costs.

Activists have a tendency to reduce investment expenditure at target firms. Some do so explicitly. For example, Professors John Coffee and Darius Palia detail how storied chemical company DuPont, faced with a proxy contest by Trian, a prominent activist fund, slashed its R&D

[151] *See* Coffee & Palia, *supra* note 23, at 53 (concluding based on a review of the literature that activism results in a decrease in R&D investment). Some research finds evidence of increased innovation "efficiency" and purports to show that activism also improves innovation "output," as measured by patent counts and citations, notwithstanding the decrease in R&D. *See* Alon Brav et al., *How Does Hedge Fund Activism Reshape Corporate Innovation?*, 130 J. FIN. 237 (2018) [hereinafter Brav et al., *Innovation*]; Tingfeng Tang, *Hedge Fund Activism and Corporate Innovation*, 85 ECON. MODELING 335 (2020). However, the studies' relatively short timeframes and chosen measures for innovation output limits their ability to speak to the extent to which activism deters idiosyncratic vision or valuable long-term investment strategies. One study looks only two years beyond the activist intervention, Tang, *supra*, at 342 tbl.5, and the other looks five years beyond the intervention without disentangling the effects by year, Brav et al., *Innovation*, *supra*, at 258 tbl.10. The value of many, if not most, valuable idiosyncratic visions and long-term investment strategies is unlikely to become apparent in those short timeframes, especially using the studies' chosen measures for innovation output (patent counts and citations). Patent attorneys advise that it takes years on average just to obtain an issued patent after applying, to say nothing of the years of research that must precede the filing of a patent application. *See, e.g.*, Vic Lin, *How Long Is the US Patent Application Process (How Much Time Does It Take to Get a Utility Patent)?*, PATENT TRADEMARK BLOG | IP Q&A, https://www.patenttrademarkblog.com/how-long-us-utility-patent-application-process (last visited July 7, 2021). In addition, R&D can be helpful not only in developing patented technologies, but also for other purposes, such as teaching companies how to assimilate and exploit external information. Wesley M. Cohen & Daniel A. Levinthal, *Innovation and Learning: The Two Faces of R&D*, 99 ECON. J. 569 (1989). Meanwhile, Brav and his coauthors find that hedge fund activists reduce technological diversity, Brav et al., *supra*, which presents a tradeoff because technological diversity may have other benefits that the Brav and Tang studies do not capture. *See* Cristina Quintana-García & Carlos A. Benavides-Velasco, 37 RES. POL'Y 429 (2007) (presenting evidence that technological diversity benefits innovative competence, with especially strong effects on exploratory innovative capability); Po-Hsuan Hsu et al., *Natural Disasters, Technology Diversity, and Operating Performance*, 100 REV. ECON. & STATS. 619 (2018) (finding evidence that technological diversity enhances firms' sustainability). Finally, other research is consistent with the view that public markets have often undervalued idiosyncratic vision and long-term business strategies, though the jury is still out on the magnitude of the short-termism problem. *See, e.g.*, Mustafa Ciftci, Baruch Lev & Suresh Radhakrishnan, *Is Research and Development Mispriced or Properly Risk Adjusted?*, 26 J. ACCT., AUDITING & FIN. 81 (2011) (presenting evidence that short-term undervaluation of R&D is due to mispricing); David Hirshleifer, Po-Hsuan Hsu & Dongmei Li, *Innovative Originality, Profitability, and Stock Returns*, 31 REV. FIN. STUDS. 2553 (2018) (presenting evidence that innovative originality is undervalued by the market); Anne Marie Knott & Carl Vieregger, *Reconciling the Firm Size and Innovation Puzzle*, US Census Bureau Ctr. For Econ. Studs. Paper No. CES-WP-16-20 (2018) (arguing that large firms are acting rationally in increasing R&D investments). *But see* Roe, *Corporate Short-Termism, supra* note 85 (arguing there is little evidence that short-termism is a pervasive problem); Barzuza & Talley, *supra* note 94 (arguing "long-term bias" may be equally problematic).

spending.[152] However, the investment-reduction effect is not limited to target firms. Rather, as Professors Coffee and Palia explain, high-profile campaigns have the effect of reducing investment expenditures across the market.[153] In other words, a significant effect of hedge-fund activism is not to correct governance abuses, but to cut back on idiosyncratic investment not producing immediate returns.[154]

The result may be a massive and unobserved stifling of economic growth. It is impossible to count the number of companies that have cut back on investments because of the *threat* of shareholder activism. Indeed, empirical studies on hedge-fund activism generally do not attempt to estimate the impact of hedge-fund activism on untargeted firms (*i.e.*, the externalities of activism). Market data suggests, however, that the type of investments most likely to be deterred by hedge-fund activism drive most economic growth. More recently, the accounting firm Deloitte reported that as of 2019, information services were by far the largest contributor to GDP growth,[155] and it will surprise nobody to know that Silicon Valley's technology ventures are a major driver of economic productivity. These ventures often begin as quixotic startups and require a good deal of idiosyncratic vision and early investment to get off the ground. Together, these trends indicate that most economic growth arises from bold business ideas that may at first elude appreciation by the markets. In turn, this suggests that by deterring this type of investment, activists and raiders may create an enormous unobserved drag on the economy in the form of principal costs. Moreover, activists, for all the reasons mentioned above, are much more likely to have this effect.

This Article does not attempt to show that activists are net detrimental overall, but rather that they are *more likely than raiders* to have a detrimental impact overall. To the extent that conclusion holds, courts and scholars should be more on their guard for mistargeting by activists as opposed to raiders, notwithstanding those activists are more likely to deter agent costs. The

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[152] Coffee & Palia, *supra* note 23, at 579 ("DuPont survived (at least for a time) by preempting Trian's strategy—with the result that, whether management wins or loses in the proxy contest, R&D expenditures decline.").

[153] *Id.* at 579–80 ("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."). A Financial Times survey in July, 2014, noted a "fundamental trend" in this industry: namely, that pharmaceutical and household consumer products companies are divesting their non-core divisions and "reassessing their portfolios." The survey is available at Scherazade Daneshku, Andrew Ward and Adam Thomson, "Drugmakers juggle non-core assets," Financial Times, July 25, 2014, at 13.

[154] Some scholars argue that these two effects are one and the same. Over-investment, under this theory, is a type of agent cost, which activists reduce by creating an "investment-limiting effect." Lucian A. Bebchuk, Alan Brav & Wei Jiang, *The Long-Term Effects of Hedge Fund Activism*, 115 COLUM. L. REV. 1085, 1138 (2015).

[155] *Changing the Lens: GDP from the Industry Viewpoint*, DELOITTE (July 2019), https://www2.deloitte.com/us/en/insights/economy/spotlight/economics-insights-analysis-07-2019.html.

possibility that activists may have a massive and unobserved negative effect on economic growth underscores the potential magnitude of this mistargeting hazard. Put another way, when activists target a firm, it is worthwhile to scrutinize their choice of target, contrary to the traditional view that corporate raiders should be kept out while activists should be encouraged. As explained in the next Part, this has profound implications for corporate law and policy.

IV. Implications for Law and Policy

The recognition that activists pose a greater threat than raiders to firm value and economic growth has a number of implications for corporate law and policy. In several ways, state and federal law have privileged corporate efforts to keep raiders out of the gates, while applying greater scrutiny to corporate efforts to keep out activists. Our analysis suggests that this pattern is unwarranted. If anything, courts and lawmakers should be more suspicious of activists than raiders, especially when the activist seeks operational or financial changes (as opposed to a sale of the target company).

This Part explores key implications of our model and analysis for corporate law and policy. Section IV.A addresses Delaware law, focusing on the judicial evaluation of poison pills. Section IV.B turns to the federal securities laws, focusing on the Williams Act and its implementing regulations. At both the state and federal levels, the law has improperly treated raiders as a greater threat than activists. We propose reforms that would equalize the regulation of raiders and activists.

A. Delaware Law

In multiple ways, Delaware law has discouraged corporate raiders but encouraged shareholder activists. In this section, we focus on how courts have evaluated the propriety of the so-called "nuclear weapon of corporate governance,"[156] the poison pill. As we explain, the emerging trend in the case law improperly scrutinizes pills designed to defend against activists more closely than pills designed to defend against raiders.

Initially introduced during the heyday of corporate raiding in the 1980s, the poison pill, also known as a "shareholder rights plan," is a corporate device that allows a board of directors to make the purchase of the company's shares beyond a specified threshold prohibitively costly and

[156] In re Williams Stockholder Litig., C.A. No. 2020-0707-KSJM, 2021 WL 754593, at *4 (Del. Ch. Feb. 26, 2021).

thereby block hostile takeovers.[157] Specifically, in adopting a pill, a company will issue rights to its stockholders that allow them to buy the company's stock at a substantial discount to the prevailing market price.[158] These rights are triggered only if a stockholder buys enough stock to cross a specific ownership threshold of the company's total shares, such as twenty percent.[159] Importantly, the pill voids any rights issued to the offending stockholder who crossed the threshold, so only other investors are allowed to buy discounted shares.[160] This substantially dilutes the offending stockholder's ownership position, making it economically irrational to ever buy enough stock to cross the threshold in the first place.[161]

If judicially sanctioned, a poison pill acts as a powerful defense against an attempt by a corporate raider to acquire the company through an unsolicited tender offer. With a pill in place, the would-be raider must either convince the board to waive the pill or wage a proxy fight and convince other stockholders to vote out the current board, so the new board can "redeem" the pill and allow the acquisition to proceed. In effect, the raider must become an activist.

Soon after the pill was first introduced, corporate raiders started attacking it as a breach of directors' fiduciary duties, but the law has developed to give well-advised boards virtually unfettered discretion to use pills to block raiders from acquiring control through a tender offer. In 1985, the Delaware Supreme Court first upheld the pill against a fiduciary duty challenge under the intermediate "proportionality" standard of review set forth in *Unocal Corp. v. Mesa Petroleum Co.*[162] Under *Unocal*'s two-pronged test, "the target board must show (1) that it had 'reasonable grounds for believing a danger to corporate policy and effectiveness existed' (i.e., the board must articulate a legally cognizable threat) and (2) that any board action taken in response to that threat is 'reasonable in relation to the threat posed.'"[163] Although early decisions suggested that there might be some teeth to this standard of review,[164] Delaware courts have since given boards the

[157] Lucian A. Bebchuk & Robert J. Jackson, Jr., *Toward a Constitutional Review of the Poison Pill*, 114 COLUM. L. REV. 1549, 1570 (2014).
[158] *Id.*
[159] *Id.*
[160] *Id.*
[161] *Id.*
[162] Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); *see* Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985).
[163] Air Prods. & Chems., Inc. v. Airgas, Inc., 16 A.3d 48, 92 (Del. Ch. 2011) (quoting Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995)).
[164] *See Moran*, 500 A.2d at 1354 ("[T]he Rights Plan is not absolute. When the Household Board of Directors is faced with a tender offer and a request to redeem rights, they will not be able to arbitrarily reject the offer."); City Capital

green light to use the pill to block virtually all unsolicited tender offers designed to lead to a takeover.[165] Other states appear to generally follow a similar approach, with many states applying an even more deferential standard of review.[166]

The Court of Chancery's well-known decision in *Air Products & Chemicals, Inc. v. Airgas, Inc.*[167] is instructive. In *Airgas*, the target company, Airgas, had in place both a staggered board and a poison pill, which effectively meant that an acquirer needed to win two consecutive proxy contests in order to effect a hostile takeover.[168] Faced with an unsolicited tender offer for all outstanding shares by a competitor, Air Products, the Airgas board refused to redeem the pill because, in its view, the offered price was too low, leading Air Products and other stockholder plaintiffs to sue for breach of fiduciary duties.[169]

The Court of Chancery ruled for Airgas on all counts.[170] In so ruling, the Chancellor expressed his "personal view" that "Airgas's poison pill has served its legitimate purpose."[171] The

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Assocs. v. Interco, 551 A.2d 787, 797-98 (Del. Ch. 1988) (holding the board may leave a pill in place "for a period while the board . . . take[s] such steps as it deems appropriate to protect and advance shareholder interests," but "[o]nce that period has closed," the board must allow stockholders to choose whether to accept the tender offer). *See also* Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 269–71 (1989) (expressing hope there would be "substance" to proportionality review under *Unocal*).

[165] *See, e.g.*, *Airgas*, 16 A.3d at 94–129 (reviewing the relevant case law and grudgingly finding himself "constrained by Delaware Supreme Court precedent" to uphold the challenged pill even though he believed that the company's "poison pill ha[d] served its legitimate purpose" based on the particular facts of the case); Bebchuk & Jackson, *supra* note 157, at 1571 (observing Delaware courts have "adopted a deferential approach to incumbents' use of poison pills," and "during the last twenty years, despite the near-universal use of the poison pill, there has not been a single case in which Delaware law was held to require directors to redeem a poison pill"). In theory, an extreme scenario could lead a court to invalidate the use of a pill to block a tender offer, such as when the directors completely fail to inform themselves as to the merits of the offer, *cf.* Smith v. Van Gorkom, 488 A.2d 858, 872–73 (Del. 1985) (describing the duty of care), or when discovery reveals particularly bad documents showing that the directors acted in bad faith with the purpose of entrenching themselves, *cf.* In re Walt Disney Co. Derivative Litig., 906 A.2d 27, 64 (Del. 2006) (characterizing "subjective bad faith" as a breach of fiduciary duty). In practice, a well-advised board will not make those mistakes, as experience has borne out.

[166] *See* Michal Barzuza, *The State of State Anti-takeover Law*, 95 VA. L. REV. 1973, 2018, 2029–30 (2009) (surveying the law across the states and finding that eleven states rejected *Unocal* duties altogether, while eleven states followed *Unocal* and there were no available cases on point for the remainder, and observing that in states that apply the business judgment rule, boards can effectively "just say no").

[167] 16 A.3d 48.

[168] *Id.* at 55; *see* Lucian A. Bebchuk, John C. Coates IV, & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887, 889 (2002) ("In combination with an effective staggered board . . . a pill provides significant antitakeover protection: the pill blocks any stock acquisition beyond the trigger level, and the staggered board forces the bidder to go through two proxy contests in order to gain control of the board and redeem the pill.").

[169] *Id.* at 55-56.

[170] *Id.* at 56–58, 129.

[171] *Id.* at 57.

court recounted that "Air Products' advances have been ongoing for over sixteen months, and Airgas's use of its poison pill . . . has given the Airgas board over a full year to inform its stockholders about its view of Airgas's intrinsic value and Airgas's value in a sale transaction."[172] Based on the trial record, the court further concluded that "Airgas's stockholder base is sophisticated and well-informed, and that essentially all the information they would need to make an informed decision is available to them."[173] But, finding himself "constrained by Delaware Supreme Court precedent," the Chancellor held that the allegedly inadequate price offered by Air Products represented a valid threat to corporate policy and that the board had acted proportionally in response to that threat.[174] In holding that Airgas satisfied the first prong, the court accepted Airgas's argument that substantial ownership of its stock by "short-term, deal-driven investors poses a threat to the company and its shareholders," referencing Delaware Supreme Court decisions that allow directors to prefer long-term success over "short-term shareholder profit."[175] The Chancellor also rejected the plaintiffs' argument that the staggered board–poison pill combination was unlawfully "preclusive," again finding himself "constrained" by Delaware Supreme Court precedent.[176]

The emerging case law on so-called "anti-activist" poison pills has taken a different turn. With the growth of activism over the past two decades, corporate boards and their legal advisers have repurposed poison pills from their anti-takeover origins to also guard against activism.[177] These anti-activist pills often have lower ownership thresholds, such as ten percent instead of twenty, and unique features designed to address common activist tactics, such as different treatment of activist and passive investors, the inclusion of "synthetic equity" in the definition of ownership, and "acting in concert" provisions that aggregate ownership by multiple hedge funds engaging in consciously parallel behavior (commonly referred to as "wolf pack" behavior).[178]

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[172] *Id.*
[173] *Id.*
[174] *Id.* at 57–58.
[175] *Id.* at 57–58, 99, 108–13 & n.410, 124 (quoting Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1154 (Del. 1990)).
[176] *Id.* at 121–22.
[177] *See generally* Marcel Kahan & Edward Rock, *Anti-Activist Poison Pills*, 99 B.U. L. REV. 915 (2019) [hereinafter Kahan & Rock, *Anti-Activist Pills*] (providing a comprehensive overview and analysis of "anti-activist poison pills").
[178] *See* Spencer D. Klein et al., *2020 Poison Pill Recap and Current Trends*, Morrison & Foerster (Feb. 25, 2021), https://www.mofo.com/resources/insights/210224-poison-pill-recap-current-trends.html (explaining recent trends in poison pills). For arguments in support of pills with activist-specific features, including an explanation of wolf pack behavior, see Coffee & Palia, *supra* note 23, at 601-02; Guhan Subramanian, *Corporate Governance 2.0*, HARV. BUS.

Although courts have upheld the use of pills against activists in two cases,[179] the record has been mixed and suggests that Delaware courts are likely to more closely scrutinize pills targeting activists than those targeting raiders.

The Court of Chancery's recent decision in *In re Williams Companies Stockholder Litigation*,[180] which is currently on appeal before the Delaware Supreme Court,[181] is illustrative. Williams is an energy company that owns and operates natural gas infrastructure assets, such as pipelines and processing facilities.[182] In early 2020, the company entered a period of extreme market turmoil due to the COVID-19 pandemic and a global oil price war.[183] Before 2020, the company's stock price had "traded at a high of $24.04 and had been relatively stable over the preceding months."[184] But soon, "the COVID-19 pandemic and the ensuing oil price war between Saudi Arabia and Russia shocked the oil market and sent stock prices plummeting."[185] By mid-March 2020, the company's stock price "had fallen to approximately $11, which was close to a 55% decline since January 2020."[186] On March 19, 2020, fearing that an activist might take advantage of this market turmoil, the Williams board adopted a poison pill specifically designed to defend against activists.[187] The pill had a five-percent ownership threshold and certain activist-specific features, including a definition of "acquiring person" that captures certain derivative interests, a broad "acting in concert" provision designed to capture wolf-pack behavior, and a limited "passive investor" exemption for certain passive investors like Schedule 13G filers.[188] On

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REV. (Mar. 2015), https://hbr.org/2015/03/corporate-governance-2-0. For a critique of anti-activist features, see Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 946–69.

[179] *See* Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310, 313 (Del. Ch. 2010) (upholding the use of a pill with a twenty-percent ownership threshold against an activist hedge fund on the ground that the activists posed a "threat that the corporation's stockholders would relinquish control through a creeping acquisition without the benefit of receiving a control premium"), *aff'd*, 15 A.3d 218 (Del. 2011); Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, 2014 WL 1922029, at *14, 21–22 (Del. Ch. May 2, 2014) (upholding the use of a pill with a ten-percent ownership threshold that distinguished between activist and passive investors against an activist hedge fund was initially justified as a defense against "creeping control" and subsequently as a defense against "effective, rather than explicit, negative control").

[180] C.A. No. 2020-0707-KSJM, 2021 WL 754593 (Del. Ch. Feb. 26, 2021).

[181] Opening Br., Williams Cos. v. Wolosky, No. 139, 2021 (Del. June 25, 2021).

[182] *Williams*, 2021 WL 754593, at *2.

[183] *Id.* at *1–2.

[184] *Id.* at *2.

[185] *Id.*

[186] *Id.* at *3.

[187] *Id.* at *1.

[188] *Id.* at *9–11. An investor who acquires beneficial ownership of more than five percent of a company's stock must, within ten days of the acquisition, file a "Schedule 13D" statement of beneficial ownership with the SEC. 17 C.F.R. §§ 240.13d-1(a), 240.13d-101. Certain passive investors who do not seek to "chang[e] or influenc[e] the control of

August 27, 2020, Williams stockholders sued the company and its board, seeking declaratory and injunctive relief regarding the pill's validity.[189]

Following trial, the Court of Chancery held that the pill was invalid under *Unocal*.[190] Reviewing the trial record, the court found that the board had identified three threats: (1) "the desire to prevent stockholder activism during a time of market uncertainty and a low stock price"; (2) "apprehension that hypothetical activists might pursue 'short-term' agendas or distract management from guiding Williams through uncertain times"; and (3) "the concern that activists might stealthily and rapidly accumulate over 5% of Williams stock."[191] The court held that the first two of these threats were illegitimate because they "run contrary to the tenet of Delaware law that directors cannot justify their actions by arguing that, without board intervention, the stockholders would vote erroneously out of ignorance or mistaken belief."[192] As to the third, the court assumed for the sake of argument that the threat was legitimate, but held that the board's response was not proportional.[193]

In addressing the precedents that the plaintiffs cited regarding the first two threats, the Court of Chancery was careful to distinguish each as involving a takeover attempt rather than pure activism.[194] In the court's telling, one case from the heyday of corporate raiders involved "well-known takeover artists," and the Delaware Supreme Court credited that those individuals "presented a takeover threat."[195] Another "involved a concrete takeover attempt."[196] A third similarly "involved a specific takeover attempt."[197] The last "involved a specific takeover attempt that started as an effort to obtain creeping control."[198] In rejecting the legitimacy of the "stockholder activism" threat, the court summarized: "None of these decisions support the notion

the issuer" are entitled to instead file an abbreviated "Schedule 13G" statement. §§ 240.13d-1(b), (c), 240.13d-102. These passive investors are referred to as Schedule 13G filers.

189 *Williams*, 2021 WL 754593, at *20.

190 *Id.* at *2, 25–37.

191 *Id.* at *2.

192 *Id.*

193 *Id.* In particular, the court took issue with the breadth of the acting in concert provision and narrowness of the passive investor exemption. *Id.* at *34–37. We take no position on this aspect of the court's opinion.

194 *See id.* at *29-33 (addressing Polk v. Good, 507 A.2d 531 (Del. 1986); Cheff v. Mathes, 199 A.2d 548 (Del. 1964); Yucaipa Am. Alliance Fund II, L.P. v. Riggio, 1 A.3d 310 (Del. Ch. 2010), *aff'd*, 15 A.3d 218 (Del. 2011); Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, 2014 WL 1922029 (Del. Ch. May 2, 2014)).

195 *Id.* at *30 (discussing *Polk*, 507 A.2d 531).

196 *Id.* (discussing *Cheff*, 199 A.2d 548).

197 *Id.* at *31 (discussing *Yucaipa*, 1 A.3d 310).

198 *Id.* (discussing *Third Point*, 2014 WL 1922029).

that generalized concern about stockholder activism constitutes a cognizable threat under *Unocal*. Rather, these cases demonstrate that a board has authority to respond to a specific takeover attempt, even when the attempt does not involve a traditional tender offer."[199] Likewise, in holding that "short-termism and distraction" is not a legitimate threat, the court emphasized that "[e]ach of Defendants' cases, unlike this case, involved takeover threats."[200] Although the court arguably left the door open for a sufficiently "concrete" threat of activism to constitute a legitimate threat,[201] the overall thrust of the opinion suggests that activism is a legitimate threat only to the extent there is an accompanying takeover threat.

Indeed, the court's conclusion that "[t]he concerns in this case" were merely "raised in the abstract" raises questions about when an activist threat would ever be sufficiently concrete to pass muster under the *Williams* court's analysis.[202] The Williams board decided to adopt its pill following the onset of a catastrophic global pandemic—among the ten deadliest pandemics in all of human history—and a global oil price war that caused extreme disruption in the industry that Williams operated in.[203] The onset of the pandemic led prominent law firms to recommend that clients consider proactively adopting a poison pill even absent a specific activist or takeover threat, which numerous companies did.[204] Tellingly, the two major proxy advisers—who normally oppose the adoption of poison pills absent a specific threat—issued policy guidance following the onset

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[199] *Id.* The court also offered that, "[r]ead broadly, the cases support the proposition that a Board can adopt defensive measures in response to concrete action by a stockholder activist," apparently without any takeover connection. *Id.* But one gets the impression from the opinion that the then-Vice Chancellor was not a fan of that broader reading.

[200] *Id.* at *32.

[201] *See id.* at *31 ("Read broadly, the cases support the proposition that a Board can adopt defensive measures in response to *concrete* action by a stockholder activist." (emphasis added)); *id.* at *33 ("When used in the hypothetical sense untethered to any *concrete* event, the phrases 'short-termism' and 'disruption' amount to mere euphemisms for stereotypes of stockholder activism generally and thus are not cognizable threats." (emphasis added)).

[202] *Id.* at *33.

[203] *Id.* at *1–2; Nicholas LePan, *Visualizing the History of Pandemics*, VISUAL CAPITALIST, https://www.visualcapitalist.com/history-of-pandemics-deadliest (last updated June 30, 2021) (COVID-19 had eighth highest death poll as of June 30, 2021).

[204] *See, e.g.*, Mark D. Gerstein et al., *Proactively Adopting a Poison Pill in Response to the COVID-19 Crisis*, HARV. L. SCH. FORUM ON CORP. GOV. (Apr. 8, 2020), https://corpgov.law.harvard.edu/2020/04/08/proactively-adopting-a-poison-pill-in-response-to-the-covid-19-crisis (observing pills can be supportable "even absent an overt takeover bid or identified activist stock accumulation" and recommending "that companies impacted by significant stock price declines proactively prepare rights plan materials, review the rights plan with the board, and either adopt or put the rights plan on the shelf"); Paul Shim et al., *Rewriting the Poison Pill Prescription: Consider Active Defenses During COVID-19*, HARV. L. SCH. FORUM ON CORP. GOV. (Apr. 5, 2020), https://corpgov.law.harvard.edu/2020/04/05/rewriting-the-poison-pill-prescription-consider-active-defenses-during-covid-19 (recommending that companies "revisit" adopting poison pills "[i]n light of the unique threat posed by the current market"); Klein et al., *supra* note 178 (observing three times as many pills were adopted in 2020 "compared to historical numbers").

of the pandemic stating that the pandemic and a resulting stock price decline could constitute a valid justification for adopting a pill.[205] One of them, which states that it "generally opposes the adoption of poison pills," specifically supported the adoption of the Williams pill, explaining that "this case warrants an exception" and even including Williams as a case study in its guidance.[206]

While Professor Jeffrey Gordon has praised the *Williams* court's decision,[207] our analysis of the differences between activists and raiders suggests that the court's instinct to support the use of poison pills against takeovers, while limiting their use against activism unaccompanied by a takeover threat, has it backward. Activists pose the greatest threat when they urge operational or financial changes to the target company, not when they push for a sale. It is in the former situation that the risks and consequences of mistargeting are greatest, that activists are best positioned to shift their costs onto other shareholders, and that the ability of other shareholders to screen the contestant's proposals is weakest. Moreover, when shareholders mistakenly tender their shares to an acquirer at a low price, the result is merely a wealth transfer, not a loss in social wealth. Unlike the activist who, armed only with public information, causes the target company to make irreversible changes, the acquirer has the freedom to stick with the current plan after consulting with management and looking under the hood. If the acquirer likes what she sees, there is no need to depart from the existing strategy and thereby destroy social wealth. For these reasons, courts should (if anything) afford boards greater deference in adopting pills when the pills are intended to defend against activist campaigns for operational and financial changes rather than against takeovers.

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[205] *See* INST. S'HOLDER SERVS., IMPACTS OF THE COVID-19 PANDEMIC: ISS POLICY GUIDANCE 6 (2020), https://www.issgovernance.com/file/policy/active/americas/ISS-Policy-Guidance-for-Impacts-of-the-Coronavirus-Pandemic.pdf (stating ISS's policies "account for the adoption of poison pills in the face of genuine, short-term potential threat situations such as the current pandemic," and "[a] severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justifications in most cases"); Aaron Bertinetti, *Poison Pills and the Coronavirus: Understanding Glass Lewis's Contextual Policy Approach*, GLASS LEWIS (Apr. 8, 2020), https://www.glasslewis.com/poison-pills-and-coronavirus-understanding-glass-lewis-contextual-policy-approach (stating the "coronavirus and the related economic crisis" may serve "as reasonable context for adopting a poison pill").

[206] Bertinetti, *supra* note 205; Glass Lewis & Co., WMB April 28, 2020 Annual Meeting: Company Updates, https://www.glasslewis.com/wp-content/uploads/2020/04/Williams-Companies-Inc_Poison-Pill.pdf (last visited July 13, 2021).

[207] Jeffrey N. Gordon, *Corporate Vote Suppression: The Anti-Activist Pill in The Williams Companies Stockholder Litigation*, COLUM. BLUE SKY BLOG (Aug. 19, 2021), https://clsbluesky.law.columbia.edu/2021/08/19/corporate-vote-suppression-the-anti-activist-pill-in-the-williams-companies-stockholder-litigation [hereinafter Gordon, *Corporate Vote Suppression*].

In contrast to the *Williams* decision, our analysis supports the Court of Chancery's validation of the use of a pill against an activist hedge fund in *Third Point LLC v. Ruprecht*.[208] There, "[i]n response to an apparent threat posed by increasing hedge fund activity in its stock," the target corporation had adopted a poison pill with a ten-percent ownership threshold for stockholders who seek to influence control of the company.[209] After the board rejected a request by an activist hedge fund stockholder to provide it with a waiver from the pill's terms, the hedge fund and other stockholder plaintiffs sued for breach of fiduciary duties.[210] The Court of Chancery upheld the pill, finding at the preliminary injunction stage that the board could likely show at trial that (1) the initial adoption of the pill was a reasonable response to the legitimate threat of "creeping control";[211] and (2) the board's subsequent refusal to provide a waiver was a reasonable response to the legitimate threat of "negative control," meaning the threat that certain persons may "exercise disproportionate control and influence over major corporate decisions."[212] Our analysis provides a third justification for the *Third Point* court's decision based on the mistargeting hazard.

The fact that activists accomplish their goals by threatening proxy contests rather than tender offers—by convincing other stockholders to hand over their proxies instead of their shares—is beside the point. In minimizing the threats posed by activists, the *Williams* court and some legal scholars have argued that many fears about activists are rooted in a "concern that stockholders will cast votes in a mistaken assessment of their own best interests," which they contend is not a valid concern under Delaware law.[213] There are at least two problems with this argument.

First, this argument rests on an incorrect statement of Delaware law. Although boards generally cannot preclude stockholders from choosing a new set of directors on the ground that

[208] C.A. No. 9469-VCP, 2014 WL 1922029, at *14, 21–22 (Del. Ch. May 2, 2014).
[209] *Id.* at *1, 10.
[210] *Id.* at *1.
[211] *Id.* at *20–21.
[212] *Id.* at *21–22.
[213] *Williams*, 2021 WL 754593, at *33 (quoting Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 931); *see also id.* at *1 (holding the stockholder activism and short-termism threats "run contrary to the tenet of Delaware law that directors cannot justify their actions by arguing that, without board intervention, the stockholders would vote erroneously out of ignorance or mistaken belief"); Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 927–28, 931–32, 938–39 (arguing that anti-activist pills cannot be justified based on concerns about mistaken beliefs, short-termism, or disproportionate influence).

the board knows better,[214] they can take more modest actions designed to ensure an orderly and informed stockholder vote, especially in the absence of an imminent proxy contest.[215] There is no a priori reason why temporary measures designed to defend against activism while the informational environment is poor—such as during periods of extreme market volatility, which limit the utility of stock prices as informational signals—should not be consistent with that principle. Indeed, the *Williams* pill was limited for one year. And ultimately, an appropriately designed anti-activist pill does not prevent shareholders from exercising their independent judgment—it only prevents an activist hedge fund (and its wolf-pack allies) from acquiring more than whatever threshold the pill uses (e.g., five or ten percent). The activist remains free to try to persuade other shareholders to support its agenda, and the other shareholders are free to vote as they like.

This last point deserves elaboration. The *Williams* court correctly ruled that the *Unocal* standard of review should apply to determine the validity of both aspects of the pill: the fact that the threshold of the pill was placed at five percent and the broad "acting in concert" provision. However, in casting the activism and short-termism threats as rooted in an invalid concern that stockholders will mistakenly vote the wrong way, the court effectively adopted the heightened standard of review established by *Blasius Industries, Inc. v. Atlas Corp.*, which provides for exacting scrutiny of board efforts to impede stockholder voting in contested elections.[216] Indeed,

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[214] Leo E. Strine, Jr., *The Story of* Blasius Industries v. Atlas Corp., *in* CORPORATE LAW STORIES 243, 269 (J. Mark Ramseyer ed., 2009); Mercier v. Inter-tel, 929 A.2d 786, 811 (Del. Ch. 2007).

[215] *See, e.g.*, AB Value Partners, LP v. Kreisler Mfg. Corp., C.A. No. 10434-VCP, 2014 WL 7150465, at *3–8 (Del. Ch. Dec. 16, 2014) (upholding advance notice bylaw against challenge by activist hedge fund and commenting that the clearest rationale for such challenges exists "where a board, aware of an imminent proxy contest, imposes or applies an advance notice bylaw so as to make compliance impossible or extremely difficult, thereby thwarting the challenger entirely"); *cf.* Third Point LLC v. Ruprecht, C.A. No. 9469-VCP, 2014 WL 1922029, at *21–22 (Del. Ch. May 2, 2014) (holding the board "may have had legitimate real-world concerns that enabling individuals or entities, such as [an activist hedge fund and its principal], to obtain 20% as opposed to 10% ownership interests in the Company could effectively allow those persons to exercise disproportionate control and influence over major corporate decisions").

[216] 564 A.2d 651 (Del. Ch. 1988); MM Cos. v. Liquid Audio, Inc., 813 A.2d 1118, 1132 (Del. 2003)) (adopting *Blasius*). Although the *Williams* court did not directly cite *Blasius*, the court used language indirectly taken from *Blasius* and drew heavily from decisions and scholarship that directly cited the case. *See Williams*, 2021 WL 754593, at *30 ("Viewing all stockholder activism as a threat is an extreme manifestation of the proscribed we-know-better justification for interfering with the franchise."); *id.* at *33 ("[T]he 'short-termism argument just particularizes the concern that shareholders will cast votes in a mistaken assessment of their own best interests.'" (citing Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 931)); Pell v. Kill, 135 A.3d 764, 790 (Del. Ch. 2016) (citing *Blasius* for the proposition that "he belief that directors know better than stockholders is not a legitimate justification when the question involves who should serve on the board of a Delaware corporation"); Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 927–28, 931–32 (arguing that "[t]he logical consequence of the reasoning in *Blasius*" is that, with

Professor Jeffrey Gordon has gone further and expressly called for *Blasius* to apply to anti-activist pills.[217] Under *Blasius*, courts uphold board actions taken with "the primary purpose of interfering with or impeding the effectiveness of the stockholder vote in a contested election of directors" only if the board can "prove a 'compelling justification' for its actions."[218] In reality, a decision to apply *Blasius* usually indicates that the court will invalidate the challenged action, making it resemble a per se rule.[219] Traditionally, however, courts have invoked *Blasius* only in rare circumstances, such as when the board tries to *dictate* the outcome of a vote or dilute an existing stockholder purely to reduce its voting power.[220] The underlying concern is that directors may "unfairly taint the election process" to entrench themselves.[221] As explained below, these concerns do not call for application of *Blasius* to anti-activist pills.

Starting with the inappropriate application of *Blasius* based on the pill's five-percent ownership threshold—such a threshold does not raise the concerns animating *Blasius*. To the contrary, when employed against an activist, a poison pill with a five-percent threshold can actually *improve* the quality of the vote. Unlike a dilutive stock issuance, an anti-activist poison pill simply stops the activist and its wolf-pack allies from acquiring *more* stock. Rather than "unfairly taint[ing] the election process," this can help to ensure a level playing field. Typically, the lead activist tips off potential allies about the imminent campaign before going public, thereby allowing these potential allies to profit off the nonpublic information and ensuring their loyalty in any upcoming vote.[222] As a result, without a poison pill to stop them, an activist and its wolf-pack

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limited exceptions, "a board's determination that shareholders are likely to vote 'the wrong way' is not a legitimate basis for taking defensive measures").

[217] Gordon, *Corporate Vote Suppression*, *supra* note 207 ("*Blasius* is the right standard for a pill, like the anti-activist pill in this case, that represents action taken for the primary purpose of interfering with the exercise of the shareholders' right to elect directors." (cleaned up)).

[218] Coster v. UIP Cos., 255 A.3d 952, 962 (Del. 2021) (quoting *Liquid Audio*, 813 A.2d at 1132).

[219] Chesapeake Corp. v. Shore, 771 A.2d 293, 323 (Del. Ch. 2000) ("In reality, invocation of the Blasius standard of review usually signals that the court will invalidate the board action under examination. Failure to invoke Blasius, conversely, typically indicates that the board action survived (or will survive) review under Unocal.").

[220] *See, e.g.*, Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 806–08 (Del. Ch. 2007) (Strine, V.C.) (observing that "*Blasius* is so strict a test that it is 'applied rarely'" and that "decisions following *Blasius* have often focused on whether the director action challenged was preclusive or coercive of stockholder choice" (quoting *Williams v. Geier*, 671 A.2d 1368, 1376 (Del. 1996)); *Coster*, 255 A.3d at 961 & n.56 (observing that actions designed "to frustrate or completely disenfranchise a shareholder vote" are impermissible and collecting cases involving dilutive stock issuances).

[221] *Mercier*, 929 A.2d at 806.

[222] Coffee & Palia, , *supra* note 23, at 565–66 (explaining that "tipping and informed trading appears to characterize [] the formation of the wolf pack" and "it is in the interest of the wolf pack leader to tip such allies, as the larger the

allies can potentially acquire a large enough position to swing the election simply by convincing a small number of large institutional investors to support them,[223] even if the majority of unaffiliated stockholders oppose the activist's proposal. This creates the potential for both disloyalty on the part of the institutional investor agents who control those votes—a second layer of agent costs related to the "separation of ownership from ownership"[224]—and mistakes by those agents, whose decisions reflect the judgments of a small number of individuals instead of the collective wisdom of the many.[225] With a poison pill, the board can ensure that the activist must instead convince something approaching a majority of unaffiliated stockholders. This is by no means an impossible task, as reflected by the recent success of activist hedge fund Engine One, which had a less than one-percent stake in the target company, in its proxy fight with Exxon Mobil.[226] In short, a poison

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").

[223] John C. Coates, *The Future of Corporate Governance Part I: The Problem of Twelve* 2 (Harv. Public Law Working Paper No. 19-07, 2018). Professor Coates observes that the so-called "Big Three" fund complexes—Vanguard, State Street, and BlackRock—controlled about fifteen percent of the S&P 500 in 2017, and from the portfolio company perspective, about a third of S&P 500 companies have four or fewer stockholders holding an aggregate of twenty percent or more of their stock. *Id.* at 13. This problem is likely to only grow worse, and it has started attracting a great deal of attention from academics and policymakers. *See, e.g.*, Leo E. Strine, Jr., *Toward Fair and Sustainable Capitalism*, ROOSEVELT INST. (Aug. 2020), https://rooseveltinstitute.org/wp-content/uploads/2020/08/RI_TowardFairandSustainableCapitalism_WorkingPaper_202008.pdf [hereinafter Strine, *Fair and Sustainable Capitalism*] (proposing an ambitious policy agenda based in part on this problem); Robert J. Jackson, Jr., Comm'r, U.S. Secs. & Exch. Comm'n, Common Ownership: The Investor Protection Challenge of the 21st Century (Dec. 14, 2018), https://corpgov.law.harvard.edu/2018/12/14/common-ownership-the-investor-protection-challenge-of-the-21st-century (commenting on problems related to the increasing concentration of voting power in corporate elections and urging policymakers to view this as an investor protection problem).

[224] Leo E. Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 9 (2010) [hereinafter Strine, *One Fundamental Question*]; Strine, *Can We Do Better*, *supra* note 93, at 449. Long ago, Berle and Means coined the term "separation of ownership and control" to describe the problems that arise when the owners of capital do not control its use (i.e., agent costs). ADOLPH BERLE & GARDINER MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932). More recently, Leo Strine, the former Chief Justice and Chancellor of Delaware, coined the term "separation of ownership from ownership" to describe similar agent costs that arise when institutional investors make voting decisions on behalf of their ultimate beneficiaries. Strine, *One Fundamental Question*, *supra*, at 9 & n.27.

[225] *See* Timothy Feddersen & Wolfgang Pesendorfer, *Voting Behavior and Information Aggregation in Elections with Private Information*, 65 ECONOMETRICA 1029, 1029 (1997) ("A strong argument for elections is that society may be collectively better informed about the relative quality of a set of alternatives than any individual. Elections provide a mechanism for aggregating private information, ensuring a better collective decision."). *See generally* H. P. Young, *Condorcet's Theory of Voting*, 82 AM. POL. SCI. REV. 1231, 1231–32 (1988) (explaining the origin of this theory in the work of the French mathematician and social philosopher Condorcet).

[226] Matt Phillips, *Exxon's Board Defeat Signals the Rise of Social-Good Activists*, N.Y. TIMES (June 9, 2021).

pill can help to ensure that an activist must persuade *unbiased* stockholders, thereby safeguarding the integrity of the electoral process.[227]

Nor does a broad "acting in concert" provision call for the application of *Blasius* to an anti-activist pill. While *Blasius* aims to prevent boards from intervening in the voting itself—guarding shareholders' freedom to vote and approve a decision preferred by the majority—the *Williams* court effectively expanded its reach to the process by which a proxy fight is organized. It is true that a broad "acting in concert" provision aimed primarily at stopping wolf-packs might also frustrate the ability of the activist to engage in confidential private negotiations and reach a preliminary understanding with institutional investors before the proxy fight. But, although this result might increase the hedge fund's risk—forcing it to start the campaign without its pack or preliminary understandings with institutional investors and engage only in public persuasions—it would not frustrate the voting itself or necessarily impose an undue burden on the activist's ability to engage in a proxy fight. In some cases, the incidental effects on the activist's ability to wage a proxy fight might be justified, while in others they might not, and thus it is inappropriate to apply *Blasius's* per se prohibition instead of the balancing test of *Unocal.*

The second problem with the *Williams* court's framing of the threats posed by activists in terms of how stockholders will vote rests on an incomplete characterization of the threats that activists pose. An activist may pose a threat not only because she might convince other stockholders to mistakenly support her value-destructive plans, but also because she might convince a self-interested board to capitulate to those demands without a stockholder vote. Directors may settle with an activist in order to avoid risking losing their seats (or otherwise suffering embarrassment) through a proxy contest, even though they believe that the activist's plan is bad for the company and its stockholders. Sometimes, it is easier to just give up. Indeed, activist campaigns are settled much more often than they are voted on.[228] When that happens, the concern is not that other stockholders will make a mistake; it is that the directors will be disloyal.

So how should courts evaluate poison pills designed to address threats posed by activist hedge funds? In our view, courts should simply apply the *Unocal* framework in a straightforward manner to determine whether a valid threat to corporate policy exists and, if so, whether the board's

[227] Although skeptical of many of the justifications offered for anti-activist pills, Professors Marcel Kahan and Edward Rock have endorsed a similar "fair process" rationale. Kahan & Rock, *Anti-Activist Pills*, *supra* note 177, at 939–46.
[228] *See supra* note 47 and accompanying text.

response is proportional. Contrary to the *Williams* court's decision, we would hold that activism may constitute a valid threat to corporate policy based on the mistargeting hazard, *especially* when the activism is unconnected to a concrete takeover attempt, though courts should root out pretext[229] and weigh whether the particular pill under consideration is a proportionate response.[230] Conceivably, testimony or documents produced in discovery could reveal that the board adopted the pill merely to entrench itself, failing at the first prong of *Unocal*, or a pill could contain sufficiently draconian features to fail at the second prong. But courts should certainly not rule out the possibility that a poison pill is warranted as a defense against mistargeting by activist hedge funds.

B. Federal Law

Aside from state law, the other major source of relevant law for corporate control contests is federal securities law. Here too, the law has discouraged raiders while doing less to keep out activists. Again, our analysis suggests that this asymmetry has it backward.

The Williams Act and its implementing regulations make hostile takeovers of public companies more difficult by imposing waiting periods, substantial disclosure requirements, anti-"warehousing" prohibitions, and other restrictions on tender offers. First, with certain exceptions, any person who acquires beneficial ownership of more than five percent of a company's stock must file a disclosure statement with the SEC within ten days of reaching the five percent stake, which prevents a would-be corporate raider from acquiring creeping control without paying a control premium.[231] This rule also applies to any "group" of persons, thereby stopping bidders from evading the requirement by forming coalitions in which each member owns less than the threshold amount.[232] Second, if a person who is about to commence a tender offer tips off other investors about the tender offer before it is made public, those other investors cannot freely trade on the information.[233] This rule helps to stop bidders from placing the target's stock in friendly

[229] *See, e.g.*, Kallick v. Sandridge Energy, Inc., 68 A.3d 242, 259 (Del. Ch. 2013) ("[T]he directors must comply with their *Unocal* duties by identifying a circumstantially proper and non-pretextual basis for their actions.").
[230] *See, e.g.*, In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 474 (Del. Ch. 2000) ("[*Unocal*] enables the court to do something that it ordinarily cannot do under Delaware corporate law: examine the substantive reasonableness of the decisions of a board of directors.").
[231] 15 U.S.C. § 78m(d) (2020); 17 C.F.R. § 240.13d-1(a) (2020).
[232] 15 U.S.C. § 78m(d)(3).
[233] 15 US.C. § 78o(e); 17 C.F.R. § 240.14e-3.

hands before the tender offer is public, which makes the takeover easier to accomplish—a practice known as "warehousing."[234] Third, upon launching a tender offer, the raider must file a detailed disclosure document with the SEC and keep open the offer for at least twenty business days, giving stockholders information and time to decide whether to accept the offer.[235] Fourth, the offeror's communications to stockholders are subject to antifraud provisions, exposing the raider to liability for any material misstatements or omissions.[236] On the whole, these restrictions give boards breathing room to implement anti-takeover defenses, protect stockholders against being driven to accept a low-priced tender offer on little notice, and ensure an unbiased "electorate."

Although these rules also constrain activists in certain ways, they have less bite in the activism context. First, although activists are also obligated to file a disclosure statement within ten days of crossing the five-percent ownership threshold, the lengthy window allows activists to acquire much more than five percent before disclosing their stake, with activists often acquiring around ten percent.[237] Although this loophole is nominally available to raiders to acquire a bigger toehold, raiders are unlikely to find it very useful because they do not need a substantial toehold to succeed—and in fact frequently succeed with no toehold whatsoever.[238] Rather, the key constraint on raiders is that they cannot acquire creeping control. Second, activists are not required to disclose in their filings their ownership of derivative interests such as options, which activists may use instead of or alongside outright stock ownership.[239] In theory, it may be possible for an activist to either "morph" those derivative interests into voting securities or convince its counterparty to vote the shares bought as a hedge, thereby imbuing the activist with voting power,[240] though some scholars have doubted that this is likely.[241] At the very least, the omission may leave investors with an incomplete picture of the activist's financial interest in the target company. Third, the narrow definition of "group" that triggers the filing requirement when

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[234] *See* Michael J. Voves, Comment, United States v. O'Hagan*: Improperly Incorporating Common Law Fiduciary Obligations into S 14(e) of the Securities Exchange Act*, 81 MINN. L. REV. 1015, 1043–44 (1997) (describing warehousing practices).
[235] 15 U.S.C. § 78o(d)(1); 17 C.F.R. §§ 240.14d-3(a), 240.14e-1(a).
[236] 15 U.S.C. § 78o(e).
[237] Kahan & Rock, *Hedge Funds*, *supra* note 15, at 1088.
[238] *See* Goldman & Qian, *supra* note 37, at 322-27.
[239] *See* Jie Guo et al., *The Role of Derivatives in Hedge Fund Activism*, 18 QUANT. FIN. 1531 (2017) (examining the use of derivatives by activist hedge funds).
[240] *See* Henry T.C. Hu & Bernard Black, *The New Vote Buying: Empty Voting and Hidden (Morphable) Ownership*, 79 S. CAL. L. REV. 811, 836-40 (200).
[241] Gilson & Gordon, *supra* note 59, at 915.

multiple funds act together fails to capture a good deal of the “wolf pack” behavior that activist hedge funds engage in, and even where it does apply, the current case law does not provide the target company with an effective remedy for violations by activists.[242] Fourth, unlike in the tender offer context, there is no equivalent prohibition on one activist hedge fund tipping off others about the imminent campaign—a common practice among activist hedge funds.[243]

There is a particularly large disconnect in the restrictions on the use of nonpublic information in these two contexts. While the SEC’s anti-warehousing rules effectively prohibit raiders from tipping off potential allies about an imminent tender offer,[244] there are no equivalent rules prohibiting activists from doing the same as to an imminent activist campaign. This discrepancy matters because tipping can help the control contestant to gain support for its campaign—a tippee is likely to support the contestant as an implicit (or explicit) quid pro quo for the tip. In other words, tipping biases the electorate. Ultimately, by forming a big enough wolf pack, the lead activist may be able to win the election even if most unaffiliated stockholders oppose the activist’s proposal. Indeed, one of the strongest justifications for anti-activist poison pills is to close this loophole and force the activist to persuade unbiased shareholders.[245]

This Article’s recognition that activists are more dangerous than raiders provides support for calls to modernize the federal securities regime to account for the modern reality of control contests. Over the past decade and a half, lawmakers and commentators have made numerous proposals to modify the federal securities laws to address modern practices by activist hedge funds.[246] These proposals raise numerous complex issues and have generated fierce debate.[247] We

[242] Coffee & Palia, *supra* note 23, at 562–70 (explaining that courts have interpreted the term” group” narrowly and noting “the absence of any meaningful remedy if a ‘group’ is formed but not reported”).
[243] *Id.* at 566 (“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 fiduciary or other duty.”).
[244] *See supra* note 233 and accompanying text.
[245] *See supra* notes 221–227 and accompanying text (arguing that anti-activist pills can be justified on this basis).
[246] *See, e.g.*, Coffee & Palia, *supra* note 23, at 592–603; Wachtell, Lipton, Rosen & Katz, Petition for Rulemaking Under Section 13 of the Secs. & Exch. Act of 1934 (Mar. 7, 2011), https://www.sec.gov/rules/petitions/2011/petn4-624.pdf (proposing SEC rulemaking to reform section 13(d) reporting requirements); S. 1744, Brokaw Act, 115th Cong. (proposing legislative amendments to section 13(d) reporting requirements); Strine, *Fair and Sustainable Capitalism*, *supra* note 223, at 16–18 (similar).
[247] *See, e.g.*, Lucian Bebchuk et al., *Pre-Disclosure Accumulations by Activist Investors: Evidence and Policy*, 39 J. CORP. L. 1 (2013); Lucian Bebchuk & Robert J. Jackson, Jr., *The Law and Economics of Blockholder Disclosure*, 2 HARV. BUS. L. REV. 40 (2012); Adom O. Emmerich et al., *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. REV. 135 (2013); Joshua Mitts, *A Private Ordering Solution to Blockholder Disclosure*, 35 N.C. CENTRAL L. REV. 203 (2013); Gordon & Gilson, *supra* note 59, at 902-16; Strine, *Wolves*, *supra* note 34, at 1895–97, 1959–62.

do not seek to evaluate the details of each of these proposals, which would be beyond the scope of this Article, but our analysis suggests that modernization of the federal securities law regime to account for the threats posed by activists is warranted. In particular, we would support extending the SEC's anti-warehousing rules to address tipping by activist hedge funds in advance of an activist campaign, thereby aligning the SEC's regulation of the use of nonpublic information by raiders and activists. This would help to safeguard against the mistargeting hazard by ensuring an unbiased electorate that evaluates each activist proposal on its merits. Such a change may even render unnecessary certain other proposals designed to address "wolf pack" behavior, such as broadening the definition of "group" to include consciously parallel action by multiple shareholders. If tipping were prohibited, wolf packs would be much less likely to form in the first place.

CONCLUSION

The conventional wisdom on raiders and activists—lambasting corporate raiders while praising shareholder activists—is wrong. Because they acquire relatively small stakes rather than entire companies, activists are more likely to destroy social wealth through mistargeting—trying to fix something that only appears to be broken—and thereby inflict harms on both their fellow stockholders and the entire economy. To the extent activists do provide value, it is primarily by opening the door to raiders. This insight has profound implications for corporate law and policy. The decades-long trend in the law discouraging raiders but encouraging activists has it exactly backward. Going forward, lawmakers and courts should be mindful of the greater risks posed by activists than raiders in determining how to regulate contests for corporate control.

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